FREP Presidential Board Berlin, 18 January 2012

Annual Activity Report 2011

1. Overview

- In 2011, the FREP completed 110 examinations (prior year: 118), including 90 sampling examinations and 20 examinations that were indication- or request-based. At 25%, the rate of financial statements found to be erroneous was similar to last year's rate (26%).
- A normalized error rate was determined in order to facilitate a more refined presentation. This rate reflects adjustments for duplicate errors as well as for examinations confirming known errors. The normalized error rate amounts to 19% for 2011 (prior year: 25%).
- The main causes of the high error rate were insufficient disclosures in the management report and the notes, primarily with respect to the potential impact of the financial and economic crisis on the situation of the company, as well as the range and challenging application of certain IFRS.
- Based on experience gathered in over 700 examinations and in order to strengthen its preventative function, the FREP participated in the IASB's Agenda Consultation 2011, addressing selected IFRS issues and making recommendations for improvement. The objective was to assist in improving not only the application of IFRS by preparers but also the enforceability for enforcers.
- The FREP added another preventative tool by beginning to hold discussions with audit firms during the fourth quarter. These discussions are intended to help prevent future errors by providing a means of analyzing to what extent errors found by the FREP in the past can be avoided in future.
- The costs of the two-tier enforcement process were budgeted at EUR 7.8 million for 2011, including EUR 6.0 million designated for the FREP. With actual costs of EUR 5.2 million, the FREP came in EUR 0.8 million under budget and slightly below the prior year figure (EUR 5.3 million). As in the prior year, the FREP had to perform very extensive and complex examinations particularly of large financial institutions, where it engaged extensive external audit capacity and commissioned expert opinions.

2. Examinations in 2011

2.1 Completed examinations

In 2011, the FREP completed a total of 110 examinations (prior year: 118, see Figure 1), including 90 sampling examinations (prior year: 106), meeting its target under its policy for sampling examinations, which requires an examination every four to five years of all companies included in a stock index, and every eight to ten 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 30% (from 1,249 to 873 entities) during the period from 1 July 2005 – the date the FREP started operations – and 1 July 2011.

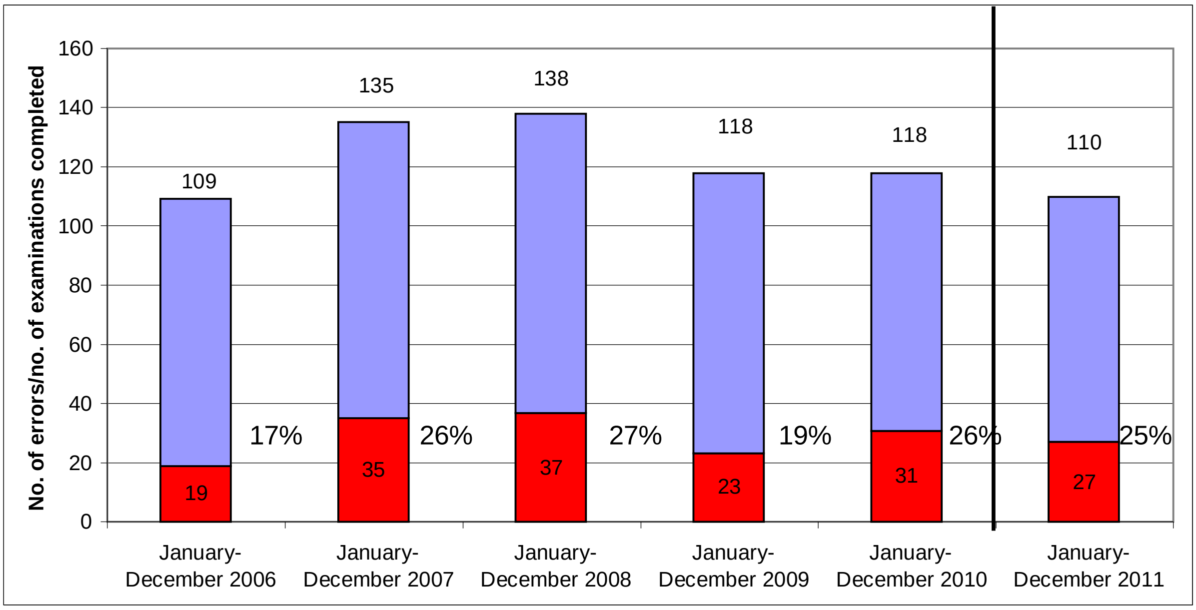

Figure 1: Completed FREP examinations, error rate trend

In addition to the sampling examinations, the FREP completed six indication-based examinations, including five examinations of semi-annual financial reports. Furthermore, 14 examinations were conducted at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – German Federal Financial Supervisory Authority), including four of semi-annual financial reports (see Figure 2).

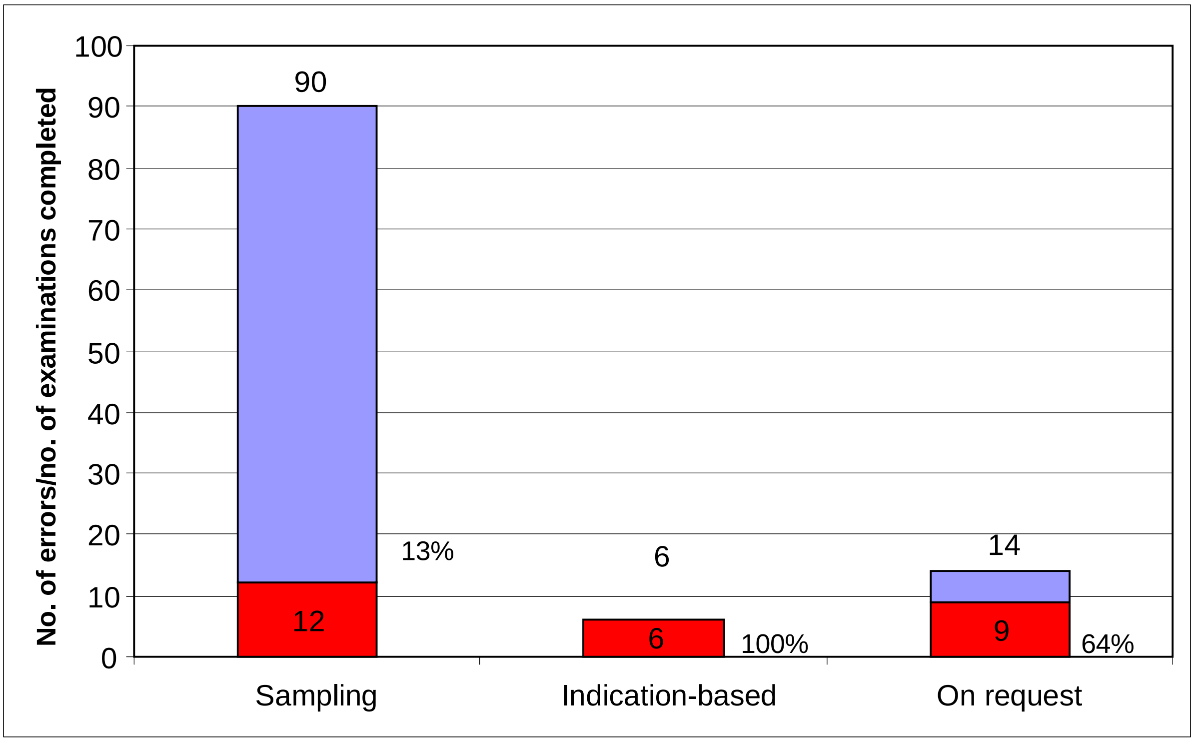

Figure 2: Completed FREP examinations by type of examination and error rate

2.2 Examination results

At 25% (prior year: 26%), the total error rate has stabilized at the average level of the past four years (see Figure 1).

As expected, the error rates found in indication- and request-based examinations completed in 2011 were high at 100% and 64%, respectively. The error rate for sampling examinations was 13%, representing a considerable decrease from the prior year (error rate 22%, see Figure 2).

When analyzed by company size (see Figure 3), the picture has changed from the prior year: Last year, the error rate for large companies, i.e. those included in a stock index, was comparable to that for small and medium-sized companies not included in an index. This has changed for the examinations completed in 2011. In 43 examinations of companies included in an index, the FREP found a total of six financial statements to be erroneous (error rate 14%). A significantly higher error rate of 31% was observed for small and medium-sized companies not included in an index, where 21 cases of erroneous financial statements were found in a total of 67 completed examinations.

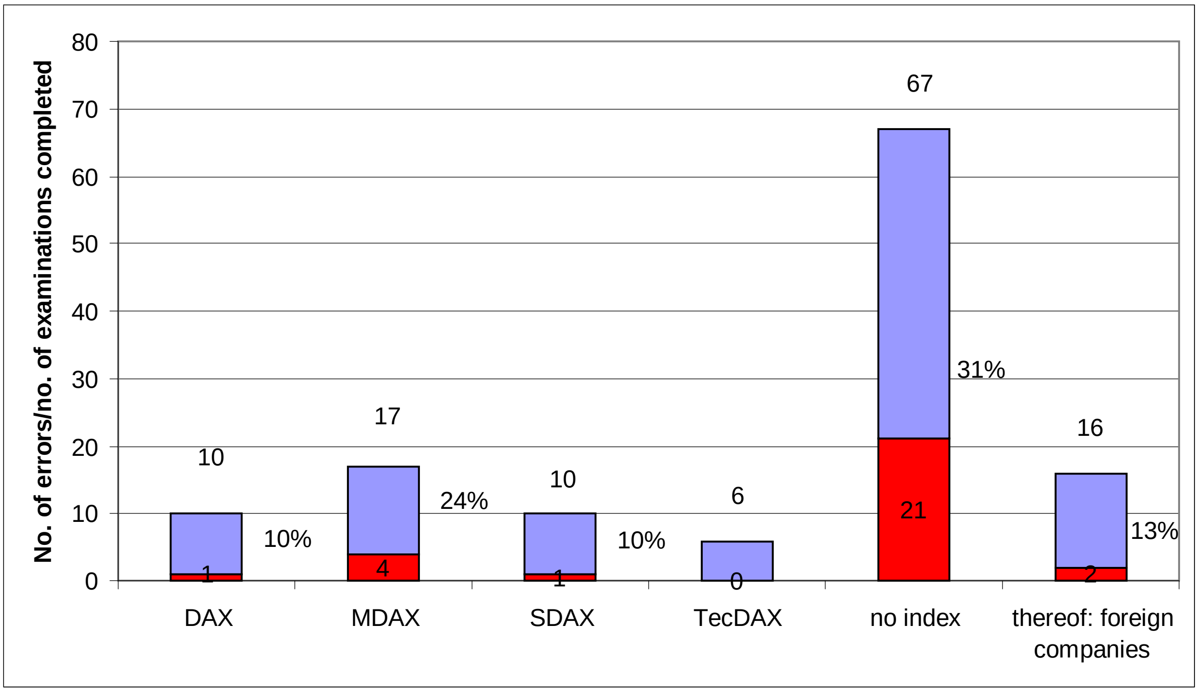

Figure 3: Completed FREP examinations by stock index, error rate

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 elimination of duplicate errors refers to examinations where the same error was found in several examinations for several reporting dates for the same company.

The same applies to examinations confirming known errors. These eliminations include primarily examinations that provide subsequent confirmation of a result the company had already previously disclosed to the public, as well as examinations where the errors found had already been referred to by the auditors in a qualified audit opinion or a disclaimer.

The normalized error rate was 19% in 2011; the results of normalizing the prior years' rates are shown in Figure 4:

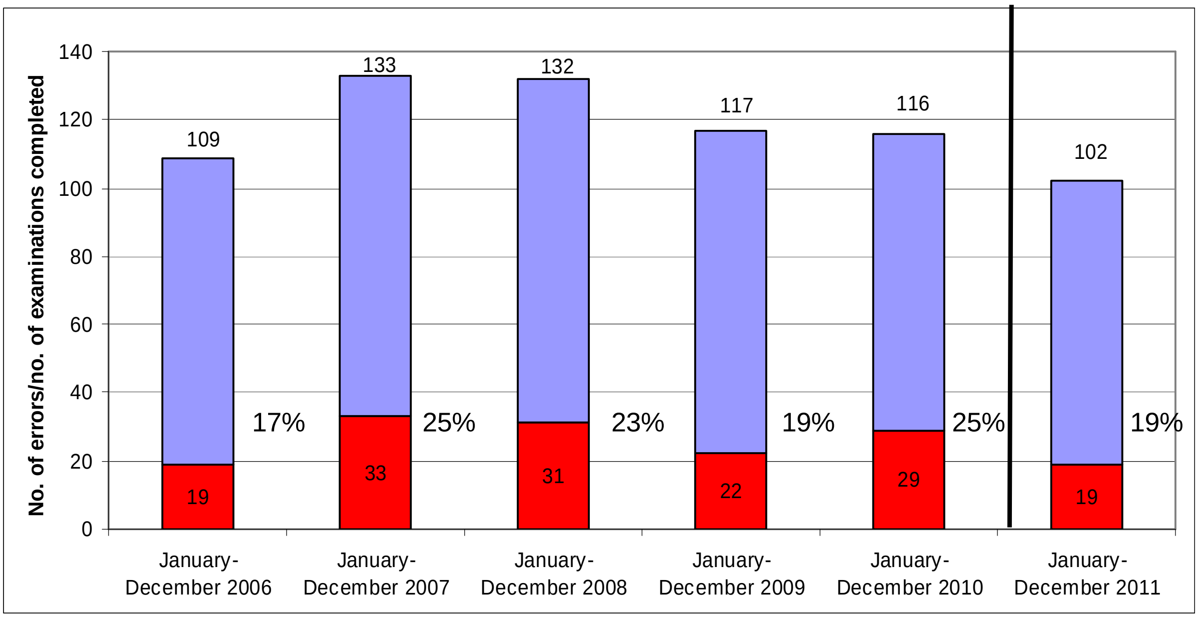

Figure 4: Completed FREP examinations, error rate trend (normalized)

When the FREP finds a set of financial statements to be erroneous, it asks the companies involved whether they accept this finding. This official inquiry is normally preceded by a very thorough discussion with the company. The FREP believes that it is important to give the companies and their auditors the opportunity to present their views and arguments and to enter into open discussions. At 81%, the percentage of companies that accept the FREP's findings of an error remains high (see Figure 5). The FREP sees this as important evidence of the quality of its work.

2007	2008	2009	2010	2011
80	82	78	72	81

Figure 5: Trend in error acceptance rate

The FREP refers all cases in which it has found errors to the BaFin, regardless of whether the companies have accepted the findings. Where findings are not accepted, the BaFin performs its own additional examination. The BaFin completed a total of five such cases in 2011. The FREP's result was confirmed in four cases and the error was made public; in one case the error was not made public, since disclosure of the error was no longer in the public interest as the company concerned had delisted. In the remaining cases the companies had already agreed with the FREP's finding of an error.

2.3 Types of errors and analysis of errors

The 27 financial statements found to be erroneous include an average of two to three infringements per company. It should be noted that, as a result of a decision of the *Oberlandesgericht* (Higher Regional Court) Frankfurt/Main, the FREP is obliged to also include as errors in the result of the examination any infringements that are individually immaterial to the financial statements examined if the examination finds the financial statements to be erroneous.

As in prior years, frequently recurring errors have been assigned to certain error categories. Figure 6 shows a ranking of the most frequently identified errors.

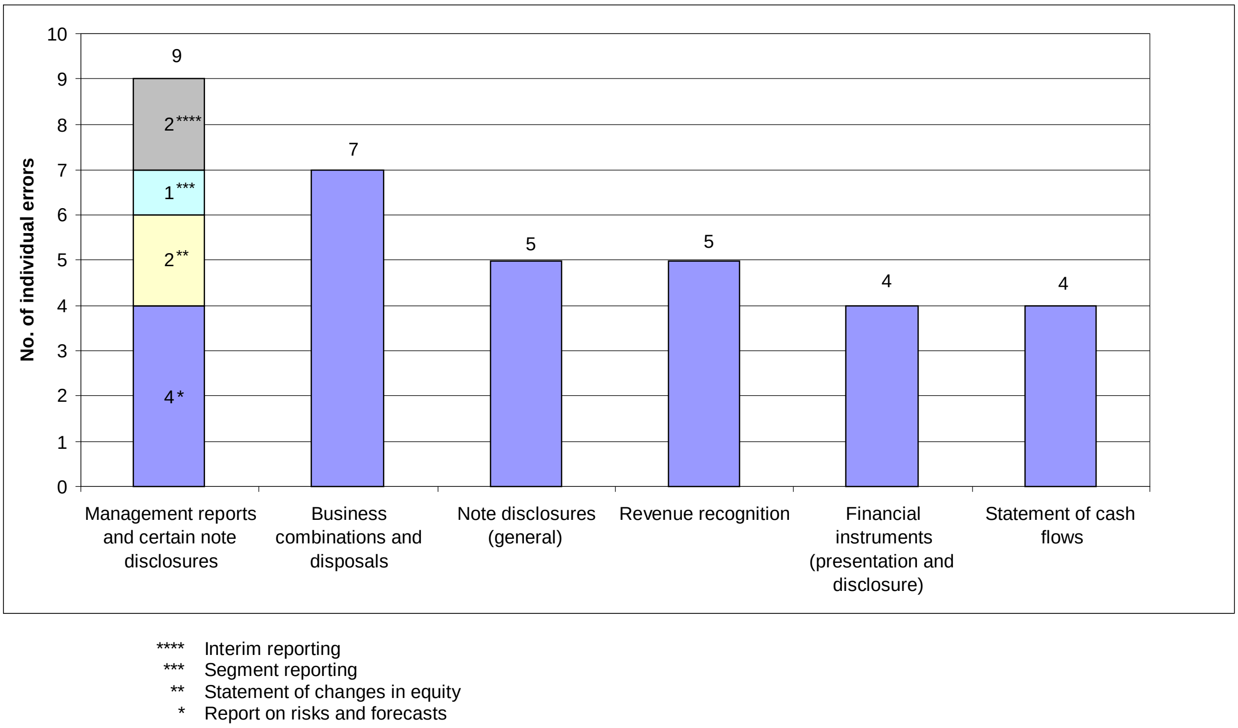

Figure 6: Most common types of errors

The FREP has identified two main causes of errors in 2011:

- Insufficient reporting in the management report and in the notes, primarily on the potential impact of the financial and economic crisis on the situation of the company
- Range and challenging application of certain IFRS

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. For instance, a total of four infringements were found where companies had a) reported on objectively existing opportunities and risks either inadequately or not at all and/or b) only provided insufficient disclosures about the company's future development. Further errors relate to deficiencies in the interim management report, statement of changes in equity and segment reporting.

Errors arising from the range and challenging application and interpretation of certain IFRS were found mainly in the accounting treatment of business combinations with seven individual errors (prior year: 16 individual errors), with infringements occurring in the areas of goodwill impairment testing (six individual errors) and purchase price allocation (one individual error).

Accounting for financial instruments is another area characterized by challenging application and is thus prone to errors on the part of preparers. A total of four infringements were found here, primarily concerning the numerous disclosures required in the notes to the (consolidated) financial statements as well as valuation issues.

In 2011, the FREP has again found an increasing number of errors in revenue recognition: Five infringements were identified in this area. These errors consisted of both incorrect recognition of revenue that did not meet the relevant criteria, for instance improper recognition of contingent receivables, and incorrect measurement of revenue recognized, for example due to the use of incorrect calculation methods for allocating revenue among periods. In addition, the FREP criticized the treatment of transactions with shareholders as income.

Finally, the FREP identified weaknesses in the preparation of the statement of cash flows: A total of four individual errors were found in this area, primarily relating to incorrect classification of certain cash flows into cash flow categories.

3. Error prevention

3.1 Recommendations to standard setters

With over 700 examinations completed, the FREP has extensive experience regarding the application of IFRS by publicly listed companies. In these examinations, it has repeatedly encountered issues whose presentation in the financial statements does not meet the objective of providing transparent, user-oriented information to the capital markets. One cause of this is the lack of enforceability of various standards. This applies mainly to requirements for the recognition of assets or liabilities that, instead of being based on objectively verifiable information, primarily rely on subjective valuation models. Specific examples are the valuation of investment property accounted for at fair value (IAS 40), capitalization of development costs (IAS 38), purchase price allocation (IFRS 3, IAS 38), recognition of goodwill (IAS 36), accounting for a bargain purchase (IFRS 3), and segment reporting (IFRS 8). The FREP is criticizing the lack of enforceability of these standards, when enforceability is supposed to be a significant quality the IFRS Foundation requires of the standards developed by the IASB.

Seeing these weaknesses and with the clear objective of improving the information provided to the capital markets, the FREP decided to issue its own comment letter for the IASB's Agenda Consultation 2011. The recommendations made by the FREP on solutions to application problems are not aimed at new issues or topics, but instead address weaknesses in existing standards which, in the FREP's opinion, need to be revised.

If this leads to accounting being characterized by less subjective assumptions, a sustained drop in the rate of errors made by preparers will likely result.

3.2 Discussions with audit firms

During the fourth quarter, the FREP's Presidential Board held discussions with the chairs of the management boards or managing directors of the five largest German audit firms. These discussions serve primarily as an opportunity to share experiences regarding the errors the FREP has found in financial statements of the audit firms' clients despite an unqualified audit opinion having been issued.

The first round of these discussions showed that both the audit firms and the FREP benefit from this sharing of experiences. The FREP's objective is to raise the audit firms' awareness of avoidable errors in order to largely prevent such future errors wherever possible. The

FREP receives useful recommendations from the audit firms, which it takes into account in its examination procedures.

In view of the clear benefits for both sides, there are plans to repeat these discussions at regular intervals. In addition, the FREP plans to cooperate with the *Institut der Wirtschaftsprüfer* (IDW – Institute of Public Auditors in Germany) in offering a similar discussion platform to all medium sized audit firms auditing publicly listed companies.

3.3 Main focus areas for 2012

Before the beginning of a new calendar year, the FREP defines the main focus areas for the coming year, which will be addressed in all of its sampling examinations if the issue is relevant to the company under examination, unless it is immaterial. The main focus areas are primarily selected based on the FREP's experience with standards and/or accounting issues that are frequently applied/treated incorrectly; reference to current economic developments that may impact accounting and reporting; and selected recently issued new standards. In addition to the well known accounting issues that have proven to be particularly prone to error recently, in 2012, the FREP will also focus its examinations on valuation and reporting issues related to the sovereign debt crisis. The following main focus areas were defined in October 2011:

1. Accounting for financial instruments affected by the sovereign debt crisis – IAS 39, IFRS 7, section 315 (1) HGB (German Commercial Code)
    - Reasonableness of determination of fair value, in particular the assessment as to whether an active market exists
    - Transparent and appropriate disclosures in (consolidated) notes and (group) management report
    - Supporting documentation
2. Report on opportunities and risks in (group) management report – sections 289 (1) sentence 4, 315 (1) sentence 5 HGB
    - Impact of agreed upon financial covenants (GAS 5.10 and GAS 15.62)
    - Complete and accurate presentation of significant risks in accordance with GAS 5.10
    - Quantification of risks in accordance with GAS 5.20
    - Presentation of significant factors impacting future development (GAS 15.83 et seq.)

3. Impairments of assets including goodwill – IAS 36
   - Reasonableness of valuation assumptions made in determining recoverable amount including discount rate (IAS 36.25 et seq. and IAS 36.30 et seq.), allocation (identification) of cash-generating units (IAS 36.80) and supporting documentation
   - Discussion of key assumptions in accordance with IAS 36.134d and 134e and disclosures on sensitivities in accordance with IAS 36.134f

4. Business combinations – IFRS 3, IAS 27
   - Evidence that the acquiree constitutes a business as discussed in IFRS 3.3, IFRS 3 Appendix A
   - Purchase price allocation, e.g.
     - Identification and measurement of operating leases and intangible assets (IFRS 3 Appendix B28-B40)
     - Note disclosures required by IFRS 3 Appendix B64-B66
   - Bargain purchases (IFRS 3.34-36)
   - Contingent consideration and subsequent adjustments to the purchase price (IFRS 3.58)
   - Business combination achieved in stages (IFRS 3.41 et seq.)
   - Loss of control (IAS 27.32 et seq.)

5. Measurement of investment properties accounted for at fair value – IAS 40
   - Discussion of valuation method and underlying assumptions (IAS 40.75d)
   - Reasonableness of valuation assumptions used in the calculation of fair value (IAS 40.40 and IAS 40.46c)
   - Supporting documentation

3.4 Other preventative measures

In many examinations, the FREP makes recommendations to companies for future financial reporting purposes even if no formal errors are identified. This helps avoid weaknesses in future financial statements. The frequency with which such recommendations were made (see Figure 7) shows that these again occurred in those areas where the IFRS requirements are particularly challenging to apply.

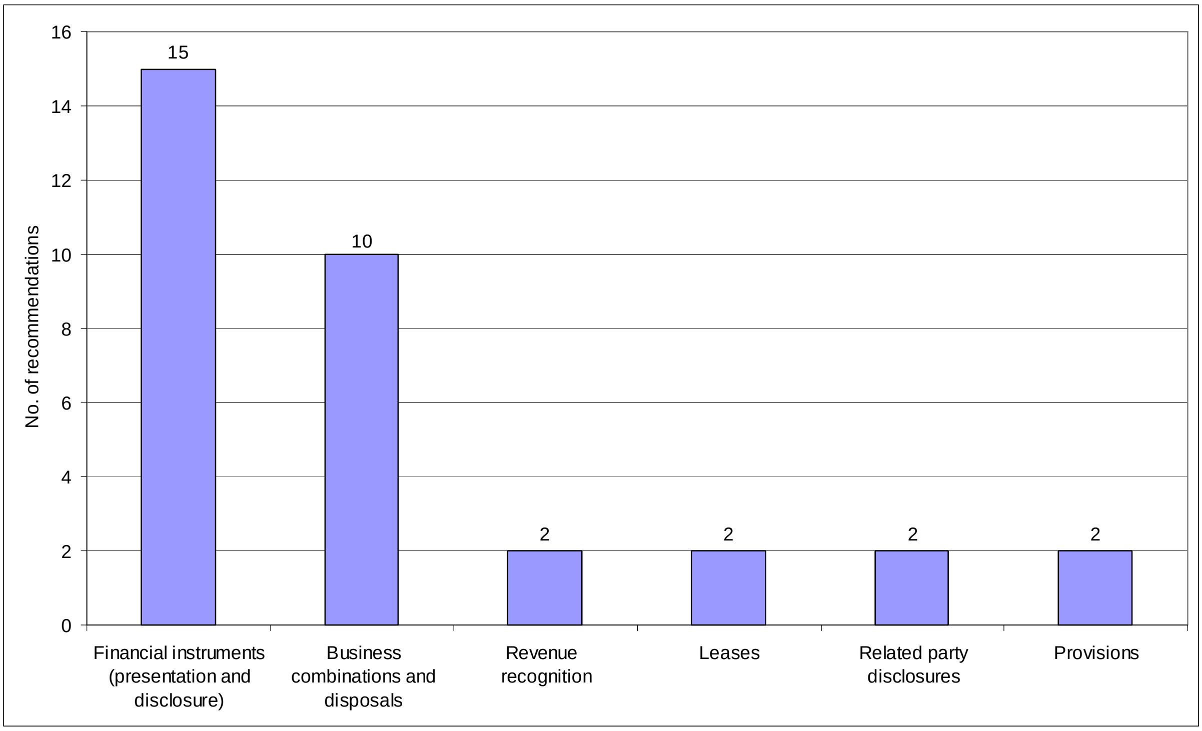

Figure 7: Most common recommendations to companies examined

The pre-clearance inquiry instrument introduced in November 2009 was only utilized once in 2011, while six inquiries were made in the prior year. This procedure helps avoid errors at the time financial statements are prepared and thus strengthens the FREP's preventative function.

All pre-clearance inquiries in 2010 and 2011 met the requirements to be accepted for review by the FREP. The FREP considered the proposed accounting treatment acceptable in four cases, while in three cases it was not considered acceptable. The FREP was able to deal with the pre-clearance inquiries thoroughly and on a timely basis, providing guidance to the inquiring companies when preparing their financial statements, thereby fulfilling its preventative function.

In order to encourage a preventative dialogue with the public, the FREP has, as in prior years, presented information on its work and its results through appearances at many events relating to business administration and financial reporting. In addition, the FREP published the results of its most recent examinations and its most important plans through press releases and/or press conferences.

4. International cooperation

The reform of European financial market supervision has also brought about several changes in the area of financial statement enforcement that were effective 1 January 2011. The Committee of European Securities Regulators (CESR), which had been coordinating accounting enforcement activities in the European Union but only had an advisory capacity, has now been replaced by the European Securities and Markets Authority (ESMA) as the European securities regulator. During its first year of existence, the ESMA has set itself an extensive agenda, for instance with respect to the consistent application and further development of IFRS.

In the area of financial reporting enforcement, the ESMA is seeking to revise the currently effective CESR Standards No. 1 and No. 2 on Financial Information. To this end, a working group was set up to discuss, review, and expand the principles of the existing standards and, where necessary, adjust them to meet the new European regulatory requirements. It remains to be seen to what extent the ESMA will actually utilize its authority to issue binding requirements for national enforcers and to what extent these can be reconciled with the national legal requirements. Another working group was set up to develop a concept for assessing materiality in an enforcement context. German interests are represented in both groups via representatives of the BaFin and the FREP.

In addition to the comments in its annual Activity Report on IFRS Enforcement, the ESMA has made several statements regarding the consistent application of IFRS in Europe, for instance with respect to disclosure requirements regarding sovereign debt. In order to help further develop IFRS, the ESMA has participated in the IASB’s post-implementation review of IFRS 8 by submitting a report on the application of this standard, setting out both IFRS 8 application issues and potential opportunities for improving the quality of the standard.

Enforcement experts from all European countries meet approximately every two months at the European Enforcement Coordination Sessions (EECS) established by CESR to discuss IFRS application issues of transnational interest. The objective is to come to a harmonized understanding of IFRS and to share initial experiences with the application of new IFRS within Europe.

5. Acknowledgements and outlook

On 30 June 2011, Dr. Herbert Meyer left his position as president of the enforcement panel at the end of his four-year term in office. Prof. Dr. Edgar Ernst succeeded him in the office of president on 1 July 2011. Dr. Meyer has done outstanding work for the FREP and it extends its sincere gratitude to him.

The FREP was able to continue its work successfully in 2011, and would like to thank the companies examined for their willingness to cooperate and 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 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 IDW, the *Abschlussprüferaufsichtskommission* (APAK – German Auditor Oversight Commission) and the *Wirtschaftsprüferkammer* (WPK – German Chamber of Public Accountants). Special thanks go to the panel members, the management and the office staff for their consistently dedicated and exceptionally professional work.

While the normalized error rate has seen a drop of six percentage points from the prior year to 19%, the total error rate for 2011 of 25% has only decreased insignificantly from the prior year (26%), stabilizing at the high average level of the past four years. Consequently, the preventative function of the FREP needs to be strengthened further. To this end, the FREP plans to expand and institutionalize the discussions with those audit firms that audit publicly listed companies. Thus, the FREP will enter into a dialogue with both large and, in cooperation with the IDW, small and medium-sized audit firms. The FREP itself intends to maintain its high professional standard.

In addition, the FREP will continue to make its examination results and analyses available to the standard setters with a preparer-oriented simplification of IFRS being the clear objective as the standards continue to develop.

In the European context, and in light of the regulatory developments, the FREP will continue to promote the successful two-tier enforcement model.

Prof. Dr. Edgar Ernst
(President of the Enforcement Panel)