Principles for unlimited scope examinations in accordance with section 342b (2) sentence 3 no. 3 HGB (German Commercial Code)

– As resolved by the Enforcement Panel and approved by the Federal Ministry of Justice and Consumer Protection and the Federal Ministry of Finance on November 15th, 2018 –

- unofficial text -
1. Background

In accordance with section 342b (2) sentence 3 no. 3 HGB, the FREP must examine a sample of consolidated and stand-alone financial statements and the related management reports of publicly listed companies as defined in section 342b (2) sentence 2 HGB (unlimited scope examination). The sampling principles described below are based on the Guidelines on Enforcement of Financial Information issued by ESMA (The European Securities and Markets Authority). These guidelines stipulate that the selection model should be based on a mixed model whereby a risk based approach is combined with a sampling and/or a rotation approach. The risk based approach should consider the risk of a misstatement (i.e. the probability of an infringement of financial reporting requirements) as well as the impact of a misstatement on the financial markets.

The selection model chosen by the FREP for its unlimited scope examinations is based on such a combined methodology and reflects the dual approach in place in Germany, which consists of both indication-based and unlimited scope examinations, and the objective of performing an examination on all publicly listed companies within a certain period (full coverage, rotation approach).

Indication-based examinations in accordance with section 342b (2) sentence 3 no. 1 HGB and examinations conducted at the request of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin – Federal Financial Supervisory Authority) in accordance with section 342b (2) sentence 3 no. 2 HGB take precedence over unlimited scope examinations. As such, unlimited scope examinations are only performed to the extent that the FREP’s capacity is not utilized by indication-based examinations and examinations performed at the request of the BaFin.

2. Sampling process for unlimited scope examinations in accordance with section 342b (2) sentence 3 no. 3 HGB

Sampling is performed using a two-step system that combines risk based selection with stratified random sampling. Unlimited scope examinations are only performed on companies not already requiring initiation of an indication-based examination. Cost-benefit considerations and the extent of public interest may also be considered when determining the details of the actual sampling process.

a) Risk based selection (selection step 1)

If there is a concrete indication of an error rather than merely an abstract risk and it is in the public interest, the FREP immediately initiates an indication-based examination. Thus, 100% of these companies are subjected to an examination on a timely basis.

Based on published information about or issued by publicly listed companies or other indications of circumstances entailing risk, such as abstract risks identified based on the
common European enforcement priorities, an initial public offering, unusual transactions (business combination or disposal of a business, transactions with related parties) and discretionary financial measures, the company’s economic position, issues noted in past enforcement examinations, etc., the FREP will aggregate companies subject to such risks into a separate group. To the extent this is in the public interest, this risk group also includes companies where, based on the company’s financial reports, indications of an infringement are not sufficiently concrete to initiate an indication-based examination, but are also not obviously inaccurate. The risk group is selected from the population of all companies subject to enforcement by the FREP.

A random sample of 40% is selected from this risk group once a year.

b) Stratified sampling (selection step 2)

The stratified sampling procedure is applied to all companies subject to enforcement that have not already been selected in the risk based selection procedure. Any company selected from the risk group is removed from the population for stratified sampling for the duration of the examination cycle. If new risk factors come to the attention of the FREP, the company becomes subject to risk based selection again.

The sample is stratified as follows:

- Companies included in the DAX, MDAX, and SDAX: Examination within each 4 to 5 year cycle
- Other companies: Examination within each 8 to 10 year cycle.

Stratifying the sample in this manner reflects the impact of a misstatement in the financial report on market confidence or investor protection.

The stratified sampling procedure covers all companies within a stratum (except for companies already selected in selection step 1 (risk based selection)), thus ensuring that all of them are equally likely of being selected for examination. The objective here is to perform an examination on all companies within a certain period (full coverage, rotation approach). In addition, the companies selected in selection steps 1 and 2 are removed from the total population of the relevant stratum and an examination is performed on all companies remaining in that stratum in the final year. If new risk factors relating to a selected company come to the attention of the FREP, the company is returned to the risk group referred to in a) above.

The sample of companies to be examined during a calendar year is normally selected at the end of the preceding year. Additional samples may be drawn to optimize utilization of the FREP’s capacity.
The sample drawn for any particular planning period under the random sampling procedure includes 20% more companies than the FREP has capacity to examine. This approach is necessary because, despite their selection, no examination is initiated during the subsequent calendar year for the following companies:

- Companies no longer subject to the German enforcement regime at the time initiation of the examination is planned
- Companies in the process of being wound up (i.e. primarily companies in bankruptcy). These companies are “returned” to the population for the subsequent sample selection procedure
- Companies whose examination is “carried forward” to the calendar year following the planning period, for instance because an examination performed by the FREP or the BaFin is still in progress when the sample is selected.

Instances of “returning” or “carrying forward” have to be documented, including the underlying reasoning.

c) Additional selection (selection step 3)

A third step covers all companies not selected in steps 1 and 2 that year. A random sample of 10 companies is selected from this group each year. 3 of these companies are selected in a manner that prevents an excessive enforcement burden on any one company. This step ensures that any company may be selected for examination at any time.

3. Selection of companies subject to unlimited scope examinations

In accordance with sections 3 (1) no. 4 and 17 (1) sentence 2 of the code of procedures of the enforcement panel, the FREP’s Sampling Committee is responsible for determining the total population of companies subject to enforcement by the FREP, designing the actual selection process, selecting companies for examination and, where applicable, setting periodic focus areas, including industry-specific ones.

4. Planning

The FREP plans its unlimited scope examinations on an annual basis. Any unlimited scope examinations selected but not initiated by year-end due to the FREP’s workload (resulting for instance from indication-based examinations) or an unexpectedly high amount of time required for selected unlimited scope examinations are carried forward to the following year. The Sampling Committee has to appropriately take into account such carryforwards in planning for the following year.