Dr. Herbert Meyer

Berlin, 4 February 2010

Annual Activity Report 2009

1. Overview

- The number of instances involving accounting errors reduced with an error rate of some 20% (previous year: some 27%)
- The scope and complexity of IFRSs as well as the financial and economic crisis are seen as the main drivers that cause errors
- For the first time there were also larger companies with a high error rate
- Case-related pre-clearance enquiries are now possible

In 2009, the FREP completed a total of 118 examinations (previous year: 138), of which 103 were sampling examinations and 14 were indication-based examinations; 5 of these in turn being examinations of half-yearly financial reports as well as one examination which was requested by the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – German Federal Financial Supervisory Authority). The examinations made in the past year were significantly more complex, particularly as a result of the financial and economic crisis; nevertheless, in 2009 we also remained within our target corridor for examinations to be performed.

The percentage of cases involving accounting errors reduced to some 20% (previous year: some 27%). However, for the first time larger firms were also to be found in the higher error rate level as compared to the overall average for all firms. This effect is mainly due to the financial and economic crisis, which particularly resulted in errors in risks and forecast reports.

Following many discussions with concerned parties, it is now possible for the first time to make case-related pre-clearance enquiries with the FREP, which companies can used to clarify queries involving complex accounting issues with the FREP before compiling their financial statements. In this manner, a further important instrument has been authorised to support the FREP’s preventive function.

2. Examinations in 2009

2.1 Completed examinations

In 2009, the FREP completed a total of 118 examinations (previous year: 138; see Figure 1) of which 103 were sampling examinations (prior year: 118). We are thus within our target corridor of approximately 110 – 140 examinations per year, which is based on the FREP's code of procedures; this provides that all companies listed in a stock market index are examined every 4 to 5 years and all other publicly trade companies are examined every 8 to 10 years.

In addition to the sampling examinations, we conducted 14 indication-based examinations of which 5 cases related to half-yearly financial reports. Furthermore, one examination was conducted at the request of the BaFin (see Figure 2).

2.2 Results of the examinations

The massive economic and financial crisis that lasted throughout 2008 impacted both consolidated and single-entity financial statements and also the work performed by the FREP in 2009. The main focus areas for examinations of financial statements ending at the end of 2008, which had already been defined by the FREP in October 2008, were significantly influenced by the risks in the financial statements that were expected to arise from the financial crisis. These included the impairment of asset values, the measurement of financial instruments as well as the reporting of risks.

First– an overview of the results:

At the end of an examination, FREP must assess whether the company's financial statements it has examined comply with the applicable accounting standards or whether they are erroneous. Accounting errors are defined as material infringements of financial reporting requirements or immaterial departures from such standards that were made intentionally.

For the first time in two years, the number of cases with accounting errors decreased to 23 (previous year: 37; see Figure 1). As a result, the error rate decreased to some 20% (previous year: some 27%). It remains to be seen in the next 2 - 3 years whether this improvement can be sustained. Truly reliable reasons for any such improvement can normally only be determined after such a time period.

For the 14 indication-based examinations that were completed in 2009 (previous year: 19; see Figure 2), at 79%, the error rate still continued to be at a similar level as that of the previous year (error rate: 84%). For the sampling examinations, the error rate was 12%; this illustrates the improvement against the previous year mentioned above (error rate: 18%).

When differentiation is made by company size, a considerably different picture appears in comparison to the previous year : in previous years, the error rate for larger companies, determined by their belonging to a stock market index (see Figure 3), was significantly lower than for small and medium-sized companies which did not belong to a stock market index. This situation changed for examinations that were completed in 2009: The larger companies, particularly those included in the MDAX and SDAX, with an error rate each of 27%, exhibit a significantly higher error rate than in previous years and compared to the average for all companies (some 20%), whereas the smaller companies which were not included in a stock market index are slightly below the average at 19%. The reasons for this relate to the impact of the financial crisis: for the first time we identified errors in the reporting of forecast data also for larger companies as well as higher error rates in the area of risk reporting. Even though it is understandable that companies become cautious when reporting in these areas, the minimum legal reporting requirements should still be fulfilled.

Special factors relating to the examination of financial institutions and the results thereof

The financial crisis has led to uncertainties in the financial statements of financial institutions, particularly in the area of structured securities in the so-called credit substitute transaction sector. In many cases, individual sub-markets had broken down and measurement models conforming to standards had to be developed. Generally, the parameters of the models could only be produced with a high level of uncertainty and with a high degree of subjective measurement latitude. In addition, at short notice in October 2008, the IASB introduced new possibilities for the re-designation of financial instruments. Under these, securities that had been required to be measured at fair value could be re-designated to categories which are accounted for at amortised cost; however, this possibility involved significant documentation requirements and strict pre-conditions.

These uncertainties, which arose quasi “overnight”, presented the preparers and auditors of financial statements, and also the FREP, with special challenges in relation to the 2008 financial statements and their examination. Accordingly, our examinations in 2009 were significantly more complex than in previous years. For this reason, we purchased additional external examination capacity for a number of examinations as foreseen in the budget.

Such partially unclear surrounding constraints for the preparation of financial statements can quickly result in accounting procedures that do not conform to standards. We noted this particularly:

- in the determination of “inactive” markets, which at times occurred prematurely and without performing the necessary test steps
- in the re-designation of securities, particularly relating to the related documentation
- in the performance of impairment tests for various assets (securities, receivables, goodwill) in cases where the deterioration in business development was not given sufficient consideration when measuring future-oriented cash flows that were used as the basis for measurement
- debatable classification of certain forms of hybrid capital as equity
- inadequate level of disclosure with regard to risks associated with financial instruments (IFRS 7)

The error rate for the 18 examinations that were completed for financial institutions, at 17%, was approximately the same as the average for all examinations (some 20%). However, we provided guidance in twice as many cases (28) as in the previous year (14) on indications of variances from standards relating to financial instruments.

When we identify an accounting error, we ask the company whether it accepts the error. This official enquiry is normally preceded by a very intensive discussion with the company. We believe that it is important to give the company and its auditors the opportunity to present their views and arguments and enter into open discussions with them. The percentage of companies that accept the errors that we have identified, approximately 80% (see Figure 4), continues at the high level experienced in the previous two years. We see this as important evidence of the quality of our work.

We refer all cases in which we have identified errors to the BaFin, irrespective of whether the companies have accepted our error findings or not. The cases in which our findings are not accepted are subjected to a further examination by the BaFin itself. In 2009, the result of this process was that the error identification was confirmed in all cases (see Figure 5). Of the 36 cases completed either by the FREP, or in the second stage by the BaFin, 35 cases were published (= 97%).

2.3 Types of error and analysis of errors

The 23 cases involving accounting errors included an average of 3 individual errors per company. In order to enable suitable measures to be developed to reduce the number of errors, these errors need to be analysed by type, frequency and cause. Accordingly, as in previous years, we defined certain categories of errors to which frequently recurring individual errors are assigned. The ranking list of the most frequently identified errors is shown in Figure 6.

<u>Errors related to the financial and economic crisis</u>

In comparison to the two previous years, we identified two significant changes:

- errors relating to forecast reporting were identified for the first time and there was a higher error rate in the area of risk reporting
- there was a significant increase in the incorrect treatment of financial instruments

The significant increase in these two areas is caused by the consequences of the financial and economic crisis and the complexity of the financial instruments that are required to be reported as well as the complex provisions under IAS 39. One of the leading groups in which the highest number of errors was identified was for the area of “Reporting disclosures”, which cannot really be directly attributed to the underlying figures (see Figure 6). The most important source of error included herein was the section of the group management report dealing with risk and forecast reporting.

<u>Risk reporting</u>

In general, the risks relating to further business development have increased due to the crisis. However, our examinations in this area revealed an increasing reluctance of companies to specify the concrete risks that make it possible for investors to obtain an appropriate picture of the risks associated with future development of the group of companies. The same applies to the reporting of risks that relate to financial instruments. In this area, the non-banking sector is affected to a great extent by financial covenants; as soon as a high probability exists that such covenants will be breached, with corresponding possible consequences for liquidity, then this risk must be reported. In such cases, our examinations also revealed deficiencies in the quality of reporting. In many cases, with non-material deficiencies, we have accordingly issued guidance to the companies. We treat cases as errors when significant risks which would have a high importance to investors' decision-making are completely omitted.

Forecast reporting

In turbulent times, the uncertainties surrounding future business development increase considerably. This makes it more difficult for companies to prepare reliable forecasts and to make a prognosis about future development. On the other hand, especially in such times, future-related information and management's assessment of future business development are particularly important for investment-related decisions made by investors. For this reason, corresponding qualitative assessments – at a minimum – of future developments are required, together with comments on the most important factors of influence and assumptions and an assessment of the significant opportunities and risks.

In some companies, our examinations revealed a strong tendency towards caution when reporting forecast information. In cases where only individual elements were missing from the forecasts, we again limited ourselves to issuing related guidance. If, however, a report of forecast information was intentionally omitted, then we considered this to be unacceptable and this led to classifying such omission as an error. Accordingly, this resulted in our identifying an error in the area of forecast reporting for the first time in 2009. The identification of this error was confirmed in the second stage by the BaFin and the case was subsequently argued before the *Oberlandesgericht* (OLG - Higher Regional Court) in Frankfurt am Main, which then confirmed the joint opinion expressed by the FREP and the BaFin.

The scope and complexity of IFRS as a source of error

In addition to the types of errors which occurred as a consequence of the financial and economic crisis, the same errors that had occurred with great frequency in previous years were again identified in 2009. This is particularly the case for those areas which are especially impacted by the scope and complexity of IFRSs.

Firstly, such cases include the accounting treatment of business acquisitions, which - with 11 cases - continues to take first place. These represent fewer cases than the previous year (24 cases), but we identified a further 36 cases (previous year: 27) of departures from the standard, which were, however, below the materiality threshold and for which it thus sufficed for us to issue guidance to the company.

Most of the departures, as in previous years, particularly occur when allocating the purchase price to intangible assets. In such cases - as reported in the previous activity report – the standard requires separation of the contribution to earnings made by individual intangible assets such as, for example, brand names and customer lists, which for the most part can rarely be done objectively and reliably in practice. The many instances of departures from the standard provide evidence of the weakness of the regulations covering purchase price allocation.

The second most common source of departures in this area occurs during the measurement of goodwill. Particularly the test for impairment of goodwill in subsequent years is complex and includes many subjective elements: allocation of the goodwill to independent business units, determination of capitalised earnings values based on complicated, future-oriented cash flow plans and derivation of suitable discounting rates, as well as very extensive disclosure requirements. This trend toward more departures from the standard may increase in times of economic difficulty, if attempts are made to influence results by possibly reducing impairment losses related to goodwill. The total goodwill disclosed by the 130 largest companies in Germany had increased to EUR 200 thousand million by the beginning of the crisis, as a result of many transactions with correspondingly high purchase prices (and goodwill) due to very optimistic business prospects. The long-term prospects have since become partially clouded due to the crisis, so that widespread impairment of goodwill was to be expected. Our examinations in this respect - and also other analyses performed - have, however, revealed that goodwill has only been written down in relatively few cases. This was achieved by using very high future planned earnings figures for measurement purposes - compared to realistic circumstances.

Further, errors arose due to the scope and complexity of IFRSs, as was the case in previous years, due to deficiencies in the required, very detailed note disclosures in the complicated area of deferred taxation as well in the consolidation area. In summary, the results of the examinations in 2009, as in previous years, illustrate that errors particularly arise in those areas in which the IFRSs show special complexity (see Figure 7). A further driver for the increased incidence of departures from IFRSs in 2009 was the difficult economic situation experienced by many companies as a consequence of the recession.

The results of long-term analysis also show that the scope and complexity of IFRS is the main driver for the errors that have been found. For the period from July 1, 2005 onwards, we have completed a total of more than 500 examinations; that is more than half of the publicly traded companies. Errors in the area of “Business acquisitions and disposals” clearly take the overall lead with a total of 58 individual errors, followed by errors in the area of “Reporting disclosures” with a total of 52 individual errors.

3. Preventive measures

3.1 Providing feedback on results of examinations to standard-setters

The preceding analysis shows that the most important measure to be taken to reduce the high error rate identified in enforcement examinations would be to simplify IFRSs. To this end, we have forwarded the results of our examinations for 2008, with the relevant explanatory comments, both to the national standard-setter *Deutscher Standardisierungsrat* (DSR – German Standardisation Board) and also to the ultimately responsible and authoritative international standard-setter in London (IASB). However, to date, no concrete steps can be perceived to have been taken in the direction of reducing the complexity of IFRSs. Due to massive pressure resulting from the financial crisis, there have been some initial steps taken solely in the area of financial instruments; the final results of this process still have to be forthcoming.

3.2 Guidance issued in 2009 and main focus areas for examinations in 2010

Even though no formal errors are identified in the course of an examination, during the course of many examinations we do provide guidance to companies relating to identified immaterial errors, which might become material for future financial reporting purposes. Insodoing, errors can be avoided in future financial statements. The frequency with which such guidance is provided (see Figure 8) shows that the departures from standards also particularly arise in those areas where IFRSs are highly complex.

Before the beginning of a new calendar year, we define the main focus areas for our examinations in the new year, which will in principle be addressed during each of our sampling examinations. As in previous years, these main focus areas are significantly impacted by the continuing financial and economic crisis (see Figure 9) and were published in October 2009 so that the preparers and auditors of financial statements can adapt their procedures for financial statements prepared as at the end of 2009 accordingly.

3.3 Pre-clearance enquiries

From November 2009 onwards, the FREP has been able to answer questions relating to specific accounting problems of publicly traded companies. This desire for so-called pre-clearance had been requested of the FREP by preparers of financial statements for a long time. A pre-clearance enquiry must be in writing and include an adequately formulated description of the specific circumstances, the company’s suggested accounting treatment and a position paper prepared by the auditors providing their opinion on the matter.

In those cases in which the FREP accepts a pre-clearance enquiry, a discussion process with the company normally occurs. Following this process, the FREP provides the company with its opinion. Even though, for legal reasons, the reply from the FREP cannot be regarded as binding, this procedure offers a good opportunity to pass on to companies the enforcement panel members’ experience from more than 500 examinations of financial reporting. Use of this procedure helps to avoid errors before financial statements are prepared and thus strengthens the FREP’s preventive function.

4 FREP’s impact

The most important goal of enforcement is to improve the quality of financial reporting. The decisive prerequisite for achieving this goal is a high level of acceptance of the FREP by preparers of financial statements and auditors within the capital markets as well as within the general public.

4.1 Impact on the preparers of financial statements

Insight into the impact of the FREP on the preparers of financial statements is provided by the joint survey carried out by the *Deutsches Aktieninstitut* [a German Association of publicly traded companies] and PricewaterhouseCoopers in 2009. Overall, this summary shows that there is a high level of acceptance by preparers of financial statements for the work performed by the FREP and the results achieved. In detail: 89% of those surveyed confirmed a high level of acceptance for the FREP and the results achieved with supporting assessments such as “highly professional” and “constructive approach to work”; 87% saw a potentially significant loss of reputation if errors are made public. This illustrates the high effectiveness of this legal form of sanction for errors made. 34% of those surveyed make necessary adjustments to their financial reporting following a FREP examination; this figure, compared to an error rate of 27% in the previous year, also shows how seriously the results of the FREP's examinations are taken.

4.2 Impact on the capital market

Investors consider published errors detected by the FREP to be a negative signal – this statement also gives an indication that the error sanctions that have been foreseen by the legislators are effective.

In the short-term (within 3 days of publication of the error) the impacts of an identified error on the quoted share price tend to be small: in a survey, average downward share price notations of 1.1% were observed. This is hardly remarkable, as many of the deficiencies that are made known in the published error report are already communicated in advance by the company itself and are corrected.

According to this same survey, in the longer term (within 150 days of publication) more significant downward share price notations of up to 25% have been observed, which provides a clearer signal of the impact of identified errors on the capital markets.

4.3 Impact on the general public

As in previous years, we have presented and disseminated information relating to the work of the FREP and the results thereof through appearances at many relevant events relating to business administration and financial reporting (overall more than 50 presentations made by FREP representatives). In addition, we published the results of the FREP's most recent examination findings and our most important plans through two press conferences held in January and October of the year - with a very good resonance in the business press and the relevant specialised press.

5 International cooperation

Up to now, enforcement bodies have been established at a national level; however, global capital markets and globally active companies demand corresponding trans-nationally structured and co-ordinated enforcement bodies. Even in Europe, we are a very long way from achieving this.

Within the context of the CESR, “European Enforcement Coordination Sessions“ (EECS) are held at which enforcement experts representing all European countries meet approximately every two months. In this forum, cases of trans-national interest concerning the application of IFRS are discussed. The objective is to reach uniform interpretation of IFRSs and to exchange initial experience gathered in connection with the application of new IFRSs within Europe.

Work in the extensive area involving harmonisation of enforcement processes and structures has, however, not commenced. The EECS was not set up with this intention and it remains to be seen whether the agreed decision to establish European enforcement agencies can produce harmonisation in the performance of enforcement procedures. The structures of the enforcement bodies vary considerably within Europe; in addition to purely government institutions (i.e. in France), there are also combined civil-law-/government-based bodies (i.e. Germany) and purely civil-law based structures (i.e. UK) in place. These structures are based on completely different national enforcement legislation, which has led to completely different processes and scopes for activity to control the content of financial statements at national level. This can lead to significant disadvantages for companies listed on stock exchanges in a number of countries. In order to limit these disadvantages, and in order to achieve a more intensive exchange of information concerning enforcement processes, we, together with the BaFin, continue to engage in bilateral discussions with the individual enforcement bodies in, for example, the UK, Spain and Switzerland.

6. FREP resources

The costs of the two-stage enforcement procedure were budgeted at EUR 7.7 million for 2009, of which EUR 6.0 million was designated for the FREP. We operated under budget by approximately EUR 1 million at an actual level of EUR 4.9 million. Admittedly, the amount for the FREP increased in comparison to the previous year (EUR 4.5 million) by some EUR 0.4 million. This was mainly caused by the previously mentioned highly complex examinations that were carried out in this year, in which we purchased additional external examination capacity for the first time.

In the past year, we have had to manage the first planned, larger scale fluctuation of employees of the enforcement panel, as many of the 4-year contracts with members of the enforcement panel expired in 2009. Five members of the enforcement panel out of 16 (calculated on a full-time basis) left us; two of these retired and three moved on to challenging positions in business. In order to maintain our staff capacity, we therefore have hired five new employees with limited-term contracts. The new colleagues have been quickly and successfully integrated into the organisation.

7. Outlook

Our intention is to strengthen the prevention-oriented tasks of the FREP. The new procedure for case-related pre-clearance enquiries will be helpful in this regard. In addition to this, we want to make our findings and analyses available to the standard-setters to an increased extent with the clear objective of simplifying IFRSs as the standards continue to be developed in the future.

The financial and economic crisis will continue to have a significant impact on 2009 single-entity and consolidated financial statements. We have taken account of the anticipated financial reporting-related risks in defining the focus areas for our examinations in 2010 (see Figure 9).

In addition, we intend to continue our bilateral discussions with other European enforcers in order to gradually move forward the harmonisation of processes and structures in this manner.

Our work continued successfully in 2009 because we were again able to count on effective support from many sources. In this connection, we would like to take the opportunity here to extend our special thanks to the companies that we examined, to the members of the FREP association, its Executive Board and Nominating Committee, as well as to our advisory group, to the responsible bodies at the German Federal Ministries of Justice and Finance, and in particular to the BaFin, the *Deutsches Rechnungslegungs Standards Committee* (DRSC - Accounting Standards Committee of Germany), the audit firms, the *Institut der Wirtschaftsprüfer* (IDW – the Institute of Public Auditors in Germany) and the *Wirtschaftsprüferkammer* (WPK – German Chamber of Public Accountants). Particular thanks go to the panel members and to our office staff for their consistently dedicated and exceptionally professional work.

DPR FREP

DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

Appendices to the Annual Activity Report 2009

4 February 2010 Dr. Herbert Meyer

Figure 1: Completed FREP examinations, error ratio trend (%)

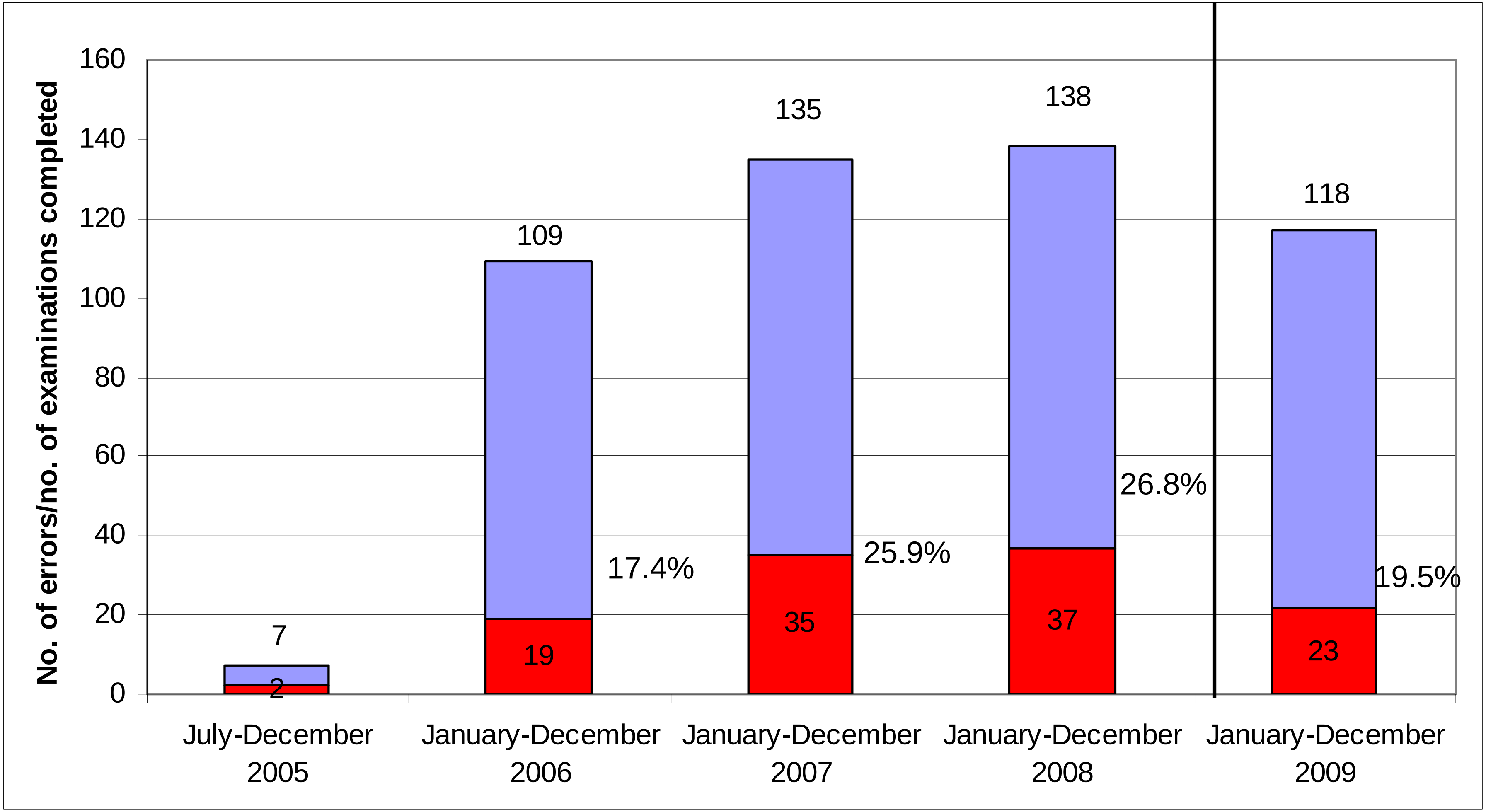


Figure 2: Completed FREP examinations by type of examination and error ratio (%) (2009)

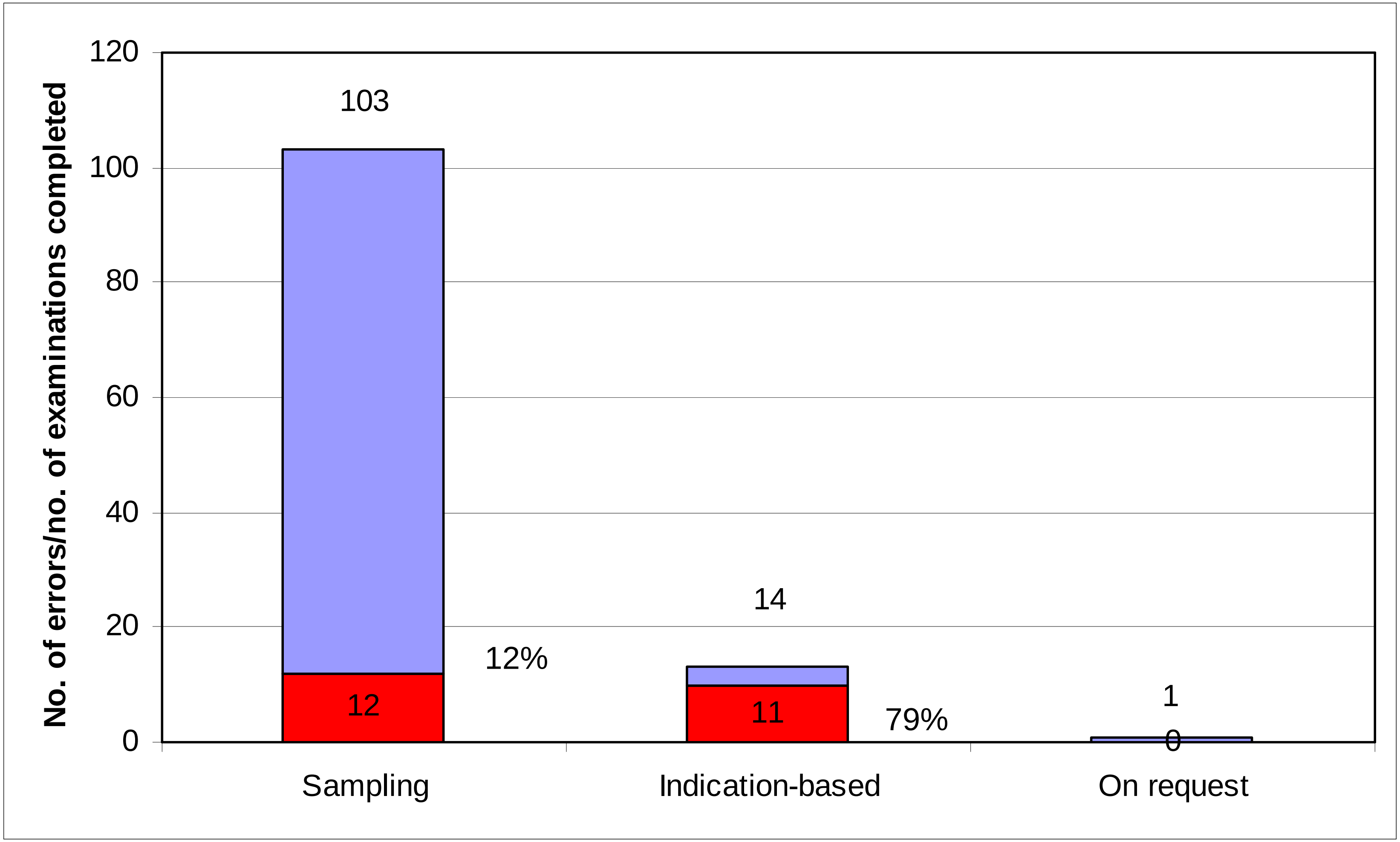
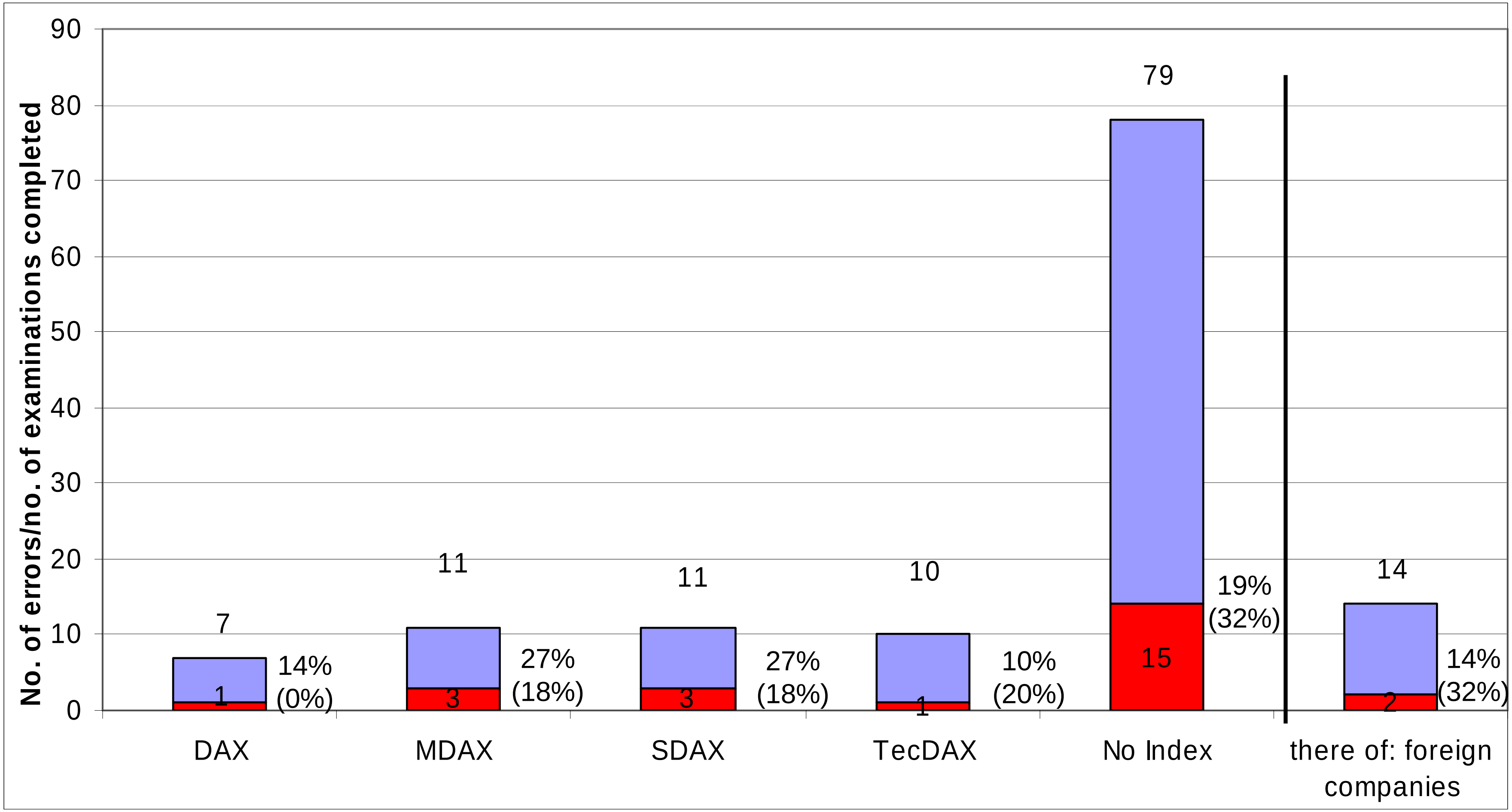


Figure 3: Completed FREP examinations by stock market index, error ratio (%) (2009)



( ) = Prior year ratio

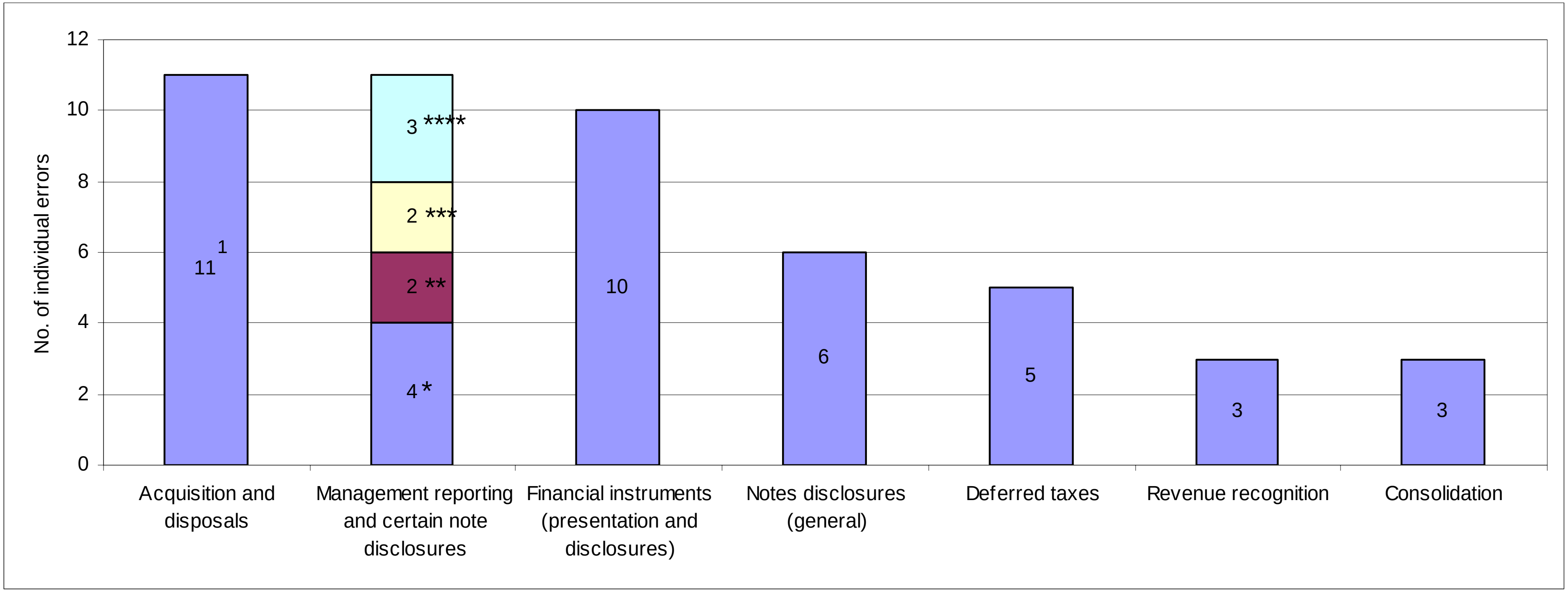
Figure 4: Change in acceptance ratio for errors identified by the FREP

	2006	2007	2008	2009
Acceptance ratio of companies as % of errors identified by the FREP	52	80	82	78

Figure 5: Results of stage 2 (BaFin) in 2009

o Procedures completed by the BaFin: (excluding cases, in which cooperation was refused)	36
o of which: same assessment as the FREP	36 (= 100%)
o of which: published	35 (= 97%)

Bild 6: Most common types of errors (2009)



[1] PPA, Goodwill, Information, Discontinued Operations, Impairment Test

**** Segment reporting

*** Related party disclosures

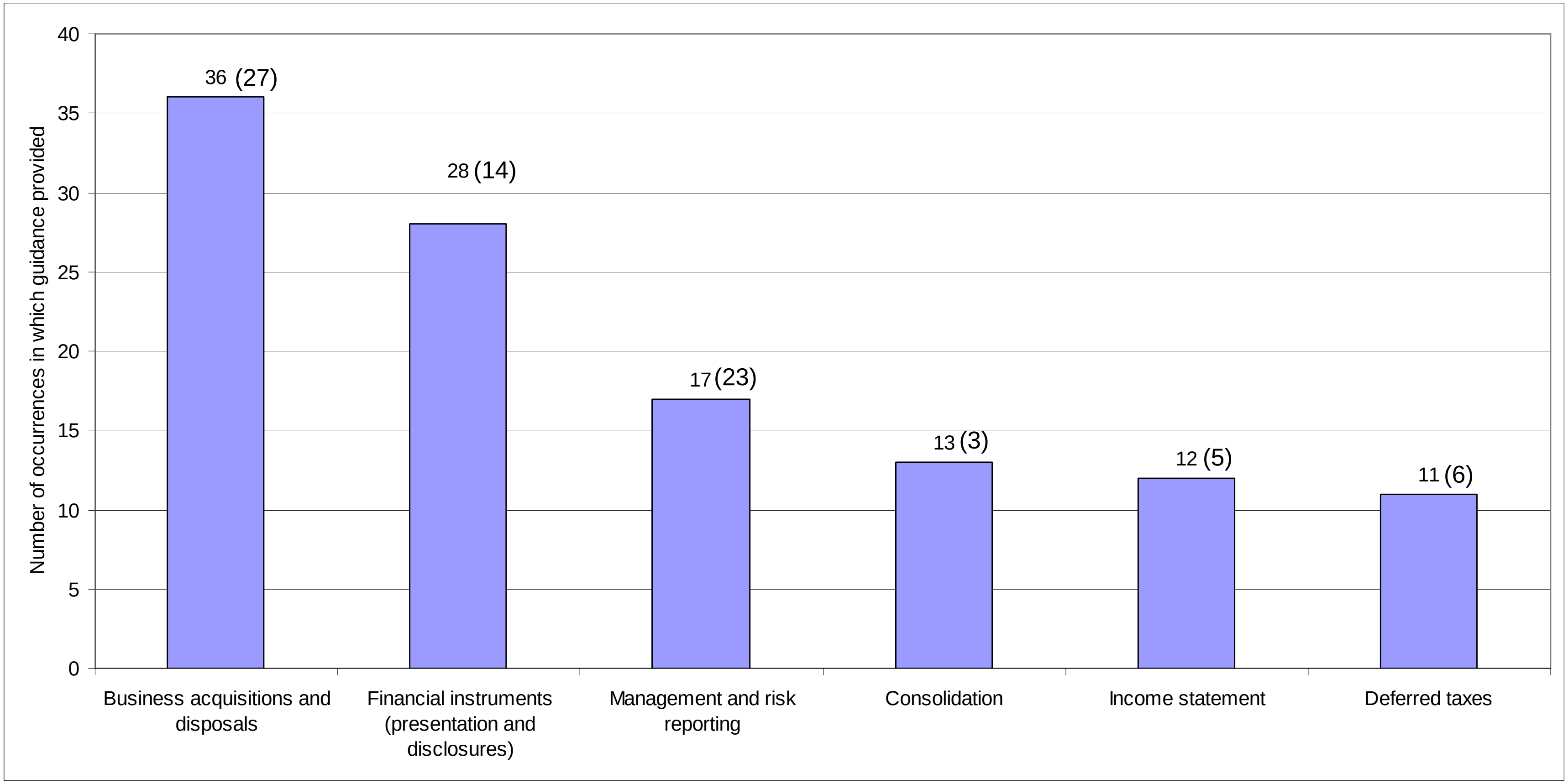
** Statement of changes in equity and tax reconciliation

* Risk and forecast reporting

Figure 7: Main causes of errors

- **Scope and complex nature of IFRSs**
- Economic situation of the companies
- Occasional lack of knowledge of standards
- A small number of “black sheep”

Figure 8: Most common topics for guidance given to companies (2009)



( ) = Prior year figure

Figure 9: Examination Areas of Emphasis 2010

1. Business combinations and the related purchase price allocation, measurement and note disclosures

2. Impairment testing of tangible and intangible assets including goodwill in light of the economic situation (including supporting documentation, note disclosures)

3. Recognition and measurement of financial instruments, note disclosures on measurement assumptions and changes in carrying amounts, as well as IFRS 7 disclosures

4. (Group) management report including risk reporting and reporting on expected developments (in particular taking into account the GASB Advice dated 27 March 2009)

5. Segment reporting in accordance with IFRS 8

6. Note disclosures on measurement assumptions used in estimating carrying amounts in financial reporting and the related uncertainty in financial statements; for example, when measuring the fair value of investment property (IAS 40.75d) and when measuring pension obligations (IAS 19.120 A)

7. Presentation and description of key financial risks relating to financial covenants (section 315(1) of the HGB (German Commercial Code), GAS 15, GAS 5; IFRS 7.18 et seq. and IFRS 7.31)

