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Corporate Governance Forum
Information for Supervisory Board and Audit Committee Members

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The monitoring obligations of the Supervisory Board hit the headlines time and again. This is mostly caused by acute corporate crises that make people ask what the Supervisory Board did to detect the crisis in good time, to induce the Executive Board to take appropriate counter-measures, and to alert investors promptly and adequately of the impending disaster. Closer inspection shows that in many cases the Supervisory Board was entirely blameless – it had intensively monitored and supervised the Executive Board at all times, scrutinized its actions on the basis of the information available, and documented and archived everything so as to stand up in court. The fact that a corporate crisis nonetheless ensued accords with the fundamental fact that all commercial endeavors involve unforeseeable risks. So a particular challenge of the Supervisory Board's activity may reside in conveying the message to investors, stakeholders, and the general public in an emergency or even preemptively that the object of its activity can "only" ever be the containment of risks – not their complete elimination.

As such, the monitoring activity is supplemented by providing management with advice on possible alternative courses of action, though here the Supervisory Board is not permitted to exceed the limit of the company's own management. The "customers" of the Supervisory Board are – according to the principles of the German Corporate Governance Code – not only the shareholders but also other stakeholders, particularly the company's employees and creditors. In formal terms, however, the Supervisory Board is accountable only to its direct clients, namely the shareholders within the framework of the General Meeting.

Monitoring and advisory areas

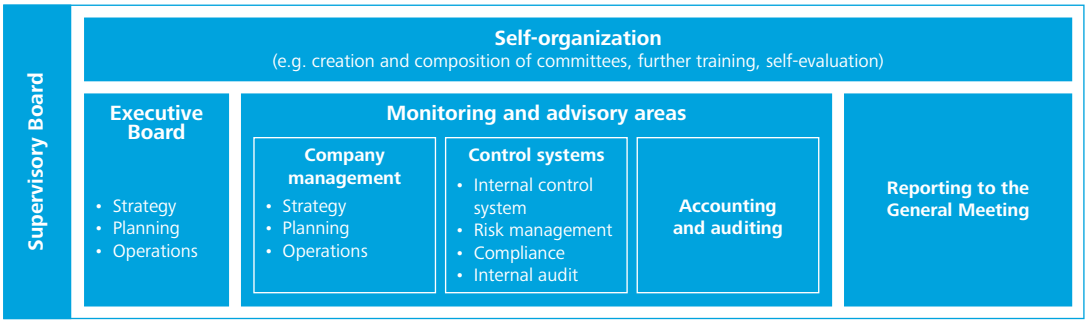
The monitoring and advisory activity of the Supervisory Board is subdivided into various interrelated areas of action (Figure 1).

The primary object of the Supervisory Board's activity is of course the company's management. As such, particular emphasis rests on management's strategic decisions in terms of "ex-ante control". In this respect the Supervisory Board's activities relate in particular to control of the premises underlying the Executive Board's strategic decisions and thus presuppose sector-specific expertise on the part of the Supervisory Board. The Supervisory Board can and should use such knowledge – without interfering in the management itself – to assist and support the Executive Board as a sparring partner in strategic considerations.[1] But of a more formal nature – almost as a safety net – is the determination of legal transactions requiring approval under § 111 (4.2) of the Stock Corporation Law (Aktiengesetz – AktG), with the aim of linking the implementation of the Executive Board's strategic decisions to the approval of the Supervisory Board.

As regards execution of the Executive Board's strategic decisions, the Supervisory Board monitors their passage into corporate planning and corporate implementation. So here it is more about ex-post controls of what actually happens in the company, controls which should show how effectively the Executive Board is planning and managing its resources.

At the same time the Supervisory Board – or the Audit Committee, if there is one – must monitor whether

Figure 1 – Monitoring and advisory areas of the Supervisory Board



[1] We refer in this respect to the contribution from Mr. Strenger on page 4 and to the contribution from Dr. Buhleier on page 10 of this issue.

the Executive Board has established effective corporate control systems to prevent or expose undesirable developments at the operational level. This obligation to monitor corporate control systems has been legally entrenched with the BilMoG (§ 107 (3.2) AktG) and, on account of the wide-ranging formulation of tasks, has led to discussions on options, limitations, and expectation gaps regarding the activity of the Supervisory Board, usually conducted as a sideline. This is particularly the case because the monitoring obligation relates to all the company's control systems – it is not confined to the parts concerned with accounting. By law, the monitoring obligations of the Supervisory Board relate not only to the accounting process but also to the entire internal control system, the risk management system, and the internal audit system.

As a basic principle, it must be borne in mind in this connection that the Supervisory Board is not itself under any obligation to verify the effectiveness of the corporate control systems. But it must assure itself that the Executive Board has for its part established the necessary corporate control systems and is monitoring their functioning by ongoing effectiveness tests.

The obligation to establish effective control systems in the company principally ensues from the general duties of care of the Executive Board (§ 76 (1) in conjunction with § 93 (1.1) AktG). The Executive Board is therefore free in principle to decide which control systems it establishes and how it does so. But there is a minimum legal requirement in § 91 (2) AktG according to which the Executive Board of a stock corporation is obliged "to take appropriate measures in particular to establish a monitoring system so that developments jeopardizing the continued existence of the corporation can be detected at an early stage" (establishment of a system for the early detection of risks).

If the Executive Board has not established corporate control systems in certain areas, the Supervisory Board must ascertain whether their establishment is necessary. This also applies to the establishment of a compliance system, though this term is not explicitly mentioned in the law. The aim of a compliance system is to ensure compliant conduct on the part of the company's legal representatives and employees and, as the case may be, on the part of third parties.

Finally, the monitoring and advisory areas of the Supervisory Board – or the Audit Committee, if there is one – include a duty to examine the company's annual and consolidated financial statements and management report and to monitor the accounting process and the statutory audit.[2] This is the area of responsibility of the Supervisory Board in which most standards and pointers are found. The target specifications for accounting and auditing are codified – in complete contrast to the requirements for corporate control systems. Cooperation with the statutory auditor is a further subject of innumerable publications and standards, including those of the Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer) and the Federation of European Accountants (FEE).

But it is precisely in the number and complexity of the standards and pointers in that area wherein the actual difficulty lies. With the introduction of the regulation in § 100 (5) AktG according to which at least one independent member of the Supervisory Board in publicly traded companies must have accounting and auditing expertise, the legislator has attempted, using yet another regulation, to let the Supervisory Board successfully complete the flood of accounting standards and regulations. As regards monitoring of the statutory audit, it is for the usual services of the audit firms to assist Supervisory Board members in implementing and documenting these requirements where possible.

Conclusion

All told, it is clear that the dualistic system practiced in Germany in the "competition among systems" has not only survived, that an increasing tendency to appoint nonexecutive directors must also be noted in English-speaking countries; further (possible) approaches for improving the effectiveness of monitoring on the part of Supervisory Board members are the subjects of much discussion, including matters of Executive Board compensation, the independence requirements of Supervisory Board members, and diversity as a success factor for the work of the Supervisory Board.

[2] See in this respect Buhleier/Krowas, Persönliche Pflicht zur Prüfung des Jahresabschlusses durch den Aufsichtsrat, in: Der Betrieb 2010, pages 1165–1170.

The advisory tasks of the Supervisory Board

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Providing advice extends the role of the Supervisory Board from a more retrospectively active control and examination body to a future-oriented board that has to think, discuss, and reach joint decisions as a corporate body. The advisory function is set out clearly in terms of the law: Under §111 (4) AktG, the Supervisory Board must approve certain transactions. The task of appointing (and dismissing) Executive Board members also presupposes a considerable quality of advice. The German Corporate Governance Code (5.1.1) mentions the task of advisor even before the monitoring function. What, now, are the concrete tasks of the Supervisory Board? It must advise on the company's strategy knowledgeably, monitor this strategy by way of transactions requiring approval, and decide on appropriate Executive Board compensation and dividend proposals. Comprehensive expertise of relevance to the company is necessary if the Executive Board is to be confronted on equal terms.

But the best expertise is useless without relevant information, and time and again there are problems in this respect: When information arrives, it is often too little, too much ("data mountain"), or too late. In the first instance, the Executive Board is under a duty to provide appropriate information; but when shortfalls are identified the Supervisory Board then has a duty to obtain such information. A best practice information regime is required if misunderstandings concerning content and timeliness of information are to be avoided.

Dealing with the advisory task convincingly thus requires the ability to discuss material transactions on the basis of relevant decision-making criteria critically and without prejudging the outcome. Only as a result of this will the requirements for a liability-absolving business judgment rule also be fulfilled. The chairman of the Supervisory Board should set an example with a high quality of dialogue among the Supervisory Board members and a culture of open discussion: in doing so, he must ensure that it is the company's interests that are addressed and not individual interests. Also vital if advice is to achieve good results are preliminary meetings between the Supervisory Board and the Executive Board with open discourse on the expectations of shareholders and employees.

A smaller number of participants and better focusing on the respective interests contribute to better results. It must be borne in mind, however, that only procedures that are advised on and minuted in a plenary meeting are legally binding. Given growing complexity, the Supervisory Board or its committees may call on outside expertise, and this is being increasingly sought in respect of the appropriateness of the amount and structure of Executive Board compensation and adequate dealing with the monitoring obligation set out in the BilMoG for the internal control, compliance, audit, and risk management systems.

This increase in advisory intensity must also involve a higher frequency of meetings: The traditional requirement of four meetings a year is no longer enough, as is clearly proven by the average now seen among DAX companies of almost seven meetings. Intensive advice in committees is now a standard part of corporate governance.

The matter of compensation is also connected with the intensification in Supervisory Board activity: The advisory task is a year-round obligation that must be remunerated by appropriate compensation for Supervisory Board members. But the recent proposal of fixed compensation for each day depending on the type of advice is unsuitable since it does not relate to a specific service. Successful advice and indeed control require giving total consideration and support over many years and cannot be compensated with daily rates. Instead, additional benchmark-related compensation should also be awarded in the event of particularly outstanding success (lasting at least three years).

Last but not least: An indispensable prerequisite for successful advice is the observance of legally binding but all too often breached confidentiality. Without confidentiality, an intensive and at times controversial exchange of ideas is impossible. It is precisely in large corporations with lukewarm performance that you can still come across improper, interest-led handling of business secrets, resulting in media-related complications and reputational damage. In such cases the offenders need to be pursued even more uncompromisingly.

Obligation to form a judgment for Supervisory Board members: No rubber-stamping!

Whenever companies attract public interest in spectacular fashion, be it because of massive losses, corruption, or insolvency, the search begins very quickly for those responsible. While such searches would even a few years ago have focused on a company's Executive Board members and officers, it is now increasingly the Supervisory Board members who are targeted by potential claimants.

Obligation to form a judgment

In its judgment of February 29, 2012 – case 20 U 3/11 – ("Piëch decision")[1] the Higher Regional Court (Oberlandesgericht – OLG) Stuttgart set out the duties of members of the Supervisory Board. According to this judgment, all individual Supervisory Board members must, before the Supervisory Board meets to take a decision, form their own judgments on the matter to be decided and may not vote before having formed such opinion. If they vote nonetheless, they are not performing their duties as members of the Supervisory Board. It is important in this respect that the OLG takes the view that the obligation to form a judgment at all times entails making a distinction, depending on the importance of the decision and the company's situation, only as regards the extent of the efforts to form a judgment. The Federal Court of Justice (Bundesgerichtshof – BGH) confirmed in its decision of November 6, 2012 – case II ZR 111/12 – that the decision of the Stuttgart OLG was legally binding and would de facto have considerable binding effect for all German courts hearing Supervisory Board matters. Participation in any Supervisory Board decision therefore at all times represents a breach of duty for the individual member if this happens without having formed his own opinion. The only question still outstanding is that of the loss caused thereby and the concrete amount of loss.

It is precisely the loss requirement that is likely in practice to represent a serious problem for any potential claimant for compensation. Any loss is always calculated by the courts on the basis of what is termed the difference hypothesis, thus the amount produced by comparing the assets of the aggrieved party in light of the contested action with the assets that would have resulted hypothetically by acting properly.

Finally, support for the Supervisory Board member in the company is also of great significance. While the Porsche family holds over 50% of the ordinary shares in Porsche so that Mr. Piëch has very strong dynastic power, a corresponding shield is lacking in many other companies, making Supervisory Board members vulnerable both from within and without: Mr. Piëch is still a Supervisory Board member at Porsche; on the other hand, for example following the Brazil affair at ThyssenKrupp, almost all previous Supervisory Board and Executive Board members have left.

Extent of the supervisory activity

Despite the criticism levelled at much Supervisory Board conduct, it is unanimously prevailing case law that the Supervisory Board can and may in no way become the company's "super Executive Board". Just as the Supervisory Board may not restrict itself to merely "rubber-stamping" the Executive Board's acts, nor may it at the other extreme take the place of the Executive Board. Under normal corporate conditions, the Supervisory Board can conduct an ex-post control of the Executive Board's activity in a permissible manner every three months. The Supervisory Board members do not at this stage have to examine individual business transactions, payments, accounting documents, components of the Executive Board's conduct, etc., but they can count on the reports of the Executive Board as truthful and then check the appropriateness of such reports in terms of content and form a judgment on this basis. The Supervisory Board members may do this as long as no evidence emerges of misconduct or a crisis in the company. This was also established, in accordance with prevailing case law, by the Stuttgart OLG in another decision from 2012 (June 19, 2012 – case 20 W 1/12). If, however, evidence emerges of failure on the part of the Executive Board (or even of other Supervisory Board members) or of a crisis in the company, the Supervisory Board must with ever greater intensity increase the extent of its control and in an extreme case dismiss any member guilty of misconduct or the entire Executive Board and appoint a new one. But again how far the Supervisory Board's criticism is permitted to go was the subject of the "Piëch decision" of the Stuttgart OLG: The critical Supervisory Board was permitted to endeavor to protect the company from wrong decisions may not go as far as damaging the company in another way. In the Piëch case, the Supervisory Board's its criticism had jeopardized Porsche's credit standing.

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[1] Preceding the judgment was an action for rescission brought by a shareholder of Porsche SE, which related to the General Meeting's resolution to formally approve the Supervisory Board. The Supervisory Board member Dr. Ferdinand Piëch had previously stated publicly that he had not succeeded in obtaining clarity on the risks of option contracts associated with Porsche's attempted takeover of Volkswagen.

Liability of the Supervisory Board and its limitation by the business judgment rule

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Introduction

The activity of the Supervisory Board has changed considerably in the past several years. Whereas it was previously for the most part an honorary office, it now involves regular work of an important and highly professional nature. Factors behind this include the composition of the Supervisory Board, the number of meetings, preparation and conduct of such meetings, and a growing committee workload. At the same time the number of claims against governing body members of stock corporations has increased enormously. In this respect it must be borne in mind that, according to information from D&O insurance companies, well over 90% of all liability cases are settled out of court.

In § 116 AktG, the liability of the Supervisory Board with respect to the company is regulated in case of culpable behavior. This provision refers to the liability of the Executive Board (§ 93 AktG). But this does not mean that the obligations of the Supervisory Board correspond to those of the Executive Board. The Supervisory Board has a different sphere of obligations, and is not responsible for the management of the company, its main task being to monitor the Executive Board.

General significance of the business judgment rule (BJR)

As is known, the liability of the Executive Board is very extensive. But there is a substantial limitation if it could be reasonably assumed when taking any corporate decision that it acted on the basis of appropriate information for the good of the company (§ 93 (1.2) AktG). This regulation, whose content by the way already applied before in case law, was in 2005 expressly adopted in the AktG by the Law on Corporate Integrity and Modernization of the Right of Rescission (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts – UMAG). The purpose of the BJR is to grant the diligently working Executive Board a broad margin of discretion when making corporate decisions, otherwise it would be impossible for the company to act. If the conditions of the BJR are met when taking a decision but the decision subsequently turns out to be wrong, the Executive Board is not liable with respect to the company.

It is often not realized that the BJR applies only when corporate decisions are taken. These do not in particular include what are termed "legally binding decisions" where obligations under the law and the articles of incorporation must be observed. If such a procedural irregularity exists, application of the BJR is excluded. Apart from that, case law lays down stringent requirements on the BJR for it to achieve "safe haven" status. All that should be recalled in this connection is the procurement of sufficient information and the possibility of avoiding an erroneous decision.

The BJR is of relevance to Supervisory Board members in two respects. First, it means for them that insofar as its existence excludes the liability of the Executive Board, there is no liability on the part of the Supervisory Board either. This is because insofar as the Executive Board has acted within the BJR, its action accorded with its obligations and no action is legally required of the Supervisory Board.

Individual significance of the business judgment rule for Supervisory Board members

But the BJR also has a primary, liability-limiting effect for the Supervisory Board. For the Supervisory Board, this limitation of liability applies in particular if it participates in any corporate decision. This includes first and foremost consenting to the Executive Board's transactions requiring approval. But also included given the different tasks of the Supervisory Board are:

- appointment/dismissal of Executive Board members and determination of their compensation
- participation in approval of the annual financial statements
- selection of and award of contract to the statutory auditor as well as definition of the main aspects of the audit
- participation in opinions required under takeover law

Another important obligation of the Supervisory Board is to pursue breaches of obligations by active or former Executive Board members. According to case law, the matter of pursuing such claims for damages represents only to some extent a discretionary decision. Thus the Supervisory Board will be unable to regularly refer to the BJR in respect of this matter.

Conclusion

In current court practice, the BJR does not represent the basis of any avoidance of liability as would be desirable. There are too many hurdles to be overcome if the BJR is to achieve "safe haven" status. Thus the courts lay down particularly stringent requirements for sufficient information as a basis of the corporate decision and sufficient documentation as well. From the viewpoint of the acting governing bodies, a much wider interpretation of "corporate decision" by the courts would be desirable.

Criminal liability of the Supervisory Board

Supervisory Board members have complex, multilayered rights and obligations. Misconduct on the part of Supervisory Board members increasingly has criminal consequences in addition to personal civil liability.

Embezzlement under § 266 of the Criminal Code (Strafgesetzbuch – StGB)

The main function of the Supervisory Board is to monitor the conduct of management in accordance with § 111 (1) AktG. The more stringently Supervisory Board members approach the corporate decision within the framework of the monitoring activity by virtue of their duty under the law or the articles of incorporation, the more stringent are the requirements of care. If, for example, the Supervisory Board approves a measure that at the same time represents a criminal offense, such as an act of embezzlement on the part of the Executive Board, every Supervisory Board member granting the approval is also liable to prosecution.

Without express approval, the personal criminal liability of the individual members would be more difficult to assess. In this respect only in glaringly exceptional cases where the Executive Board acted in a grossly inefficient or unlawful way and the Supervisory Board knew about it would it be possible to base criminal liability on aiding and abetting by omission. But even then it is still necessary for the unlawful actions of the Executive Board to be directed against the company's financial interests. This is because the Supervisory Board has an obligation of guarantor only in this respect.

Other criminal entanglements of the Supervisory Board member are conceivable in cases where his control activity covers actions of the Executive Board that might trigger obligations to provide compensation. In this respect the Supervisory Board has an obligation to care for assets within the meaning of § 266 StGB, i.e. the Supervisory Board is obliged to pursue claims for damages against the Executive Board. Exceptionally, only in the event of damaging negative publicity for the company or if the claim cannot be realized is it possible to forebear from doing so.

But in addition to its monitoring obligations, the Supervisory Board also has primary, i.e. decision-making, powers. The BGH made it clear in its Mannesmann decision that Supervisory Board members were also obliged to act within the terms of reference of §§ 93, 116 AktG and to refrain from any measures that would result in the occurrence of certain financial loss for the company. But not every decision of the Supervisory Board that results in a loss for the company represents at the same time a breach of the obligation to care for assets. The Supervisory Board is blameless as long as the decision is taken within the framework of a corporate action that is supported by a sense of responsibility, is oriented exclusively to the good of the company, and rests on a diligent decision-making basis. But the appropriateness of compensation decisions on Executive Board salaries has sharper contours (see § 87 AktG). The BGH has also made it clear that disbursement of company assets in breach of fiduciary duty must be assumed if a special payment not agreed in the employment contract for performance owed is exclusively rewarding in nature and brings the company no future benefit whatsoever.

Accounting offenses

One of the most important tasks of the Supervisory Board is to participate in the examination and determination of the approval of the annual and consolidated financial statements. There are also risks of criminal liability here in the event of erroneous accounting. Under § 331 (1, 2) of the Commercial Code (Handelsgesetzbuch – HGB), anyone falsely reflecting or concealing a company's circumstances is liable to prosecution. Not every breach of accounting regulations leads to criminal liability, but there must be a considerable breach of duty, which is only the case if the accounting method used was completely unjustifiable. The Supervisory Board member must also know or at least regard it as a possibility that the presentation in question is wrong or contains a concealment.

Breaking the obligation of confidentiality

Breaching the obligation of confidentiality under § 404 AktG establishes a duty of secrecy for Supervisory Board members. If the Supervisory Board member discloses or makes use of a secret, he is liable to prosecution. But there must be a corresponding intent to observe and interest in observing secrecy. Not every fact known to the Supervisory Board member is a secret. But if value is attached to confidential treatment of the fact and justified financial interests are concerned, the Supervisory Board member has a duty to maintain silence.

Conclusion

In his actions, the Supervisory Board member must also increasingly take account of criminal provisions. The more complex and more untransparent the facts, the greater the need to seek legal advice.

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Composition of the Executive Board by the Supervisory Board

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Supervisory Board members are confronted with the challenging task of filling the Executive Board with the "best heads" in the interests of the company. The assessment required for this purpose of the candidate's technical and human skills is but one aspect of the process: the Supervisory Board must observe a host of legal provisions when selecting and filling the Executive Board.

Exclusive competence of the Supervisory Board

As laid down by the AktG, the Supervisory Board decides as an overall governing body and autonomously on the appointment and reappointment of Executive Board members and their employment contracts. Accordingly, the Supervisory Board is under no legal obligation to heed the specifications of the General Meeting, individual shareholders, and third parties even if they are contained in the articles of incorporation. Also of no consequence are agreements that grant the General Meeting or other persons co-decision rights of any kind.

Nor may the Supervisory Board assign its powers to appoint Executive Board members to any committee established by it, which means that it must decide on such procedures in plenum. The same rule applies to conclusion, amendment, and termination of Executive Board employment contracts, which means that neither committees nor individual Supervisory Board members may decide in particular on matters connected with Executive Board compensation. The Supervisory Board may if need be entrust a committee with, say, managing negotiations on the main points of the employment, contacting recruitment consultants, etc.

Corporate discretion

In accordance with its exclusive competence for the composition of the Executive Board, the Supervisory Board has its own corporate discretion when deciding on the composition of the Executive Board. No agreements or rules in the articles of incorporation whatsoever may effectively restrict such discretion. The Supervisory Board must at all times in its decisions observe the legal suitability requirements and grounds for exclusion (§ 76 (3) AktG). Regarded as a benchmark for its human resources policy are the interests of the company, which fundamentally requires long-term human resources planning taking account of suitable candidates for the managerial position in question and permits only appropriate compensation for the activity as manager.

When questioning the reappointment of Executive Board members, the Supervisory Board must deal with the past performance of the Executive Board member in question and reach a decision on the reappointment taking account of the person of the member, the function of the position in question, and the tasks to be fulfilled. In this connection the Supervisory Board should already have ensured at the time of the initial appointment that the Executive Board employment contracts did not specify such high compensation that the Executive Board member in question would not be reappointed. Depending on the circumstances of the individual case, any earlier binding undertakings on the part of the Supervisory Board on continued payment of full salaries or very high pensions may be impermissible because they inappropriately restrict the Supervisory Board's discretion and may result in the Supervisory Board's reappointing an unsuitable Executive Board member to the detriment of the company.

Nondiscrimination

The protection granted by the General Equal Treatment Law (Allgemeine Gleichbehandlungsgesetz – AGG) against discrimination on grounds or race or ethnic origin, sex, religion or belief, disability, age, or sexual orientation applies to members of the Executive Board insofar as it concerns the conditions for access to employment and promotion. The Supervisory Board may not therefore be guided by such factors in its recruitment decisions since candidates rejected for such reasons may be entitled to claim compensation. Conversely, the Supervisory Board should not decide "solely for worthy reasons" in favor of anyone who displays the attributes established in the AGG (example: the Supervisory Board appoints a woman so that a woman is "finally" represented on the Executive Board). This may lead to discrimination against the rejected candidates who do not have the corresponding attribute. Thus the guideline applies to Supervisory Board members that they may not base their recruitment decisions for filling managerial positions on the features specified in the AGG.

Given the current lively debate being conducted in society and political circles about the mandatory involvement of women at senior management level in companies, reference is made to section 5.1.2 of the German Corporate Governance Code (GCGC) according to which one of the principles of good corporate governance of a listed company is that the Supervisory Board will pay attention to diversity in respect of the composition of the Executive Board and in doing so strive in particular

to take due account of women. As such, the Supervisory Board must ensure that implementation of the (non-mandatory) objective of taking due account of women does not conflict with its obligations under the AGG.

Term of office

The maximum term of office of Executive Board members of a stock corporation is five years from when they take office. Reappointments for five-year terms are permissible, on which the Supervisory Board may decide not earlier than one year before expiry of the term of office under way. The BGH decided in 2012 that the Supervisory Board did not breach this principle if it had already (amicably) canceled the appointment with the Executive Board member more than one year before expiry of the term of office and then decided on the reappointment – for a maximum term of five years. The maximum term of five years also applies to employment contracts, which are handled in a legally separate matter. Employment contracts may, however, contain extension clauses, which state that the contract will be continued if the Supervisory Board reappoints the Executive Board member.

Executive Board compensation

The core element of any employment contract is the provision on the Executive Board member's compensation. Here the Supervisory Board must proceed with particular sensitivity: on the one hand, attractive compensation is necessary to attract outstanding Executive Board members and, on the other, it may not exceed the appropriateness limit set in § 87 (1) AktG. The appropriateness of Executive Board members' compensation could fill many a book and is a regular topic of public debate. Since setting Executive Board members' compensation at inappropriately high levels can result in the Supervisory Board's being liable for damages, it must exercise correspondingly great care.

The Supervisory Board decides autonomously within the framework of the appropriateness limit laid down by § 87 (1) on the salaries of Executive Board members. So it is not bound by rules in the articles of incorporation or guidelines issued by the General Meeting containing provisions connected with this matter. This also applies in respect of any resolution of the General Meeting of a listed company on the compensation system (say-on-pay): such a resolution is not binding on the Supervisory Board, with the resulting public impression generated being that it may in practice be likely to influence the Supervisory Board.

In summer 2013 the Bundestag decided in the context of the Amendment of the German Stock Corporation Act (Aktienrechtsnovelle) that the Supervisory Board of a listed company had to submit to the general meeting each year the system for compensating Executive Board members for a binding vote. If by its resolution the General Meeting rejects the compensation system submitted by the Supervisory Board, the Supervisory Board will be obliged to adapt the compensation system. The current Bundesrat sees considerable practical problems in this rule and has therefore convened the Joint Committee (Vermittlungsausschuss) and for the time being stopped entry into force of a binding say-on-pay.

On January 1, 2014, the new rules enter into force in the Banking Law (Kreditwesengesetz – KWG), which in implementation of the CRD IV Directive limits the bonuses of executives of financial institutions and financial service providers. The Supervisory Boards of such companies will therefore in future have to heed the principles and compensation ceilings set out in the KWG when setting Executive Board salaries. If existing contracts contain compensation components that are inconsistent with the provisions of the KWG, they will have to be adapted as soon as possible to the new legal situation.

Recommendations for practice

Supervisory Boards reach their human resources decisions autonomously using their own discretion. Accordingly, they are not bound by instructions or other influences from the General Meeting, individual shareholders, and third parties. A principle of this type might breach the provision, not for the time being in force, on any binding say-on-pay. Since the selection of Executive Board members and the appropriateness of their compensation have of late been subject to particular attention on the part of the general public and the legislator, Supervisory Board members must in this respect expect their activity to be scrutinized critically and thus to reach particularly carefully considered decisions.

Corporate strategy and its monitoring by the Supervisory Board

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The ongoing financial and economic crisis has done and is doing much to make investors, Executive Board members, and Supervisory Board members aware of the issue of a corporate strategy based on opportunities and risks. Even though the German economy is performing well above the average by international standards, German companies are currently extremely preoccupied with acquiring further competitive advantages and exploiting the market opportunities coming their way.

The corporate strategy determines the company's basic orientation for ensuring its future success. Development and implementation of the corporate strategy are core corporate governance tasks and come within the area of responsibility of the Executive Board in a stock corporation (§ 76 (1) AktG). The illustration on the next page gives a standardized overview of the development of a corporate strategy.[1] By law, Supervisory Boards do not have to (jointly) develop the corporate strategy but must instead monitor the corporate strategy and its implementation (§ 111 (1) AktG).

As part of the Supervisory Board's advisory tasks, however, it is now increasingly expected that it will oversee the corporate strategy, provide proactive stimuli, and monitor it in a future-oriented manner. In accordance with this modern understanding, the German Corporate Governance Code (GCGC) requires the Executive Board to vote on the company's strategic orientation with the Supervisory Board and to discuss strategic implementation with it at regular intervals (paragraph 3.2 GCGC).

The debate on corporate strategy is generally triggered by the annual report to be given by the Executive Board to the Supervisory Board on the intended business policy (§ 90 (1.1) AktG), during which it is usual to address deviations from objectives reported in the past. Increasing reporting and debating frequency is also conceivable if, for example, the Supervisory Board demands reports during the period on the status of the strategic implementation. In practice, a strategy committee or strategy meeting enables the Supervisory Board to go into the corporate strategy in depth.

The mirror image of the Supervisory Board's task to advise on corporate strategy is an obligation on the part of the Executive Board to take advice from the Supervisory Board on corporate strategy and to reflect on its suggestions constructively and critically. In doing so, the technical skills and industry-specific knowledge of experienced Supervisory Board members can be utilized and the proposed corporate strategy can be scrutinized independently of the Executive Board. From the perspective of the Executive Board, the Supervisory Board's advice on strategic matters provides an opportunity to reach agreement between the Executive Board and the Supervisory Board on the planned corporate strategy and, as a result, to ascertain at an early stage the Supervisory Board's future support when the strategy is implemented.

The company's particular situation, structure, and market position should at all times be considered when the Supervisory Board advises the Executive Board. In doing so, the Supervisory Board can take advantage of its industry-specific experience to act as a sparring partner with the Executive Board in terms of strategic considerations. The advice must be targeted at the propriety, legality, profitability, and fitness for purpose of the company's strategic orientation. The Supervisory Board exceeds its limit on providing advice if it interferes in the management of the company, a matter for which the Executive Board has direct responsibility (§ 76 (1) AktG). In the literature, for example, the preparation and transmission of alternative plans by the Supervisory Board is regarded as impermissible.

In assessing the corporate strategy, the Supervisory Board will attend to whether the corporate strategy is complete, the underlying assumptions are coherent in themselves, the resources needed for its implementation are available, implementation of the strategy is measurable, and a connection exists to Executive Board compensation that is sustainable and oriented to the long term.

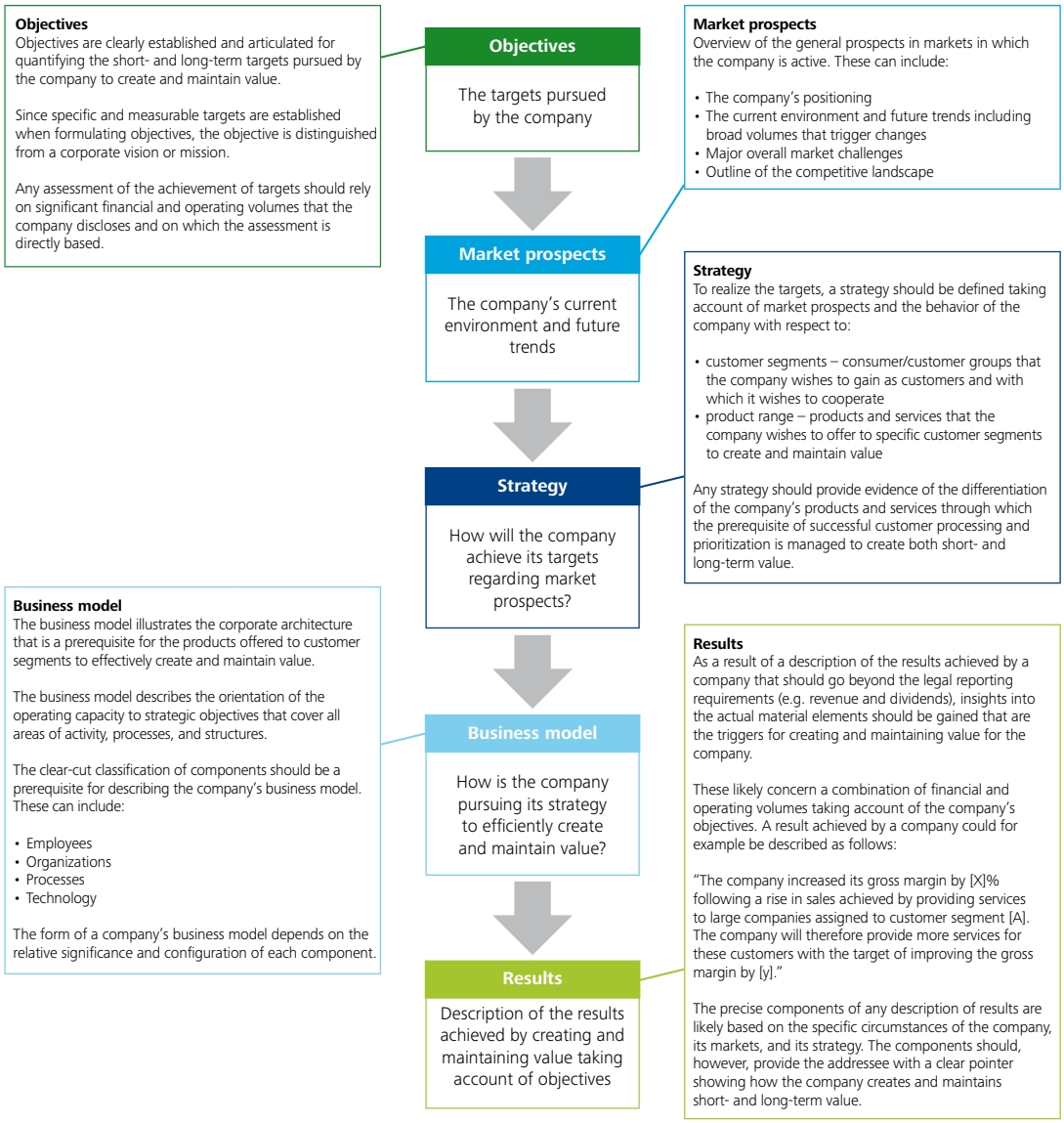
As a basic principle, the Supervisory Board may subject the corporate planning and thus the corporate strategy to its approval (§ 111 (4.2) AktG) provided the core of the Executive Board's ultimate authority remains untouched and the transactions subjected to the Supervisory Board's approval are specific and can be delimited. The Supervisory Board's reservation of approval for the corporate planning ensures that the Supervisory Board can have a significant influence on the corporate strategy developed and proposed by the Executive Board before it is implemented.

[1] See also Deloitte UK: Governance in focus – Describing your strategy and business model, 2012, S. 3.

Independently of the extent to which the Supervisory Board becomes involved in the corporate strategy, the Supervisory Board and the individual Supervisory Board member must understand it in such a way that they can

- scrutinize the appropriateness of the business model;
- appraise the targets and measurements for advancing the creation of value;
- assess the risks inherent in the strategy; and
- form a conclusive judgment as to whether the Supervisory Board can support the corporate strategy or whether it should be "further adjusted" or rejected.

Figure 1 – Standardized development of a corporate strategy



Obligations related to the work of Supervisory Board committees

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Under § 111 (1) AktG, the Supervisory Board of a company or an SE organized on a two-tier basis must monitor the management, ie. the Executive Board. But unlike the Executive Board of a company, the Supervisory Board does not meet all the time and is also because of its size with often as many as 20 members only in particularly exceptional situations able to hold more than the four meetings per calendar year required by law for listed companies. At the same time Supervisory Board members must exercise their tasks as required by law and may not confer them on third parties (§ 111 (5) AktG).

Committees

Committees therefore play an important role in the Supervisory Board's practical work. They are focused on specific areas of responsibility, can meet more frequently on account of their smaller size, and are often made up of Supervisory Board members who have particular expertise in the committee's area of responsibility. In addition, however, committees may consist only of Supervisory Board members.

The legislator does not stipulate the creation of committees, but the law does contain provisions that apply if the Supervisory Board decides to establish an appropriate committee, such as an Audit Committee.

Supervisory Board committees may either prepare decisions of the entire Supervisory Board or decide them in its stead. But it has never been possible for certain tasks such as appointment and dismissal of Executive Board members to be assigned to a committee for a decision. The legislator has further restricted the permissibility of such decision-taking committees in the past several years. So, for example, since the changes brought about by the Law on the Appropriateness of Executive Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG) in 2009, the entire Supervisory Board must decide on Executive Board compensation. Previously, this was regularly decided in a committee of the Supervisory Board. In addition, auditing the annual and consolidated financial statements may not be assigned to the Audit Committee but is instead a task for the entire Supervisory Committee.

Obligations and liability

If the Supervisory Board establishes committees, this changes the obligations of the other Supervisory Board members. As a basic principle, each Supervisory Board member is responsible for ensuring that the Supervisory Board carries out its tasks in accordance with its obligations. The law stipulates in referring to the obligations of the Executive Board in § 93 (1) AktG that each Supervisory Board member must carry out his tasks with the care of a diligent and conscientious manager. Supervisory Board members with professionally gained specialist knowledge are subject to increased requirements regarding questions in the areas concerned. In its Hertie decision, the BGH also held that each Supervisory Board member had to have the minimum necessary expertise and skills for the office.

As regards the work of committees, the Supervisory Board members not active in the committee are responsible only for monitoring the committee work and are liable only for breaching this monitoring obligation. To satisfy this principle, committees must in particular report regularly and comprehensively on their work in the Supervisory Board plenum.

If, however, the Supervisory Committee breaches any obligation, a Supervisory Board member is not liable if he has verifiably attempted to convene the Supervisory Board before the obligation was breached. But stringent requirements are laid down in this respect. A mere "No" vote is not enough in such cases. The Supervisory Board member must also give his dissenting opinion and attempt to deter the Board from breaching its obligations. However, there is no requirement on the part of the Supervisory Board member in cases of this type to resign his office or take legal action against any unlawful resolution of the governing body.

The Supervisory Board and its committees may avail themselves of the expertise of specialists when carrying out their tasks. As desired by the legislator, however, specialists will be called in only for specific questions and not, say, for long-term monitoring of the Supervisory Board's work. In practice, Supervisory Boards often make use of the expertise of external counsel if complex or unresolved legal issues arise. Following the most recent Ision decision of the BGH, calling in expert advice may even exclude misconduct on the part of governing body members if the expert's assessment subsequently proves to be incorrect. But such exclusion of misconduct is subject to strict conditions: as a basic principle, the advice must be available in writing and be provided by acknowledged independent counsel on the basis of a comprehensive statement of the facts. The counsel's results must also be subjected by the Supervisory Board members to a critical plausibility test.

Transactions requiring approval and the Supervisory Board

The skills and tasks of the governing bodies of a stock corporation are allocated by law and strictly separated. As opposed to the Executive Board with its direct responsibility for managing the company (§ 76 (1) AktG), management is not the responsibility of the Supervisory Board, whose duty is to monitor corporate governance. Under § 111 (4.1) AktG, management responsibilities may not be conferred on the Supervisory Board. The Supervisory Board may not constitute this competence itself nor may the articles of incorporation specify such allocation. Nor, as a basic principle, do the shareholders have the right to participate in the management of the company; the general meeting may decide on such matters only if required to do so by the Executive Board (§ 119 (2) AktG). But stock corporation law specifies that reservations of approval must be granted to the Supervisory Board for certain transactions to facilitate its (preventative) control of the Executive Board. Case law has further granted the General Meeting an unwritten power of participation if crucial (structural) decisions are involved. This enables both governing bodies, and particularly the Supervisory Board, to influence the Executive Board's management – despite what is in fact strict division of responsibilities.

Transactions requiring approval

Under § 111 (4.2) AktG, the articles of incorporation or the by-laws of the Supervisory Board must determine the reservations of approval that grant the Supervisory Board a right of veto in respect of certain types of transactions. While this right does not restrict the Executive Board's power of representation, it nonetheless affects its management. At the instigation of the Executive Board when it requests prior approval, the Supervisory Board assumes joint responsibility in respect of management even though it can neither conduct the transaction in question itself nor instruct the Executive Board to do so. The Supervisory Board has the right to prevent the transaction being conducted by withholding its approval. Despite such influence and, as the case may be, the veto, the Executive Board remains fully responsible for the transaction; the Supervisory Board's approval does not release it from its duties of care and any liability to pay damages. If the Supervisory Board exercises its veto, the Executive Board may obtain approval from the general meeting, which must decide on this matter with a three-quarter majority.

In practice, transactions requiring approval are usually covered by the bye-laws of the Supervisory Board because such orders – unlike the articles of incorporation – may not be easily amended formally and are not published. Which transactions must be subjected to the reservation of approval is not determined by law and is solely at the discretion of whoever drafts the articles of incorporation and the Supervisory Board. They must be based on the requirements of the company and enable preventative control of the Executive Board by the Supervisory Board. Thus, according to the recommendation in section 3.3 GCGC, only transactions of vital significance should be included, particularly in the event of a fundamental change in the assets, financial, and earnings position. In addition, according to the preamble to the law, crucial decisions on strategy and important investment decisions that would likely fundamentally change the company's earnings prospects should receive particular consideration. So the legal requirements for transactions requiring approval should not be fulfilled with merely generally worded clauses on reservations that, as the case may be, soften the management autonomy of the Executive Board.

Unwritten competence of the General Meeting

Exceptionally, the Executive Board must obtain the approval of the general meeting for specific management measures. In its "Holzmüller" decision (BGHZ 83, 122), the BGH affirmed this special competence in the event of the spinoff of (part of) a business that affected about 80% of the assets. In its subsequent "Gelatine" judgments (BGHZ 159, 30), it put the competence of the general meeting in concrete terms and restricted it to "quantitatively and qualitatively weighty measures of relevance to membership rights"; thus, for example, in the event of the restructuring of the company of the magnitude of the Holzmüller case, which amounts to a measure to amend the articles of incorporation.

Recommendation for practice

It is advisable to specify reservations of approval in the bye-laws of the Supervisory Board or the Executive Board for transactions of fundamental significance that occur fairly rarely and to regularly review their scope.

Reservations that come within the ordinary course of business should be avoided. Supervisory Boards should be aware that determination of reservations of approval is a matter for their professional judgment.

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Form of Supervisory Board information

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Provision of information to the Supervisory Board is rightly a perennial corporate governance topic. The understanding of the BGH of the entrepreneurial and advisory interpretation of the monitoring task has long become part of Supervisory Board practice. The Supervisory Board does justice to its role as a past- and future-oriented controller only if it is checks its information supply continuously and in a well-arranged manner. The arrangement of the information supply is not least a basis for fulfilling its obligations to make assessments of relevance to liability (§§ 116, 93 AktG).

Duty to provide and obtain appropriate information

The reports from management are undoubtedly the Supervisory Board's most important sources of information. The Executive Board's duty to provide such reports is set out in the Stock Corporation Law (§ 90 (1) AktG). But the Supervisory Board's parallel duty to obtain information is apparent from its right to require supplementary reports (§ 90 (3) AktG). Case law sets stringent requirements of differing levels depending on the company's situation.

The Supervisory Board's organizational task

It is precisely in large and in particular listed companies that the proactive organization of information flows is indispensable. The Supervisory Board must exploit its opportunities. It must heed sector-specific compliance risks (legality). In addition to the individual calculation, a test question on significant individual actions profitability) is whether they form part of a coherent corporate strategy. If the company is listed, the "capital marketability" of its publicity is also a subject for monitoring. This includes not only the annual and consolidated financial statements but also corporate governance reporting, and particularly the declaration of compliance with the GCGC (§ 161 AktG).

Direct contact with employees

The organization of the information supply is put to the test in direct contact with employees. Banking and insurance supervision law provides for direct contacts with controlling and internal audit managers. Supervisory Boards also report direct contacts outside the uncontested cases suspicions regarding the Executive Board. The relationship of trust with the Executive Board must not be compromised. Safeguards result in an information regime jointly decided with the Executive Board.

Use of expert advice

The Supervisory Board must arrive at its own judgment. For this purpose, it may make use of expert advice (§ 111 (2.2) AktG). In individual cases this is inevitable to protect against liability. Agreement with the Executive Board (rightly only declaratory) in any jointly adopted information regime also helps ensure trust in this respect in an institutionalized manner. The Supervisory Board's right is at the same time its obligation. Only by careful examination of the expert's qualifications and independence is his opinion on any reliable information strengthened (Ision case law). It is best practice to obtain a confirmation of independence. This is also required when selecting the statutory auditor (section 7.2.1 GCGC).

Practical recommendation: Disclosure of the information regime

The monitoring duty requires the Supervisory Board to proactively organize its own information supply. The information regime agreed with the Executive Board is a sign of trustful cooperation between the governing bodies. In particular, it helps avoid losses of trust arising from important contacts established by the Supervisory Board with employees and experts. Disclosure of the information regime sends a signal of good corporate governance. The proper forum for disclosure is voluntary reporting (section 3.10 GCGC) or the corporate governance statement (§ 289a HGB).

Further literature of the author (in German)

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Leyens, Information des Aufsichtsrats, 2006, 482 p.

The reporting obligations of the Supervisory Board

The Supervisory Board's reporting obligations to the General Meeting have continuously gained in significance in the past several years. For decades it has been practice to comply with the reporting obligation under § 171 (2) AktG with formulations, updated only once a year, of little informative value. The recent increase in depth of detailed content is due to court decisions made since 2005 in which the formal discharge of the Supervisory Board was successfully challenged because the Supervisory Board had failed to exercise its reporting obligation sufficiently on account of a report consisting merely of set phrases.

Form of reporting

The report usually included as part of the business report forms part of the reporting requirements to be displayed before the ordinary General Meeting is convened and/or to be made available on the company's website. It must be submitted to the business register with the Federal Gazette and publicized when the annual financial statements are announced.

Function of the report

The Supervisory Board's report serves two main purposes. It should inform the shareholders and the general public of the result of the audit of the annual financial statements and summarize them in a clear concluding statement. With its report, the Supervisory Board also gives an account of its own activity, stating in which manner and to what extent it has examined and monitored the Executive Board's management.

Material content of the report

§ 171 (2) AktG requires the Supervisory Board to reiterate and explain its audit findings. The scope is a matter for the Supervisory Board's discretion. In unproblematical cases, it is sufficient for the Supervisory to state in set phrases that it has examined the financial statements and that the audit has not led to any objections. With problematical financial statements or particular risks, the Supervisory Board should explain its position in some depth. This is particularly the case if the statutory auditor's opinion has been issued with qualifications. Finally, the Supervisory Board's report must contain a concluding statement on the result of its examination and state in particular whether it has raised objections and has approved the annual financial statements and, as the case may be, the consolidated financial statements and the IFRS financial statements and thus approved the individual financial statement under § 172 (1) AktG. If the Executive Board is also obliged to submit a report on relations with controlling companies (dependence report), it must also include a report on the examination of this report and a concluding statement on the examination of the dependence report (§ 314 (2 and 3) AktG).

The Supervisory Board must also state to what extent it has examined the management during the period. While in good years a short report has been seen as sufficient, reporting requirements have increased as companies have encountered financial difficulties.

It is a legal obligation for listed companies to set out the number of times the Supervisory Board met along with details of which committees existed in the year under review. Under section 5.5.3 GCGC, conflicts of interest must also be notified. A positive declaration of the company's compliance is possible in this context, since any departure from the declaration of compliance fundamentally justifies challenging the formal discharge of the Supervisory Board. In a recent decision of May 14, 2013, the BGH made it clear that an incorrect declaration of compliance went beyond a technical breach. As regards the Supervisory Board's reporting, the GCGC does not, according to with the BGH, precisely require the Supervisory Board to report to the General Meeting on the details of its members' conflicts of interest. Rather, it is sufficient to report on the emergence of conflicts of interest and their treatment but not on the nature of the conflict of interest. This is correct, because the Supervisory Board's reporting is limited by its obligation to maintain confidentiality regarding business secrets in accordance with § 116 in conjunction with § 93 (1.1) AktG.

Summary

The Supervisory Board is well advised to critically inspect the report to the General Meeting usually prepared by the legal or staff department since any reporting made up of set phrases entails the risk that its formal discharge will be challenged. As a basis principle, the content and scope of the requirements concerning the Supervisory Board's activity and the obligation to report on such activity are increased in times of financial difficulty for the company. With listed companies, particular attention must be paid to the presentation of conflicts of interest that have emerged and their treatment: in doing so, the Supervisory Board may restrict itself to presentation of the emergence of such a conflict and the way in which it dealt with it.

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Deloitte CFO Survey: Companies are gearing up

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One of the Supervisory Board's most important tasks when proactively monitoring the Executive Board is to provide advice and support in strategic matters. As such, there is still a high degree of uncertainty concerning the future economic climate in Germany and its effects on corporate growth.

Economic expectations and the strategic plans of major German companies are two of the central themes explored twice a year in the Deloitte CFO Survey, a survey of German CFOs.[1] Thus Executive Boards and Supervisory Boards can compare their own assessments and plans with current business sentiment.

Positive economic and business prospects

Current sentiment among German companies shows that the good economic prospects are encroaching on corporate planning, which is reflected in higher investments and more offensive market positioning.

CFOs assess the business environment positively. They see the economic climate optimistically on a 12-month view. They also rate financing terms favorably, as regards both availability and costs. The greater stability in the euro zone is reflected in a sharp decline in perceived uncertainty.

In the most recent surveys, there was a striking difference between good economic prospects and restrained corporate positioning. This gap seems to be closing now. Companies' business prospects have risen considerably, are clearly in the positive area, and are at their highest level since the Deloitte CFO Survey began at the start of 2012.

This is coupled with the hope of higher revenues and margins. Unlike in the previous year, revenue and margin expectations have risen 50 and 70 percentage points respectively. Expected growth is becoming more profitable.

This is affecting investment planning.

For years, investments have been the problem child of the German economy, and a change in trend is now being seen. Companies' investment intentions have risen sharply in the last six months.

This process is being driven not least by the fact that companies particularly wish to use their accumulated capital reserves for investments in the year ahead.

Companies banking on innovation and cost management

While cutting costs still very much heads the list of priorities for CFOs, the trend is downward. Instead, companies are increasingly banking on offensive strategies, particularly the development of new products and services. Innovation therefore ranks high on the list of priorities alongside cost management.

It is here that German companies are focusing their investments. More than half are planning to increase R&D investments. Expenditure on organizational development and on marketing should also rise in 2014.

Companies currently see the main risk for the next 12 months in rising energy costs, followed by the skills shortage. Here there have been significant changes. A year ago the dominant risk was of an unstable financial system.

Conclusions

All in all, the results of the fourth Deloitte CFO Survey show that German companies are increasingly on a growth trajectory. The Deloitte CFO Confidence Index, which represents overall economic assessments and corporate growth orientation, has risen sharply from 16 to 25 and is thus clearly in the positive area (see Deloitte CFO Survey 2/2013, p. 5).

Supervisory Boards should be aware of the general economic situation and the economic drivers and risks. This means that there is still scope for an increased use of continuous dialogue with Executive Boards on strategic planning.

[1] 157 CFOs of major German companies took part in the Deloitte CFO Survey 2/2013, published in November 2013. Just under 60% of the companies have revenues of over €500 million, and over 40% of more than €1 billion. The study can be downloaded from www.deloitte.com/de/cfosurvey.

Latest news on financial reporting enforcement – current FREP audit priorities 2014

In mid-October the FREP published its main audit focus areas for the coming year. In addition to the traditional main focus areas – such as the goodwill impairment test – the five main audit focus areas concern matters that arise from the adoption of new IFRS or amendments to existing standards. While error rates in FREP procedures have fallen in the past several years, implementation of new or amended regulations is frequently accompanied by uncertainties in initial application and specifically conceals the risk of overlooking details. As in previous years, the FREP gives details on the regulations to which particular attention is being paid.

Goodwill impairment test

As before, the FREP places greatest emphasis on demonstrating the consistency and reliability of cash flow forecasts. Care must be taken that forecasts coincide with management reporting and that there is adherence to the budget. It is also very important to derive the growth rate and the discount rate, for example by means of a documented peer group analysis. Key valuation assumptions must be described in sufficient detail.

Business combinations

In addition to meaningful note disclosures regarding the factors giving rise to goodwill or a negative difference amount and the financial effects of a transaction, the FREP will expressly focus on the determination of fair values with respect to the principles of IFRS 13. This new standard is of fundamental importance not only in respect of business combinations but also for other standards with fair value measurements.

Defined benefit pension obligations

IAS 19 has been substantially amended in parts, which may have a particularly significant effect on accounting for defined benefit pension obligations. Thus the abolition of the corridor method may lead to the disclosure of a much higher pension obligation. More comprehensive note disclosures than before are necessary, as regards for example the description of benefit plans, associated risks, and sensitivity analyses to be conducted. The FREP stresses the necessity of transparency and consistency in the determination of the discount rate, which is of particular significance given the turbulent interest rate environment in the past two years.

New consolidation standards

IFRS 10, 11, and 12 saw the introduction of new standards on consolidation and assessment of joint arrangements. Compared with the previous dominant concept, IFRS 10 places a stronger emphasis on actual conditions, which can lead to considerable changes in the basis of consolidation. This can also affect key financials like revenue and earnings in the consolidated financial statements if proportionate consolidation is abolished for joint ventures. IFRS 12 provides for more comprehensive disclosures than were previously necessary. In the EU the new standards must be applied for periods beginning on or after January 1, 2014; early adoption is permissible in this respect. If early adoption is not observed, disclosures on the anticipated effects of future adoption are necessary. The FREP will pay express attention to their informational value.

Group management report

The FREP is focusing on the new requirements arising from adoption of German Accounting Standard GAS 20. These include the comparison of prior-year forecast with actual results, the increased requirements regarding level of detail of forecasts, and the presentation of risks and the risk management system.

Recommendations for Supervisory Board practice

Added to the main audit focus areas is the requirement for comprehensive documentation of accounting issues. This is even more the case if there are judgemental areas (parameters, future earnings potentials, risks) whose interpretation needs to be justified. To what extent a company is FREP-compliant is also a matter of interest to the Supervisory Board. In this connection, the following questions arise:

- Are the current 2014 main audit focus areas of relevance to the company being investigated and taken into consideration?
- Is the accounting of new or modified transactions FREP-compliant and sufficiently documented? Are there judgemental areas?
- Is the company sufficiently well prepared for the FREP procedure?

"FREP Guidelines for Executive and Supervisory Boards" summarizes all the main topics concerning the procedure. This brochure can be downloaded from www.corpgov.deloitte.com/site/GerDe/enforcement or a hardcopy may be requested via corporate.governance@deloitte.de.

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New features of GAS (DRS) 20 on the management report

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GAS 20 presents a new standard on the group management report under § 315 HGB. Adoption of the standard is recommended for the management report under § 289 HGB on annual financial statements.

GAS 20 must be adopted for periods ending after December 31, 2012, and is thus a focus of particular attention for the 2013 financial year and for upcoming meetings of the Supervisory Board and Audit Committee.

Basics

GAS 20, adopted by the ASCG on September 14, 2012, and published in the Federal Gazette by the BMJ on December 4, 2012, in accordance with § 342 (2) HGB, ushered in a fundamental overhaul of the commercial law requirements for (group) management reporting.

This new standard systematically summarizes or cancels the following existing standards: GAS 15 "Management Reporting", GAS 5 "Risk Reporting", and the sector-specific GAS 5-10 "Risk Reporting by Financial Institutions and Financial Service Institutions" and GAS 5-20 "Risk Reporting by Insurance Enterprises". GAS 16 "Interim Financial Reporting", which contains the principles for the interim management report, was also amended (see issue 2/2013 of this newsletter).

GAS 17 "Reporting on the Remuneration of Members of Governing Bodies" was not integrated into GAS 20 since this standard relates both to (group) note disclosures and to the requirements of the (group) management report.

Sector-specific features of risk reporting by financial institutions and insurance companies were included separately in the main part of the standard, which must therefore in principle be adopted independently of sector, in annexes 1 and 2 to GAS 20.

The specific requirements stipulated in the law and under the standard for publicly traded entities within the meaning of § 264d HGB for (group) management reporting have been separately designated in GAS 20 where the relevant items are preceded by a "K".

The standard setter's objective was to focus on the requirements of (group) management reporting. As a result, recommendations cease in principle to be contained in GAS 20.

Material changes

The concepts used in the standard have to some extent been redefined in GAS 20.11. In particular, new definitions of "key financial" and "key performance indicator" were introduced. Notwithstanding the definition in GAS 15.8, "opportunity" and "risk" have been defined.

The principle of materiality and the principle of granularity of information were added as overarching principles of (group) management reporting. No longer contained in GAS 20 is the principle of concentration on sustainable value creation (GAS 15.30–35).

In particular, the fundamentals on the report on economic position are set out in much greater depth and structured more clearly than in GAS 15. Various items on financial and nonfinancial key performance indicators have been newly added in this connection. Nonfinancial key performance indicators have gained heavily in significance in the standard.

Important new features of the standard – particularly also in the perception of the literature that has so far appeared on the standard – concern forecast reporting.

Worthy of particular mention here is the shortening of the forecast period from (at least) two years (GAS 15.86) to (at least) one year (GAS 20.127) – calculated from the last (group) reporting date. But this apparent simplification must be seen in conjunction with the increasing requirements regarding level of detail of forecasts. Clear requirements for forecasting are now defined in such a way that it is no longer possible to describe merely a trend in the expected change but instead the direction and intensity of the likely development must be disclosed. GAS 20.130 continues to mention the types of forecasts that fulfill or do not fulfill the requirements. The following overviews provide examples of permissible and impermissible forecasts.

Impermissible	
Qualitative forecast Verbal assessment	**Comparative forecast** Qualitative comparison with the actual value
For 2014, we expect satisfactory net income.	For 2014, we expect improved net income on the preceding period.
For 2014, we expect reasonable customer satisfaction.	For 2014, we expect improved customer satisfaction compared with the preceding period.
For 2014, we expect normal staff turnover.	For 2014, we expect a decline in staff turnover compared with the preceding period.

Permissible		
Qualified comparative forecast Qualitative details on direction and intensity	**Interval forecast** (Value-based) scope	**Point forecast** Numerical value with concrete characteristic
For 2014, we expect improved net income with a moderate increase on the period under review.	For 2014, we expect improved net income with net income budgeted between €35 million and €38 million.	For 2014, we expect improved net income. Budgeted net income is €36 million.
For the following period, we expect a slight improvement in customer satisfaction.	For the following period, we again expect high to very high customer satisfaction.	For the following period, we again expect high customer satisfaction.
For the following period, we expect a sharp increase in staff turnover.	For the following period, we expect staff turnover of 8 to 12%.	For the following period, we expect staff turnover of about 10%.

Forecast reporting is also extended as a result of GAS 20.126, according to which forecasts must be provided of the most important financial and nonfinancial key performance indicators (e.g. customer satisfaction) reported in the report on economic position.

Opportunity reporting has been substantially enhanced. As a basic principle, the same rules apply to them as to risk reporting.

The group's/entity's individual important opportunities and risks to be addressed must be placed in relation to the forecasts of the group/entity management by showing the possible effects on likely development. Individual risks must be reported in categories or by disclosing a ranking for the purpose of increased clarity or the significance of the risks.

The reporting on strategies contentiously discussed in the literature – other than as provided in the draft version – is not binding but is an optional recommendation.

Supervisory Board and (group) management report

The (group) management report must be submitted to the Supervisory Board for examination (§§ 170, 171 AktG) and is the subject of the financial meeting of the Supervisory Board or the Audit Committee in which the statutory auditor also reports on the result of his audit of the (group) management report.

The Supervisory Board must in particular check that the forecasts contained in the (group) management report specified for external purposes concur with the other budgeted figures obtained within the framework of the monitoring activity.

The same rule applies to risks and opportunities and to other (group) management report content.

The most significant internal key performance indicators (KPIs) reported to the Supervisory Board should, as the case may be, be echoed in aggregated form with actual and expected values in the (group) management report.

Implementation of the amended requirements of GAS 20 can be one of the statutory auditor's main audit focus areas agreed on the audit contract. This applies in particular against the background of the Financial Reporting Enforcement Panel (FREP) having announced the amended requirements of GAS 20 as its own main audit focus area. This includes in particular:

- Comparison of prior-year forecast with actual results (GAS 20.57)
- Increased requirements regarding level of detail of forecasts (GAS 20.128)
- Presentation of risks (GAS 20.146 et seq.) and the risk management system (GAS 20.K137 et seq.)

References

Deloitte (editor), Der Lagebericht, Stollfuß-Verlag Bonn, 2013, ISBN 978-3-08-318200-9.

Events

- Corporate Governance Initiative in the German real estate sector: Seminar of the ICG Real Estate Board Academy, Hamburg, February 13 to 14, 2014, and Munich, April 3 to 4, 2014

Publications and further information

- Plendl/Kompenhans/Buhleier (editors): The Audit Committee in the Stock Corporation – Practical Guidelines for Supervisory Boards
- Deloitte Global Center for Corporate Governance: Women in the boardroom – A global perspective
- Global Economic Outlook Q4 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 – FREP Guidelines for Executive and Supervisory Boards
- Finance & Accounting Forum, booklet 3/2013
- CFO Survey 2/2013 – Companies are gearing up
- Manufacturing for Growth – Interviews and discussions by 12 CEOs from leading German companies on Germany's economic competitiveness
- Senior Management Reporting – Study from twelve countries on the importance of senior management reporting
- Update on the 2013 accounting date – Support with financial reporting at the end of the accounting period

Responsible editor

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Note

Please send an email to corporate.governance@deloitte.de if you have questions about the content, if this newsletter should be sent to different or further addresses, or if you no longer wish to receive it.

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