

FREP Presidential Board

Berlin, 28 January 2015

**Annual Activity Report 2014**

1	Overview .....	2
2	Examinations in 2014 .....	3
	2.1 Examination results .....	3
	2.2 Types of errors and analysis of errors.....	6
	2.3 Acceptance rate.....	8
	2.4 Recommendations made.....	9
	2.5 Follow-up on 2013 .....	10
	2.6 Experience with GAS 20 .....	11
3	Error prevention.....	14
	3.1 Overview .....	14
	3.2 Enforcement priorities for 2015.....	15
	3.3 Workshops with members of supervisory and management boards .....	17
	3.4 Speeches given as part of the FREP's public relations activities.....	18
4	Developments in Europe .....	18
	4.1 Overview .....	18
	4.2 European Enforcers Coordination Sessions (EECS).....	18
	4.3 ESMA Guidelines on Enforcement.....	20
	4.4 Other ESMA publications.....	21
5	Acknowledgements and outlook .....	21

## 1 Overview

- In 2014, the error rate has stabilized at a low level that is similar to 2013.
- The FREP completed 104 examinations (prior year: 110), including 99 sampling examinations, three indication-based examinations, and two examinations performed at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – Federal Financial Supervisory Authority) in 2014. At 13%, the rate of financial reporting errors found was slightly lower than the prior year's rate of 14%.
- 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 12% in 2014 (prior year: 11%).
- The FREP has further expanded its error prevention activities in 2014. These activities included, for instance, workshops with members of supervisory and management boards, especially with audit committee members of publicly listed companies.
- The follow-up on 2013 also found positive results once again: All errors identified were corrected in the subsequent financial statements. The vast majority of FREP recommendations were also implemented the following year.
- One area of focus of the international cooperation with ESMA in 2014 was the FREP's and the BaFin's participation in the working group on common European enforcement guidelines. The FREP considers the two-tiered nature of the German enforcement process to comply with the Guidelines.
- The FREP's expenses of EUR 5.33 million were slightly lower than in the prior year (EUR 5.39 million).

## 2 Examinations in 2014

### 2.1 Examination results

In 2014, the FREP completed a total of 104 examinations (prior year: 110). 13 of these 104 examinations identified errors. This corresponds to an error rate of 13%, slightly below the prior year rate of 14% (Fig. 1).

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

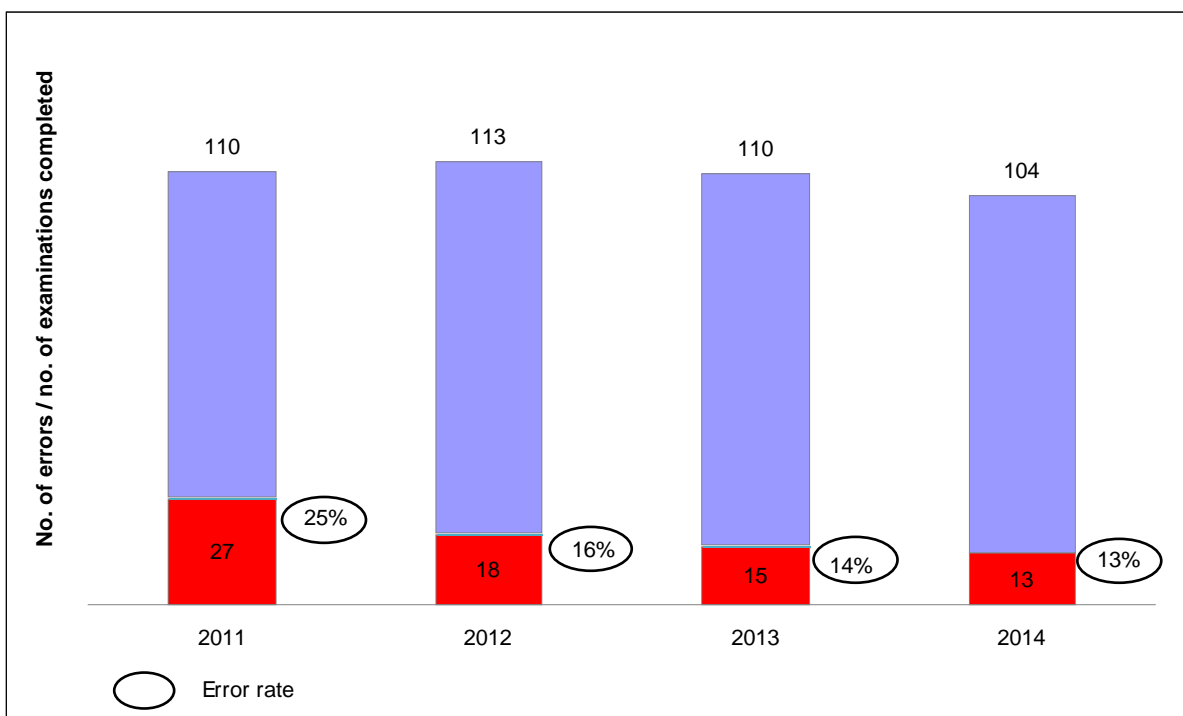


Figure 1: Completed FREP examinations, error rate trend

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 of 12% was slightly lower than in the prior year, indicating that, all in all, the error rate has stabilized in 2014 (Fig. 2).

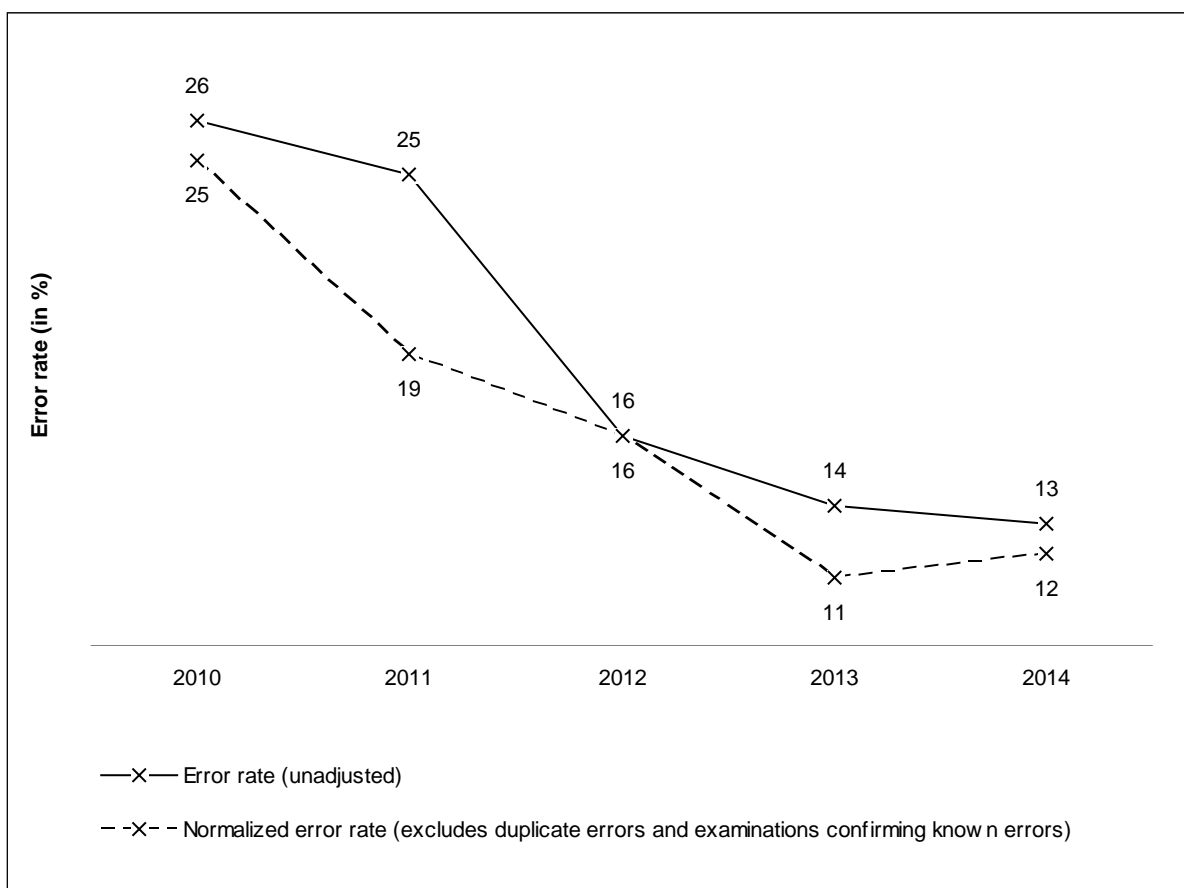


Figure 2: Error rate trend

The error rate stabilized at a low level due to the following:

- FREP examinations have become a well established component of the rules governing publicly listed companies and their auditors;
- a high degree of stability in international financial reporting standards in recent years;
- more attention on the part of supervisory boards (especially the audit committee);
- proportionately fewer smaller companies in the population subject to enforcement as some of these companies have left the Regulated Market;
- positive impact of the FREP's error prevention activities.

The total number of examinations in 2014 was consisted of the following: 99 out of 104 examinations completed were sampling examinations (Fig. 3). The FREP also completed three indication-based examinations, including one examination of a semi-annual financial report. Two further examinations were conducted at the request of the BaFin, including one related to a semi-annual financial report.

This means that the total number of indication- and request-based examinations completed (5) has decreased significantly from the prior year (12). As expected, the error rate for these examinations exceeds that found in sampling examinations.

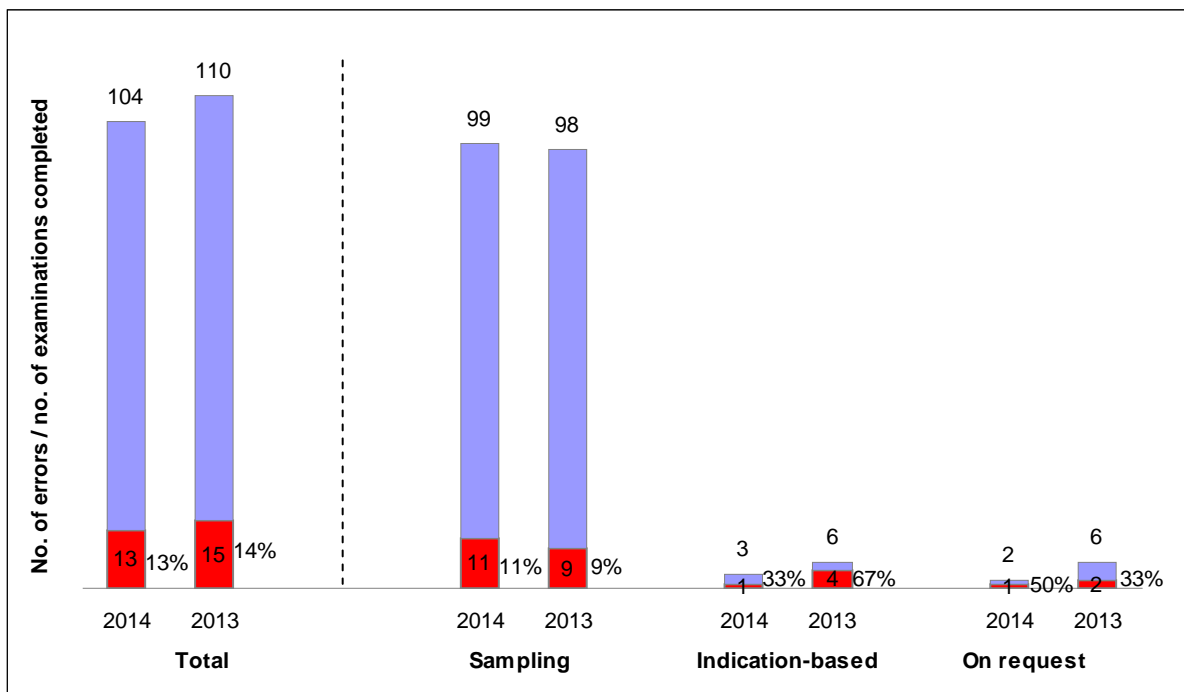


Figure 3: Completed FREP examinations by type of examination and error rate

An analysis of completed examinations by company size (i.e. inclusion in a stock index) indicates that the 16% error rate for smaller companies not included in a stock index exceeds the prior year's rate (14%), although it remains below the rate for 2012 (21%). The error rate of 3% for companies included in a stock index was significantly lower than in the prior year (13%). All companies for which errors were identified had their registered office in Germany (Fig. 4).

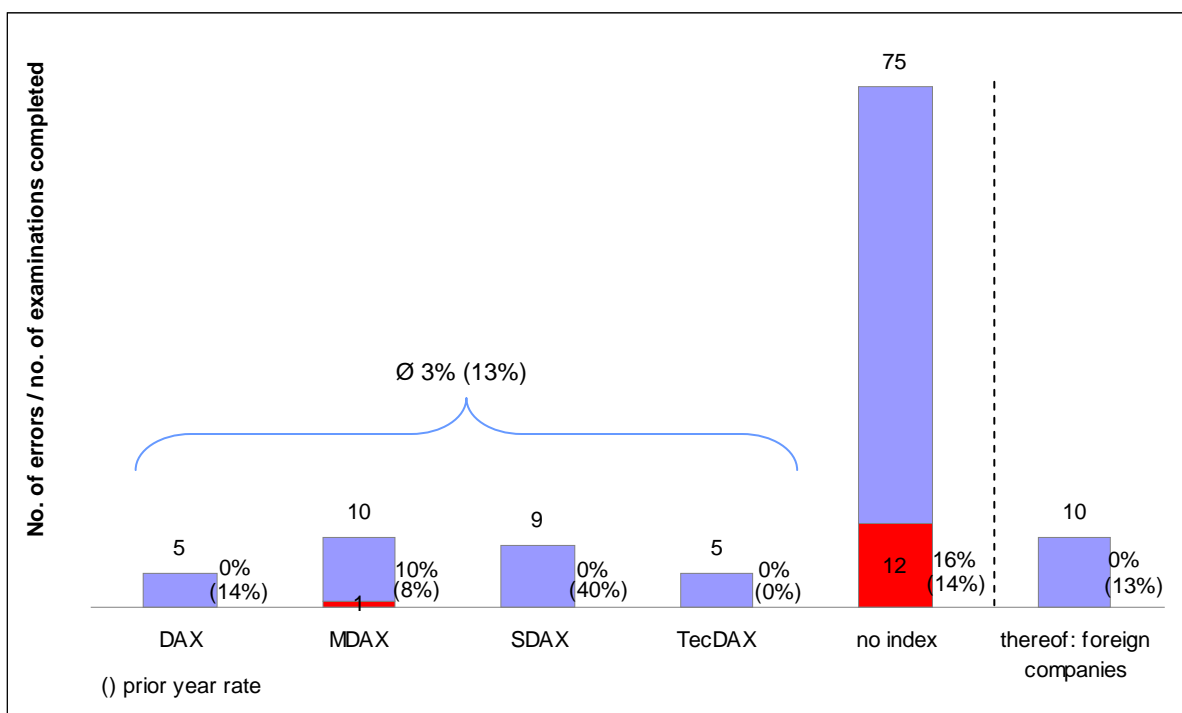


Figure 4: Completed FREP examinations by stock index and error rate

## 2.2 Types of errors and analysis of errors

The 13 examinations completed in 2014 which identified errors found an average of approximately 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 an examination that identifies an error any infringements that are individually immaterial to the financial statements examined.

The errors found were again attributable to the following factors:

- comprehensiveness and application challenges of certain International Financial Reporting Standards (IFRS) with respect to accounting for complex transactions and
- insufficient reporting in the notes and in the management report.

Fig. 5 shows the most frequently identified errors:

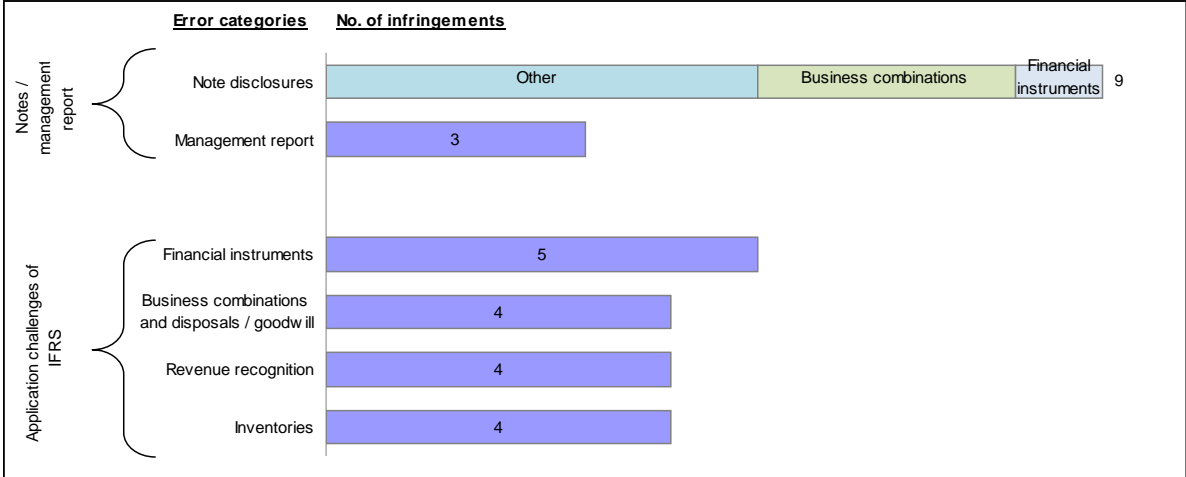


Figure 5: Most common types of errors

As in the past, reporting in the management report and in the notes represented an important source of errors (Fig. 5). Errors in the notes were found mainly in disclosures related to business combinations and disposals/goodwill impairment testing (3 infringements), infringements with respect to disclosures on financial instruments and, for instance, insufficient or missing related party disclosures (5 other infringements). Finally, three infringements related to reporting in the management report.

Application challenges with respect to certain IFRS related especially to financial instruments and business combinations and disposals/goodwill.

The area of business combinations and disposals/goodwill was marked by errors both in distinguishing between consideration for the acquisition of a business and compensation for services provided by shareholder-managers employed by the company subsequent to the business combination and weaknesses in the performance of goodwill impairment tests (total of 4 infringements).

Another area remaining prone to error in 2014 is the accounting for financial instruments. A total of five infringements related to measurement of financial instruments.

Four errors each were identified with respect to revenue recognition and accounting for inventories.

### 2.3 Acceptance rate

When the FREP identifies an error, 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 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. At 77%, the percentage of companies that accept the FREP's findings of an error remains high in 2014 (Fig. 6). The FREP sees this as important evidence of the quality of its work.

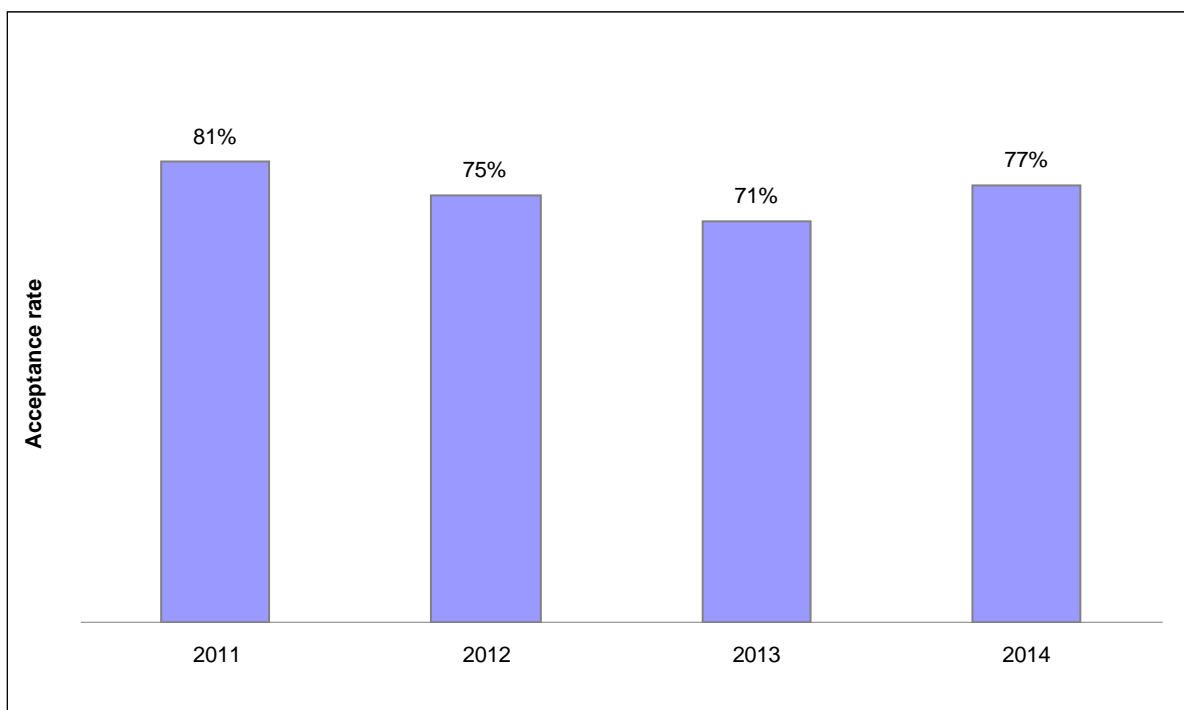


Figure 6: Trend in error acceptance rate

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 three such cases in 2014. The FREP's result was confirmed in two cases and the error was made public.



**2.4 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 (see chapter 3.1).

Fig. 7 shows the most common categories of recommendations. An analysis shows that recommendations can be attributed to application challenges posed by certain IFRS as well as insufficient reporting in the notes and management reports. The recommendations made with respect to management reports primarily concerned the application of GAS 20 (see chapter 2.6). Insufficient note disclosures also related to business combinations (nine recommendations), non-current assets (three recommendations), and provisions (one recommendation) as well as other accounting issues (ten other recommendations).

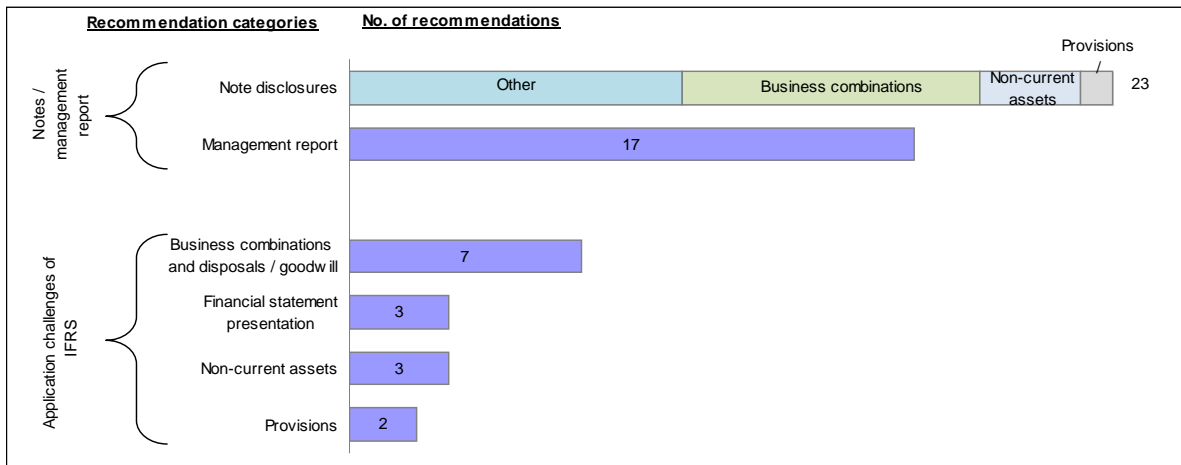


Figure 7: Most common recommendations to companies examined

## 2.5 Follow-up on 2013

The FREP has been systematically following up on the correction of errors found in the prior year and the implementation of recommendations made in the prior year based on publicly available information since 2013.

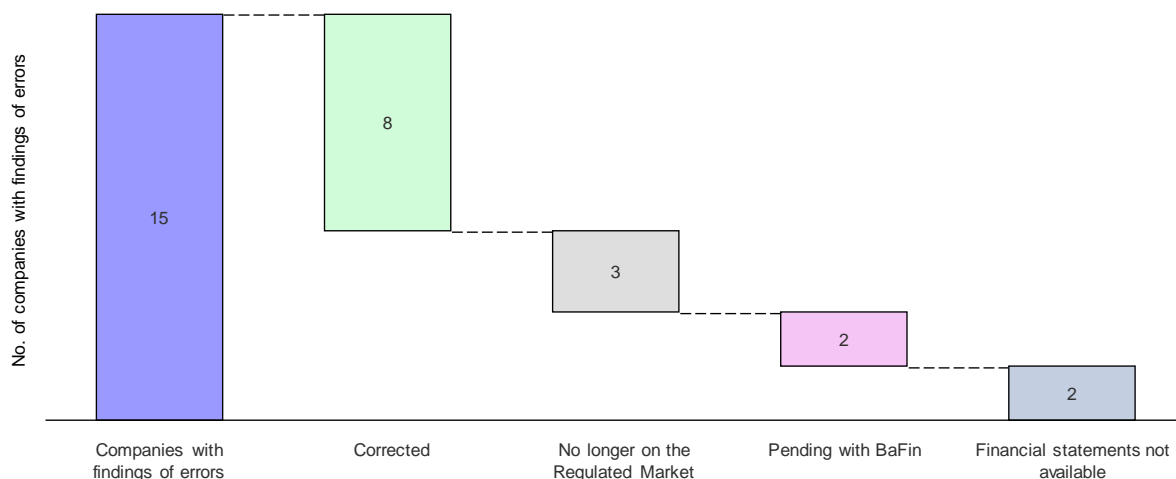


Figure 8: Correction of errors found in 2013

All companies where the FREP identified an error in 2013 and where follow-up was feasible corrected the error in the subsequent financial statements (8 out of 15). For the remaining seven companies it was not possible at the time of the follow-up to determine whether errors had been corrected for the following reasons (Fig. 8): Three companies were no longer part of the enforcement population as they were no longer listed on the Regulated Market. For two 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. The financial statements of two companies were not available at the time of the follow-up, one of these due to the insolvency of the company. The other company was a foreign issuer whose financial statements were not publicly available.

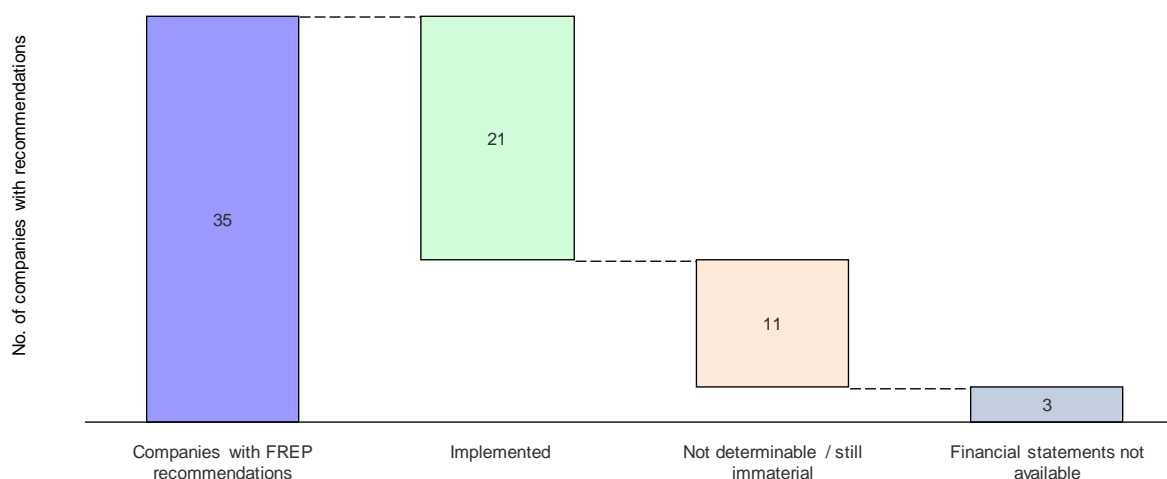


Figure 9: Implementation of recommendations made in 2013

In addition to the correction of errors, the FREP also followed up on whether its recommendations were implemented. Out of a total of 35 companies receiving recommendations in 2013, 21 companies have implemented the FREP's recommendations (Fig. 9). For 11 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 three companies were not available at the time of the follow-up, making it impossible to determine whether the recommendations have been implemented.

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

## 2.6 Experience with GAS 20

The group management report, especially the new requirements arising from GAS 20, was among the FREP's enforcement priorities in 2014. The FREP reviewed the company's compliance with GAS 20 in a total of 43 examinations in 2014. 25 of these examinations were completed by December 31, 2014. While no errors were found with respect to the management report in any of these examinations, the FREP made recommendations for future financial reporting purposes when it identified instances of non-compliance with the requirements of GAS 20. These recommendations related primarily to risk reporting.

Examinations of risk reporting focused on the presentation of risks and the risk management system. An analysis of the risk disclosures revealed that in approximately half of the examinations, risks were not quantified (Fig. 10). In these cases, the FREP reviews the extent to which this presentation is consistent with internal risk reports and whether it makes the different levels of relevance of the various risks to the company's net assets, financial position, and earnings clear to the reader of the financial report. The FREP also noted that the majority of companies still presented risks summarized by category rather than choosing to show a ranking of risks. A few companies did not provide an overall view of their risks in combination. The risk management system, on the other hand, was presented appropriately by nearly all companies.

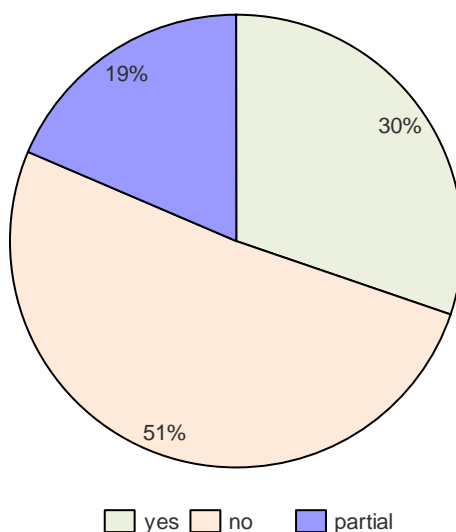


Figure 10: Quantification of risks

The FREP found that nearly all companies examined chose to use the shorter forecasting horizon of one year in their report on forecasts (Fig. 11). To date, the FREP has not noted any infringements with respect to the level of detail of forecasts selected by companies. Quantitative forecasts were provided in more than half of all cases.

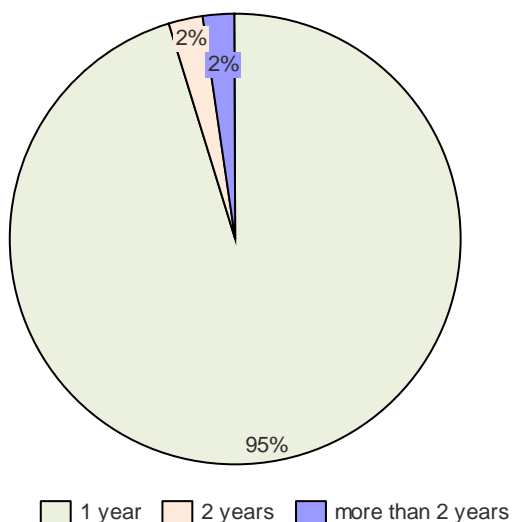


Figure 11: Forecasting horizon

Room for improvement was identified with respect to the consistent presentation of performance indicators in the management system, report on the company’s economic position (course of business as well as net assets, financial position, and earnings) and in the report on forecasts (Fig. 12), especially when it comes to non-financial performance indicators that are closely related to financial indicators such as market share or order intake.

	Management system	Course of business and net assets, financial position, and earnings	Comparison of actual results with prior year forecast	Forecasts
Financial performance indicators	◆	◆	◆	◆
Non-financial performance indicators	◆	◆	◆	◆

Figure 12: Consistent presentation of performance indicators

It was not always clear which performance indicators were the most significant. In their comparison to actual results, approximately one quarter of the companies examined either did not include all of the performance indicators forecasted in the prior year or reflected them incompletely. Finally, the FREP noted that the forecasts provided did not cover all of the most significant performance indicators.

In light of these findings, the FREP has identified consistent and transparent reporting in the group management report on the most significant financial and non-financial performance indicators as one of its enforcement priorities for 2015 (see chapter 3.2).

As in the prior year, 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) met in 2014 to share information regarding the status of the implementation of GAS 20. Another such discussion planned for 2015 will include a report on experience gained in the FREP’s follow-up on its GAS 20 recommendations.

### 3 Error prevention

#### 3.1 Overview

To perform its error prevention function, the FREP has launched several activities in recent years to help prevent errors (Fig. 13).

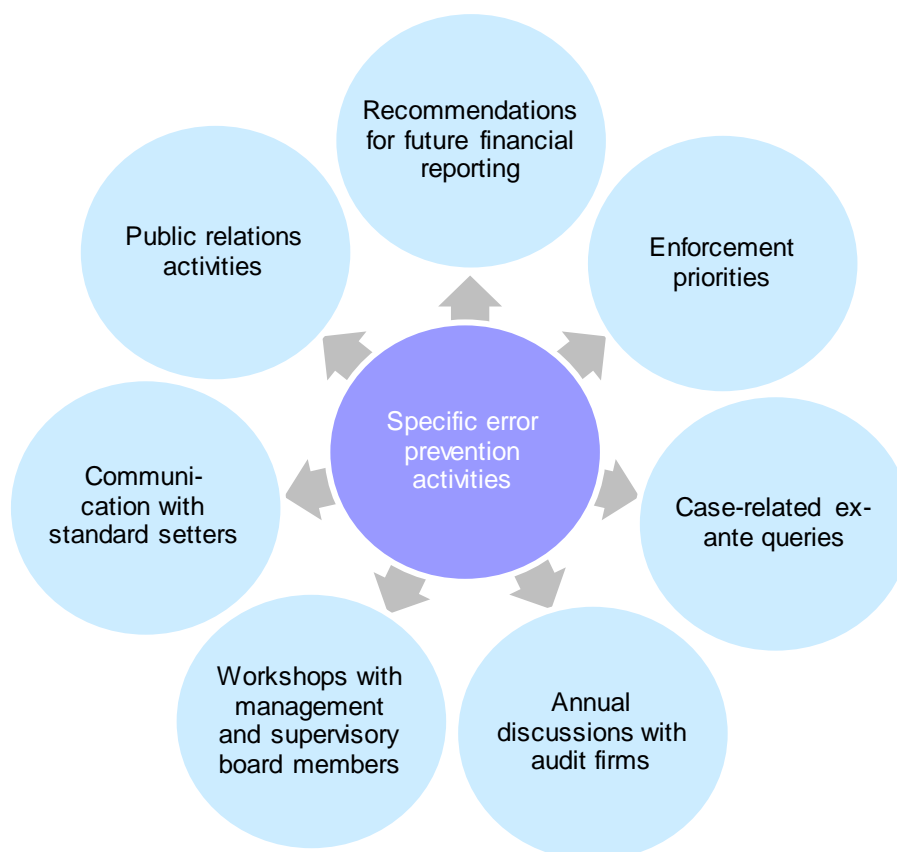


Figure 13: Error prevention activities of the FREP

These include providing the companies it examines with recommendations relating to future financial reporting (see chapter 2.4). Such recommendations are intended to improve the quality of future financial statements and avoid weaknesses in financial reporting.

Another error prevention measure are the enforcement priorities the FREP publishes annually in the fall. The enforcement priorities for the following year were announced by the FREP in October 2014 in order to give companies and auditors an opportunity to critically review the corresponding accounting issues (see chapter 3.2).

Case-related ex-ante queries represent another error prevention instrument aimed at avoiding errors and providing guidance to companies during financial statement preparation. The case-related ex-ante query, an instrument introduced in November 2009, was utilized once in 2014 (prior year: 4).

Since 2012, the FREP has 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, which also took place in 2014, is intended to make the FREP's approach transparent to auditors in order to ensure that accounting weaknesses are already identified during their audit.

The FREP has created a similar forum in the form of workshops with members of supervisory and management boards (see chapter 3.3).

Another error prevention activity essential to improving the quality of financial reporting is a regular exchange of information with standard setters. In 2014, the FREP discussed especially management reporting in accordance with GAS 20 with the German standard setter (see chapter 2.6).

Finally, the FREP continued to report on its work and experience in speeches and seminars (see chapter 3.4) as well as in articles as part of its general public relations activities in 2014.

### **3.2 Enforcement priorities for 2015**

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 first based on the new consolidation standard that became effective during the previous calendar year. Second, the issues of deferred tax and presentation of legal issues and legal risks were selected because they have proven particularly critical or prone to error in the past. Finally, FREP examinations will also prioritize

reviewing the reporting on performance indicators in the management report in accordance with GAS 20.

The following enforcement priorities for 2015 were announced in October 2014:

1. Preparation and presentation of consolidated financial statements and related note disclosures (IFRS 10, IFRS 12)
2. Financial reporting of companies with joint arrangements and related note disclosures (IFRS 11, IFRS 12)
3. Recognition and measurement of deferred tax assets (IAS 12)
4. Presentation of legal issues and related legal risks (IAS 37, GAS 20)
5. Consistent and transparent reporting in the group management report on the most significant financial and non-financial performance indicators (section 315 HGB (German Commercial Code), GAS 20, GAS 17)

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 and refer to the following:

Presentation of legal issues and related legal risks (IAS 37, GAS 20):

- Recognition and measurement of provisions for legal risks (IAS 37)
- Evidence of the extremely rare case that no reliable estimate of provisions for legal issues can be made in accordance with IAS 37.26, especially over several periods or across several legal issues
- Clear separation of disclosures on provisions for legal risks required by IAS 37.85 from disclosures on contingent liabilities for legal issues required by IAS 37.86 in the notes to the consolidated financial statements
- Evidence of the extremely rare case that a legal issue need not be reported on and compliance with the minimum disclosure requirements of IAS 37.92
- Disclosure of accounting policies that are relevant for an understanding of the financial statements in accordance with IAS 1.117, e.g. regarding recognition and measurement of provisions for material pending class action suits



- Transparent and understandable reporting in the group management report on legal risks in accordance with section 315 (1)(5) HGB, GAS 20.116 et seq., and, where applicable, GAS 20.A1.19 et seq. or GAS 20.A2.17 et seq.

Consistent and transparent reporting in the group management report on the most significant financial and non-financial performance indicators (section 315 HGB, GAS 20, GAS 17):

- Presentation of calculation of company-specific performance indicators and – where reasonably feasible – reconciliation to amounts reported in the consolidated IFRS financial statements (GAS 20.K45, GAS 20.104)
- Presentation of significant changes in performance indicators compared to actual prior year results (GAS 20.113) and prior year forecast (GAS 20.57) as part of the analysis of the course of business and the position of the group (section 315 (1)(1) to (4) HGB)
- Presentation of the expected change in forecasted performance indicators compared to actual results for the year under report (GAS 20.126, GAS 20.128) and disclosure of significant underlying assumptions (GAS 20.120) in the report on forecasts (section 315 (1)(5) HGB)
- Presentation of performance indicators relevant to the compensation system for management board members (section 315 (2)(4) HGB, GAS 17.78 et seq.)

### **3.3 Workshops with members of supervisory and management boards**

In addition to the auditor and the FREP and the BaFin, the supervisory board represents another fundamental component of enforcement, so it is essential that the supervisory board follow and take into account the approach and activities of the FREP in performing its supervisory function. As workshops and seminars with supervisory board members, especially those that are members of the audit committee, contribute significantly to error prevention, the FREP has strengthened its activities in this area in 2014 in order to ensure information is shared between the FREP and supervisory boards and audit committees. The objective was to make supervisory board members more aware of errors the FREP considers avoidable. In addition to supervisory board members, participants also included members of management boards.

The discussion of the issues and challenges specific to examinations of “China-AGs” (German AGs with operations located exclusively in China) with management board

members and German supervisory board members of “China-AGs” at the German Equity Forum held by Deutsche Börse AG in November 2013 was followed by a workshop with chief financial officers and audit committee chairs of real estate companies held in cooperation with the department of Professor Dr. Hans-Joachim Böcking at Johann Wolfgang Goethe University in Frankfurt in October 2014. This workshop covered industry-specific issues and errors frequently identified in real estate company accounting.

### **3.4 Speeches given as part of the FREP’s public relations activities**

In 2014, the FREP increasingly fulfilled the general public relations aspect of its error prevention function by giving speeches and seminars. The Presidential Board and the FREP’s members utilized various platforms and technical conferences to provide insight into the FREP’s work and approach. Nearly 50 separate speeches were given in total, primarily to company representatives and auditors.

Speakers discussed general trends in enforcement, but also covered the FREP’s perspective on specific accounting issues such as goodwill impairment testing as well as accounting for deferred tax and for business combinations. Speeches were also delivered on current trends in accounting, such as reports on the FREP’s experience with GAS 20. In addition, the FREP took the opportunity provided by industry-specific conferences to make companies, for instance in the real estate industry, aware of accounting issues found to be particularly prone to error in the past.

## **4 Developments in Europe**

### **4.1 Overview**

In addition to assisting with developing European Common Enforcement Priorities, in 2014, the FREP primarily cooperated with ESMA in two areas:

- Active participation in the European Enforcers Coordination Sessions (EECS,)
- Participation in working groups to develop the Enforcement Guidelines and ESMA reports.

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

As in prior years, attending the meetings of the EECS was a key component of the FREP’s international cooperation in 2014. The EECS represent a forum for national enforcers and ESMA to discuss IFRS application issues of transnational interest that meets approximately

nine times per year. In 2014, the FREP presented, on an anonymous basis, numerous 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. Where the discussion among national enforcers at the EECS-level indicated ambiguity in the interpretation of standards or divergence in practice with respect to their application, the related cases were presented to and discussed with representatives of the IFRS Interpretations Committee (IFRS IC) and the IFRS IC addressed and followed up on them as appropriate. ESMA makes extracts containing selected decisions of national enforcers discussed at the EECS meetings available to the public. A total of 180 decisions by national enforcers have been published in 16 extracts since 2007, most recently in November 2014.

In October 2014, ESMA issued European common enforcement priorities jointly identified by national enforcers and applicable to consolidated financial statements of publicly listed companies for the fiscal year ended 31 December 2014. The FREP has adopted these European enforcement priorities without change due to their relevance to the German capital market and has added two national enforcement priorities (see chapter 3.2).

### 4.3 ESMA Guidelines on Enforcement

The revision of the CESR Standards on Financial Reporting was completed in 2014. The following represents a chronological summary of the development of these Guidelines:

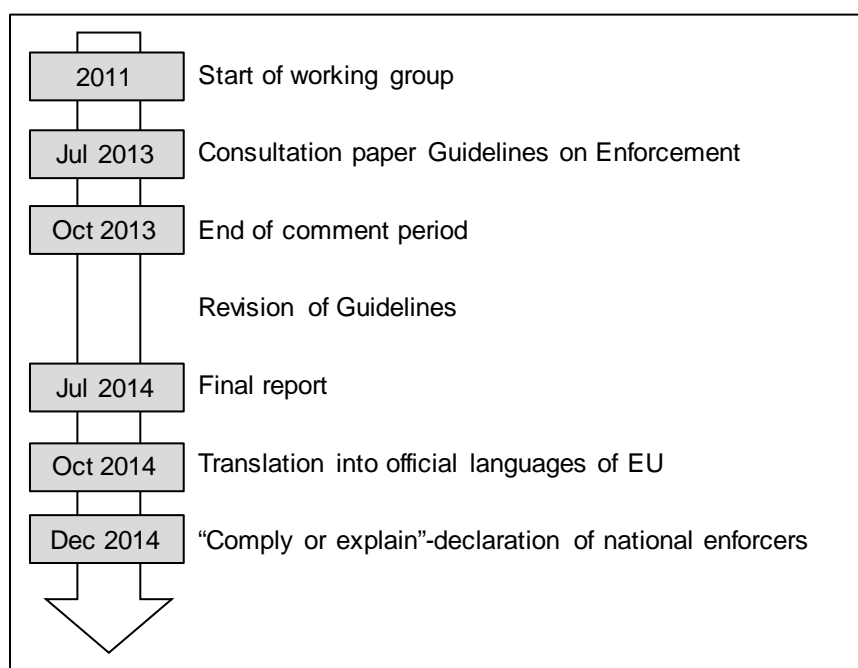


Figure 14: Guidelines on Enforcement

In revising the Guidelines, the ESMA working group on the new Guidelines on Enforcement, which included representatives of the FREP/BaFin, took into account significant aspects and criticisms contained in the 31 comment letters received in response to the "ESMA Guidelines on Enforcement" consultation paper. During the revision, particular attention was paid to the comment letter received from the ESMA Securities and Markets Stakeholder Group (published on 20 December 2013). The final report entitled "ESMA Guidelines on Enforcement" was then issued in July 2014. The Guidelines were translated into all official languages of the European Union and published on the ESMA website in October 2014.

The Guidelines cover the objective, concept and scope of enforcement, as well as the characteristics of European enforcers. They also address the creation of a pre-clearance process, selection of companies for examination, examination procedures, and enforcement actions. Finally, the Guidelines contain statements on European coordination and reporting, especially on discussing cases at EECS meetings.

Of particular significance to the FREP is the fact that the two-tiered nature of the German enforcement process complies with the requirements of the final Guidelines.

#### 4.4 Other ESMA publications

In June 2014, ESMA issued a report entitled „Review on the application of accounting requirements for business combinations in IFRS financial statements” addressing current financial reporting issues related to accounting for business combinations in order to promote consistent application of the related IFRS requirements. The investigation, in which both the FREP and the BaFin participated, analyzed the accounting treatment applied to business combinations in the 2012 annual financial statements of 56 issuers in Europe. It identified deficiencies such as information on assets/liabilities acquired being presented at only a highly aggregated level and meaningless and incomplete descriptions of the factors determining goodwill or a gain on a bargain purchase.

In addition, ESMA published a consultation paper entitled „ESMA Guidelines on Alternative Performance Measures” in February 2014, with comment letters due by May 2014. The consultation paper proposes guidelines on presenting alternative performance measures (e.g. for their calculation, definition, and reconciliation). ESMA received 58 comment letters during the comment period. A final report is expected in 2015 once all comments have been analyzed.

## 5 Acknowledgements and outlook

The FREP was able to continue its work successfully in 2014 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, panel members, the management and the office staff for their consistently dedicated and exceptionally professional work.

In November 2014, the FREP announced that its Nomination Committee had reelected Professor Dr. Edgar Ernst, president of the FREP since July 2011, for a second term of office with the approval of the BMJV in agreement with the BMF. Professor Dr. Edgar Ernst will remain in office for another regular four-year term (July 2015 to June 2019).

The FREP will continue to fulfill its error prevention role in 2015 in order to improve the quality of financial reporting for the long term. It is planning on continuing its regular exchange of information with supervisory board members in the future.

In the European context, the FREP, together with the BaFin, will continue to work closely with the European enforcers. The April 2015 EECS meeting will be hosted by the FREP in Berlin.

The FREP will celebrate its 10<sup>th</sup> anniversary at a ceremony on 3 July 2015.

Prof. Dr. Edgar Ernst

(President of the Enforcement Panel)