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Information for Supervisory Board and Audit Committee Members

Contents

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Deliberations on audit reform – an academic view

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In the aftermath of the financial crisis, the European Commission has critically scrutinised the role of the auditor in the interest of stable financial markets. The political need for action supposedly arising from this analysis is stated in the rationale given for the draft regulation as motivated by the fact that it was "difficult for many citizens and investors to understand how the auditor [in view of significant losses, Ed.] could give their clients (especially banks) an unqualified opinion" (KOM(201 1) 779, p. 2).[1]

This explanatory statement highlights two phenomena which recur regularly. Firstly, we notice a gap in expectations, i.e. there is a discrepancy between the expectations of an audit of financial statements on side of the interested public and the actual fulfilment of the tasks. Usually, this gap in expectations is based on the fact that an audit for correctness is confused with an audit of the management. The auditor however is tasked primarily with auditing the conformity of financial statements with accounting principles. Whether or not the company's management has achieved good performance is not the object of the audit. After all, a motor vehicle roadworthiness certificate likewise does not guarantee that a car will be accident-free for the next two years.

Building on the misinterpretation outlined above regarding the function of the audit of financial statements, we find the basis of the second recurring phenomenon: in the face of the gap in expectations, negative corporate developments are interpreted as a signal for improvement suggestions by standard-setters; this applied to the Control and Transparency in Business Act (KonTraG) and the Transparency and Publicity Act (TransPuG) in Germany as much as to the Sarbanes-Oxley Act in the USA. Now, the financial crisis is giving rise to improvement suggestions. It should be noted, however, that it is not only the trigger mechanisms for standard setting activities which recur, but also many of the solutions suggested. Intensifying audit activities, changing the audit approach, improving audit communication, outlawing non-audit services alongside the audit, intensifying the cooperation between the auditor and the Supervisory Board/Audit Committee, requiring (internal or external) rotation and increasing competition in the audit market have not been suggested for the first time.

Precisely because the suggested solutions are not new, it is strange that neither the statements, including opposing views, that were given during the consultation phase for the Green Book nor the comprehensive existing academic literature can be identified within the regulation proposal. For this reason, the following selected suggestions will be evaluated from an academic point of view. Many of the findings from the past continue to apply here.

[1] To improve legibility, we have foregone giving sources when reproducing empirical results. The relevant sources may be requested from the author as required.

Restriction/ban on non-audit services

Article 10 of the draft regulation stipulates a ban on the rendering of non-audit services by the auditor, because non-audit services could compromise the auditor's independence. However, what this fails to appreciate is that they can also lead to learning effects. Therefore, a "strict separation of audit and consultancy ... is not indicated" (Quick (2002)).

Empirical studies here reach mixed results regarding the effects on audit quality and independence. Analogously, the theoretical and analytical literature shows no consistent findings. One cause may be due to the fact that the impairment of independence is caused less by the delivery of non-audit services themselves, but are rather due to the engagement relationship. Here, one should assume that an intensive discussion between the Supervisory Board/Audit Committee and the potential auditor promotes independence.

However, it should also be borne in mind that not only independence in fact must be ensured. All dependencies between client and auditor that could create the impression of a lack of independence (independence in appearance) should be avoided. For the German profession, sections 319 and 319a of the Commercial Code (HGB) create a basis of certainty. However it should be noted that the catalogue of non-audit services leading to an engagement disqualification in Article 10 Paragraph 3 of the draft regulation is significantly more extensive than the one in §§ 319 f. HGB.

Requirement for (internal/external) rotation

A compulsory rotation, where after a time horizon regulated by law either the responsible audit partner is swapped out (internal rotation) or the audit company that had been engaged must be replaced as a whole (external rotation), is likewise suggested as a measure to ensure the independence of the auditor.

The draft regulation stipulates in Article 33 that for public interest entities the auditor may manage a mandate for a maximum of six years, for Joint Audits for a maximum of nine years.

In the evaluation of a compulsory rotation, it should first of all be recorded that a discussion on this topic had already taken place on the European level approximately ten years ago. Ultimately, the question must be answered whether a longer duration of the mandate has a positive effect on audit quality because the auditor realises client-specific learning effects, or whether it leads to negative effects due to company myopia. It is not surprising that the empirical evidence shows that in early phases of the client relationship the positive learning effects predominate. Fraud, reporting errors and unusual accounting practices occur more frequently in the first few years of client relationships, as a rule, and decrease with the length of the mandate.

Apart from factual audit quality, the perceived credibility of audited financial statements should also be scrutinised, especially for capital market-oriented companies. Empirical results show that longer mandate terms are seen positively by investors and rating agencies and can also lead to better loan capital conditions.

However, there are also findings that document company myopia. For example, the likelihood of issuing a qualified opinion decreases with the length of the mandate. Incidentally, the decision in 2004 was in favour of internal rotation, for sound reasons. New scientific evidence about the trade-off between profound knowledge of the client and company myopia does not exist.

Influencing the competitive structure of the audit market through Joint Audits

The European Commission sees a further problem in the competitive structure of the audit market. In most of the leading economies, more than 75% of the capital market-oriented companies are clients of one of the Big Four auditors. Such concentration rates are seen as anti-competitive. In addition, there are concerns that the Big Four companies graded as system-relevant have become so large meanwhile that the withdrawal of one company from the audit market would cause lasting frictions in the financial markets.

In principle, the Commission's concern is understandable. However, there remains a question whether Joint Audits represent a helpful remedy. First of all, it must be stated that the evidence about the advantages and disadvantages of Joint Audits is contradictory. Empirical research can show cost increases in part, but also cost decreases in individual cases. Likewise, findings about the substantive benefits of Joint Audits are uneven. In particular, it is noticeable that the European Commission favours combinations of Big Four and non-Big Four auditors, whereas empirically one finds advantages precisely in Joint Audits between two Big Four auditors.

Finally, it can be supposed that Joint Audits will lead only formally to a softening of the market concentration. In fact, two distinct partial marketplaces may result, one for Big Four and one for non-Big Four auditors.

Implications for Supervisory Board activity

Among the many suggestions made by the Commission, the intensification of the cooperation between auditor and Supervisory Board/Audit Committee may well be the most promising. Article 32 takes the Audit Committee increasingly to task in the selection of the auditor; logically, this should also include agreement on the audit focal points. In addition, Article 23 demands more intensive communication between auditor and Audit Committee, which particularly includes the audit results. Here, Supervisory Boards/Audit Committees should act especially carefully and communicate this as well. Otherwise, the suggestion to appoint auditors through a government agency might receive further nourishment. Such a change in the responsibility for engaging the auditor would be likely also to influence the type and goal of the audit in the long run. Whether the benefits for audited companies would increase in this way is at least unclear.

Supervisory Board audit of the financial statements

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One of the personal duties of Supervisory Board members stipulated in the Stock Corporation Law (Aktiengesetz – AktG) is to "inspect the Financial Statements, the Management Report and the proposed appropriation of distributable profit, for parent companies (…) also the Consolidated Financial Statements and the Group Management Report" (§ 171 (1.1) AktG). The inspection by the Supervisory Board represents a preparatory measure for its resolution on the approval of the financial statements. As part of the Supervisory Board's inspection, the legality and appropriateness of the financial statements should be evaluated. The Supervisory Board must report the results of its inspection in writing to the Annual General Meeting (§ 171 (2.1) AktG).[1]

Requirements for Supervisory Board members

The statutory provisions demand adequate fulfilment of the inspection task by the Supervisory Board. Due to the increasingly complex business activity and internationalisation of companies, as well as changes in the law and innovations in the financial reporting standards, the technical and personal requirements made of Supervisory Board members are increasing continually. Exaggerating slightly, we could say that the inspection by the Supervisory Board is "the art of evaluating the compliance and appropriateness of the (consolidated) financial statements within 30 minutes"[2].

Even if this is not mentioned explicitly in the statutory provisions, all Supervisory Board members must have sufficient knowledge of accounting and of audits in order to be able to fulfil their inspection duty. This results from the duty of every Supervisory Board member to inspect the financial statements in person. As early as 1982, the Federal Supreme Court (Bundesgerichtshof – BGH) had emphasised in the Hertie decision that "a Supervisory Board member must possess those minimum skills and knowledge which enable them to understand and expertly evaluate all normally arising business processes without the help of a third party"[3]. In this context, the personal inspection duty may not be discharged by transferring it to the Audit Committee, financial experts within the Supervisory Board or third parties, such as the auditor, so that every Supervisory Board member must at least be able to classify the work of the auditor and the Audit Committee and to reach a final overall assessment independently.

Subtasks as part of the inspection

The adjacent illustration shows the individual subtasks and/or steps which Supervisory Board members may carry out in order to fulfil their inspection duty.

One critical factor in fulfilling the inspection duty is time, which is usually very limited. Adequate time management would seem indispensable here. Even before the relevant meeting dates are determined, binding dates for submission of the documents should be agreed with the Executive Board and the auditor. In addition, it is advisable to set timeframes for queries to the Executive Board and the auditor. An increase in the efficiency of the inspection can also be achieved where semi-annual and quarterly reports are discussed continuously in meetings with the Executive Board and these have raised awareness among the Supervisory Board for important topics.

For individual Supervisory Board members, it is important initially to gain an overview of the available documentation. In this context, the auditor's audit report should be read critically. Here, the focus should be especially on the initial opinion of the auditor on the Management Report, the explanation of material accounting and valuation bases as well as the audit opinion. Attention should be paid to whether the audit opinion is unqualified or qualified and/or whether it contains notes.

Following this, the Supervisory Board member should determine focal points for their own inspection duty, depending on their knowledge of the company, its business activity and the overall economic situation. Even though the Supervisory Board does not demand such an intensive audit as the auditor delivers, it is nevertheless expected that the Supervisory Board mentions those topics which it, due to its specialist prior knowledge, may assess differently from the Executive Board or the auditor. The financial statements must be examined by the Supervisory Board on the basis of all information known to it for plausibility and subjected to a business analysis.

The wealth of experience of the Supervisory Board and its independence from the process of generating financial statements should be utilised to uncover unconscious errors, but also deliberate presentation of facts which could point towards mismanagement. Particularly

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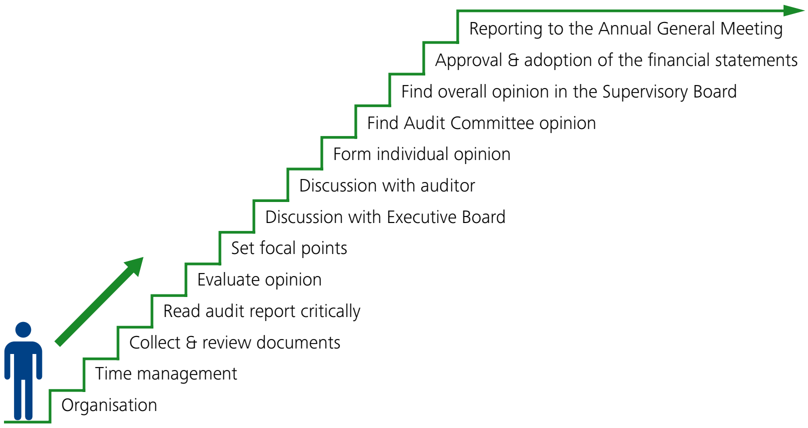
1 For more on this topic, see e.g. Buhleier/Krowas: Personal Duty to Inspect the Financial Statements by the Supervisory Board, in: Der Betrieb, 2010, p. 1165–1170.
2 Hakelmacher, in: Hakelmacher's ABC of Finances and Balance sheets, 4th Ed. 2005, p. 176.
3 BGH judgement dated 15.11.1982, II ZR 27/82, NJW 1983, p. 991ff.

Sub-tasks as part of inspecting the financial statements by the Supervisory Board



for questions about the appropriateness of the financial statements, the Management Report and the resolution on the appropriation of profits, it is recommended that the Supervisory Board maintains open and direct dialogue with the Executive Board.

Approaches for discussion with the Executive Board often exist. In principle, significant changes in comparison to the previous year's financial statements should be brought up and explained by the Executive Board. Furthermore, assessments of intrinsic value for goodwill, immaterial assets, deferred taxes, tangible assets or equity investments could be of particular relevance. Likewise, the question of existing, off–balance-sheet transactions, including the effects of any inclusion in the financial statements, could be asked by the Supervisory Board. Not least, it should be queried whether in the Management Report the description of the business performance and the forecast report are plausible and consistent with other information submitted by the Executive Board (e.g. business planning).

To support their own inspection activity, the Supervisory Board can set special focal points for the auditor in advance of the audit.[4] After the audit, it should request a report about the agreed focus points, which also includes a specific assessment of the remaining risks. It seems evident that Supervisory Board members should seek a discussion with the auditor. Here, questions about controversial topics can be posed, such as presentation of facts and breaks in continuity as well as ambiguities in the audit reports.

In addition, they can find out in which areas the auditor had differences of opinion with the Executive Board, whether anything unexpected came up during the course of the audit and how the character of the financial reporting policies should be assessed in general.

Judgment formation and reporting procedures

The individual Supervisory Board member must finally form a personal judgment on the basis of their inspection activities about the legality and appropriateness of the financial statements. Provided the Supervisory Board has created an Audit Committee, then this reports at the accounts review meeting to the whole Supervisory Board. The assessment and the judgement of the Audit Committee should be taken into account by individual Supervisory Board members in their personal evaluation. Finally, the Supervisory Board forms an overall opinion, which either consists of an endorsement of the financial statements or of explanations of the objections against the same.

Through the written report to the Annual General Meeting, the audit receives public approval by the Supervisory Board and insofar supports the credibility of the financial statements. When endorsing the financial statements, brief and formalised reports are generally sufficient.

To summarise, it should be stated that the Supervisory Board should particularly intensify its cooperation with the Executive Board and the auditor in order to accomplish its inspection duty. Here, the views of the auditor on critical topics should be actively demanded, his insights gained during the audit requested and an open, trusting exchange promoted.

[4] For more on this, please see Kompenhans/Buhleier/Splinter: Determination of audit focal points by Supervisory Board and auditor, in: The Audit, 2013, p. 59–66.

Recognition and measurement in the IFRS balance sheet – an outline

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One of the main tasks for Supervisory Board members is monitoring the company and its financial reporting. For the public, analysts and shareholders, the IFRS consolidated financial statements are usually the focus of interest. In order to use such financial statements properly, however, it is necessary to understand correctly what they actually include. What is shown on the balance sheet and at which value is not irrefutable fact, but rather a matter of definition, i.e. it depends on the respective accounting principles. Only in this way can it be explained that the balance sheet totals in large companies can diverge by many millions, depending whether the balance sheet has been compiled under IFRS or other rules. To make Supervisory Board activities easier, we will give an overview in the following of the rules under which various items in an IFRS balance sheet are recognised and valued.

In principle, only those items should be recognised under IFRS which fulfil the definition and recognition criteria of an asset, a debt or of equity capital and for which reliable measurement is possible. The measurement follows neither a strict conception of historical values nor of fair values. Rather, IFRS uses a spectrum of partly alternative permissible measurement standards, such as depreciated purchase or production costs, different concepts for the fair value or the settlement value. In addition, the principle of individual measurement applies. The specific regulations on the measurement of individual asset or debt items are not stipulated centrally, but rather in the respective standards.

The following table illustrates the material asset, equity and liability items in an IFRS consolidated financial statement, as well as their measurement standard. Certain balance sheet items may be shown as both long-term and short-term; to keep it simple, we have avoided multiple allocations in the above illustration (e.g. for provisions, other financial assets and financial liabilities).

(Depreciated) purchase/production costs

Purchase/production costs encompass all consideration provided in exchange for the item to be measured. For assets, this is either the amount of cash paid for the purchase or production or the fair value of another type of consideration at the point of purchase or production. In subsequent periods, these purchase or production costs are decreased by accumulated scheduled depreciation and accumulated impairment costs. For intangible assets, however, scheduled amortisation is not recognised if the useful life cannot be determined, so that only an annual impairment test is to be carried out (impairment only approach).

Alternative subsequent measurement at current fair value for tangible fixed assets, intangible assets and property held as investment property

In subsequent periods it is permissible to carry out a measurement at fair value; in the case of property held as investment property, fair value changes are to be recognised in net income, while others are recognised without affecting net income (under other earnings). The fair value is defined as the price one would receive in a normal transaction between market participants on the measurement date in the case of a disposal of an asset or would pay in the case of transferring a debt. Such a value is not specific to the company.

Accumulated proportional value of the equity investment

The investment is initially measured at purchase cost. Subsequently, the carrying amount of the shareholding is adjusted in accordance with the owner's share of profit or loss, the changes in other earnings and the other equity capital changes of the associated companies (equity accounting).

Undiscounted measurement based on rates of taxation, the validity of which is expected for the period in which an asset is realised or a debt is settled

Deferred taxes as expected tax effects from differences of assets and liabilities between IFRS financial statements and tax accounting are to be valued at those rates of tax which are expected to apply for the realisation of the future tax claim or the settlement of the future tax liability. Here, the rates of taxes (and tax regulations) are used which are applicable or announced on the reference date of the financial statements.

Balance sheet item	Measurement principle
Assets	
Non-current assets	
Property, plant and equipment	Depreciated purchase/production costs or fair value
Property held as investment property	Depreciated purchase/production costs or fair value
Intangible assets	
With determinable useful life	Amortised purchase/production costs or fair value
With indeterminate useful life (incl. goodwill)	"Impairment only" approach
Investments in associates	Accumulated proportional value of the equity investment
Deferred tax assets	Undiscounted measurement based on rates of taxation, the validity of which is expected for the period in which an asset is realised or a debt is settled
Other financial assets	
Assets held to maturity	Amortised costs
Assets available for sale	Fair value or purchase cost
Originated loans and receivables	Amortised costs
Derivative financial assets	Fair value
Current assets	
Inventories	The lower of net realisable value and purchase/production cost
Trade receivables and other receivables	Amortised costs
Receivables from finance lease arrangements	Amortised net investment value
Short-term tax claims	Amount of an expected repayment or payment from the tax office is expected, based on rates of taxation valid on the reference date of the financial statements or which will be valid shortly thereafter
Cash and cash equivalents	Amortised costs
Long-term assets and disposal groups held for sale	Lower amount of carrying amount and fair value less costs to sell

Balance sheet item	Measurement principle
Equity and Liabilities	
Capital and reserves	
Subscribed capital	
Capital reserves and other reserves	
Revenue reserves	
Amounts recognised in equity without effect on income in connection with assets held for sale	
Proportion of equity attributable to owners of the parent	
Non-controlling shareholders	
Non-current liabilities	
Financial liabilities	
Originated interest-bearing and non-interest-bearing financial liabilities	Amortised costs
Derivative financial liabilities	Fair value
Pension obligations	Actuarial projected unit credit method
Deferred tax liabilities	Undiscounted measurement based on rates of taxation, the validity of which is expected for the period in which an asset is realised or a debt is settled
Provisions	Present value of future settlement values
Current liabilities	
Trade and other payables	Amortised costs
Short-term tax debts	Amount of an expected repayment or payment from the tax office is expected, based on rates of taxation valid on the reference date of the financial statements or which will be valid shortly thereafter
Debts in direct connection with long-term assets and disposal groups held for sale	Lower amount of carrying amount and fair value less costs to sell

Amortised acquisition costs for financial assets and financial liabilities

Initial recognition occurs at the fair value, plus or minus transaction costs. Amortised acquisition costs are determined from the initial recognition amount less intermediate repayments, plus (minus) the accumulated amortisation of any difference between the original acquisition costs and the amount repayable at final maturity, using the effective interest rate method, less any impairment.

Fair value for financial assets and financial liabilities

Initial and subsequent measurement is carried out at fair value; here, fair value changes for derivatives and e.g. trading securities must be recognised as affecting net income in the income statement. Fair value changes of financial assets in the category of "available for sale" however must be collected (without effect on net income) under other earnings.

Lower of cost and net realisable value

This measurement standard, which is only applicable to inventories, stipulates that the net realisable value is compared with the purchase/production cost and the lower of these recognised. The net realisable value is the estimated sales revenue achievable in the ordinary course of business, less the costs to final completion and the selling expenses. This refers to a company-specific value, which should not be confused with the fair value.

Amortised net investment value for finance leases

This refers to the present value of the minimum lease payments plus the unguaranteed residual value of the leased asset. This value recognised as a leasing receivable is decreased as a rule by repayments from the lessee during the duration of the contract.

Amount of a repayment or payment which is expected from the tax office, based on rates of taxation valid on the reference date of the financial statements or which will be valid shortly thereafter

The actual income tax assets and liabilities for the current and previous periods are to be recognised at the amount at which a repayment from or payment to the tax office is expected, taking into account the valid tax laws and rates of taxation on the reference date of the financial statements.

Lower of carrying amount and fair value less costs to sell

This particular measurement affects long-term assets and/or groups of these as well as associated liabilities and discontinued operations, as soon as is expected that return flows are generated primarily from disposal and not through continued use. In such a case, these assets held for sale and associated liabilities must be recognised at the end of the balance sheet and should be measured at the lower value of the carrying amount and the fair value, less costs to sell. Scheduled depreciation is then suspended.

Actuarial projected unit credit method

Under this, performance shares from pension commitments are allocated to years of service. This occurs in line with a particular plan formula. In every year of service, an additional performance share of the final entitlement to benefits is earned and added to the present value of the pension commitment, so that this includes the earned entitlement to benefits accumulated by the balance sheet date.

Present value of future settlement amount

The settlement value of a provision is the best possible estimate of the amount required to settle the commitment on the balance sheet date, before tax. In the case where the interest effect is material, the future liability must be disconted.

Equity is initially measured at fair value. A subsequent measurement may not be carried out due to its definition as a residual value from the difference between assets and liabilities. Rather, equity changes result from capital transactions with shareholders or from earnings components.

This overview is intended to convey a general understanding of the contents of the balance sheet. In the depths of IFRS regulations, there are many special rules which can lead in individual cases to special and indeed unexpected results. Supervisory Board members should request an explanation of these. Essentially, the point is that Supervisory Board members ask themselves whether the IFRS balance sheet together with the rest of the financial statement parts convey a true and fair view of the company's position.

Key questions for Supervisory Boards in the 2012/2013 reporting season

In 2012, the German economy grew by only 0.7%. In the previous year, growth had been around 3%. With this small plus in 2012, Germany still fared significantly better than other European economies, some of which slipped into recession. For 2013, the Federal Government expects growth of 0.4%, once more at the 2012 level; in 2014 it is predicted to rise to 1.6%. Here it assumes that a significant acceleration in economic activity will take place from the second half of the year 2013 onwards. With regard to the large economies in the USA, China and Japan, forecasting institutes also expect that a clear improvement in the economic situation will occur from the middle of 2013. However, it should not be overlooked that the financial crisis is not yet over. For example, it can be assumed that further countries will need help in reducing their debt. Therefore the current growth forecasts are fraught with risks and the prospects for 2013 and 2014 remain rather uncertain.

Furthermore, the work of Supervisory Boards is once again in the public spotlight. Triggered by planning errors in large projects, there are questions being asked about the quality of the monitoring activity overall. It is therefore more important than ever for Supervisory Board members to keep focussed on effective supervision and their adherence to/fulfilment of the formal requirements (e.g. documentation).

The following key questions are intended, against this background and especially in relation to monitoring of the Executive Board/the company management by the Supervisory Board, to support them in initiating and/or steering a qualified discussion in the committee meetings. Not all questions on this list are of equal importance for each individual company; nor is the list to be considered exhaustive. Which questions are of importance and which additional topic areas must be addressed depends on the specific supervisory situation.

Going concern

- At what intervals does the management monitor the company' (situational, daily, weekly, monthly) and is the liquidity plan updated on a rolling basis?
- Is the liquidity plan subjected to stress tests (e.g. scenario analysis) at regular intervals?
- Is a strategic planning process implemented in order systematically to determine the overall direction of the company and to recognise danger potentials in case of deviations?
- Is there a risk of violating credit agreement clauses (covenants), which could result in higher interest payments and/or the cancellation of bank credit?
- Is there a risk that the company's rating could be downgraded, causing borrowing to become more expensive?
- Have risks become more specific (e.g. particular legal disputes), which if they occur, either taken by themselves or together with other risks, could become a threat to the going concern for the Group and/or an individual Group company?

Irregularities (fraud)

- What are the central instruments for anchoring good Corporate Governance culture in the company in the long term (e.g. Code of Ethics, training courses for employees on appropriate behaviour towards customers/suppliers/colleagues)?
- Which instruments/measures exist that are targeted at discovering irregularities? Are these instruments/measures integrated into the respective systems (risk management system, internal control system, internal audit system)?
- Is the susceptibility of the organisation to irregularities evaluated regularly (e.g. also by consulting expert third parties)?
- Were there irregularities in the form of manipulations of financial reporting and/or misappropriation of assets?
- Have cases of bribery (on the customer side to promote sales or on the company side during purchasing) or competition law violations been discovered?
- In case of irregularities, are these pursued resolutely and, where applicable, are disciplinary measures initiated against those responsible?

Risk Management System (RMS) and Internal Control System (ICS)

- Is there an overall concept for the RMS and ICS and how is this anchored within the organisation?
- Does the 'tone at the top' and 'tone from the top' support the control environment within the company, in order to strengthen the compliance culture?
- How are external service providers (e.g. shared service centre, IT service providers) integrated into the RMS and ICS structure?
- What instruments does management use to monitor the effectiveness of RMS and ICS?
- Are there currently significant complaints about the functionality of the RMS and/or the ICS (e.g. from Internal Audit or the auditor)?
- Is the functionality of the RMS and/or the ICS endangered by planned or implemented restructuring measures?

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- As part of RMS, are ad hoc risks reported alongside regular reports to the relevant risk collecting points in the company?
- Does the RMS also include the capture/reporting and handling of strategic risks (e.g. no longer valid assumptions about regional sales markets for large investments or reputational damages for a brand)?
- Are there supplier risks on the procurement side, so that the supply of (raw) materials could be in danger?
- Are there particular dependencies on a few customers or systemic risks (cluster risks) in the customer structure?
- What securities or other guarantees were given to/for customers/suppliers/other business partners?
- How should the IT environment be evaluated under security aspects and with regard to adherence to legal guidelines, e.g. on data protection?

Internal Audit (IA)

- Does IA, compared to the size and the complexity of the whole business – and compared to the sector/other companies – have sufficient staff and do the IA auditors take part in regular training measures?
- Is the independence of IA employees from the situations/departments/business units which they audit assured?
- Is the IA audit plan defined and carried out systematically on the basis of risk factors (e.g. susceptibility to wrongdoing in particular regions, high levels of errors/discrepancies in particular units, complex business like trading in derivatives)?
- Does the IA audit plan stipulate permanently installed auditing support for large projects, in order to enable early identification of significant deviations from the plan with regard to time and costs?
- Aside from performance audits and against a background of the increasing importance of corporate governance/compliance issues, are compliance audits being carried out more (e.g. anti-trust and anti-corruption guidelines, internal codes of conduct)?
- Does Internal Audit make use of expert third parties in the execution of its tasks, or are certain areas of its remit outsourced entirely?
- Is the elimination of identified deficiencies consistently followed up and monitored?
- Does IA also function as a training ground for management trainees, so that qualified internal employees are available for staffing management positions, as applicable?
- How is the effectiveness of the Internal Audit system monitored?

Standard setters/enforcement

- Are there any effects resulting from new financial reporting standards which will apply in future to the company's accounting and/or are there effects that can be recognised today from current standard setting projects (IASB, FASB) (e.g. leasing, financial instruments, revenue recognition)?
- Are the audit focal points published annually by the German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung – DPR) explicitly taken into account in the financial statements (e.g. special quality assurance measures)?
- In the case of a DPR audit: what findings are/were there?

Financial Statements

- How should the resources for financial reporting with regard to the number of staff and existing technical knowledge be viewed? Is there a 'talent plan' to develop future managers for the financial area?
- What accounting strategy does management pursue in general? Does it pursue a more conservative or a neutral, in parts possibly aggressive strategy?
- Were the methods of accounting/measurement changed in significant areas and if so, what effects resulted for the financial statements?
- Goodwill and other non-current intangible assets (IFRS)
  - Is the impairment test founded on the overall plan confirmed by the Supervisory Board?
  - What sensitivities do the impairment tests show when using different scenarios?
  - Where no impairment has been identified: how large is the buffer between the carrying amount of the CGU to be tested and the comparison value (value-in-use or fair value less costs to sell)?
  - What value adjustment requirement has resulted and where is it shown in the consolidated statement of income?
- Pension provisions
  - What significant pension plans exist in the Group and what accounting and/or cash-effective risks are connected with it?
  - For Contractual Trust Arrangements (CTA), are there any risks with regard to the insolvency resistance of the plan assets with the result that offsetting them against pension provisions could be endangered?
  - What discount rates and other input parameters (salary increases, pension increases) were used for the pension plans in different countries and how do they relate to the bandwidths published by actuaries (upper end, middle or lower end)?
  - How did the yield of the plan asset categories in the past business year develop and what yields are expected in future compared to these?

– From 2013, the corridor method may no longer be used, and further changes apply (IAS 19 (revised)). What effects will the 2013 revision have on the financial statements and were these effects explained in the Notes? (This is required under IAS 8.30.)

- Financial assets: What risks exist with regard to the measurement of financial assets (credit risk, availability of market values, measurement models)?
- Deferred taxes
  - At what level were deferred tax assets recognised for loss carry-forwards and/or interest carry-forwards?
  - Were deferred tax assets not recognised/written off because of missing prospective usage opportunities and was the same planning consistently applied here as for other impairment tests?
- Special purpose entities
  - How is the non-recognition of special purpose entities in the consolidated financial statements justified and is this procedure secured with appropriate notes/expert opinions?
  - What operational risks are connected with the existing special purpose entities?
- Notes to the financial statements/Management Report
  - How was it ensured that all necessary disclosures are included in the Notes to the consolidated financial statements under IFRS (e.g. check lists, external support)?
  - Does the segment reporting in the Notes to the consolidated financial statements reflect the view of the management (Management Approach)?
  - Is the segment reporting also in alignment with the Executive Board reports to the Supervisory Board and the representation in press releases?
  - Are the statements in the Group management report on business expectations (forecast report) and risks (risk report) in alignment with the planning assumptions for the impairment tests and publications about the business development?
  - Was the Group management report already compiled using the German Financial Reporting Standard No. 20 Group Management Report and/or which effects will mandatory compliance from 2013 have?

The Supervisory Board's focal points in 2013

The Deloitte Global Center for Corporate Governance has published the third edition of its annual Directors' Alert. Its title, 'Lead or be led: time to take advantage of the new business reality' immediately raises the question of whether we really do live in a totally new "business reality" today, in the aftermath of the global financial and economic crisis. The Directors' Alert does not claim to have generally applicable solutions at the ready, but rather aims to give food for thought for Supervisory Board discussions. The focus here is on a total of ten selected topics on which the current upheavals in the economic environment require proactive measures to be taken by corporate leaders.

The complete brochure can be downloaded without cost from the webpage at http://www.corpgov.deloitte.com or requested by email from corporate.governance@deloitte.com.

The 2013 AGM season's topics

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This year's Annual General Meeting season began with a thunderbolt. On 18 January 2013, the shareholders of the ThyssenKrupp corporation met in Bochum for the first big Annual General Meeting of the year. With a loss of 5 billion euros it was to be expected that the Annual General Meeting would be anything but comfortable for Gerhard Cromme as Chairman. And, as expected, the shareholders made use of all available possibilities: from a dismissal motion to applications for special audits. However, we should note that the ThyssenKrupp AG Annual General Meeting is not to be seen as representative of the whole Annual General Meeting season 2013, because of the existential problems the steel company is facing.

Nevertheless, this AGM season will once again bring up many topics which appear with frequency and are debated intensively. The following aspects will surely be among them:

Operational business at the centre

The focus of investors, considerably more than in previous years, has moved on to operational topics and companies' performance. In this context, forecast reporting will come under close scrutiny. In many cases, companies no longer dare to make specific predictions, which is certainly understandable in principle. However, this does little to calm investors, and this practice does not conform to the IFRS rules. The way out here lies in openly communicating the underlying conditions and the sensitivity of how the company's earnings react to changes in them.

Ending the number chaos

Overall, we can recognise that investors at home and abroad are no longer willing, year after year, to have to work their way through adjusted earnings in painstaking detail. Executive and Supervisory Boards should not think that investors are unable to see through this number chaos. Quite the opposite: as long as there are new ways of adjusting earnings, investors will pay rather close attention and will check how valid the calculations really are. The same applies to the cash flow statement. Here, too, owners are forced to spend more time on the derivation of their free cash flow than on the analysis of the reported figures. Executive and Supervisory Boards should therefore not be surprised if investors use their own models to calculate suitable key figures.

Dividends

After shareholders were very spoiled in 2012 by high dividend payments, expectations for 2013 are accordingly equally high. These expectations are in line with the whole capital market environment, in which dividends are given a particular significance. In spite of this, shareholders will pay close attention to whether the suggested dividend has indeed been earned or whether it is even being paid from capital. This was the case during the year 2012 – either in whole or in part – for every fifth DAX share. Even where reference is made to a strong cash flow, if the dividend exceeds net retained profits, the Executive and Supervisory Boards should be prepared for accordingly critical questions to be asked.

Remuneration

In the 2013 Annual General Meeting season, the topic of remuneration will once again play an important role for both the Executive Board and the Supervisory Board. The remuneration systems conforming to (VorstAG) the law on renuneration of the excecutive board, two to three years after being introduced, show their full effect for the first time, and it is worth checking whether adjustments are necessary. In particular, questions will be asked about whether the system of fixed and variable remuneration is well balanced. Remuneration systems are only transparent to the shareholders as owners when these are presented in a transparent and understandable way. Here, companies should review for comprehensibility not only the remuneration systems themselves, but also the remuneration reports. The more complex a remuneration system is, the more intensively shareholders will scrutinise it. It is sensible to work with worst and best case scenarios. Of course, the maximum remuneration should be disclosed that would be conceivable in the event of the best possible development and utilisation of all remuneration components. The topic of Executive Board remuneration undoubtedly also includes pension commitments.

For Supervisory Board remuneration, fixed remuneration will continue to dominate, and distinct increases will be visible at the same time. It is important here to exercise moderation and to ensure that the remuneration also includes function-relevant parameters. Committee work should deliberately be rewarded differently. In this way, it is possible to move from key figure-related variable to a function-related, differentiated remuneration for the Supervisory Board.

Supervisory Board and Annual General Meeting

Overall, the focus of the discussion will be even more strongly on the Supervisory Board than it has been the case in recent years. This applies initially to the Chairman of the Supervisory Board, but will be extended to all Supervisory Board members. The new role of the Supervisory Board results from its considerably more extensive list of duties, but also from the fact that shareholders see the responsibility for questions more and more as lying with the Supervisory Board. This leads automatically to significantly more questions to the Supervisory Board, which should relieve the Executive Board. At the same time, it is the job of the Chairman of the Supervisory Board not to give the impression that the Supervisory Board runs the business. It is important here that Supervisory Board and Executive Board are skilled in interacting with each other, both in their respective roles in the system and also at the AGM, and present themselves according to their allocation of tasks.

Super election year 2013

In the 2013 Annual General Meeting season, in the DAX alone around 70 new representatives will be elected on the capital side. Here, shareholders will initially pay attention to the goals set by the Supervisory Board itself with regard to its composition and will compare the self-imposed goals to the nominated candidates. The individual candidates nominated will be subjected to thorough questioning, although they are in the unfortunate situation of not being able to give the answers themselves. In any case, new candidates should present themselves in person, which to start with assumes their presence, which should be a matter of course. Also, the Supervisory Board or the nomination committee should make the whole nomination process as comprehensible as possible. Here, a high degree of transparency leads to a lower number of questions. Surely, the diversity discussion will be a constant companion during 2013 once more, which Chairmen of Supervisory Boards should not see as a problem, but rather as an opportunity to give information about the target composition of the committee.

Independence

The debate about the independence of Supervisory Board members will experience a new dimension, since the Corporate Governance Code stipulates new regulations, but has not given any final explanations on these. Here, care should be taken that individual Supervisory Board members up for election are not seen as "unelectable" due to their lacking independence. There is a fundamental difference between "dependent" and "unelectable", although this distinction will often get lost in the general discussion. Here, too, the Chairman of the Supervisory Board is required to deliver quality communication. In particular, he should not underestimate this topic.

Sustainability

The topic of sustainability is seen by the shareholders as a (normal) part of the corporate strategy. The times in which sustainability was viewed as a special interest only are gone forever. Therefore, the administration likewise should attempt to deal with this interrelated topic area not in isolation, but should convey that sustainability is a pillar of the company's direction. Confining themselves to glossy flagship projects from brochures would not meet this claim. However, at the same time this does not mean that shareholders necessarily demand integrated reporting. The management is free to decide in how far the financial and non-financial information are or have to be presented as interlinked.

Overall, we can assume that the 2013 Annual General Meeting season will be rather quiet, even though the Annual General Meetings at ThyssenKrupp and Siemens gave a different impression. German companies have managed well in general and are therefore in the pleasant situation of being able to report positive results as well. This will of course also have a positive effect on the mood of the shareholders. At the same time, the strong constitution of most companies will quickly reveal those companies that have not managed, in an overall positive environment, to deliver similarly respectable results. The AGMs of these latter companies will therefore be all the less comfortable. Fortunately, this affects only a minority of all companies, so that in 2013 we should not see too many turbulent Annual General Meetings, such as that at ThyssenKrupp AG.

Understanding the CFO's role

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Business planning is one of the most important fields of activity about which the Executive Board is required to report the Supervisory Board (§ 90 (1.1) German Stock Corporation Act (AktG). The organisation of the planning process remains here in the responsibility of the Executive Board. In this cross-functional process, the Finance Director or Chief Financial Officer (hereafter also CFO) takes on more and more responsibility, which goes hand in hand with a general expansion of his/her role. For our understanding of corporate planning, an understanding of the new CFO role is therefore indispensable.

Drivers of the new CFO role

Traditionally, the CFO concentrated on accounting and preparing financial statements, as well as corporate financing. As part of the planning process, the CFO took charge in particular of coordinating the operational planning process, inclusion in strategic questions was sometimes limited. The expansion of the CFO's role is thanks in particular to the rise of the idea of shareholder value and to his/her role as the connecting link between company and financial markets. The close connection to the financial markets assigns a high degree of responsibility to the CFO in times of financial and euro crises as well as the increased structural importance of institutional investors. The role of the CFO is therefore no longer only defined within the company, but to an increasing degree also by the financial markets and the relevant public.

The Chief Executive Officer (CEO) as well as analysts and investors require his/her commitment to strategic work at the highest level. Here, he/she actively shapes topics such as the globalisation of the company through M&A activities, investments abroad or changes in locations. He/she participates in the identification and assessment of growth potential. In this context, the CFO translates the capital market expectations into strategic as well as operational financial targets and breaks them down to the lower levels in the company.

In doing so, the CFO has to manage insecurities and the currently extreme volatility in the financial markets. This new environment in the financial markets not only affects the finance function itself and the company's financing, but also overall strategy.

The expansion of the CFO role shows up very clearly in the Deloitte CFO Survey, which is carried out every six months and reflects the assessments and expectations of CFOs at large German companies on macro-economic, strategic and financial sector topics. In this sense, the following deliberations are applicable in the first instance to large companies, although one can suppose that the trends showing up in large companies will also radiate out in different forms to smaller companies and are likely to be found there, too.

CFO role requirements

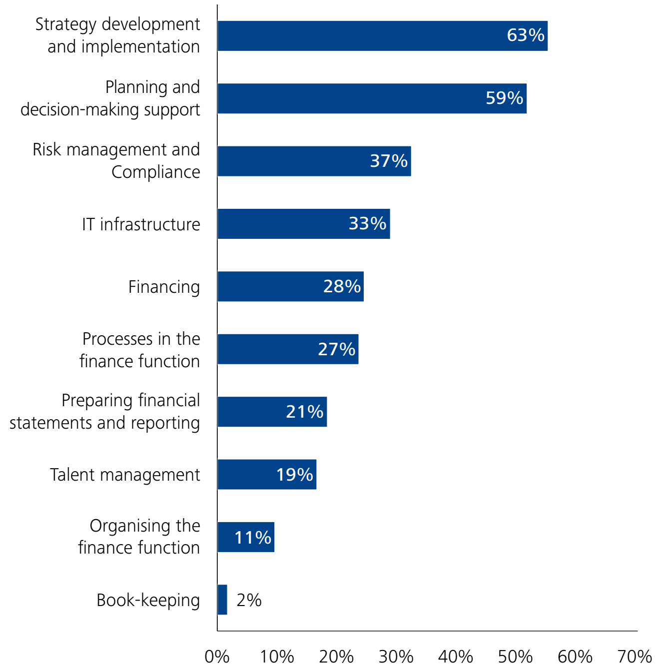
It has been shown empirically on a very fundamental level that the range of tasks and the role requirements have expanded. CFOs in large German companies spend just under half of their working day on topics which clearly belong to the spectrum of strategic tasks. Strategy development and the derivation of the financial strategy for the company are part of this strategic role, the other part is strategy implementation and operational controlling of the company. In the other half of their working time, CFOs apply themselves to topics that are more in line with traditional types of tasks, such as protecting the assets of the company as well as safeguarding financial operations and optimising administrative processes.[1]

However, in the current situation with a high level of uncertainty in the whole economy, their integration into strategy development and implementation dominates the CFO agenda even more strongly. The degree of uncertainty to which CFOs see themselves exposed is unusually high, 91% estimate the level of uncertainty as very high, high or above average.[2] The results from other countries – the Deloitte CFO Survey is carried out in over 20 countries – confirm this assessment.

Strategy development and implementation enjoy the highest priority in this environment. For 63% of surveyed CFOs, this strategic topic is at the very top of their agenda. Planning and decision-making support follow closely behind, some distance behind are the issues of risk management/compliance (37%) and IT infrastructure (33%). The classic CFO task areas trail far behind, for example, financing (28%) and preparing financial statements/reporting (21%).

1 Deloitte CFO Survey 1/2012. Uncertainty clouds good business prospects.
2 Deloitte CFO Survey 2/2012. Controlled defensive as strategy.

Figure 1 – CFO Tasks
Question: which tasks are you currently working on with the highest priority?



Source: Deloitte CFO Survey 2/2012

Figure 2 – CFO: roles-challenges
Question: what challenges are you confronted with currently in your role as CFO?

Source: Deloitte CFO Survey 2/2012

Many CFOs are however currently still insufficiently prepared for this expanded task profile. The high degree of integration into strategy development becomes clear also in the challenges which CFOs face. Here, improving strategy implementation (47%) and improving decision-making support (46%) dominate. Only then do balancing effective and lean control systems (41%) or ensuring information quality (41%) follow.

The additional role requirements and the challenges connected with them also have an effect on the personal concerns of CFOs. Most of the CFOs are worried about the fact that they are required on the one hand to reduce the costs of the finance function permanently – not even they can escape the current trends towards cost reduction as a preferred corporate strategy –, and on the other, that requirements from the CEO, other Executive Board members and the Supervisory Board increase constantly.

Conclusions

The CFO is more and more an important contact person for the Supervisory Board in the preventative supervision of business activity. He/she is also the main contact for the finance experts on the Supervisory Board, as required in § 100 (5) German Stock Corporation Act (AktG). As part of business planning, the CFO can significantly improve planning quality through explicit capital market orientation as well as fact-based analysis and communication. This expanded role profile enables the CFO to fulfil the increased demands from the CEO and the other Executive Board members, without losing his/her independence in assessing the business situation. The Finance Director thus becomes, alongside the Chief Executive Officer, one of the central points of contact for the Supervisory Board and its members. An open dialogue with the Finance Director can therefore be very helpful for the supervisory and consultation activity of the Supervisory Board.

If you would like to participate in our Survey (as CFO of a large company), discuss the results or have suggestions for us, we would be delighted if you contacted us under
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www.deloitte.com/de/cfosurvey.

The Supervisory Board's monitoring duty

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Upper Regional Court of Stuttgart (Oberlandesgericht Stuttgart) decision dated 19.06.2012 – 20 W 1/12

The Higher Regional Court in Stuttgart recently dealt with Supervisory Board members' monitoring duty.

Facts of the case

In the case which formed the basis of this decision, the insolvency administrator of a stock corporation sued the former Supervisory Board members of the company for damages, as he alleged they had not fulfilled their duty of monitoring towards the Executive Board.

The Chief Executive Officer of the stock corporation, who at the same time ran a sole trader construction company, had transferred all employees of the construction company to the stock corporation, whereby the sole trader company continued to carry out construction contracts using the stock corporation's employees. The stock corporation received reimbursement of expenses at the level of the net wage costs plus 40% of the social costs for hiring out the employees. Subsequently, the sole trader company suffered payment difficulties and no longer paid the debts. Due to the high costs, the stock corporation then had to file for insolvency. The insolvency administrator was of the opinion that the Supervisory Board members had neglected their duty by not asserting a claim against the Chief Executive Officer and not making use of any control mechanisms to avoid the damage.

Decision

The OLG Stuttgart resolved, as did the court of first instance, that a claim for damages against the Supervisory Board members did not exist.

A claim for damages did not arise for the reason that the Supervisory Board members had neglected to assert claims against the Chief Executive Officer. The obligation to act on the part of the Supervisory Board members assumes firstly that they were aware or should have been aware of the missing payment of invoices by the sole trader company. In this context, the insolvency administrator must demonstrate and prove that the Supervisory Board members' potentially negligent behaviour had caused damages within their sphere of duties. He should thus have demonstrated and proved that the Supervisory Board knew or should have known that the sole trader company had not rendered the consideration for the previous assignment of employees and that receivables were still open. However, the insolvency administrator had neither demonstrated this sufficiently nor had he named promising evidence on this.

The extent of the monitoring duties of the Supervisory Board depended on the circumstances in each case. In principle, ongoing monitoring of the Chief Executive Officer in explicit detail was neither expected nor permissible, rather, it was sufficient that the Supervisory Board had an idea of the material bases of the management of the business and the most important business events. An obligation to request reports and to carry out investigations over the Chief Executive's head resulted only as a secondary measure if the Chief Executive Officer's reports were unclear, incomplete or recognisably inaccurate or if the Supervisory Board had received credible clues of the CEO's wrongdoing. Therefore, it was not fundamentally a task for Supervisory Board members to audit individual receivables and payments or the book-keeping of the company in detail. In times of crisis, however, as well as where there were hints of a breach of management duties and in particular clues towards management measures threatening the company's existence, a more intensive supervisory activity was required.

Such hints had not been evident to the Supervisory Board members in this case, so that increased monitoring duties could not be assumed.

Practical points

With its decision, the Higher Regional Court in Stuttgart follows the view unanimously represented in the literature, that § 111 (1) AktG does not result in a duty for the Supervisory Board to audit the entire business activity of the Chief Executive Officer in every detail (MüKo-AktG, 3rd ed. 2008, § 111 Rn 44 ff.). Rather, the monitoring activity of the Supervisory Board must normally be carried out in a restrained way.

In the case of a worsening situation, the Supervisory Board must however switch over to supportive monitoring and request additional reports. Also, it must check the introduction of special reservations of consent. When a crisis occurs, the Supervisory Board must switch over to constructive monitoring, analyse the situation and consider existence-maintaining measures for the company. In particular, the Supervisory Board must specifically consider the redesign of business management competencies as well as the dismissal and new appointment of Executive Board members. As long as such risk situations are not identifiable for the Supervisory Board, however, it maintains the normal monitoring duties.

Breach of trust by Supervisory Board members fraudulently billing attendance fees

The Higher Regional Court in Braunschweig stated in its decision dated 14 June 2012 (file no. Ws 44/12 and Ws 45/12) that the Supervisory Board can make itself liable to prosecution under criminal Law for breach of trust if it causes or tolerates a remuneration payment to Supervisory Board members which is in contradiction to the remuneration stated in the Articles of Association.

Facts of the case

Both defendants were chairmen of the Supervisory Board of N plc in direct succession. The Articles of Association of N plc contain a regulation to say that Supervisory Board members are to be recompensed for participating in Supervisory Board meetings, alongside their fixed and variable remuneration, by an attendance fee of EUR 150 per day. It developed into common practice that members of the N plc Supervisory Board not only requested the attendance fee for participation in Board meetings, but also for a number of other appointments, such as discussions with N plc's Executive Board or even for travel days before Board meetings. In total, N plc paid out excess attendance fees in 819 cases. Both defendants gave the member of staff who was responsible for paying out the Board remuneration specific instructions regarding the dates for which she should pay out the attendance fee to the Supervisory Board members, including themselves. The behaviour of both defendants caused N plc a pecuniary loss of EUR 122,850.

The Court's decision

The prior instance, the Regional Court, had refused to commence main proceedings, since the Supervisory Board members had no duty to preserve the company's assets. In its grounds, it referred to the ruling of the Federal Supreme Court, which had recognised for Executive Board members that they had no duty to preserve company assets when making decisions affecting their own earnings. The Higher Regional Court of Braunschweig, however, confirmed that a breach of trust was punishable both due to active behaviour and also omission. The conflict of interest typically arising for Executive Board members in the negotiation of their earnings did not exist in this case: the remuneration of Supervisory Board members, in accordance with § 113 German Stock Corporation Act (AktG) was not negotiated, but was stipulated in the Articles of Association. The defendants had therefore not been accused of negotiating unlawful remuneration, but rather the unlawful implementation of an unambiguous statutory regulation on the determination of remuneration. The court takes the view that no grave breach of duty is required to constitute a factual breach of trust, if the decision to be made leaves no scope for discretion. A procedure which is regulated by the clear wording of Articles of Association permits in the view of the Higher Regional Court no scope for alternative action, so that even attendance in the interest of the company on the dates claimed for and the many years of the billing practice had no influence on the criminal liability of the defendants.

However, billing their own remuneration in breach of the statutes is not the sole reason for the criminal liability of Supervisory Board members. The Higher Regional Court also presumed guarantor status for the Supervisory Board members and therefore liability due to negligence. Aside from their duty to prevent payments in breach of statutes to themselves, a duty falls to the members of the Supervisory Board to prevent unlawful payments to other members, provided that they obtain knowledge of this as part of the supervisory duty.

Practical consequences

The judgement shows the risks under criminal law for Supervisory Board members in matters of their own remuneration. To safeguard themselves, it is recommended that they review the Articles of Association in detail and follow the relevant statutory regulations strictly – even where it affects only small remuneration amounts. Where they have knowledge of unlawful billing by other members of the Supervisory Board, the Chairman of the Supervisory Board is required to convene a meeting of the Supervisory Board and to bring about a resolution which requires the Chief Executive Officer to change the unlawful procedure. Members of the Supervisory Board must induce the Chairman to convene a meeting of the Supervisory Board, and, should he refuse, must convene a meeting of the Supervisory Board themselves § 110 (2) German Stock Corporation Act (AktG). If necessary, the Supervisory Board is required to make the payments contravening the Articles of Association dependent on its approval through an ad-hoc restriction and to prevent them § 111 (4.2) German Stock Corporation Act (AktG). Even if a Supervisory Board meeting would not attain the required majority of votes, Supervisory Board members are only released from their criminal liability if they have undertaken every reasonable action in order to bring about the necessary decision by the Supervisory Board.

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Current legal developments

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German Federal Supreme Court (BGH) confirms judgement on Piech's "Sardinia Statements" (Corporate Governance Forum 3/2012)

In its decision dated 6 November 2012 (file no. II ZR 111/12), the Federal Supreme Court confirmed the legal opinion of the Higher Regional Court of Stuttgart about the so-called "Sardinia Statements" by Porsche Supervisory Board member Piech. The previous instance had decided that Supervisory Boards are under a duty, especially for complex, risky or strategically important business activities, to reach an independent risk analysis Higher Regional Court of Stuttgart judgement dated 29 February 2012 – file no. 20 U 3/11; see also Corporate Governance Forum 3/2012).

The decision

The defendant, Porsche Automobil Holding SE, had submitted an appeal to the Supreme Court against the denial of leave to appeal by the Higher Regional Court of Stuttgart. In the above-mentioned decision, the supreme court confirmed the appellant court's opinion. The Higher Regional Court's ruling is thus legally binding.

In its grounds, the Senate refers in particular to the fact that the appellant court had ruled in accordance with the Supreme Court decisions given to date. Any action by a Supervisory Board member is to be found in breach of duty and unlawful if the Board member does not fulfil their monitoring duty. It is precisely their supervisory activity which manifests their status as a Supervisory Board member. On the basis of the paramount importance of this supervisory function, a Supervisory Board member has a duty to inform themselves about material risks arising from the actions of the Executive Board, and to assess these independently and objectively. Statements by a Supervisory Board member which affect the creditworthiness of the company also represent a violation of duty, since this is to be viewed as a breach of their duty of trust. A Board member who is simultaneously a shareholder of the affected stock corporation may in such a case in certain circumstances not appeal to their constitutionally guaranteed right to criticise the company, insofar as it is mandatory for criticism of the Executive Board not to endanger the creditworthiness of the company.

The affirming decision of the Supreme Court underlines the practical consequences for Supervisory Board members already described in Corporate Governance Forum 3/2012, in particular, not neglecting their own training, so as to be in a position at any time to carry out a meaningful self-critical reflection of their own expert knowledge about material business activities. In future, an increased interest in and critical analysis of Supervisory Board member statements, whether these be purely factual or of a legal nature, is more important than ever for Supervisory Board practice.

Action plan by the EU Commission on the modernisation of European business law and Corporate Governance

In a press release dated 12 December 2012, the EU Commission announced that it had adopted an action plan in which future initiatives in a business law context as well as in the area of Corporate Governance are outlined. The EU's Internal Market and Services Commissioner, Michel Barnier, sees in the action plan a path for the future and a significant promotion of corporate governance.

Short overview of the action plan

The action plan contains in essence three core areas. Firstly, it sketches a guideline, the goal of which is to strengthen the transparency between companies and investors. Its purpose is a more 'open' Corporate Governance, to increase mutual responsibility and achieve a gain in integrity. Secondly, the long-term commitment of shareholders is to be fostered. To do this, rules are to be created which increase the shareholders' participation and have an identity-promoting character. This is to be achieved primarily by measures which enable a more transparent insight and, resulting from this, more functional monitoring of the activity of the company's management. The third core point relates to an improvement of the legal framework for the cross-border activities of European companies. Intention and purpose of this model are to simplify cross-border constellations of any kind in business law with regard to their assessment and especially their practical implementation. The initiatives dealt with in the action plan are both of a legislative and non-legislative nature.

Practical consequences

Depending on the intensity with which the action plan is implemented, the interplay between company management and shareholders will become more transparent, to a greater or lesser degree. This leads simultaneously also to taking the shareholders to task more and more. By receiving additional rights, naturally additional responsibilities ensue for the shareholders vis-à-vis the company. The realisation of the action plan is intended in the first instance to promote the interplay between company management and shareholders in terms of shaping corporate goals, and subsequently to lead to greater joint responsibility.

A look at IFRS: the Statement of Changes in Equity

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The statement of changes in equity is a separate, mandatory component of IFRS financial statements (IAS 1.10). It presents the changes in an entity's equity between the beginning and the end of the reporting period, which reflect the increase or decrease in its net assets (IAS 1.109) and thus represent an important source of information for users of financial statements. Furthermore, as with the other components of the financial statements, the disclosure of a statement of changes in equity for the previous period is prescribed (IAS 1.38 et seq.).

Fundamental structure

In practice, the statement of changes in equity is normally presented in tabular form, as is also the case in the illustrative example in the Appendix to IAS 1. While the columns show the individual categories of equity, the sources of the changes in equity are shown in the rows. The first item is a restatement of the opening balance, insofar as the retrospective correction of an error is required pursuant to IAS 8.42. The same applies if accounting policies were changed and these changes must be made retrospectively under the applicable IFRS. In this connection, IAS 1.110 makes it clear that such an adjustment is not a change in equity but an adjustment to the opening balance of retained earnings or – if so required by the relevant IFRS – to another component of equity.

Sources of changes in equity

Following any restatement of the opening balance, the comprehensive income for the reporting period is to be shown in a single row. This is defined on the one hand by the transactions recognised in the profit or loss statement (income statement) and on the other by the income recognised in other comprehensive income (OCI). Other comprehensive income includes, for example changes not taken to profit or loss in the fair value of held-for-sale securities and currency translation differences in the group and – mandatorily from the 2013 financial year onwards – the actuarial gains and losses resulting from changes in assumptions relating to defined benefit pension plans. Apart from the comprehensive income, further changes in equity such as transactions with owners (in their capacity as owners) are to be presented, whereby contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control are to be shown separately (IAS 1.106 (d) (iii)). The last row of the statement of changes in equity shows the final balance at the closing date of the reporting period.

Allocation of the sources to the components of equity

The above-named sources of changes in equity are to be allocated to the columns of the statement of changes in equity according to the relative equity component affected (IAS 1.106 (d) (i + ii)). These include the subscribed capital, the capital reserve, revenue reserves, the earned result and the various matters recognised in other comprehensive income such as, for example, the currency translation reserve, the revaluation reserve and the reserve resulting from cash flow hedges. In addition, the share of non-controlling equity investors in group subsidiaries is to be stated separately. Finally, a column with reclassifications is to be inserted into the statement of changes in equity insofar as transactions have led only to a change of the same amount between individual equity components (for example the conversion of reserves into subscribed capital in the course of a capital increase out of retained earnings).

Optional disclosures in the Notes

An entity shall present, either in the statement of changes in equity or in the Notes, an analysis of other comprehensive income by item and also the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share (IAS 1.106A & 1.107).

Relevance to DPR

Within the framework of the Corporate Governance of an entity it should be noted that the German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung – DPR) has explicitly mentioned shortcomings in the statement of changes in equity in its current Activity Report for 2011, underlining the equally prominent presentation of the statement of changes in equity in comparison to other components of the financial statements required by IAS 1.11. Apart from the completeness of the disclosures, in particular the reporting of disclosures required to be included in the statement of changes in equity in the Notes instead might well be a frequent source of errer. Moreover, it should be noted that capital contributions and dividends are not recognised in comprehensive income (see explanation in IAS 1.BC75).

Events

- Deloitte Executive Dinner with Volker Bouffier, State Premier of Hessen, Frankfurt, 4 June 2013
- Liability of Managers and Supervisory Boards, Stuttgart, 4 June 2013
- Deloitte Executive Dinner with Dr Guido Westerwelle, Federal Minister for Foreign Affairs, Berlin, 6 June 2013
- Deloitte Executive Dinner with Winfried Kretschmann, State Premier of Baden-Württemberg, Stuttgart, 18 November 2013

Publications and further information

- Plendl/Kompenhans/Buhleier (editors): The Audit Committee in the Stock Corporation – Practical Guideline for Supervisory Boards
- Deloitte Global Center for Corporate Governance: Women in the boardroom – A global perspective
- Director's Alert 2013: Lead or be led
- Global Economic Outlook Q1 2013
- Self-evaluation Supervisory Board: Support for the efficiency check, 2nd edition
- Self-evaluation Audit Committee: Support for the efficiency check, 2nd edition
- Self-evaluation Supervisory Board: Support for the efficiency check for municipal enterprises
- Enforcing financial reporting – DPR guideline for Executive and Supervisory Boards
- Finance & Accounting Forum – Current news for managers: Special Edition Shared Services, issue 1/2013
- Kompenhans/Buhleier/Splinter: Determination of audit focal points by Supervisory Board and auditor, in: The Audit, 2013, p. 59–66
- The Sustainable Board. White Paper from the Deloitte Global Center for Corporate Governance
- Buhleier/Splinter: The Corporate Governance Code and the financial expert on the Supervisory Board, in: BOARD – Magazine for Supervisory Boards in Germany, issue 3/2012, p. 106–109

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Note

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