

At a glance: Corporate Governance according to BilMoG

KPMG's Audit Committee Institute (ACI)

The German Act on the Modernisation of Accounting Law (Bilanzrechtsmodernisierungsgesetz – BilMoG), which became effective on 29 May 2009, includes, in addition to accounting regulations, a number of provisions aimed to further enhance and improve the Corporate Governance of capital market oriented companies. The innovations are based on the proposals in the EU Statutory Audit Directive and the Amending Directive, and focus on the supervisory board, its audit committee, its specified monitoring tasks and the appointment of an independent financial expert. At the same time, the mandatory disclosure requirements on Corporate Governance have been expanded. Two new elements, the Corporate Governance statement and a description of the main features of the accounting-related internal control and risk management system, have been added to the (group) management report.

Overview of Corporate Governance innovations

Organisation and responsibilities of the supervisory board/audit committee

- The supervisory board/audit committee must include at least one independent financial expert: para. 100 sec. 5 and para. 107 sec. 4 AktG, para. 324 sec. 2 sent. 2 HGB
- Specification of the monitoring tasks of the supervisory board/audit committee: para. 107 sec. 3 sent. 2, para. 124 sec. 3 sent. 2, para. 171 sec. 1 sent. 2 and 3 AktG
- Obligation to set up an audit committee (isolated if necessary): para. 324 HGB

New mandatory disclosure requirements on Corporate Governance

- Corporate Governance Statement (with more detailed Declaration of Conformity): para. 289a HGB, para. 161 AktG
- Report on the accounting-related internal control and risk management system: para. 289 sec. 5 and para. 315 sec. 2 no. 5 HGB

Who is affected?

The Corporate Governance implications of the BilMoG affect in most cases – but not exclusively – capital market oriented companies (“kapitalmarktorientierte Unternehmen”) as defined by para. 264d HGB (German Commercial Code). This new term includes all German entities that have issued securities as defined by para. 2 sec. 1 sent. 1 WpHG (German Securities Trading Act) – i.e. not only shares but also debt instruments, participation certificates etc. – in an organised market as defined by para. 2 sec. 5 WpHG, or which have applied for admission of these shares for trading in such a market. Therefore not only AGs (public limited companies) and KGaAs (limited partnerships with share capital) will have to comply with these regulations, but also GmbHs (private limited companies), GmbH & Co. KGs (limited partnerships with a limited liability company as general partner), Genossenschaften (cooperatives) and SEs (european companies), if they are oriented towards the capital market. Furthermore some regulations like para. 107 sect. 3 sent. 2 AktG (German Corporation Act), which specifies the supervisory board’s monitoring tasks, also apply to private companies.

When do the regulations become effective?

The amendments of the German Corporation Act have come into force in May 2009. However, for the requirement to appoint an independent financial expert on the supervisory board or audit committee, a transitional rule is in place (para. 12 sec. 4 EGAktG-Introductory Act to the German Corporation Act). The obligation to set up an isolated audit committee will become effective as from 1 January 2010. The report on the accounting-related internal control and risk management system, as well as the new Corporate Governance Statement, will have to be disclosed in the financial statement for fiscal years beginning after 31 December 2008.

Internal Organisation of Supervisory Board and Audit Committee

Recommended action

- › Review of the composition of the supervisory board/audit committee; definition of criteria to determine expertise and independence and – if necessary – modification of the internal rules of procedure
- › Appointment of an independent financial expert and disclosure in the Corporate Governance Statement
- › Continuous training of the members of the supervisory board/audit committee in the fields of financial accounting or auditing

DCGK demands on the chairman of the audit committee

- Section 5.2: He should not be the chairman of the supervisory board (proposal)
- Section 5.3.2: He should be independent and should not have been a member of the company's management board during the last two years (proposal)
- Section 5.3.2: He should have specialist knowledge and experience in the application of accounting principles and internal controlling processes (recommendation)

Recommended action

- › Documentation of the existing control systems and reporting to the supervisory board
- › Creation of adequate review procedures regarding functionality and adequacy of the control systems
- › If necessary, the management board can be instructed to extend, improve or (if they do not already exist) establish these control systems

› Independent financial expert mandatory

The supervisory board of a capital market oriented company must, in future, include at least one independent member with expertise in the areas of financial accounting or auditing (para. 100 sec. 5 AktG). If such a company has appointed an audit committee, at least one member of the audit committee must fulfil these criteria (para. 107 sec. 4 AktG); this can be the same person. These requirements do not apply as long as all members of the supervisory board/audit committee have been appointed before 29 May 2009. Also these provisions do not affect the additional rules in the DCGK (German Corporate Governance Code) regarding the chairman of the audit committee.

The following persons are regarded as having the necessary expertise within the meaning of the BilMoG:

- members of the public accounting and tax consultancy professions or persons with specialised professional qualifications,
- financial directors, employees with expertise in the fields of financial accounting and controlling or analysts,
- long time members of audit committees or worker's councils who have acquired this expertise in the course of their activities by undertaking special training.

The arguments set out in the law refer with regard to independence to Section 5.4.2 DCGK, which states that a member of the supervisory board is considered independent if he or she has no business or personal relationships with the company or its management board which cause a conflict of interests. The EU Commission Recommendation of 15 February 2005 on the role of non-executive directors or members of the supervisory board of listed companies and members of their committees is only mentioned at the secondary level. Annex II of this recommendation includes a non-exclusive list of significant aspects that could pose a threat to their independence. The EU recommendation is not binding though; on the contrary, it is the supervisory board's responsibility to decide in individual cases whether an individual member of the supervisory board can be regarded as independent. However, the law states specifically that the chairman of the audit committee shall not be a member of the company's management board.

› Specific responsibilities of the supervisory board

The BilMoG also places greater emphasis on individual aspects of the supervisory board's monitoring function. Although this is already covered by para. 111 sec. 1 AktG, which states that the supervisory board shall monitor the management board, the BilMoG (para. 107 sec. 3 sent. 2 AktG) now makes it clear that the supervisory board is responsible for monitoring:

- the financial accounting process,
- the effectiveness of the company-wide internal control system, the risk management system and the internal auditing system, and
- the audit of the financial statements, i. e. the independence of the auditor and the additional services rendered by the auditor.

These tasks, which are primarily the responsibility of the supervisory board, can be delegated either entirely or in part to the audit committee. The proposal on election of the auditor shall also be based in future on the recommendation of the audit committee (para. 124 sec. 3 sent. 2 AktG).

Monitoring the effectiveness of these corporate control systems will pose a special challenge. As a first step, the supervisory board will have to consult the management board, which must provide the supervisory board with information that enables it to perform an independent assessment of the reliability of the systems, if necessary with the help of the auditor. In addition to the identification of the existing processes, the existence of an adequate documentation will in particular be indispensable for this purpose.

› **Obligation to set up an (isolated) audit committee**

Para. 324 HGB places a fundamental obligation on capital market oriented companies to set up an audit committee, to appoint to this committee at least one independent member with expertise in the fields of accounting or auditing and to charge it with responsibility for the fulfilment of the aforementioned monitoring tasks.

The responsibilities assigned to the audit committee can also be assumed by the supervisory board as a whole, provided this body includes a financial expert as required by para.100 sec. 5 AktG. Therefore, the obligation to set up an audit committee is only a catchall element that refers solely to capital market oriented companies without any supervisory body. For all other companies there is no need for action.

However, in the case of larger supervisory boards it may be advisable, for reasons of effectiveness, to delegate the monitoring tasks voluntarily (at least at a preparatory level) to the audit committee. An audit committee established at a corporate group level does not release capital market oriented subsidiaries from the aforementioned obligation to establish an audit committee.

Recommended action

- › Investigation of whether the establishment of an isolated audit committee is absolutely essential or advisable
- › Decision of the supervisory board with regard to which tasks should be assigned to the audit committee
- › Creation of an organisational structure for the approach adopted by and criteria for the constitution of the audit committee

Disclosure obligations on Corporate Governance

› **Internal control and risk management systems report**

Capital market oriented companies must describe the main characteristics of the accounting-related internal control and risk management system in their management report (para. 289 sec. 5 HGB). This obligation to report also applies to the group management report if one of the subsidiaries included in the consolidation or the parent company itself is capital market oriented (para. 315 sec. 2 no. 5 HGB). Already existing main structures of the financial accounting process shall be described; a statement on effectiveness is not required. The provision is not intended to prescribe either the obligation to establish or the content of the internal control or risk management system. If such a system does not exist, this shall however be disclosed in the management report or the group management report. The auditor shall audit the correctness of the description; an audit of its reliability is not foreseen. However, the auditor must report any significant weaknesses in the accounting-related internal control system and the risk management system at the accounts review meeting of the supervisory board or the audit committee (para. 171 sec. 1 sent. 2 AktG).

Recommended action

- › Identification of the accounting-related internal control and risk management systems
- › Ensurance that they are properly documented
- › Review of the effectiveness of the (group) accounting processes and of the corresponding controls

› Declaration of Conformity and Corporate Governance Statement

Supervisory and management boards of listed public companies and – this is new – companies that have issued other non-stock securities to be traded in an organised market as defined by para. 2 sec. 5 WpHG and have traded their shares at their own instigation using a multi-lateral trading system pursuant to para. 2 sec. 3 sent.1 no. 8 WpHG (e.g. open market) must in future make their Declaration of Conformity with the DCGK permanently accessible to the public on the company's website. They now also have to explain why individual recommendations are not complied with.

In addition, a Corporate Governance Statement must be published in a special section of the management report or on the company's website (para. 289a HGB). The management report may in this case only include a reference to the publication on the website. The Corporate Governance Statement must include:

- the Declaration of Conformity with the DCGK prescribed by para. 161 AktG,
- relevant details with regard to significant Corporate Governance practices that go beyond the legal requirements, together with information stating where these are available to the general public, and
- a description of the approach adopted by the management and supervisory boards, as well as the names of the members of their committees and the approach adopted by them.

If the information about approach and composition are published on the company's website, a reference is sufficient. For the Corporate Governance Statement no audit by the public auditor is required (para. 317 sec. 2 sent. 3 HGB).

Recommended action

- › Detailed consideration by the management board and the supervisory board of the structures of their cooperation and its documentation
- › Ensurement that the topics covered by the DCGK are discussed on a regular basis, during the meetings of the bodies as well as in-between.
- › Positioning for topics which deviate from the recommendations of the DCGK

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