Annual Activity Report 2010

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1. Overview

- Number of financial statements found to be erroneous remains high with an error rate of 26% (prior year 20%)
- Errors still mainly driven by complexity of IFRS and financial statement effects of financial and economic crisis
- Following five years of financial statement oversight in Germany, political, business and government leaders acknowledge FREP’s work as exemplary
- Successful introduction of pre-clearance enquiries as preventative instrument

In 2010, the FREP completed 118 examinations (prior year: 118), including 106 sampling examinations and 8 indication-based examinations. In addition, the FREP provided timely responses to 6 pre-clearance enquiries, which it has been authorized to accept since the end of 2009.

At 26% (prior year: 20%), the rate of financial statements found to be erroneous was slightly higher than the average of the past four years. The main drivers of the high error rate were again the complexity of IFRS as well as the impact of the financial and economic crisis. The crisis led to errors particularly in reports on risks and forecasts. As in the prior year, the error rate for large companies included in a stock index almost equaled that for small and medium-sized enterprises that are not part of an index.

In conjunction with the five-year anniversary of the FREP, political, business and government leaders recognized the FREP for its role as a confidence builder for the capital market and praised the two-tier enforcement structure in Germany as a prime example of a successful private-public partnership model in financial markets supervision.
2. Examinations in 2010

2.1 Completed examinations

In 2010, the FREP completed a total of 118 examinations (prior year: 118, see Figure 1), including 106 sampling examinations (prior year: 103). This puts us within our target corridor of approximately 105-130 examinations per year. This corridor is based on 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. It should be noted that the total number of companies subject to enforcement in Germany has decreased by more than 25% (from 1,249 to 914 entities) during the period from 1 July 2005 – the date the FREP started operations – and 1 July 2010.

In addition to the sampling examinations, we conducted 8 indication-based examinations, including 3 examinations of semi-annual financial reports. Furthermore, 4 examinations were conducted at the request of the BaFin, including 2 of semi-annual financial reports (see Figure 2). We also replied to 6 pre-clearance enquiries.

2.2 Examination results

In 2010, the FREP mainly examined consolidated and stand-alone financial statements for the years 2008 and 2009. Therefore, as in the prior year, the financial and economic crisis in 2008 and 2009 has significantly impacted the FREP’s work. The FREP’s main focus areas for the financial statements to be examined in 2010, as defined in October 2009, were clearly characterized by risks in the financial statements that were expected to arise from the financial crisis. These include recoverability of assets, valuation of financial instruments, as well as reports on risks and forecasts.

At the end of an examination, the FREP has to assess whether the examined company’s financial statements are in accordance with the applicable financial reporting standards or whether they are erroneous. An error in financial reporting is defined as a significant departure from financial reporting standards or an insignificant but intentional departure from such standards.

In comparison to the prior year, the number of financial statements found to be erroneous has increased to 31 (prior year: 23; see Figure 1). As a result, the error rate of 26% (prior year: 20%) stabilized slightly above the average of the past four years, confirming that the
reduction in the error rate noted last year was not sustainable in the long-term as previously discussed on a number of occasions.

The error rates found in the indication- and request-based examinations completed in 2010 were comparable to those of the prior year. For the sampling examinations, the error rate was 22%, representing an increase from the prior year (error rate 12%, see Figure 2).

Looking at company size, the picture is unchanged from the prior year: Last year, the error rate for large companies, i.e. those included in a stock index (see Figure 3), was comparable to that for small and medium-sized companies not included in an index. This was again the case for the examinations completed in 2010. In 46 examinations of companies included in an index, the FREP found a total of 12 financial statements to be erroneous (error rate 26%). The same error rate of 26% was observed for small and medium-sized companies not included in an index.

When we find a set of financial statements to be erroneous, we ask the company whether it accepts this finding. This official enquiry is normally preceded by a very thorough discussion with the company. We believe that it is important to enter into open discussions with the company and its auditors, giving them the opportunity to present their views and arguments. The percentage of companies that accept our findings of an error continues at between 70% and 80% (see Figure 4), remaining at the high level seen in prior years. We see this as important evidence of the quality of our work.

We refer all cases in which we have found errors to the BaFin, regardless of whether the companies have accepted our findings. Where our findings are not accepted, the BaFin performs its own additional examination. In 2010, the result of this process was that the finding was confirmed in 22 of the 25 cases completed by the BaFin (= 88%). These 22 cases were made public (see Figure 5).

2.3 Types of errors and analysis of errors

The 31 financial statements found to be erroneous include an average of 2 to 3 infringements per company. In order to facilitate the development of appropriate measures to reduce the incidence of errors, these infringements have to be analyzed by type, frequency and cause. To this end, as in prior years, we have assigned frequently recurring errors to certain error categories. Figure 6 shows a ranking of the most frequently identified errors.
As in the prior year, we have identified two main causes of errors:
  o the complexity of IFRS
  o the impact of the financial and economic crisis

2.3.1 Impact of the financial and economic crisis

As in the prior year, the report on risks and forecasts which is contained in the group management report was an important source of errors:

Report on risks

The risks relating to companies’ further business development have generally increased due to the financial and economic crisis. However, the FREP’s examinations in this area have revealed an increasing reluctance on the part of companies to report on specific real risks that make it possible for investors to accurately assess the future development of the consolidated company. We noted the same reluctance with respect to reporting on risks arising from financial instruments. In this area, the non-banking sector is affected to a greater extent with respect to certain financial covenants. As soon as it is highly probable that such financial covenants will be breached, possibly impacting the company’s liquidity, this risk has to be reported. It is particularly in this area that the FREP’s examinations have revealed reporting deficiencies. In many cases with immaterial deficiencies, the FREP has made corresponding recommendations to the companies for purposes of future financial reporting. However, where material risks existed but were not disclosed at all, although that would have been of significant importance to the investor’s investment decision, the FREP has identified these as errors (total of 2 infringements).

Report on forecasts

In turbulent times, the uncertainties surrounding future business development increase considerably, making it difficult for companies to prepare reliable forecasts and to reliably assess their future development. On the other hand, it is particularly in times like these that future-oriented information and management’s assessment of future business development is of key importance to investors’ in making their investment decisions. For this reason, at a minimum, appropriate qualitative assessments of a company’s future development are required, including a discussion of the most important assumptions and determinants as well as an assessment of significant opportunities and risks. In light of this, the FREP has also found several deficiencies in its examinations of reports on forecasts. Where only certain elements
were omitted from the forecasts, the FREP made appropriate recommendations. However, intentionally omitting the entire report on forecasts was considered unacceptable, and such omissions were classified as errors. Based on that policy, the FREP identified errors in the report on forecasts in two cases in 2010.

2.3.2 Complexity of IFRS

In addition to the types of errors that were due to the financial and economic crisis, examinations in 2010 again found the errors that had occurred very frequently in prior years. This is especially the case in those areas particularly impacted by the complexity of IFRS.

With 16 (prior year: 11) individual errors, the accounting treatment of business combinations tops the list of frequently occurring errors. Most infringements here were related to the goodwill impairment test (7 individual errors). The goodwill impairment test required at least annually is complex to perform in practice, particularly challenging in times of economic difficulty, and contains a large number of subjective elements. These include allocating goodwill to cash generating units, deriving appropriate discount rates, determining capitalized earnings values based on complex cash flow forecasts as well as preparing very extensive note disclosures. This trend towards more infringements can worsen in times of economic difficulty if companies attempt to manage earnings by reducing goodwill impairments as much as possible. By the beginning of the crisis, the total goodwill recognized by the largest 130 companies in Germany had increased to approximately EUR 200 billion as a result of a large number of transactions with high purchase prices (and goodwill) due to very positive business prospects. The latter have frequently become much less positive during the crisis, leading to an expectation of widespread goodwill impairments. However, our examinations have shown that goodwill impairment losses were recognized in only relatively few cases. This was achieved by forecasting - compared to the real situation - rather high future earnings for valuation purposes.

The second most common source of infringements in business combinations occurred in the allocation of the purchase price to intangible assets (total of 5 individual errors). The standard requires – as discussed in previous activity reports – the contribution made by individual intangible assets, such as brand name or customer base, to earnings to be separated, which in most cases can rarely be done objectively and reliably in practice. The many instances of departures from the standard provide evidence of the weakness of the standard on purchase price allocation.
Another highly complex and, as a result, error-prone area is the accounting for financial instruments, where a total of 5 individual errors were identified. Particularly the extensive note disclosures in the (consolidated) financial statements and what the standard refers to as Level-3 measurements gave rise to discussions.

A further area characterized by complexity is accounting for leases. We have identified 4 individual errors in this area in 2010. These mainly involved the incorrect classification of lease agreements as operating leases despite several key criteria in IAS 17.10 for a finance lease being objectively met, as well as insufficient note disclosures on lease agreements. In some cases, incorrect lease classification significantly impacts the assessment of the financial position, cash flows, and results of operations.

Another 4 individual errors arose, as in previous years, in the area of deferred taxes, which is multi-faceted and complex to apply, requiring, among others, very extensive forecasts to provide evidence of the recoverability of deferred taxes on loss carryforwards.

In summary, the results of the examinations in 2010, as in previous years, illustrate that errors arise especially in those areas in which IFRS is particularly complex. In 2010, as in 2009, a further driver for departures from the standards was the difficult economic situation of many companies as a result of the economic crisis.

A long-term analysis also shows that the complexity of IFRS is the main driver of the errors that have been found. Since 1 July 2005, we have completed a total of more than 600 examinations, representing over 60% of all entities subject to enforcement. Errors in the area of “Business combinations and disposals” clearly take the overall lead with a total of 74 individual errors, followed by errors categorized as “Management reports and certain note disclosures” with 64 individual errors. Accounting for deferred taxes, which is complex to apply in practice, is also a frequently occurring type of error, with a total of 32 infringements (see Figure 7).

The complexity of the IFRS requirements is largely driven by the strategy reflected in the IFRS-standards to consistently recognize as many assets and liabilities at fair value as possible. The objective behind that strategy is to enable users to derive at least an approximation of the enterprise value from the statement of financial position. However, particularly for industrial companies, the fair value of the majority of assets and liabilities cannot be derived from market values, as these are not available. As a result, companies resort to derived values, which have to be determined using complex valuation models. The amount of latitude in
this method of determining fair value is large, opening up enormous structuring opportunities for the reporting entity and significantly increasing complexity. For this reason, in many cases, the stringent continuation of the fair value approach as applied in practice is not suitable for improving the usefulness of the information to financial statement users and for meeting the general objectives of financial reporting such as reliability and comparability. An analysis of the accounting errors found by the FREP during the period from 2008 to 2010 shows that in the majority of cases the errors relate to fair value (see Figure 8).

2.3.3 Other

Additional errors not attributable to the reasons discussed above were mainly identified in the areas of revenue recognition, related party disclosures and segment reporting.

Revenue recognition

In 2010, we have increasingly found errors in revenue recognition: We have identified 8 infringements in this area. These errors consisted mainly of improper recognition of revenue that did not meet the relevant criteria, for instance because an inflow of economic benefits from a transaction was objectively not probable or because a transaction with shareholders was incorrectly treated as income. In addition, in one case we objected to the incorrect recognition of profit from construction contracts under IAS 11. In another case, consideration received from vendors was not netted correctly.

Related party disclosures

The FREP has identified 5 significant departures from the standard and, therefore, errors due to missing or insufficient related party disclosures. In these cases, the financial statement user was provided with incomplete or insufficient information for assessing to what extent the financial position, cash flows, and results of operations of the company may have been affected by related parties.

In addition to the identification, disclosure and discussion of all relevant related parties, the FREP pays particular attention in its examinations to the inclusion of individuals and the completeness and structure of the transactions as well as the disclosure of management remuneration. An important source of information for us are the sometimes very detailed disclosures in the dependency report, which we use to review the required IAS 24 disclosures and to assess their reasonableness.
Segment reporting

We identified 3 infringements in segment reporting under IFRS 8, which we had noted in October 2009 as an area we would focus on in 2010.

The FREP regularly requests the internal management report – as provided to the management board – as a basis for the review of whether the requirements of IFRS 8 have been complied with. In the examination itself, particular attention is paid to the identification, content and definition of reportable segments, completeness of segment disclosures, consistency of segment disclosures with the key management measures discussed in the report, the discussion of key measures not derived from IFRS, the reasonableness of reconciliations and any interdependencies between IAS 36 and IFRS 8.

3. Error prevention

3.1 Feedback on examination results to standard setters

The preceding analysis shows that the most important measure to be taken to reduce the high error rate found in enforcement examinations would be to simplify IFRS requirements. To this end, we have forwarded the results of our examinations for 2008 and 2009, 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, we have not seen any specific steps taken in the direction of reducing the complexity of IFRS. Merely in the area of financial instruments some initial steps have been taken with the development of IFRS 9 due to massive pressure resulting from the financial crisis; the final results of this process remain to be seen.

3.2 Recommendations made in 2010 and main focus areas for 2011

In many examinations, we make recommendations to companies for future financial reporting purposes even if no formal errors are identified. This helps avoid errors in future financial statements. The frequency with which such recommendations were made (see Figure 9) shows that these again occurred particularly in those areas where IFRS is highly complex.
Before the beginning of a new calendar year, we define the main focus areas for the coming year, which will normally be addressed in all of our sampling examinations. As in the previous two years, these main focus areas are characterized by the continuing financial and economic crisis (see Figure 10) and were published in October 2010 so that preparers and auditors of financial statements can prepare accordingly with respect to 2010 financial statements.

3.3 Pre-clearance enquiries

The FREP has been authorized to answer questions from companies subject to enforcement relating to specific accounting issues since November 2009. Preparers have expressed a desire for such a process, known as pre-clearance, to the FREP for a long time. A pre-clearance enquiry must be in writing and include an adequate description of the specific circumstances, the company’s proposed accounting treatment and a position paper prepared by the auditors providing their opinion on the matter.

Where the FREP accepts a pre-clearance enquiry, a discussion normally takes place between the company and the FREP. Following this discussion, the FREP provides the company with its opinion. Even though, for legal reasons, the FREP’s response cannot be binding, this procedure offers a good opportunity to pass on to companies the enforcement panel members’ experience of financial reporting gained in more than 600 examinations. This procedure helps avoid errors at the time financial statements are prepared and thus strengthens the FREP’s preventive function.

The ability to request a pre-clearance response from the FREP was well received by companies in 2010. The FREP received a total of six pre-clearance enquiries related to complex accounting issues in 2010. All pre-clearance enquiries met the requirements to be accepted for review by the FREP. The FREP considered the proposed accounting treatment acceptable in four cases, while in two cases it was not considered acceptable (see Figure 11). The FREP was able to deal with the pre-clearance enquiries thoroughly and on a timely basis, providing guidance to the enquiring companies when preparing their financial statements, thereby fulfilling its preventative function.

We would like to acknowledge that, without exception, companies and auditors provided high quality supporting documentation, clearly analyzing the pros and cons of the proposed accounting treatment.
4. 5 years of financial statement oversight in Germany

The FREP celebrated its fifth anniversary with a ceremony in Berlin on 1 July 2010. Political, business and government leaders pointed out the vital role the FREP and its work have played over the past years with respect to confidence in the capital markets.

Federal Justice Minister Sabine Leutheusser-Schnarrenberger emphasized that, rather than creating a new government agency for financial reporting oversight, a concept encompassing both independent self-regulation and government supervision was developed. She stated: “Legislators followed the right path back then, and the Financial Reporting Enforcement Panel has become a real success story.”

Christian Strenger, member of the Government Commission on the German Corporate Governance Code and member of the supervisory board of the largest German fund company DWS provided an appreciative summary of the FREP’s effect on the capital markets: “Looking back at the FREP’s first five years, the view is clearly a positive one: By systematically establishing and expanding its activities, it has created an important element of confidence for the capital market.”

Dr. Werner Brandt, chairman of the Governing Board of DPR e.V. and chief financial officer of SAP AG, also provided a very positive assessment of the FREP and its work: “As the private element of the dual enforcement process, the FREP is a model of success for a private-public partnership which was developed in close cooperation between representatives of the accounting and auditing community and the Federal Ministry of Justice and continues to be actively supported by them.”

5. FREP’s impact with respect to the capital market and the general public

Recent empirical studies, including one published by Ruhr-University Bochum and Georg-August-University Göttingen in 2010, document the continuing preventative effect of enforcement in Germany. Investors consider published errors detected by the FREP to be a negative signal – this is another statement indicating that this legislated sanction of errors is making an impact. Particularly in the long-term, companies that have to publish an error experience significant decreases in the price of their traded securities.

As in prior years, we have presented and disseminated information on the work of the FREP and its results through appearances at many events relating to business administration and
financial reporting (FREP representatives made a total of more than 40 presentations). In addition, we published the results of the FREP’s most recent examinations and our most important plans through press releases and/or press conferences with very good response in the business press and the relevant trade press.

6. International cooperation

The reform of the European financial market supervision has also led to several changes in the area of financial statement enforcement effective 1 January 2011. The Committee of European Securities Regulators (CESR), which has been coordinating accounting enforcement activities in the European Union but has only had an advisory capacity, will now be replaced by the European Securities and Markets Authority (ESMA), the European securities regulator with appropriately increased authority. ESMA will develop binding technical standards for the design and performance of enforcement examinations to replace the CESR standards, which have been non-binding.

It is positive that the European Enforcement Coordination Sessions (EECS) established under CESR, where enforcement experts for all European countries meet approximately every two months, will be maintained under ESMA. This forum discusses mainly IFRS application issues of transnational interest. The objective is to come to a uniform interpretation of IFRS and to share initial experiences with the application of new IFRSs within Europe. In the extensive area of harmonization of enforcement processes and structures, however, much remains to be done.

The structure of enforcement bodies varies considerably across Europe: In addition to purely governmental institutions (e.g. in France), there are also combined public/private bodies (e.g. Germany) and purely private structures (e.g. United Kingdom) in place. These structures are based on completely different national enforcement legislation, which has led to completely different processes and scopes for financial statement oversight at the national level. In order also to converge the structures and processes in Europe, a working group was created within the EECS framework. The FREP and the BaFin are members of this working group. Our objective here is to incorporate at the European level as many elements of the very successful process in Germany as possible.
7. FREP resources

The costs of the two-tier enforcement process were budgeted at EUR 8 million for 2010, including EUR 6.0 million designated for the FREP. With actual costs of EUR 5.3 million, the FREP came in EUR 0.7 million under budget. However, the amount for the FREP increased by EUR 0.4 million compared to the prior year (EUR 4.9 million). This was mainly caused by very extensive and complex examinations particularly of large financial institutions, where we engaged extensive external audit capacity and commissioned expert opinions.

8. Outlook

The rate of financial statements found to be erroneous did not show a sustained decrease in 2010, but has instead returned to the high average level of the past four years. As a result, we intend to strengthen the preventative function of the FREP. The pre-clearance enquiry process, which has become an established instrument for preventing errors in a short period of time, will contribute to meeting this objective.

In addition, we will continue to make our examination results and analyses available to the standard setters with the simplification of IFRS being the clear objective as the standards continue to develop.

Our work continued to be so successful in 2010 solely because we were again able to count on effective support from many sources. We would like to extend our particular gratitude to the companies that we examined, to the members of the FREP association, its Governing Board and Nomination 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). Special thanks go to the panel members and to our office staff for their consistently dedicated and exceptionally professional work.

Dr. Herbert Meyer

(President of the Enforcement Panel)
Appendices to the Annual Activity Report 2010

20 January 2011

Dr. Herbert Meyer
Figure 1: Completed FREP examinations, error rate trend
Figure 2: Completed FREP examinations by type of examination and error rate (2010)

- Sampling: 106 examinations, 22% error rate
- Indication-based: 8 examinations, 50% error rate
- On request: 4 examinations, 100% error rate
Figure 3: Completed FREP examinations by stock index, error rate (2010)
Figure 4: Trend in error acceptance rate

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Figure 5: Results of second tier (BaFin) in 2010

- Procedures completed by the BaFin: 25
  - of which: FREP finding confirmed 22 (= 88%)
    - of which: published 22 (= 100%)
Figure 6: Most common types of errors (2010)

- Business combinations and disposals: 16
- Management reports and certain note disclosures: 12
- Revenue recognition: 8
- Financial instruments (presentation and disclosures): 5
- Leases: 4
- Deferred taxes: 4

*** Segment reporting
** Related party disclosures
* Reports on risks and forecasts
Figure 7: Most common types of errors (2005-2010)

- Business combinations and disposals: 74
- Management reports and certain note disclosures: 64
- Note disclosures (general): 34
- Deferred taxes: 32
- Financial instruments (presentation and disclosures): 23
- Statement of cash flows: 17
Figure 8: Fair value as driver of complexity in IFRS
Figure 9: Most common recommendations to companies examined (2010)

- Reports on risks and forecasts: 20
- Business combinations and disposals: 14
- Financial instruments (presentation and disclosure): 10
- Related party disclosures: 4
- Revenue recognition: 4
Figure 10: Main focus areas for 2011

1. Business combinations and related purchase price allocation, measurement and note disclosures as well as the treatment of contingent consideration

2. Recoverability of assets such as goodwill, including note disclosures and supporting documentation (reasonableness of assumptions made in determining recoverable amount, e.g. discount rate)

3. Recoverability of financial instruments accounted for at fair value including supporting documentation (reasonableness of significant measurement assumptions)

4. Recoverability of investment properties accounted for at fair value including supporting documentation (reasonableness of significant measurement assumptions)

5. Group management report including report on opportunities and risks (section 315 (1) of the HGB (German Commercial Code), GAS 15, GAS 5)

6. Distinction between equity and liability (IAS 32), particularly the treatment of costs incurred to issue equity and of limited partners’ interest in earnings

7. Presentation of significant assumptions about the future and major sources of estimation uncertainty (IAS 1.125 et seq.)
Figure 11: Pre-clearance enquiries

- Received six pre-clearance enquiries in 2010, all of which met the criteria for acceptance for review by the FREP

- High-quality supporting documentation provided (analysis of pros and cons of proposed accounting treatment)

- Proposed accounting treatment considered acceptable by the FREP in four cases, not acceptable in two cases