Information on the examination process of the Financial Reporting Enforcement Panel (FREP)

This information is designed to explain the enforcement examination process and the principles behind it to companies subject to enforcement and to individuals involved with the examination procedure. Please also refer to the information the FREP has made available on its website, including the FREP’s Code of Procedures and Principles for Random Sampling (in German only).

1. Legal basis

The Financial Reporting Compliance Act ["Bilanzkontrollgesetz"] dated 15 December 2004 introduced a two-tier enforcement regime in order to enforce compliance with the relevant financial reporting standards.

The activities of the Financial Reporting Enforcement Panel ("FREP" or "the Panel"), an institution organized under private law and recognized by the Federal Ministry of Justice and Consumer Protection in agreement with the Federal Ministry of Finance (sections 342b to 342e German Commercial Code ["Handelsgesetzbuch" - HGB] represent the first tier. At the second tier, the Federal Financial Supervisory Authority ["Bundesanstalt für Finanzdienstleistungsaufsicht" – BaFin] steps in (sections 106 to 111 Securities Trading Act ["Wertpapierhandelsgesetz" – WpHG] to determine whether an error has occurred if the FREP’s opinion differs from the company’s, to order the publication of identified errors, and to perform an examination using sovereign means if a company is not willing to cooperate with the FREP in the examination.

Companies subject to the enforcement process are publicly listed companies who, being issuers of securities as defined in section 2 (1) WpHG that are admitted to trading, have Germany as their home country (section 342b (2)) sentence 2 HGB).

The task of the Panel and/or the BaFin is to examine whether the most recently approved separate financial statements and the related management report, the most recently approved consolidated financial statements and related group management report, the most recently issued condensed financial statements and related interim management report, and the most recently issued payment reports or consolidated payment reports
(further referred to as “financial reports”), including the underlying bookkeeping, comply with legal requirements, including German generally accepted accounting principles and other financial reporting standards permitted by law (section 342b (2) sentence 1 HGB).

If the examination finds the financial report to be erroneous, the company must publish the errors identified and the reasoning in the Federal Gazette and in a multi-regional financial newspaper if ordered to do so by the BaFin.

2. Initiation of an examination

The Panel initiates an examination

1. if there are specific indications of an infringement of financial reporting requirements (indication-based examination),
2. at the request of the BaFin, if it has such indications (request-based examination),
   or
3. without any specific indication based on random sampling (unlimited scope examination).

No. 1 and No. 2 (further referred to as “focused examinations”) may also be applied to financial statements and reports covering the financial year prior to the financial year referred to in section 342b (2)) sentence 1 HGB (section 342b (2a) HGB). No. 3 cannot be applied to either examinations of condensed financial statements and the related interim management report or the payment report and consolidated payment report (section 342b (2) sentence 4, 2nd half-sentence HGB).

An indication-based examination is not initiated if such examination is clearly not in the public interest.

An enforcement examination is not performed while an action to declare the financial report null and void under section 256 German Stock Corporation Law [“Aktiengesetz” – AktG] is pending or if a special auditor has been appointed in accordance with section 142 (1) or section 258 (1) AktG, provided that the subject of the special audit, the audit report, or a court decision on the special auditor’s final findings in accordance with section 260 AktG are sufficient (= hindrance reasons).
In addition, the Panel only performs an examination if the company under examination is willing to cooperate with the Panel in the examination. If the company declares its willingness to cooperate, the legal representatives of the company and the other individuals they have designated as contact persons must provide accurate and complete information and documents.

If the company refuses to cooperate or does not declare its willingness to cooperate within a reasonable period, the Panel notifies the BaFin of such refusal. The BaFin then orders an examination at the second tier of enforcement at its discretion.

3. The company's cooperation in the examination

The Panel contacts the legal representatives of the company under examination, usually the management board. A sufficient number of legal representatives to legally represent the company must declare whether they are willing to cooperate with the Panel in the examination. In addition, they have to designate other individuals as contact persons to whom the Panel can address its questions and requests in performing the examination.

The company’s financial statement auditor may also be designated a further contact person. Involving the financial statement auditor in the examination is desirable to facilitate the efficient and appropriate performance of the examination, and is generally in the interest of both the company and the auditor. If the financial statement auditor is designated a contact person, the company has to release the auditor from his obligation of professional secrecy vis-à-vis the Panel. A further reason the involvement of the auditor is appropriate is that he is unconditionally required to provide information to the BaFin at the second tier of enforcement, and the first tier examination should have access to the same sources of information as the one at the second tier.

4. Initial documents

When initiating the examination, the Panel requests the approved separate financial statements and the approved consolidated financial statements (preferably in the form of the annual report) together with the related management reports, as well as the audit reports issued by the auditor. The Panel also requests the auditor’s list of unadjusted audit differences as well as a statement from the legal representatives that they believe the effect of the unadjusted audit differences in the separate or consolidated financial statements and
of the uncorrected disclosures in the management reports, individually and in total, to be immaterial. The semi-annual financial report and the interim management report are requested for focused examinations of condensed financial statements; for focused examinations of (consolidated) payment reports, the Panel requests the report subject to the examination.

5. Examination process

Once the company has declared its willingness to cooperate with the Panel in the examination, the responsible Panel chamber, as determined using the Panel’s allocation system and consisting of the president, vice president and one additional Panel member, will name the responsible Panel member and the quality control Panel member. The responsible Panel member and the quality control Panel member, who collaborates with the responsible Panel member, are also full-time Panel members.

The FREP ensures that the personnel involved in a specific FREP examination are independent of the company and its financial statement auditor in order to perform the examination in an impartial and unbiased manner. All individuals must maintain strict confidentiality.

The responsible Panel member contacts the company. He sets the areas to be examined based on the documents requested as part of the request for the company’s cooperation and handles any additional correspondence and discussions with and examination procedures relating to the company.

The Panel corresponds with the company in writing, either by mail or fax. The company may also communicate with the Panel using electronic means; however, it alone bears the risks involved in sending emails. However, any binding declarations by the company have to be made in writing, as well.

In certain cases, it may be useful to have a discussion on challenging accounting issues directly with the company and the financial statement auditor or to review extensive documentation at the company’s location. The responsible Panel member will coordinate this with the company.
6. Scope of the examination

The scope of a focused examination is limited to the issues for which indications of infringements in the financial report were identified. However, the Panel is free to expand the scope of the examination if other infringements of financial reporting standards are identified during the examination.

In an unlimited scope examination, the Panel selects areas to be examined, usually based on its review of the financial statements, audit reports, and documents requested. These areas focus on critical accounting issues or financial statement line items which may give rise to concerns regarding the appropriateness of the financial statements. Hence, the scope of the Panel’s examination is limited in these types of examinations, as well.

7. Examination results

At the end of his examination, the responsible Panel member and the quality control Panel member report to the responsible chamber, which then determines whether the financial report is erroneous.

If the chamber determines that the financial report is not erroneous, the Panel reports this to the company and the BaFin.

If the Panel finds that the financial report is erroneous, it asks the company whether it concurs with the presentation of the facts, the error and its reasoning. If the company concurs, the BaFin is notified and orders the publication of the error unless publication is not in the public interest or, in rare cases, the company’s interests outweigh the reasons in favor of such publication.

If the company does not concur with part or all of the finding of an error, the BaFin initiates an enforcement examination at the second tier and subsequently either confirms or dismisses the results of the Panel’s examination. The BaFin will then order the publication of the error where appropriate.
8. Time and cost expended on the examination

The Panel is interested in an efficient and smooth enforcement examination; this likely also applies to the company and all individuals involved. To this end, the Panel sets adequate but short deadlines for responding to its questions and submitting requested documentation.

An unnecessary delay in providing responses or requested documents will be viewed by the Panel as a discontinuation of the company’s cooperation and the enforcement case will be referred to the BaFin.

As the examination focuses on selected critical issues and financial reporting questions, the issues have in all likelihood already been dealt with in the preparation and audit of the financial statements. Therefore, if proper documentation was prepared, providing the information and documents requested by the Panel requires minimal time and cost to be expended.

As the FREP’s expenses are allocated across all companies subject to the enforcement regime, the company does not incur any additional costs in this regard. Any costs incurred in connection with an examination at the second tier of enforcement, however, are borne by the company, if the BaFin confirms the result of the FREP’s examination.

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