FREP Presidential Board

Berlin, 25 January 2018

Activity Report 2017

1 Overview .............................................................................................................................2

2 Examinations in 2017 ........................................................................................................3
   2.1 Examination results ..................................................................................................3
   2.2 Types of errors and related analysis ........................................................................6
   2.3 Acceptance rate .......................................................................................................8
   2.4 Length of examinations ............................................................................................9
   2.5 Recommendations made .......................................................................................10
   2.6 Follow-up ................................................................................................................11
   2.7 Selecting companies for examination ....................................................................12

3 Error prevention ...............................................................................................................15
   3.1 Overview ................................................................................................................15
   3.2 Enforcement priorities for 2018 ..............................................................................16
   3.3 Discussions with audit firms ...................................................................................18
   3.4 Public relations activities ........................................................................................18

4 Developments in Europe .................................................................................................19
   4.1 European Enforcers Coordination Sessions and working groups .........................19
   4.2 Consultation on the European Supervisory Authorities .............................................20
   4.3 Results of the ESMA Peer Review regarding compliance with the “ESMA Guidelines on enforcement of financial information” ...........................................21

5 Acknowledgements and outlook ......................................................................................23

List of abbreviations .............................................................................................................24
1 Overview

- At 15%, the error rate for 2017 was similar to that of the last three years. The normalized error rate, reflecting adjustments for duplicate errors as well as for examinations confirming known errors, amounted to 14% in 2017, higher than the prior year rate of 12%.

- In 2017, the FREP completed 99 examinations (prior year: 96), including 91 unlimited scope examinations, three indication-based examinations, and five examinations performed at the request of the BaFin.

- The follow-up on 2016 shows that nearly all errors identified were corrected in the subsequent financial statements. As in prior years, the vast majority of FREP recommendations were implemented the following year as well.

- Actively participating in the EECS and in working groups once more represented the key components of the FREP's European cooperation in 2017.

- The Peer Review performed by ESMA during the year confirmed the high quality of the FREP's enforcement activities. The Peer Review found the FREP’s selection model to be good practice Europe-wide.

- The European Commission’s consultation on the European Supervisory Authorities came to the conclusion that there is no need for significant changes in enforcement.

- The FREP’s expenses of EUR 5.08 million were in line with the prior year (EUR 5.13 million).
2 Examinations in 2017

2.1 Examination results

In 2017, the FREP completed a total of 99 examinations (prior year: 96). 15 examinations identified errors. This corresponds to an error rate of 15%, in line with prior years (Fig. 1).

Figure 1: Completed FREP examinations, error rate trend
As in the past, a normalized error rate was determined in order to facilitate a more refined presentation and analysis, reflecting adjustments for duplicate errors and for examinations confirming known errors. The normalized error rate for 2017 of 14% was higher than in the prior year (12%) (Fig. 2).

Figure 2: Error rate trend

The examinations completed in 2017 consisted of the following: 91 out of 99 examinations completed were unlimited scope examinations. The FREP also completed three indication-based examinations, including one examination of a semi-annual financial report. Five further examinations were conducted at the request of the BaFin, including two related to semi-annual financial reports.
The 12% error rate for unlimited scope examinations was slightly higher than in the prior year. The error rates for indication- and request-based examinations completed remained high at 67% and 40%, respectively (Fig. 3).

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 errors were found exclusively for companies not included in a stock index (error rate: 27%; prior year: 25%). One company for which errors were identified had its registered office outside of Germany (Fig. 4).
2.2 Types of errors and related analysis

The errors found in 2017 were again attributable to the following factors:

- Comprehensiveness and application challenges of IFRS with respect to accounting for complex transactions
- Insufficient reporting in the notes and in the management report
Fig. 5 shows the most frequently identified errors:

![Error categories vs. No. of infringements chart]

<table>
<thead>
<tr>
<th>Error categories</th>
<th>No. of infringements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note disclosures</td>
<td>17</td>
</tr>
<tr>
<td>Management report</td>
<td>11</td>
</tr>
<tr>
<td>Current and deferred tax</td>
<td>4</td>
</tr>
<tr>
<td>Business combinations and disposals / goodwill</td>
<td>3</td>
</tr>
</tbody>
</table>

Figure 5: Most common types of errors

Once again, reporting in the notes and in the management report represented a significant source of errors in 2017. Four out of 17 infringements found in notes related to disclosures regarding related party transactions. There were three cases of infringements of IFRS 8 (segment information), such as omission of the disclosure of the amount of revenue from major customers or of a significant geographical market. In three cases, disclosures on a business combination or the goodwill impairment test were considered erroneous.

The eleven infringements in the management report largely related to a view of the company’s net assets, financial position, and earnings that was not true and fair as presented in the report on the company’s economic position.

Application challenges of certain IFRS with respect to accounting for complex transactions related especially to current and deferred tax and business combinations and disposals/goodwill. Findings of an error in the current and deferred tax category dealt primarily with recognition of deferred tax assets on temporary differences and/or loss carryforwards when the relevant criteria were not met.

Finally, the FREP found three infringements related to business combinations and disposals/goodwill. In one case, an acquisition of shares from non-controlling interests was not accounted for correctly, and the other two cases involved an overstatement of goodwill.
2.3 Acceptance rate

When the FREP identifies an error, it asks the company involved whether it accepts this finding. The finding of an error is frequently preceded by a 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 discussions without bias. 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 to be inappropriate.

In 2017, the acceptance rate was 100% (Fig. 6).

![Figure 6: Trend in error acceptance rate](image)

All examinations in which errors are found are referred to the BaFin, regardless of whether the company has accepted the finding. The BaFin always initiates its own examination whenever the company has not accepted the finding of an error, which was not the case in 2017. In 2017, the BaFin completed two examinations that originated in prior years (prior year: four examinations). In both examinations, the FREP’s result was confirmed and the error was made public.
Companies refusing to cooperate with the FREP in an examination are subjected to an examination by the BaFin. The BaFin completed three such examinations in 2017. In one case, the BaFin completed the examination without finding an error; the other two cases were discontinued by the BaFin as the company had de-listed in the meantime.

2.4 Length of examinations

An analysis of the length of examinations for the years 2014 to 2017 shows that, on average, examinations are completed in 8.2 months (Fig. 7). 82% of examinations were completed within one year, 41% within six months. About 18% of examinations lasted longer than one year. These cases frequently resulted in a finding of an error (43%).

![Figure 7: Length of examinations 2014 to 2017](image)

In 2017, examinations lasted an average of 7.5 months.
2.5 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 rectify weaknesses in future financial statements and improve the quality of financial reporting.

The most common categories of recommendations are shown in Fig. 8. In 2017, recommendations were primarily attributable to insufficient reporting in the notes and management reports. Recommendations made with respect to management reports where largely preventative recommendations on the application of GAS 20 with respect to the presentation of key financial performance indicators, the presentation of alternative performance measures, and the report on risks.

Insufficient note disclosures were identified, among others, with respect to business combinations, segment information, related party disclosures, and financial instruments. Finally, application challenges of IFRS with respect to accounting for complex transactions related especially to the categories financial statement presentation as well as business combinations and disposals/goodwill.

![Figure 8: Most common recommendations to companies examined](image-url)
2.6 Follow-up

In 2017, the FREP has once again systematically followed up on the correction of errors found in the prior year as well as on the implementation of recommendations made in the prior year based on publicly available information.

Twelve of the fifteen companies where the FREP identified an error in 2016 corrected the error in their subsequent financial statements (Fig. 9). In one case, the error identified by the FREP was not corrected, which resulted in the FREP initiating an indication-based examination. For one company, it was not possible to determine whether the error had been corrected at the time of the follow-up since the examination was still pending with the BaFin at the second tier as the company had not accepted the FREP’s finding of an error. One company is no longer subject to the FREP’s enforcement regime as it has switched to the nonregulated market.
Figure 10: Implementation of recommendations made in 2016

Out of a total of 35 companies receiving recommendations as part of a FREP examination in 2016, 25 companies have implemented the recommendations (Fig. 10). For eight companies, either it was not possible to determine whether the recommendation had been implemented solely by reviewing the subsequent financial statements, or the issue giving rise to the recommendation remained immaterial (no material misstatement of net assets, financial position, or earnings). In two cases, no financial statements were available, which frequently occurs when a company becomes insolvent.

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

2.7 Selecting companies for examination

In accordance with section 342b (2) sentence 3 no. 3 HGB, the examinations performed by the FREP must include unlimited scope examinations (on a sampling basis). To this end, the FREP has defined principles approved by the BMJV and the BMF which were most recently amended on 15 December 2016; this document is publicly available on the FREP’s website.
The population consisted of 621 companies when the sample was selected.

In the various steps, the FREP initiated

- step 1: 24 examinations (including 5 indication-based examinations)
- step 2: 87 examinations (including 2 examinations from the prior-year selection)
- step 3: 2 examinations

It should be noted that an examination is only initiated provided there are no legal reasons or other substantive circumstances preventing initiation of the examination, such as a de-listing of the company. Examinations not initiated in the year of selection are carried forward to the following year.

In five cases, the FREP’s Pre-Review Committee encountered concrete indications of erroneous financial reports, leading to the initiation of an examination in each case. The indications identified by the FREP resulted from the follow-up, general research in the media, or from information provided by a third party. In addition to the examinations discussed above, the BaFin identified concrete indications of erroneous financial reports in three cases in 2017 and requested the FREP to initiate examinations (request-based examinations). Out of this total of eight focused examinations, three related to semi-annual financial reports.
The APAReG, which came into effect in 2016, allows the APAS to inform the FREP of indications of erroneous financial reports identified in its supervision of the audit profession. For the first time, communication received from the APAS in accordance with section 66c (1) sentence 1 no. 1 and sentence 2 WPO has led to indications of erroneous financial reports being reviewed in focused examinations.

As part of our ongoing efforts to refine our approach for identifying companies with abstract risk for sampling purposes, the following additional risk factors were defined and will be used starting with the next selection (in early 2018):

- Deficient corporate governance (recommendation resulting from the ESMA Peer Review; see chapter 4.3)
- Delays in preparing for imminent application of new financial reporting standards (see chapter 3.2)
3 Error prevention

3.1 Overview

As in prior years, the FREP once again undertook several error prevention activities in 2017 to help avoid future errors (Fig. 12).

Figure 12: Error prevention activities of the FREP

For instance, the FREP made nearly 60 individual recommendations with respect to future financial statements to companies subject to examinations (see chapter 2.5 for categories of recommendations).

In addition, the FREP announced its enforcement priorities for 2018 in November 2017 in order to give companies and auditors an opportunity to critically review the corresponding accounting issues (see chapter 3.2 for further detail).

In order to already prevent errors during financial statement preparation and to provide accounting-related guidance to companies, the FREP introduced the case-related ex-ante
query in November 2009. This instrument was used once in 2017 (19 cases completed in total since 2009).

In addition, the FREP’s prevention activities in 2017 included its annual discussions with audit firms (see chapter 3.3 for further detail).

To improve the quality of financial reporting standards, the FREP’s preventative instruments include a regular exchange of information with standard setters as well.

Furthermore, the FREP’s preventative measures also focused on general public relations activities (speeches and seminars as well as articles and commentaries) in 2017 (see chapter 3.4 for further detail).

3.2 Enforcement priorities for 2018

In November 2017, the FREP announced its enforcement priorities for the following calendar year. These are addressed by the FREP in unlimited scope examinations to the extent they are material.

Enforcement priorities are selected based on issues that have either proven particularly critical or susceptible to error in the past or that pose a high risk of future errors due to changes in the law or in the political environment.

The following enforcement priorities were announced for 2018:

1. Disclosure of the expected impact of implementation of major new standards in the period of their initial application
2. Specific recognition, measurement, and disclosure issues of IFRS 3 Business Combinations
3. Specific issues of IAS 7 Statement of Cash Flows
4. Recognition and measurement of provisions in accordance with IAS 37 and related disclosures
5. Group management report and group declarations
The first three enforcement priorities represent the “European Common Enforcement Priorities” identified by national enforcers in cooperation with ESMA.¹ Further details on the two enforcement priorities representing the FREP’s additional national enforcement priorities, “Recognition and measurement of provisions in accordance with IAS 37 and related disclosures” and “Group management report and group declarations”, have been provided as follows:

**Recognition and measurement of provisions in accordance with IAS 37 and related disclosures**

including the following specific issues:

- Non-recognition where no reliable estimate can be made as well as compliance with the disclosure requirements (IAS 37.26 and 37.86)
- Omission of standard disclosures under the protective exemption and compliance with the minimum disclosure requirements (IAS 37.92)
- Disclosures regarding estimation uncertainties (IAS 37.85(b), IAS 1.125 and 1.129)
- Aggregation of provisions (IAS 37.87)
- Disclosure of items of income and expense related to specific provisions (IAS 1.97 and 1.98(b), (f) as well as (g))

**Group management report and group declarations**

- Reporting on alternative performance measures as key financial performance indicators (section 315 (1) sentence 3 of the HGB)
- Presentation of possible impact of Brexit on the group’s future net assets, financial position, and earnings (section 315 (1) HGB)
- Inclusion of disclosures on the diversity policy in the group corporate governance declaration (section 315d HGB in connection with section 289f (2) no. 6 HGB) and inclusion of the nonfinancial group declaration (section 315b HGB)

The latter issue was selected due to the amendment to the HGB resulting from the Law to Strengthen Companies’ Nonfinancial Disclosure in their Management Reports and Group Management Reports (CSR Directive Implementation Law) (Gesetz zur Stärkung der nicht-...)

¹ The common European enforcement priorities along with detailed explanations can be downloaded from the ESMA website.
3.3 Discussions with audit firms

Each year, the FREP holds discussions with the management boards or managing directors of the five largest German audit firms aimed at providing insight on the FREP’s activities using specific cases. In 2017, discussion topics included errors identified in the most recent round of examinations and issues noted in the financial reports of companies audited by the relevant audit firm.

Once a year, the FREP also holds a discussion with representatives of medium-sized audit firms auditing publicly listed companies via the platform of the IDW. This sharing of experiences is intended to make the FREP’s approach transparent to auditors in order to raise the auditors’ awareness of potential problem areas. In January 2017, the FREP gave a speech at this event discussing the enforcement priorities for 2017 in order to make auditors aware of the associated sources of errors.

3.4 Public relations activities

In 2017, the FREP once again used its general public relations activities to provide insight into its activities as well as into technical topics specific to financial reporting. The president, vice president, and managing director as well as the FREP’s members gave presentations and participated in discussions at nearly 25 technical conferences. These events were primarily aimed at company representatives and auditors. The speeches dealt mainly with national and European developments in enforcement. Topics of speeches and discussions also included financial reporting issues prone to error, such as impairment testing. In addition, as in prior years, the panel’s Presidential Board delivered a speech on the enforcement priorities issued for the following year at the annual “Financial Statement Oversight” conference of Deutsches Aktieninstitut in November 2017.

Furthermore, publications and technical articles on topics such as the enforcement priorities for 2017 and the impact of political crises on financial reporting were published in 2017.
4 Developments in Europe

4.1 European Enforcers Coordination Sessions and working groups

Attending the meetings of the EECS remained a key component of the FREP’s international cooperation in 2017. The EECS represents a forum for national enforcers and ESMA to discuss IFRS application issues of transnational interest that meets approximately nine times per year.

In 2017, the FREP presented, on an anonymous basis, issues in the EECS meetings 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. ESMA makes extracts containing selected decisions of national enforcers discussed at the EECS meetings available to the public. A total of 235 decisions by national enforcers have been published in 21 extracts since 2007; for legal reasons, cases from Germany are not included.

In addition to attending EECS meetings, representatives of the FREP participated in ESMA’s “Financial Disclosure”, “IFRS 13 Fair Value Measurement”, and “Financial Instruments” working groups during the year. Furthermore, ESMA has had a working group on IAS 12 Income Taxes since 2016 that is coordinated by a representative of the FREP. One member of the FREP is also a member of the “Sub-group of EECS on U.S. GAAP”, which is tasked with dealing with issues arising in connection with examinations of U.S. GAAP financial statements.

The results of the “IFRS 13 Fair Value Measurement” working group were communicated to the IASB and published on 11 September 2017.

The FREP also contributed its experience to the working group on the “ESMA Guidelines on Alternative Performance Measures (APMs)".
4.2 Consultation on the European Supervisory Authorities

The European Commission held a public consultation on the operations of the three European supervisory authorities EBA, EIOPA, and ESMA from 21 March to 16 May 2017. The consultation document contained questions and suggestions aimed at improving the effectiveness and efficiency of the operations of the supervisory authorities going forward.

Two of the total of 32 questions in the consultation document dealt with financial reporting. One of the questions primarily asked whether enforcement and supervisory convergence with respect to financial reporting need to be strengthened.

A total of 227 organizations - mainly public, but also some private - from 26 EU member states participated in the consultation, including 40 from Germany.

The outcome of the consultation was made available to the public in a feedback statement dated 20 June 2017.²

Results relating to the FREP were as follows:

- The large majority of participants do not consider it necessary to strengthen enforcement with respect to financial reporting; only a few participants perceive opportunities for further harmonization
- Enforcement should remain a national responsibility

It can be concluded, then, that consultation participants do not consider significant changes in enforcement necessary.

Following completion of the consultation, the Commission issued a proposed revision to the ESMA regulation on 20 September 2017. In the FREP’s view, this proposal does not result in significant changes with respect to the enforcement of financial reporting.

² The feedback statement can be downloaded from the website of the European Commission.
4.3 Results of the ESMA Peer Review regarding compliance with the “ESMA Guidelines on enforcement of financial information”

ESMA issues guidelines in order to establish consistent, efficient, and effective supervisory practices within Europe and to ensure the common and uniform application of Union law (see Art. 16 of the ESMA regulation). The competent national enforcement institutions and financial market participants are obliged to make every effort to comply with those guidelines.

In late 2016, ESMA started its first peer review regarding compliance with the “Guidelines on enforcement of financial information” by European enforcers and issued a final report on 18 July 2017. The review focused on compliance with the following Guidelines:

- Guideline 2: Sufficient human and financial resources/technical expertise (professional skill and experience)
- Guideline 5: Selection methods
- Guideline 6: Examination procedures

Enforcement institutions in a total of 29 states (27 EU member states and 2 EFTA states) completed a self-assessment questionnaire developed by ESMA for this Peer Review, followed by additional on-site visits to enforcement institutions in seven states including Germany.

In connection with the on-site visit, the FREP realized that it needs to be able to provide ESMA with company-specific examination files despite the general requirement to maintain confidentiality. This resulted in the issue being subsequently clarified in the 2nd FiMaNoG, dated 23 June 2017, which codified the FREP’s obligation – similar to that of the BaFin – to promptly provide ESMA with any and all information and documents required for the performance of its duties.

Regarding the issues investigated in the Peer Review, ESMA’s final report concludes that national enforcers comply with the principles-based guidelines in varying manners and degrees.³

³ The final report can be downloaded from the ESMA website.
ESMA has not found any infringements of the Guidelines on enforcement by the FREP and has included in its final report the following statements regarding enforcement in Germany:

- The FREP has highly experienced examiners and sufficient resources
- Its principles for sampling companies for examination are a good example of how an appropriate selection can be made; other European enforcers could learn from these principles (good practice)
- The quality of examinations performed is considered high
- The outcomes of the examinations could be more informative for investors

As part of the Peer Review, ESMA also identified a total of 21 good practices. The majority of these good practices is already implemented in the FREP’s operations or is applied using alternative means. Especially the following good practices reflect the FREP’s actual practice:

- In-process quality review of examinations performed
- Contacting each company examined (i.e. more than just a desktop review) and sending a questionnaire even if no indication of erroneous financial reports has been encountered
- Performing examinations on site (where necessary)
- Defining an IPO as an abstract risk for purposes of selecting companies for examination

Within the limits of the law and the FREP’s charter, the FREP will implement the recommendations ESMA made specifically on the work of the FREP to the extent the benefits of doing so are considered to exceed the related costs. Overall, the FREP viewed the Peer Review as a highly professional and constructive ESMA measure for improving enforcement practice. ESMA will now work with the national enforcers to see whether enforcement in Europe can be converged further by amendments to the Guidelines or by other work in this area.\(^4\)

5 Acknowledgements and outlook

The FREP was able to continue its work successfully in 2017 and would like to thank the companies examined and their auditors for their willingness to cooperate and for 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, at the BMF, and in particular the BaFin, the ASCG, the audit firms, the IDW, and the APAS. Special thanks go to the vice president, managing director, panel members, and office staff for their consistently excellent work.

Under the heading “The FREP’s Significance to Audit Committees”, an event aimed at sharing experiences with the audit committee chairs of DAX30, MDAX, and SDAX companies was held in cooperation with the Schmalenbach-Gesellschaft für Betriebswirtschaft e. V. on 12 January 2018.

In addition to the discussions with the representatives of the five largest German audit firms held each year, the FREP also plans to start holding discussions with the management boards or managing directors of medium-sized audit firms in 2018. The representatives of the six audit firms with the next highest section 319a HGB revenues from financial statement audit services will be invited to a discussion with the FREP’s leadership on a rotating basis about once every three years.

The FREP will continue to fulfill its error prevention role in 2018 in order to improve the quality of financial reporting for the long term.

In the European context, the FREP, together with the BaFin, will continue to work closely with the European enforcers in 2018.

Professor Dr. Edgar Ernst
(President of the Enforcement Panel)
List of abbreviations

APAReG  German Audit Oversight Reform Act (Abschlussprüferaufsichtsreformgesetz)

APAS  German Audit Oversight Body (Abschlussprüferaufsichtsstelle)

ASCG  Accounting Standards Committee of Germany (Deutsches Rechnungslegungs Standards Committee e. V.), Berlin, Germany

BaFin  Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht), Bonn / Frankfurt/Main, Germany

BMF  Federal Ministry of Finance (Bundesministerium der Finanzen), Berlin, Germany

BMJV  Federal Ministry for Justice and Consumer Protection (Bundesministerium der Justiz und für Verbraucherschutz), Berlin, Germany

EBA  European Banking Authority, London, England

EECS  European Enforcers Coordination Sessions

EFTA  European Free Trade Association

EIOPA  European Insurance and Occupational Pensions Authority, Frankfurt/Main, Germany

ESMA  European Securities and Markets Authority, Paris, France

EU  European Union

FREP  Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung DPR e. V.), Berlin, Germany

GAS  German Accounting Standard

HGB  German Commercial Code (Handelsgesetzbuch)

IAS  International Accounting Standard

IDW  Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer e. V.), Duesseldorf, Germany

IFRS  International Financial Reporting Standard

U.S. GAAP  United States Generally Accepted Accounting Principles

WPO  German Public Accountant Act (Wirtschaftsprüferordnung)

2nd FiMaNoG  Second Financial Market Amendment Act Resulting from European Legal Instruments (Zweites Gesetz zur Novellierung von Finanzmarktvorschriften auf Grund europäischer Rechtsakte)