Capital Markets: Enforcing Financial Reporting – an Insight into the German Enforcement System

Speech at UEH University of Economics, Ho Chi Minh City, Vietnam

Prof. Dr. Winfried Melcher
German Certified Public Accountant

23rd March 2016
<table>
<thead>
<tr>
<th>Year</th>
<th>Position/Examination</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975-1978</td>
<td>Industrial business management assistant (Bayer AG, Leverkusen)</td>
</tr>
<tr>
<td>1979-1984</td>
<td>Academic Studies of Business Administration and Economics (University of Cologne)</td>
</tr>
<tr>
<td>4/1988</td>
<td>Steuerberater-Exam (German Tax Consultant)</td>
</tr>
<tr>
<td>1/1990</td>
<td>Wirtschaftsprüfer-Exam (German Independent Public Auditor)</td>
</tr>
<tr>
<td>4/1999-4/2009</td>
<td>Assistant Professor (University Rostock - Auditing / International Reporting / Group Accounting)</td>
</tr>
<tr>
<td>since 5/2009</td>
<td>Honorary Professor in Auditing (University Rostock)</td>
</tr>
<tr>
<td>2010-2015</td>
<td>Visiting Professor (Berlin School of Economics and Law - International Auditing)</td>
</tr>
<tr>
<td>since 4/2014</td>
<td>Flying Professor (VGU, Saigon - International Accounting/ International Auditing)</td>
</tr>
<tr>
<td>9/1984-4/1996</td>
<td>KPMG AG Wirtschaftsprüfungsgesellschaft, Düsseldorf (Audit / Audit related Advisory / IT-Audit / National and international Engagements)</td>
</tr>
<tr>
<td>5/1996-6/2001</td>
<td>Managing Partner of KPMG offices in M-V (Schwerin / Rostock)</td>
</tr>
<tr>
<td>9/2001-9/2013</td>
<td>KPMG AG, DPP Audit &amp; Accounting Germany, Berlin</td>
</tr>
<tr>
<td>since 10/2013</td>
<td>Independent Public Auditor, Business Consultant, Flying Professor</td>
</tr>
</tbody>
</table>
Agenda

1. Introduction
2. International Background (IOSCO)
3. Insight into the German Enforcement System
   3.1. Institutions in Charge of the Enforcement
   3.2. The Enforcement Process
   3.3. Activity Report 2015
   3.4. Enforcement Priorities 2016
   3.5. Impact of the Activities of the FREP

http://www.wiwi.uni-rostock.de/bwl/rewe/downloads/dateien-aus-dem-bereich-publikationen/
1. Introduction

Capital markets under spotlight at VN Business Forum

In a report presented to the Vietnam Business Forum 2015 on December 1 the Capital Markets Working Group expressed its appreciation of efforts made by the Ministry of Finance (MoF), the State Securities Commission (SSC), the stock exchanges, and the Vietnam Securities Depository (VSD) over recent years to improve the legal framework to create more favorable conditions for indirect investment activities but they also expect more changes to come.

“We welcome and appreciate the decision from the Prime Minister on State divestments in Official Letter No. 1787/Ttg-DMDN dated October 8, 2015,” the report said. Under the Letter, the government will have a divestment plan for State capital in ten companies, including Vinamilk, FPT, and Bao Minh Insurance.

The group believes this is a wise decision, expressing the determination of the Prime Minister and the government in regard to equitization. “The decision, along with allowing the increase in foreign ownership, is a breakthrough to bring Vietnam’s stock market to the emerging markets ranking,” according to the report.

(www.english.vietnamnet.vn 4th Dec 2015)
Principles for fair, effective and transparent markets

- Capital markets act like shy deer – trust runs away quickly

- International Organization of Securities Commissions (IOSCO)

  Objectives and Principles of Securities Regulations (June 2010)
  - Protecting Investors
  - Ensuring that markets are fair, efficient and transparent
  - Reducing systemic risks
  Sets out 38 principles in 9 categories for Regulators of Capital Markets

- One element of fair, efficient and transparent markets is the enforcement of financial reporting

www.iosco.org
2. International background

- Information taken from publicly available sources
  - www.iosco.org
  - Annual Report 2014
    (the Annual Report 2015 is going to be issued in June 2016)
  - About us …
IOCSO  Regional Committees

Vietnam is a member of the Asia-Pacific Committee (SSC State Securities Commission)

Germany is a member of the European Committee (BaFin Federal Financial Supervisory Authority)
3. Insight into the German Enforcement System

- Information taken from publicly available sources
  - www.frep.info
  - Activity Report 2015 (English version)
- Information taken from own insight
  - Support to clients in official inspections
  - 2005 till 2013
3.1 Institutions in charge of Enforcement

- Enforcement of financial reporting is performed in Germany in two stages;
  - the first stage involves a government-appointed privately organized institution, the Financial Reporting Enforcement Panel (FREP) www.frep.info as its active body, while
  - the second stage is performed by the Federal Financial Supervisory Authority (“Bundesanstalt für Finanzdienstleistungsaufsicht” – BaFin www.bafin.de), which has sovereign authority.
- The Financial Reporting Enforcement Panel (FREP) has been examining financial reporting of companies listed in the regulated market in Germany since 1st July 2005.
Three Pillars of Enforcement

Enforcement = to ensure that financial reporting rules are properly applied by companies

Independent Auditor

Board of Directors

Federal Financial Supervisory Authority (BaFin)
Financial Reporting Enforcement Panel (FREP)

1st stage

2nd stage

www.frep.info
Organization of the FREP

- FREP workforce
  - President
  - Vice President
  - 14 further members of the FREP (auditors, tax consultants, practitioners)
- Panel for one case (organized like a court)
  - President or Vice President
  - 1 member in charge
  - 1 further member
  - 1 member as a “cold” reviewer
- Cost is approximately € 5 Mio. p.a.
Population for the Enforcement Activities

- Population for examinations
  - There were appr. 1,000 **capital market oriented** companies in 2005
  - companies, whose **financial instruments** are authorized to trade within regulated markets on domestic stock exchanges
  - Financial instruments can be **equity** or **debt**
  - In 2015 capital market oriented companies decreased to appr. 800

- Number of FREP activities
  - Goal: **Full coverage**, that means that each company has to be examined within a certain amount of time
  - 2005 till 2015: approx. 1,100 examinations performed
  - In average a company is examined once in 10 years (but some companies were examined several times)
3.2 Enforcement Process

- The Panel will initiate 3 types of examinations:
  - **Examination with cause**, if there are concrete indications of an infringement of financial reporting requirements,
  - **Examination on request**, at the request of BaFin, when certain indications exist or
  - **Random sampling examination**, without any concrete indications based on random sampling
FREP examination process (1)

Initiation of Examination

- Random-sampling
- With cause
- BaFin request

Clarification

- Notification to BaFin
- Potential reasons for exemption

Preparation

- Communication with the company (is it willing to cooperate?)
- Assignment of a responsible chamber
- Identification of a responsible Panel Member
- Identification of a Quality Review Panel Member
FREP examination process (2)

**Examination Process**

- **FREP** First analysis
  - First analysis of company’s documents
  - First list of questions to the company
  - Responses to FREP

- **Company** First answers
  - Review of the questions (with assistance of the auditor, if necessary)

- **FREP** Further examination
  - Review of the responses
  - Further fact-finding measures
  - Second list of questions to the company

- **Company** Further answers
  - Review of additional lists of questions
  - Clarification with FREP
  - External expert opinion, if necessary
  - Response to FREP

- **FREP** Consultation with company
  - Review of responses
  - External expert opinion, if necessary (usually from audit companies with high level of expertise and extensive capital market experience)
  - Meetings with the company, if necessary (and with its auditor, if necessary)
  - Preliminary findings

© DPR 2014
FREP examination process (3)

Conclusion of Examination

### Preparation for the chamber meeting
- Memo to the chamber
- Examination report
- Examination report critique

### Conclusions
- Error: yes/no
- Recommendations
- Information to the company

### Company’s reaction to conclusions reached
- Information to BaFin
- Information to the Accountants’ Chamber (WPK), if necessary
- Information to the prosecution authorities, if necessary

### Final information requirements
BaFin examination process

Process of Publication

- If necessary, review of findings by BaFin
- Publication review
- Publication order
- Appeal procedure
- Publication by the company
  - Filing an opposition
  - Filing a complaint
  - Federal gazette and
  - Official journal for statutory stock market announcements (Börsenpflichtblatt) / Electronic information system

Possible outcomes
- Company does not accept FREP's findings
- Company accepts FREP's findings

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3.3 Activity Report for 2015

- Published by the FREP in February 2016 in German and English
- [www.frep.info](http://www.frep.info) > Publications > Activity Reports > 2015
- Main result: Total error rate for 2015 was 15% (12 out of 81 examinations)
Examination Results for 2012 till 2015

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Examinations Completed</th>
<th>No. of Errors</th>
<th>Error Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>113</td>
<td>18</td>
<td>16%</td>
</tr>
<tr>
<td>2013</td>
<td>110</td>
<td>15</td>
<td>14%</td>
</tr>
<tr>
<td>2014</td>
<td>104</td>
<td>13</td>
<td>13%</td>
</tr>
<tr>
<td>2015</td>
<td>81</td>
<td>12</td>
<td>15%</td>
</tr>
</tbody>
</table>
Error trend for 2012 till 2015
Completed FREP Examinations by Type of Examination and Error Rate
Completed FREP Examinations by Stock Index and Error Rate

![Bar chart showing completed FREP examinations by stock index and error rate.](chart.png)

- **DAX**: 8 errors, 13% prior year rate
- **MDAX**: 13 errors, 8% prior year rate
- **SDAX**: 11 errors, 9% prior year rate
- **TecDAX**: 4 errors, 0% prior year rate
- **No index**: 45 errors, 20% (16%) prior year rate
- **Thereof: foreign companies**: 6 errors, 0% prior year rate

www.frep.info
### Most Common Types of Errors

<table>
<thead>
<tr>
<th>Error categories</th>
<th>No. of infringements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management report</td>
<td>5</td>
</tr>
<tr>
<td>Note disclosures</td>
<td>4</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>6</td>
</tr>
<tr>
<td>Business combinations and disposals / goodwill</td>
<td>5</td>
</tr>
<tr>
<td>Contingent liabilities/assets</td>
<td>3</td>
</tr>
</tbody>
</table>
Most Common Recommendations to Companies

<table>
<thead>
<tr>
<th>Error categories</th>
<th>No. of recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes / management report</td>
<td></td>
</tr>
<tr>
<td>Note disclosures</td>
<td>15</td>
</tr>
<tr>
<td>Management report</td>
<td>12</td>
</tr>
<tr>
<td>Application challenges of</td>
<td></td>
</tr>
<tr>
<td>IFRS</td>
<td></td>
</tr>
<tr>
<td>Business combinations and disposals / goodwill</td>
<td>4</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>2</td>
</tr>
</tbody>
</table>

www.frep.info
Length of examinations 2005 to 2015

Total number of examinations: 1,143

- < 6 months: 508 (44%)
  - Examinations with findings of errors: 54 (11%)
  - Examinations without findings of error: 454 (89%)
- 6 to < 12 months: 481 (42%)
  - Examinations with findings of errors: 113 (23%)
  - Examinations without findings of error: 368 (77%)
- >= 12 months: 154 (14%)
  - Examinations with findings of errors: 66 (43%)
  - Examinations without findings of error: 88 (57%)

Average length of examinations: 7.5 months
Factors for Errors

The errors found in 2015 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
The Financial Reporting Enforcement Panel (FREP) discovered, that the consolidated financial statements of Deutsche Bank group as of 31. December 2012 and the group management report for 2012 contain errors:

… Neither in the notes to the consolidated financial statements nor in the group management report of Deutsche Bank AG the extent of resource outflows from litigations that are not unlikely, and the impact of legal risks on earnings and the financial condition of the group are made sufficiently clear. At the balance sheet day the legal litigation risks of the Bank include numerous civil lawsuits and significant regulatory proceedings.

The development of provisions for pending litigation is not separately shown in detail in the notes although this is required by IAS 37.84. Contrary to IAS 37.13 f. and IAS 37.85 f. it is not clear which legal risks have been provided for and which risks have not been accounted for following IAS 37.26 and which risks covered by contingent liabilities were quantified or only described verbally.

…
Frankfurt am Main, November 2015
Deutsche Bank Aktiengesellschaft
The Federal Financial Supervisory Authority (BaFin) discovered, that the consolidated financial statements of the group and the financial statements of the parent Intertainment Aktiengesellschaft as of 31. December 2012 contain errors:

1. The trade liabilities in the consolidated financial statements are understated by 1.5 Mio. Euro, because a liability with Paramount Pictures Corp. that existed since the end of 2014 at the latest. This is in conflict with IAS 39.14, IAS 8.42, which state that a financial liability has to be accounted for, when the company becomes part of a financial instrument, and material errors resulting from previous periods have to be corrected retroactively.

2. In the financial statements of the parent trade liabilities are understated by at least 1.5 Mio. Euro, because the liability with Paramount Pictures Corp. was not accounted for. This is in conflict with § 246 (1) sentences 1 and 3 HGB, which state, that the financial statements have to include all liabilities of the company.

Munich, December 2015
Intertainment Aktiengesellschaft

Translation of the error publication, 29th December 2015, eBundesanzeiger
No error but strong recommendation: the company should change financial reporting.

List of areas where the FREP would focus on in the following year:

- Specific situations can be discussed upfront with the FREP.
- Panel discussions with auditors of capital market oriented companies.
- Sharing of experiences and creating transparency, e.g., reporting implementation issues to the IASB.
- Making the public aware of the work of the FREP.

source: (www.frep.info)
3.4 FREP Enforcement Priorities for 2016

The following enforcement priorities for 2016 were announced in November 2015:

- Impact of the financial markets conditions on the financial statements
- Statement of cash flows and related disclosures
- Fair value measurement and related disclosures
- Revenue
- Business combinations

Chance for the preparers to get at least this right
3.5 Impact of the Activities of the FREP

- High-quality work done by the FREP
- Pressure on companies to perform better accounting (including a review in the following year whether the company complies)
- If necessary, the error has to be reported publicly
- Strengthening of the position of the auditors of financial statements
- Pressure on auditors to maintain high audit quality
- If necessary, note to WP-chamber (disciplinary proceedings against the auditor)
- Especially in the financial crisis (2007, 2008) the financial statement oversight system proved effective
- Number of capital market oriented companies decreased from 1,000 in 2005 to 800 in 2015
Continued: Impact of the Activities of the FREP

- Financial statements oversight serves strengthening the trust in the accuracy of financial reporting and, as a consequence,
- Increases trust in the capital markets

- Information taken from publicly available sources
- www.ssc.gov.vn
  - Annual Report 2013 (English version)
  - Annual Report 2014 (English version)

- Annual Reports are not published on the English Website, but are only available on the Vietnamese Website.
New Year’s Greetings Message from the Chairman of the State Securities Commission of Vietnam

On behalf of the leadership of the State Securities Commission of Vietnam, I would like to convey our most sincere sentiments to all working and retired cadres and staff of the securities sector, the market participants and journalists of media agencies in the field of securities on the occasion of the New Year 2016.

www.ssc.gov.vn/
SSC - State Securities Commission of Viet Nam

as of 1st January 2016

Inspection, supervision and enforcement (not only financial reporting)

Main violations in 2013 and 2014 were: Reporting and disclosure violations, order placing without money in accounts, borrowing stock to sell, not separating funds of customers, stock price manipulation, insider trading, …
Organization of the SSC (comparable with BaFin including FREP) / Supervision and Inspection Departments

- Management
  - 1 Chairman
  - 3 Vice chairmen

- Inspection and examination teams
  - 14 inspection teams
  - 33 examination teams

- Cost not published in the annual report
Sanctioning of Administrative Violations

In 2013: 108 decisions of sanctions for administrative violations with total fines of over 8 billion VND; (approximately 320,000 Euro)

In 2014: 121 decisions of sanctions for administrative violations with total fines of over 10 billion VND; (approximately 400,000 Euro)

www.ssc.gov.vn/
## Differences at First Sight*

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of organization</strong></td>
<td>Federal Financial Supervisory Authority, controlled by Federal Ministry of Finance</td>
<td>Privately organized association, supervised by the BaFin</td>
</tr>
<tr>
<td><strong>Enforcement of capital markets</strong></td>
<td>Focus is on capital market participants</td>
<td>Focus is only on financial reporting</td>
</tr>
<tr>
<td><strong>Enforcement of financial reporting</strong></td>
<td>Only on the 2nd stage (rarely)</td>
<td>Mainly done on the 1st stage</td>
</tr>
<tr>
<td><strong>Sanctioning</strong></td>
<td>Companies with an error are ordered to issue an adhoc publication in the federal gazette within two weeks</td>
<td>Errors are reported to the BaFin (see BaFin)</td>
</tr>
</tbody>
</table>

*) needs further research
Room for Questions and Discussion
Thank you for your attention and discussion!

Prof. Dr. Winfried Melcher
German Certified Public Accountant

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