

# New non-financial reporting regulations in Germany: What are the implications of BilKoG and BilReG?



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Trucost Briefing – 17 January 2005

## Briefing Highlights:

- **'Bilanzkontrollgesetz' (BilKoG) and the 'Bilanzrechtsreformgesetz' (BilReG) move German financial reporting towards International Accounting Standards (IAS/IFRS)**
- **BilReG contains the requirement to report on non-financial performance indicators, such as environmental issues, and applies to listed German companies from the 1<sup>st</sup> January 2005**
- **BilKoG will come into force on the 1<sup>st</sup> July 2005 as a two stage enforcement process**
- **The new legislation will improve access to international financing – what are the implications for German companies?**

On 29<sup>th</sup> October 2004 the German parliament passed unanimously the 'Bilanzrechtsreformgesetz' (BilReG) and the 'Bilanzkontrollgesetz' (BilKoG) which move German financial reporting towards International Accounting Standards (IAS/IFRS), and introduce new control mechanisms, thus fulfilling the requirements of the EU Modernisation Directive. The main goal is to strengthen company integrity and increase transparency for the benefit of shareholders. The reporting of relevant non-financial information, for example on environmental issues, is a new requirement.

The new laws have been welcomed especially by larger companies because they are seen to increase 'international readability' and give access to international financial markets. More than 1000 companies in Germany will be affected by the regulation. Over 450 companies will have to change over to IAS/IFRS, because they have previously used Handelsgesetzbuch (HGB) or US GAAP accounting rules. Few companies that are quoted in other international markets and are already using US GAAP or other internationally recognised standards will benefit from a deferred start for the BilReG in 2007.<sup>i</sup>

The background to the new laws is the EU Accounts Modernisation Directive that is designed to bring European accounting requirements in line with modern accounting practice. The Directive requires Member States to make changes to national law concerning the

form and content of company accounts and the content of the Directors' and Auditors' reports.

## Box 1. The Bilanzrechtsreformgesetz (BilReG)

Question	Answer
What is it?	New law that extends reporting duties of German companies in line with IAS/IFRS. It introduces stricter rules to exclude biased auditors. Non-financial performance indicators such as environmental or employee issues are a new reporting requirement.
Who needs to comply?	German companies with the obligation to consolidate, and who are "capital market oriented", i.e. whose stocks are admitted at regulated markets (over 780). Companies with the obligation to consolidate that have applied to be admitted at regulated markets on their accounting date. Non-capital market oriented companies, or companies without obligation to consolidate (some 219 German companies), can opt for IAS/IFRS. <sup>ii</sup> Some exemptions apply, and exemption thresholds have been increased to match the EU Modernisation Directive. <sup>iii</sup>
Effective date?	1 <sup>st</sup> January 2005 (1 <sup>st</sup> January 2007 for some 75 German companies that are quoted in other international markets and are already using US GAAP or other internationally recognised standards)

## Bilanzrechtsreformgesetz (BilReG)

There are two central aspects to the BilReG: The internationalisation of accounting law and the strengthening of the audit.

The requirements for the management report will be extended to include:

<sup>i</sup> PriceWaterhouseCoopers, *IAS/IFRS - Kapitalmarktorientierte Unternehmen in Deutschland*, April 2004

<sup>ii</sup> Wahlrechte der IAS-Verordnung 1606/2002

<sup>iii</sup> §§ 267 Abs. 1, 293 Abs. 1 HGB

- The analysis of business development and results
- A balanced and comprehensive analysis of business development and state of the company
- Financial performance indicators that are relevant for the business activities
- Description of relevant targets and strategies of the company’s legal representatives
- Description of the prospective development, including material opportunities and risks
- Assumptions that above statements are based on must be included

A new feature of BilReG is the addition to §289 HGB which contains the requirement to report on non-financial performance indicators, such as environmental or employee issues, as far as these are relevant for the understanding of the state and progression of a business, and influence the ability of a company to conduct its business. Remarkably, this paragraph has so far not attracted much attention, as public discussion currently focuses on the difficulties and costs of moving towards new accounting standards. It is Trucost’s experience, however, that the largest German companies are amongst the most thorough environmental reporters in the world.

Also, guidance about the new requirement has so far been limited to a reference to a 2001 EU Commission Recommendation.<sup>iv</sup> This recommends, amongst others, "where appropriate and relevant to the nature and size of the business operations of the company and to the reporting and to the types of environmental issues relevant to the enterprise, information on the environmental performance of the enterprise, [disclosures] such as energy use, materials use, water use, emissions, waste disposals. This information could usefully be provided by means of quantitative eco-efficiency indicators and, where relevant, detailed by business segment."

It is important to note that according to §1 Umweltauditgesetz, any results of environmental audits that are included in management reports are subject to audits as defined in §§322 and 323 HGB; this means that the environmental disclosures made under the new BilReG will be audited in the same way as financial information.

As a reaction to recent scandals (Enron, Parmalat), auditors will be excluded from the audit of a company if the possibility of bias exists; this could be, for example, because of business, financial or personal connections

<sup>iv</sup> Commission Recommendation on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies, 30<sup>th</sup> May 2001, 2001/453/EC

between company and auditor. The auditor may have provided consultancy services in relation to the annual accounts of the company. The new §319a of the Handelsgesetzbuch (HGB) defines quantitative thresholds for the exclusion of auditors. A consultant who has provided the results that are presented in the accounts or management report cannot act as auditor for the same company. This applies also to any results of environmental consultancy that a company includes in their management discussion.

### Bilanzkontrollgesetz (BilKoG)

Coming into force on the 1<sup>st</sup> July 2005, the BilKoG introduces a two-stage control mechanism. Where any doubts exist about the veracity of a company’s annual accounts, additional controls of the accounts may be carried out by an independent and accredited institution. This stage is based on the idea of self regulation of the business community. In fact, German industry has embraced this concept and set up such an independent institution, the Trägerverein für eine Deutsche Prüfstelle fuer Rechnungslegung (DPR) e.V.

However, further enforcement is possible where the controlling institution encounters lack of cooperation, or where an amicable solution with the company in question cannot be found. The Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) can in these cases take over and enforce the control of the accounts.

#### Box 2. The Bilanzkontrollgesetz (BilKoG)

Question	Answer
What is it?	Controls the legitimacy of accounts through spot checks or where indications of accounting errors exist (prompted, for example, by press reports or whistle blowing)
Who needs to comply?	German capital market-oriented companies
Who controls?	The inspection is to be carried out by an accredited, independent institution. If companies do not cooperate with this institution, or an amicable solution cannot be found, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin - Federal Financial Services Supervisory Institution) can enforce and carry out the inspection.
Effective date?	1 <sup>st</sup> July 2005

While this law has been designed with financial scandals in mind, it is conceivable that wrongful environmental disclosures could lead to such investigations where high environmental risks are involved.

## International comparison

What may stimulate German interest in the new regulation is companies' exposure to international financial markets. In the US and the UK, investors are increasingly taking environmental aspects of a company's activities into account, and have actually called for improved disclosure and analysis of opportunities and risks.<sup>v</sup> Reporting of material environmental risks will become mandatory in the UK on 1<sup>st</sup> April 2005 and in France environmental reporting has been required by regulation since 2002.

German companies are likely to welcome the opportunity to access international capital as a result of moving to internationally readable financial reporting, thus German companies are expected to increasingly seek foreign capital. In doing so, they will need to be aware of the expectations of foreign financial markets, in particular reporting on non-financial risks.

### United Kingdom

From 1<sup>st</sup> April 2005, over 1200 companies listed in the UK will be required to produce an Operating and Financial Review (OFR), in addition to the Annual Reports and Accounts. The broad scope of the OFR is to provide shareholders with the opportunity to review a range of information on the company's strategy and performance. It should present a balanced and comprehensive analysis of the key issues "to the extent necessary" for shareholders to gain an understanding of the company's development, performance or position. The review should include analysis using financial and other Key Performance Indicators (KPIs), including information relating to the environment and employees. Similar to the Sarbanes-Oxley law in the US, the OFR will have to include an analysis of both past and future issues and performance. The onus is on the directors of the company to decide what is material and therefore what should be reported in the OFR.

### France

Annual reports and accounts of French quoted companies must 'contain information on how the company takes into account the social and environmental consequences of its activities'<sup>vi</sup>.

<sup>v</sup> For example: FT Letter to Editor: Directors must discuss full range of OFR issues, November 30 2004, by F&C Asset Management, Henderson Global Investors, Insight Investment and Jupiter Asset Management

<sup>vi</sup> Article 116 of the Law on New Economic Regulations, 2002

Companies must report on a certain set of qualitative and quantitative, social and environmental indicators. These should include water and raw materials consumption, energy use (including measures to improve energy efficiency and to move towards renewable energy), land use, emissions to land, air and water, and noise, smells and waste. While a generic, non sector-specific list of emissions to land, air and water has been determined by the ministries for environment and industry, companies commonly use the Global Reporting Initiative (GRI) Indicators.

Auditors must follow the same rules for non-financial disclosures as for financial disclosures: their statement is necessary if the information has potentially an impact on the accounts or the financial standing of a company. It is the auditors' legal liability to ensure that they have verified the disclosures correctly.

### US

Companies listed in the US must disclose environmental liabilities in a 'Management's Discussion and Analysis' section if:

- They would change a reasonable investor's view of the company
- There are governmental enforcement proceedings with sanctions over \$100,000
- They exceed 10% of the company's value

The Sarbanes-Oxley Act 2002 is designed to protect investors by ensuring that any foreseeable risks are disclosed. The Act requires senior executives of companies to certify that they have personally reviewed their company's controls and procedures to identify, quantify and disclose material changes in financial or operating conditions, including indications of future performance. It is having a significant impact on the content and level of company reporting (with concomitant increase in internal control costs and external audit costs as much as 38% higher).

Many European companies with US listings, or Securities and Exchange Commission (SEC) registered companies, are considering the implications of delisting, and de-registering their shares under the US Securities Exchange Act 1934. In fact, a recent FT article claimed that the majority of German blue-chip companies with US stock market listings would like to avoid the cost and time of complying with US regulation, by withdrawing from their US listing.<sup>vii</sup> German companies are also lobbying the US Securities and Exchange Commission

<sup>vii</sup> FT, Germans angered by US red tape, 19<sup>th</sup> November 2004

for an easier route to de-registration, so that they can buy out their US shareholders.<sup>viii</sup>

The SEC, on the other hand, is faced with increasing demands from investors to ask for even more environmental disclosures of companies, stating that failure to disclose environmental liabilities is “artificially inflating the market’s assessment of a company’s shareholder value.”<sup>ix</sup>

## Conclusions

To fulfil the requirements laid out in BilReG and the EU Modernisation Directive companies should consider devising appropriate KPIs for non-financial matters. The challenge will lie in defining what is material to a company, and in determining non-financial KPIs using a defensible and rigorous process, that can be audited. The Commission Recommendation on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies (2001), referred to in BilReG, may give a first indication; however, one size does not fit all in terms of environmental performance indicators. Depending on the specific business activities that a company is engaged in, the standard set of KPIs, as suggested in the Commission Recommendation, may not be truly relevant to the company. A recent study by Trucost into the number of KPIs that would be material to FTSE All Share companies concluded that 86% of them would have to report on a maximum of four KPIs; 26 KPIs would cover the significant environmental impacts of every company in the FTSE All Share Index.<sup>x</sup> The same can be expected for companies in the DAX 30.

A number of reporting guidelines exist which companies may wish to refer to, but companies will have to analyse their environmental impact in-house to determine material opportunities and risks. This becomes even more relevant in an international context. The EU Modernisation Directive will be enforced in all member states, and regulation on environmental reporting is also on the increase in the US. A proactive approach on environmental reporting can pay off in many ways, such as favourable comparison with peers or the building of a track record of transparency which may serve a company that finds its reputation threatened by environmental issues.

## How can Trucost help?

German companies that want to access international capital will face substantially increased interest in their non-financial risks. They will be faced with two significant challenges: fully understanding the implications of these requirements and establishing appropriate and transparent audit processes to comply with the new regulations in Germany.

Trucost provides directors with a comprehensive and reliable means of determining the appropriate environmental issues to report on for the OFR and EU Directive. This transparent process allows environmental impacts to be passed through a materiality test that relates each impact to turnover and profit, in order to provide appropriate environmental KPIs. This is then presented in rank order, along with performance benchmarks against peer companies and across the industry. Trucost has helped many companies to identify material environmental issues and thus satisfy the requirements of the BilReg and EU Directive in a cost-effective manner.

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<sup>viii</sup> CBI, *British/German Delegation to SEC*, December 2004

<sup>ix</sup> The Rose Foundation, *Fooling Investors and Fooling Themselves*, 2004

<sup>x</sup> Trucost Special Report, *Developing Environmental Key Performance Indicators for UK Companies*, August 2004