

Read
&
Understand

Annual Reports

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On a daily basis, annual reports and the financial information contained therein form the central basis for an adequate assessment of the opportunities and risks to which companies are exposed. The importance attached to financial information has also been demonstrated by the recent economic and financial crisis: the misjudgment of (financial) transactions is generally regarded as a co-trigger – as it is not sufficiently clear in the financial statements of many companies. As a result, transpacific requirements have risen continuously, especially in the IFRS financial statements discussed here. Their average size has increased significantly in recent years; some now have up to 400 pages. As a result, today's annual reports can hardly be blamed for a lack of information. Critics complain in particular of the so-called information overload: almost endless tables, transitions and verbal information – transparency looks different. This is a dilemma in which assistance in reading business reports is urgently needed. This is precisely the purpose of this lecture.

The fact that companies are increasingly required to provide more information in their financial statements is ultimately also a reflection of the complexity of today's business activities: the opening up of new markets through mergers has become the norm, as has sales of parts of companies to concentrate on the core business. In addition, there are complex co-employment compensation programs, contracts with customers for different services with interdependent fees and, to finance the activities, novel complex financial transactions. In this context, in the financial crisis, such transactions in particular generated negative headlines, which took the approach of "securitizing" and distributing them "relieving the balance sheet" among more parties: in the accounts of the individual companies involved, these risks were often no longer visible.

In order to adequately reflect the current company developments in the annual reports, companies today demand not only more comprehensive but above all more up-to-date information. Instead of valuing balance sheet items, for example with (historical) acquisition and manufacturing costs, more and more items are to be recognized at current fair value, especially in particular under IFRSs. For example, while the cost of historical acquisition can be reliably collected on the basis of the payments made for a property at the time, current values usually have to be estimated by the companies. They are therefore subject to a higher degree of uncertainty compared to historical valuations. At the same time, the values may be influenced by the exercise of discretion in the context of the estimation procedure in terms of accounting policy. In addition, the regular updating of fair value on successive reporting dates can lead to significant profit volatility: The result no longer fluctuates with the development of the business but may be influenced by the fair value fluctuations of financial instruments or investment properties. As a result, the result shown in the IFRS financial statements is to be interpreted differently today than it was almost a decade ago.

This booklet aims – supplementary to the lecture – to make it easier to understand today's increasingly complex financial information. It is to make it easier for you to read and interpret annual reports and also to introduce you to the auditor's tasks as auditor. On the basis of frequently occurring questions and compressed answers, relevant topics are explained.

In addition – **voluntary and not relevant for the exam**, but only if you are interested in - the **IFRS Illustrative disclosures with sample Consolidated Financial Statements** provide you with a practice-oriented tool to deepen the content. It is available free of charge on KPMG's homepage under

<https://home.kpmg/xx/en/home/services/audit/international-financial-reporting-standards.html>

(as of 1st September 2024) and, using the example of a fictitious global corporation, represents a possible form of group financial statements.

Who sets the content of the annual reports?



The European Union Regulation on the Application of International Accounting Standards of 19 July 2002 ("EU IAS Regulation") requires all capital market-oriented entities that are required to prepare consolidated financial statements under the law of one of the Member States to apply the **International Financial Reporting Standards (IFRS)**. These consolidated financial statements of capital market-oriented companies are thus subject to uniform requirements for the setting of legislation and transparency.

In response to the EU-IAS Regulation, the German legislator has also granted non-capital market-oriented companies the right to prepare their consolidated financial statements in accordance with IFRS, rather than in accordance with the national provisions of the **German Commercial Code (HGB)** which apply in principle.

The legislator has implemented the obligation or the right to vote to apply IFRS in Section 315a HGB with a so-called dynamic reference to the international principles. With this reference, IFRS become part of HGB – although they are not subject to any customary legislative process for commercial law. IFRS are implemented by the **International Accounting Standards Board (IASB)** in London. It consists of 16 members appointed by the International Financial Reporting Standards Foundation (**IFRS Foundation**). While the IASB is solely responsible for the preparation and further development of IFRS, the IFRS Foundation organizes the dissemination of IFRS and ensures the financing of the IASB. The aim of this two-stage organization is to ensure the IASB's extensive professional independence.

Since different interpretations may occur in the application of some IFRS, the **IFRS Interpretations Committee** is also included in the overall organization. Both the IASB and IFRS Interpretations Committee are issuing new standards and interpretations only within the framework of a formal standard setting procedure (**due process**). This ensures that globally accepted accounting standards only gain their validity after a multi-stage process has been completed. The aim is to give the interested public the opportunity to comment on discussion papers in advance, but in any case, on drafts of new standards and interpretations in writing. Only after evaluation and discussion of the comments received can a final standard be adopted.

In the EU, a new standard or an interpretation is only applicable if it has been adopted by the EU Commission in a formal procedure (**endorsement**) involving a technical advisory group, the Member States and the EU Parliament.

Despite this formal procedure, IFRS are subject to a higher dynamic in terms of amendments and additions than is the case with German commercial accounting rules.

Content

 1	General information on the annual report	4
 2	Statement of comprehensive income	9
 3	Statement of financial position	17
 4	Statement of cash flows	21
 5	Statement of changes in equity	23
 6	Notes (to the financial statements)	26
 7	Management report	31
 8	The role of the auditor	33

General information on the annual report



The annual report contains, among other information, the consolidated financial statements and the group management report as key components. In addition, the annual financial statements of the parent company are also normally included in the annual reports of some companies.

What are the differences between the annual and the consolidated financial statements?

The **consolidated financial statements** provide a comprehensive insight into the **net assets**, the **financial position** and the **results of operations** of a **group**, i.e. a group of companies.

On the other hand, the **annual financial statements** represent the economic situation of an **individual company**.

In the consolidated financial statements, the individual companies of a group of companies are depicted as if the different group companies were a single company. For this purpose, the balance sheets and income statements of the subsidiaries and the parent company are added together, and intra-group relationships (such as capital interests, receivables, liabilities, revenues and interim profits) are eliminated. On the other hand, the annual financial statements of the parent company still contain the inter-group relationships. These include, among other items, shares in affiliated companies and the dividends and interest income paid by the subsidiaries.

Under the terms of the HGB and the EU-IAS Regulation, capital-market-oriented companies are to submit consolidated financial statements in accordance with IFRS. In addition, any parent and subsidiary company subject to the regulations of the HGB must prepare annual financial statements in accordance with the HGB regulations. However, the annual financial statements of the parent company and the individual group companies, as determined by the statutory regulations, serve only to determine the respective distribution of profits of the subsidiaries to the corresponding owners of the parent company and to determine the income taxes of the individual companies.

What is a scope of consolidation?

The scope of consolidation is defined as those companies that are included in the consolidated financial statements of a parent company through full consolidation. A **subsidiary** is a company controlled by another company (**parent company**).

Whether a company based in Germany has to prepare a consolidated financial statement *is also clear from* the **HGB** for capital-market-oriented companies. Only in the next step will the **IFRS** regulations determine *which* companies will be included in the consolidated financial statements.

According to the HGB, control always exists when the parent company holds more than 50 percent of the voting rights in the subsidiary. In addition, control under the HGB also exists in cases where the parent company has the right to appoint the majority of the administrative, management or supervisory body which determines financial and commercial policy, as well as to determine the financial and business policy on a contractual or statutory basis.

General information on the annual report

This **concept of control**, which is based on company law criteria, was also the basis of IFRS for a long time. However, it has been increasingly criticized, since control can often be achieved through other designs that are not covered by the concept of control.

For this reason, the control definition of IFRS has been revised; it has been following a new concept since 2013. However, the new rules on the **concept of control** are in principle only mandatory for companies in the EU from 2014 onwards: because the European legislator had postponed the first application in the EU compared to the first application date provided for by the IASB due to the complexity of the regulation. However, voluntary early application of these regulations was also possible for companies in the EU. Thereafter, in contrast to the HGB, no fixed threshold values or precisely defined voting rights are a prerequisite for the control concept. Much more it is to assess the overall economic content of the relationship. Thus, a control under these rules may also exist without a majority of voting rights, since IFRS assumes that a (legal) person who has the control about the disposal of activities of a company and is thus subject to the risks which itself can be controlled by the position of this person at the company, controls the company. These rights do not necessarily have to consist of voting rights or certain other rights. Different indicators should be considered in combination in order to determine whether there is a dominant position in the overall picture.

However, in addition to the **subsidiaries**, the consolidated financial statements also include other undertakings in which the parent company has a stake but which it does not control. If the parent company manages another undertaking together with one or more parties, the latter must be included as a **jointly controlled entity** (e.g. **joint venture**) in the consolidated financial statements. The involvement of such companies does not take place as in the case of subsidiaries in the context of full consolidation. Depending on certain criteria, jointly controlled entities are either represented using the **equity method**, i.e. with a share of equity capital, or a **pro rata accounting** of assets and liabilities, as well as expenses and income equal to the participation ratio in the jointly controlled entity.

If the parent company is able to exert **significant influence** over an entity, since it has the possibility to participate in the financial and business policy decisions, this significant influence is also represented in the parent's consolidated financial statements by applying the equity method. The **equity method** does not include the individual assets and liabilities of the company in the consolidated balance sheet. The parent company's exposure to the company is represented only by the share of the company's equity – that is, the figure in the parent company's consolidated financial statements is made in a single line under the item "Financial investments accounted for according to the equity method".

The delimitation of the scope of consolidation – i.e. the decision on which companies are to be included in the consolidated financial statements according to which procedures – is an essential prerequisite for the consolidated financial statements to correctly reflect the economic situation of the group of companies.

Why does the annual financial statements of the parent company not provide information on the course of economic and financial position of the group?

Often, the parent company of the group is not active on the market itself. The operating results of the company are then generated in the individual subsidiaries and may not be distributed to the parent company until later years.

General information on the annual report

However, even if the parent company directly exploits services on the market, the value-added processes of the other group companies are also not represented in the annual financial statements of the parent company. The income statement of the parent company therefore does not normally reflect the result generated within the group during the accounting period.

Instead, the success of the group must be determined by means of the consolidation of all group companies, including the parent company. For this purpose, the accounts of the companies are added together and intra-group transactions – in particular distributions, but also sales transactions – are eliminated.

In order to assess the financial and economic position of the group, only the consolidated balance sheet is primarily relevant. The group is understood as an economic entity. In many cases, extensive interdependencies within a group result from internal financing agreements and performance relationships. It is only through the consolidated financial statements that the elimination of these internal links will make it clear what the actual situation of the group is. For example, a margin can be realized when inventories are sold from one company within the group to another company in the same group. This is not apparent in an annual financial statement. In the consolidated financial statements, however, this margin is eliminated until the inventories are actually sold to a third party outside the group of companies.

Which accounting standards are based on the annual financial statements of the individual group companies?

In principle, annual or individual financial statements in Germany must be prepared in accordance with the regulations of the HGB. However, large corporations may publish individual IFRS financial statements in the Federal Gazette instead of HGB annual financial statements. However, the obligation to prepare annual financial statements in accordance with the HGB remains in place. This is due to the fact that only such financial statements is permissible for the assessment of the distribution of profits to the shareholders of the parent company and as a basis for the tax determination of profits. To conceptual delimitation, the legislator refers to these IFRS financial statements, which are intended for publication, as "**individual financial statements**", as opposed to "**annual financial statements**" to be prepared in accordance with the HGB rules.

What is the difference between International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS)?

All accounting standards adopted by the International Accounting Standards Board (IASB) (IAS 1 to 41, IFRS 1 to 16) as well as the interpretations of the accounting standards prepared by the IFRS Interpretations Committee (IFRIC) ("IFRIC Interpretations" or "SIC Interpretations") have been subsumed under the umbrella term "IFRS" since the IASB was reorganized in 2001. Since then, newly published accounting standards are referred to as "IFRS", new interpretations are referred to as "IFRIC". The previous standards and interpretations retain their "IAS" and "SIC" specifications. They will gradually be replaced by updated IFRS or included in other existing IFRSs

General information on the annual report

What does IFRS consolidated financial statements consist of?

IFRS consolidated financial statements consist of (1) a **statement of profit or loss and other comprehensive income** (=statement of comprehensive income), (2) a **statement of financial position** (=balance sheet), (3) a **statement of cash flows**, (4) a **statement of changes in equity** and (5) **notes** (=appendix) to the financial statements.

Although if the **management report** or a similar reporting instrument does not form part of the consolidated financial statements in accordance with IFRS, the group management report remains a mandatory reporting element in addition to the consolidated financial statements for companies that are required to prepare their consolidated financial statements in accordance with IFRS in accordance with the EU-IAS Regulation. This is due to the fact that the German legislator has explicitly obliged the German IFRS financial statements preparers to comply with the regulations that apply to the preparation of a management report. The IFRS Practice Statement "Management Commentary", published in 2010, is therefore not applicable in Germany. In addition, certain additional disclosures in IFRS consolidated financial statements must be supplemented in accordance with the HGB. This includes, for example, those on the **share ownership list** (=list of investments; data on subsidiaries participations), auditor's fees, as well as employee numbers and board members remuneration.

What does IFRS consolidated financial statements consist of?

The management report is a predominantly verbal report by the management: in addition to the financial statements, the business performance (including the results of the business) and the situation of the group must be presented, analyzed and assessed in the context of the macroeconomic and industry-related conditions. This analysis shall include the most significant financial and, to the extent that the group's business performance and, as far as the company's performance is concerned, non-financial performance indicators. **Financial performance indicators** are commonly understood as the key figures according to which management controls the company, i.e. profitability measures or capital commitment measures such as the Return on Capital Employed (ROCE). **Non-financial performance indicators** may affect workers' or environmental concerns. Customer satisfaction measures are also included in the non-financial performance indicators.

In addition, the expected development of the group with the significant opportunities and risks of future business activities should be explained. The forecast orientation makes it clear that the management report also complements the financial statements in a forward-looking manner.

In addition to the general presentation of the situation, specific reporting elements are required by law: in order to take account of the increasing importance of financial instruments, special risks must also be reported. In addition, where the parent company or a subsidiary is capital-market-oriented, groups must address the main features of their accounting-related internal control and risk management system. The statutory regulations on the management report also provide for further reporting requirements. In addition to research and development, they also include the broad outlines of the remuneration system as well as a supplementary report and disclosures relevant to takeovers in listed companies.

General information on the annual report

Companies based in Germany must comply with the corresponding **German Accounting Standard No. 20 Group Management Report** (DRS 20) of the **German Accounting Standards Committee e.V. (DRSC)** in the case of management reporting. DRS 20 complements the legal requirements for group (consolidated) management reporting and is also recommended for the (individual) management report.

What are cross-references in the IFRS consolidated financial statements?

While the group management report is a separate reporting instrument, the notes to the consolidated financial statements are an integral part of the consolidated financial statements. The purpose of the notes to the consolidated financial statements is, among other things, to further break down and explain the amounts reported in the consolidated balance sheet, the consolidated comprehensive income statement, the consolidated statement of cash flows and the consolidated statement of changes in equity. In order for the final reader to be able to find the explanations for an item in the consolidated financial statements in a targeted manner during the analysis of one of the components of financial statements, cross-reference must be made from one component of the financial statements to the corresponding passage in the notes to the consolidated financial statements. In many cases, it is necessary for objective reasons to present the explanations on a topic in a summary in the notes: In these cases, e.g. for several balance sheet items, reference to the same place in the notes is made.

What is the relationship between the annual report and the (consolidated) financial statements?

With the annual report companies present themselves to the interested public. Scope and structure of the annual report are generally not legally limited. However, annual reports usually contain the consolidated financial statements as well as the group management report of the reporting company.

These reporting tools are subject to IFRS and HGB requirements in terms of content, form and structure. The auditor's opinion will also regularly refer to the consolidated financial statements and the group management report. The annual report thus contains both legally standardized reporting elements as well as representations in which the company representatives are free to in the presentation, as well as audited and unaudited information. In the following, we will focus on the consolidated financial statements and the group management report.



Statement of comprehensive income



The (consolidated) statement of profit or loss and other comprehensive income (=statement of comprehensive income) provides an insight into the group's business performance between two reporting dates

What is the difference between the consolidated statement of comprehensive income in accordance with IFRS and the income statement in accordance with HGB?

2

The IFRS statement of comprehensive income is structured in two stages. In addition to the **profit or loss of the period**, the **other comprehensive income** is presented. Both components together result in the **comprehensive income**. This comprehensive income thus includes all income and expenses that the group generated in the financial year. If the changes in equity caused by the shareholders (such as distributions or capital increases) are added to the total result, the **total changes in equity** are obtained. (Compare "The consolidated statement of changes in equity").

The comprehensive income can be represented as a financial statement's component. In this case, the profit or loss is only an intermediate size. After the profit or loss, the other comprehensive income is presented to finally represent the sum of both components – the comprehensive income. The financial statements are called **consolidated statement of comprehensive income**.

Alternatively, the comprehensive income can also be represented in two financial statements. In this case, the first statement, the statement of profit and loss, represents all income and expenses to be recorded in profit or loss; it therefore ends with the profit or loss. Subsequently, a second statement shows the reconciliation of the profit or loss over the items of other comprehensive income up to the comprehensive income. This second statement is called the **consolidated statement of other comprehensive income**.

In practice, both variants prevail. The concepts for the financial statements and the name of the components can be chosen by each company itself and therefore differ in practice. The terms "profit/loss of the period", "annual surplus" and "net profit for the period" are also common – each with or without prefix "group".

The presentation of the other comprehensive income must be divided into two subcomponents: the first group consists of items that are never to be reclassified into profit or loss. The second group consists of those items which, under certain conditions, are to be reclassified as profit or loss.

The IFRS standards specify which income and expenses are to be included in the profit or loss on the one hand or in other comprehensive income on the other, and which are to be reclassified as profit or loss.

In comparison, HGB does not know of any "other comprehensive income", but instead only a measure of the value of the success of the year in which all income and expenses of this period are recorded: net income or net loss for the year.

Statement of comprehensive income

What is the difference between profit or loss and other comprehensive income?

The IFRS standards specify which income and expenses are to be recorded in profit or loss on the one hand and in other comprehensive income on the other. The IASB acknowledges that the division into the two components of the overall comprehensive income has so far not been following a convincing concept, but rather has been decided on a case-by-case basis. The attempt to explain it is as follows:

In the **profit or loss**, the profit contribution from the central business activities is mainly shown in relation to the group's main areas of activity in the past financial year. This results for the period thus show the performance of the business model or, in the case of diversified groups, of the business models with which the group competes on the market. Typically, in order to implement these business models, management must make operational as well as financial decisions. Therefore, **net profit** for the period is often voluntarily divided into an **operating** as well as a **financial result**.

Other comprehensive income, on the other hand, mainly include changes in the value of assets or liabilities resulting from changes in market data, such as exchange rates or other market parameters, where management can only have a small impact on. This includes expenses and income from the continuous measurement of the fair value of certain financial instruments, from valuation changes in pension provisions, from the translation of financial statements of foreign operations, as well as from hedging transactions or from the revaluation of property, plant and equipment. Characteristic of these changes in value recognized in other comprehensive income is that they are not initially cash-effective. In this respect, it is not foreseeable when they will lead to cash inflows or outflows for the group in the ordinary course of business. For example, an increase in the pension provision due to an increase in life expectancy leads to a negative effect (expense) in other comprehensive income. However, higher cash outflows will not occur until the long term – and this is when pension payments have to be made longer than previously expected. Cumulative currency gains, which are regularly generated from the translation of financial statements of foreign companies in order to prepare the consolidated financial statements in a single currency, are also only realized in cash terms when a foreign company is sold.

In the above examples, income and expenses from the revaluation of property, plant and equipment as well as from changes in valuations from pension provisions are to be classified among the group of items that are never reclassified into profit or loss. All other examples, on the other hand, are reclassified to profit or loss at a later date. For example, the currency effects from the translation of trades of foreign business activities are reclassified (recycled) from other comprehensive income to profit or loss when the business is divested. The influence on the overall comprehensive income in this case is zero.

The **tax effects (deferred taxes)** on the individual items of other comprehensive income are to be reported either directly in the consolidated comprehensive income statement or, alternatively, in the notes to the financial statements.

Statement of comprehensive income

How reliable is the reported comprehensive income?

Since the income statement under IFRS, as well as in accordance with HGB, is not based on measurable cash inflows and outflows, estimates are required for a large number of items in the income statement; these values are correspondingly measured. This can already be seen in the first line item of the income statement: Revenue is not only shown as the proceeds received in money from the sale of goods or services. For example, if a plant construction power plant created as part of a production contract over a longer period of time, revenue can already be recorded during the completion phase according to the (estimated) degree of completion, although the delivery and service has not yet been completed – often before the customer pays for the service. Since production expenses are incurred during the production period of sales orders, the upstream sales recording is intended to determine an accrual-based success.

The discretionary liability of the profit determination increases with the discretionary liability of the prescribed valuation measures: While the acquisition costs can be determined relatively without measurement, the determination of the fair value is estimate- and assumptions-dependent. Measurement at fair value is particularly important for IFRS accounting. Since the fair value is determined at the balance sheet date, transparency about the current value ratios increases – and thus the relevance of balance sheet information compared to historical valuation measures. However, with the vast majority of positions valued at fair value, the fair value cannot be "read" directly on the market. In these cases, it is estimated by so-called valuation methods. This estimate can be made by adjusting market prices of comparable assets or liabilities. Alternatively, the present value of the expected net payments must be determined from the assets and liabilities to be valued. Present value adjustments are also required, for example, in impairment tests for property, plant and equipment and thus for the determination of impairments or for the calculation of long-term provisions.

How does the reliability of the reported results become clear?

In order to enable the reader to assess the extent of the uncertainty, the consolidated financial statements contain information on the valuation measures applied for individual assets and liabilities as well as further disclosure requirements. Where fair values are estimated as present values, even the valuation assumptions used shall be disclosed. This applies in particular to the interest rate used. IFRS also has extensive disclosure requirements for risks arising from financial instruments.

It is essential to take a look at the notes: On the basis of this information, in particular, effects from increasingly complex financial transactions can be traced. This is important, for example, when receivables are "sold" for financing purposes (so-called factoring), but at the same time guarantees, options or other collateral are granted – and thus withhold risks arising from the receivables portfolio that was actually sold. In these cases, it is questionable whether the claims in question may be fully booked in accordance with the principles of IFRS and whether the agreed proceeds from the sale may be realized.

Statement of comprehensive income

So-called **sale-and-lease-back transactions**, which, for example, lead to the sale and simultaneous rental of a property, can generate liquid funds and at the same time capital gains without any change in the use of the property by the company. The purpose of such transactions may be to increase the reported result, to improve balance sheet relations and to raise financial resources. All these backgrounds become transparent for the balance sheet reader only through the supplementary notes.

If a business assessment is a risk that the estimate may need to be revised within the next year and that this may have a material impact on earnings, this fact and the underlying assumptions must be reported in the consolidated financial statements. Similarly, the effects should be set out in the notes if such a change has occurred.

What method is used to structure the income statement?

The income statement or the first part of the consolidated statement of comprehensive income can be prepared according to the **total cost method** or the internationally accepted cost of sales method. In the case of the former, the total performance of the period is shown: In addition to the revenues, the services produced in the period are also shown, which are not sold – for example, as changes in inventories or capitalized own services. Total performance is offset against expenses incurred in the period. In the **cost of sales method**, the revenues are compared with the production costs of the products or services sold in the financial year regardless of the financial year in which the production costs were incurred. There are therefore differences in the expenses for stock changes – i.e. goods that are manufactured in stock, for example – as well as in other capitalized own services which are not reported in the cost of sales method. Nevertheless, the annual net profit is the same according to both methods.

Another major difference is the breakdown of reported expenses. In the total cost method, all expenses incurred are classified according to types of expenses, such as material and personnel expenses. On the other hand, in the cost of sales method, expenses are allocated to the operational functional areas of manufacturing, research and development, as well as sales and administration. Since in the cost of sales method the production costs of the services sold are directly compared with the revenues, the gross margin can be calculated from the subtotal, the so-called gross profit, in relation to the revenues. In many cases, companies directly supplement a corresponding subtotal, so that the gross margin can be read directly from the income statement.

How can the final addressee of the financial statements gain a quick insight into the course of business?

If the detailed presentations in the management report are too complex for the assessment of the group's business development, you can analyse the development of earnings for a first impression. How successful the group was able to establish its business model on the market, can be analyzed primarily on the basis of the development of the operating result compared to the previous year and – one step further – in comparison with the group's competitors.

Statement of comprehensive income

In the year-on-year comparison, special effects are to be noted; for example, changes in the scope of consolidation may distort the comparison if necessary. For example, the purchase of a company included in the consolidated financial statements may lead to an increase in sales in the year under review. At the same time, however, the associated integration costs could also have an impact on the consolidated profit. The sale of a subsidiary may result in a profit or loss, which results from the group's point of view as the difference between the assets and liabilities sold on the one hand and the proceeds on the other. For internationally active companies, the development of exchange rates can also have a significant impact on earnings and year-on-year comparison. In addition, changes in accounting policies or introductions of new standards may affect the year-on-year comparison. Information on this is provided by the presentation of the accounting principles in the consolidated financial statements.

How sustainable is the presented result?

In connection with the presented result, there is often talk of "**normalized profit**" today: On the basis of the notes and a survey of management, analysts usually try to determine an adjusted annual result for extraordinary, rare or one-off events or transactions. This serves as the basis for the company valuation or the valuation of the share.

Some companies meet the information needs of analysts and show additional subtotals in the income statement, such as operating profit before special expenses such as restructuring costs, special depreciation or sales of subsidiaries. The limits of such an approach are based on the preliminary methods for the structure of the profit and loss account. For example, in the cost of sales method, no separate presentation of restructuring expenses is permitted. On the contrary, the latter are to be attributed to the operational functions of manufacturing, research and development, as well as distribution and administration. At most, one "of which"-remark per line is considered here. Therefore, companies are more likely to present such special effects in the notes to the consolidated financial statements.

An exception is the **result from discontinued operations**, which are calculated separately from the company's continued business activities under international accounting standards. In this way, the development of the earnings situation compared to the previous year is presented more clearly. In addition, this type of disclosure makes it possible to better assess the future development of earnings from continuing operations.

As an alternative to the exclusive presentation of the result from discontinued operations, the resulting income and expenses can also be shown in separate columns for the financial year and the previous year, according to the breakdown of the income statement. In this way, the information content of the income statement is increased. The disadvantage here, however, is that it can become more complex and therefore more difficult to read. If only the result from discontinued operations is shown in a separate line in the income statement, the income and expenses that result from this result must be presented in the notes.

Statement of comprehensive income

What is EBIT, EBITA and EBITDA?

These abbreviations refer to common interim balances in the income statement to describe the group's operating performance. **EBIT** (earnings before interest and taxes) corresponds to the operating result (operating result) or earnings before financial result and income taxes. **EBITA** (Earnings before interest, taxes and amortization) describes the operating result before deduction of scheduled depreciation and amortization of intangible assets. **EBITDA** (Earnings before interest, taxes, depreciation and amortization) also takes into account the scheduled depreciation and impairment of property, plant and equipment. The aim of these key figures is to eliminate unplanned and probably non-recurring impairments on the one hand and to approximate the operational cash flow on the other hand by adding the most significant non-cash expenses to the operating result. Other non-cash expenses and income, such as movements in provisions in particular, but also revenues that have not yet led to a cash inflow, are not taken into account.

It should be noted that these measures do not represent non-GAAP measures defined by IFRSs and can therefore be used differently by any company. If a company uses such "**non-GAAP measures**" – for example, if it controls the company according to these performance indicators – the definition of the size used and a reconciliation to the figures in the consolidated financial statements should be recognizable to the addressee of the financial statements.

Why is the group's result to be distributed, on the one hand, to shareholders of the parent company and, on the other hand, to non-controlling shareholders?

Shareholders' dividend claims are based on the result of the company in which they are involved. The consolidated financial statements summarize several companies as if they were legally one company. The consolidated financial statements thus show the economic result of a group of companies. Shareholders which, in addition to the (dominant) parent company, have a stake in a consolidated subsidiary are described as non-controlling shareholders. From the group's point of view, however, they are also shareholders; their share of the consolidated net assets is reported in group equity. The differentiated presentation of the consolidated result in the income statement shows which part of the consolidated result is attributable to the shareholders of the parent company and which part is attributable to the non-controlling shareholders of the consolidated subsidiaries.

What is the difference between basic and diluted earnings per share?

The **basic earnings per share** show how high the group's earnings from continuing business activities are in relation to each **common share** in circulation. **Diluted earnings per share** also take into account the so-called **potential ordinary shares**, which would lead to dilution if all option or conversion rights were exercised. In this context, dilution is the reduction in earnings per share due to the assumed increase in the number of ordinary shares outstanding. The number of ordinary shares outstanding may result by, for example, a capital increase or by exercising the options related to convertible bonds. Convertible bonds are financial instruments that enable the creditor to convert his debt from the bond into an equity instrument, a common share.

Statement of comprehensive income

Which segment makes the highest profit contribution, which the lowest?

Companies whose shares or bonds are publicly traded, or which have required the admission of these securities to trading on a stock exchange are obliged to draw up a segment reporting. In a segment reporting, the group is divided into its key business areas. In the case of diversified business models in particular, it is possible to see the potentially very different profit contribution of the individual business models – the segments.

According to IFRS, segment reporting is based on the so-called **management approach**. This means that the company's data is represented in a way that is used internally for control. This applies not only to the division into segments, but also to the accounting method used. For example, if internally controlled by HGB figures, these must be presented in segment reporting.

The background is that the external financial statement addressees should also gain insight into the information available to the internal decision-makers for control and resource allocation. In this way, the financial statement addressees can identify in which areas the majority of the earnings are generated and which may place a more burden on the Group. Not all subunits that control the internal decision-makers separately must also be disclosed in the external segment reporting. Rather, segment reporting should only represent the main subunits.

According to IFRS, this is to be achieved by correspondingly high thresholds for a separate reporting obligation. A reconciliation of the segment data to the figures of the consolidated financial statements is also required if the internal accounting method differs from IFRS.

In addition to the information relating to the identification and summary of the operating segments, additional information for the entire company must be provided in the notes. These enterprise-wide data include, for example, revenues with external third parties for each group of similar products and services, revenues by geographical area and significant concentrations of sales on individual customers.

What does "impairment" mean?

All non-current assets must be regularly checked in accordance with IFRS to determine whether there is evidence that the value of the asset is no longer greater than or equal to the carrying amount stated in the balance sheet – i.e. whether the balance sheet item is no longer valuable. A long-term asset is considered to be overvalued if the carrying amount is not covered by its selling price (**fair value less costs to sell**) or by the discounted cash flows (**value of use**) expected in the future when it is used. As soon as indicators (**triggers**) of such impairment are available, appropriate impairment tests and, where appropriate, unscheduled depreciation (**impairment expenses**) shall be carried out. Such calculations may be caused, for example, by technical ageing, new improved own products or competing products, as well as insufficient returns.

The assessment of the value of **goodwill** is particularly complex. This is due firstly to the fact that this refers firstly to entire companies or companies and, secondly, reflects the assessment of the future potential of an acquisition. As goodwill, the amount is capitalized by which the purchase price paid for an enterprise exceeds the current value of the acquired net assets (asset values less debt).

Statement of comprehensive income

This surcharge reflects the expectations of the acquirer – for example, the future realization of synergies through the integration of the acquired company. In many cases, however, these expectations turn out to be vague hopes in the wake of a business acquisition – therefore, goodwill must be tested for impairment. IFRS require an **annual impairment test** of the otherwise non-scheduled goodwill (as opposed to commercial accounting, which provides in addition to scheduled annual depreciation an unscheduled depreciation in the event of a foreseeable impairment). The complexity of the impairment test is due to the fact that the goodwill is only valuable together with parts of the group. This part of the group, the so-called **cash-generating unit** (CGU), to which goodwill has been allocated, is now to be valued in total. Such corporate valuations are among the most complex valuation tasks in international accounting. Such an impairment test requires numerous valuation assumptions, which are a significant margin of discretion. Therefore, detailed information on impairments and underlying calculations is required in the notes to the financial statements

Is financial expense equal to interest expense?

No, interest expense is part of the financial expense. In addition to interest expense, the latter often includes realized and unrealized foreign currency losses and write-downs on unconsolidated investments, loans and other financial instruments.

How is interest expense determined?

Interest expense often involves more than just the combined interest on debt capital. For example, if a 1 percent bond is issued from EUR 100 million in nominal terms to EUR 90 million (under pari) over ten years, with transaction costs of EUR 2 million, net cash and cash equivalents of EUR 88 million will be allocated to the company. On the other hand, it will have to repay a total of EUR 100 million after ten years. In this case, the annual interest expense consists of one percent to EUR 100 million and an annual amortization of the difference between the return amount and the issued nominal amount.

This development (EUR 100 million – EUR 88 million = EUR 12 million EUR) is distributed over ten years. It increases the bond debt up to the amount owed at the time of repayment. International standards require the disclosure of the so-called effective interest rates, which reflect the total interest rate, in the notes.

How are share-based compensations recorded?

Share-based compensation is now a standard element of executive compensation structures. The aim is to link remuneration to the performance of the shares to which senior executives (medium term) contribute. Share-based compensation can be granted through so-called **stock options**, i.e. the subscription right to shares (**equity-settled share-based payments**). However, special payments can also be offered, which are determined according to the share price development (**cash-settled share-based payments**).

Statement of comprehensive income

According to IFRS, expenses for such components of remuneration must be recorded over the period in which the employee performs the corresponding service. For equity-settled share-based payments, the expense is measured at the fair value at the time of grant and is not revalued thereafter. For example, if the employee is granted an option that becomes exercisable after three years, if he or she is still working in the company, the expense from the share-based compensation shall be distributed over these three years. The same applies in principle to cash-settled share-based payments – but with the difference that the obligation to pay money is continuously revalued up to the time of performance.

Additional questions related to the statement of comprehensive income

- Are there material non-annual recurring expenses or income such as additions to restructuring provisions, impairments, gains or losses (e.g. from the sale of subsidiaries) which put the comparison of the previous year and the sustainability of the reported result into perspective?
- Are in the statement of comprehensive income (e.g. financial result or other result) included material unrealized income or expenses (e.g. income or expenses from the market valuation of financial instruments held for trading purposes)?
- Have other operating income and expenses changed significantly and, if so, why (for example, through reversals of provisions or through gains/losses from asset disposals)?
- How does the reported effective tax expense relate to the expected tax expense of the group? What is the result of any significant changes in tax expenses?
- Are there risks that could jeopardize the sustainability of the results or even the continuation of the group (such as technological developments, image or quality problems, claims, etc.)?



Statement of financial position



The (consolidated) statement of financial position (=balance sheet) shows the assets of a group at the balance sheet date. At the same time, it provides insights into the group's financial sources. For most companies, this cut-off date falls to 31st December.

On what valuation basis were the consolidated balance sheet and the balance sheet of the holding company prepared?

Accounting and valuation in consolidated and annual financial statements is predominantly carried out on the assumption that business activities will continue (**going Concern**). If the assumption cannot be maintained, for example because of insolvency proceedings, these circumstances and the necessary change in the basis of the valuation shall be disclosed. The liquidation values, determined as individual disposal or destruction values, are usually significantly below the continuation values.

How are continuation values determined?

If the business continues, all assets are valued at the cost of acquisition or production at the time of their acquisition or manufacture. In the following financial years, the assessment is based on different standards: property, plant and equipment such as machinery and buildings are regularly depreciated as planned; financial instruments are mainly valued at fair value. According to IFRS, goodwill and other intangible assets such as trademarks are often regarded as unusable assets and are therefore not depreciated as planned but are only periodically tested for a possible impairment. Customer receivables are recognized at the amount that is expected to be paid. Inventories are tested for possible value reductions using market prices.

What is the result of changes in assets and liabilities?

The change of a balance sheet item can have various causes: Purchases and sales of assets, borrowing and repayment of debt and equity, as well as follow-up valuations and changes in the valuation of balance sheet items (depreciation, write-downs, changes in accounting principles). Changes in the scope of consolidation by acquiring or selling subsidiaries or joint ventures may also be considered as a cause. Without analyzing the other components of the consolidated financial statements, such as the notes, it is not possible to understand the changes in the consolidated balance sheet. For example, an increase in inventories and the subsequent decrease in trade receivables could be linked to a drop in sales. However, an increase in inventories may also be due to the acquisition of a subsidiary.

What results in a capitalized goodwill?

In the balance sheet of the parent company, the purchase of a company at acquisition cost (i.e. the purchase price) is accounted for under the "shares in affiliated companies". On the other hand, the consolidated balance sheet does not include the shares, but the acquired assets and liabilities at fair

Statement of financial position

value. As goodwill, the amount is capitalized by which the purchase price paid for a company exceeds the current value of the assets and liabilities acquired from the group perspective. This surcharge reflects the expectations of the acquirer – for example, the future development of synergies through the integration of the acquired company. Goodwill is shown in the consolidated balance sheet among the intangible assets. Since the goodwill is not depreciated according to IFRS, it must be tested annually for possible impairment.

What is an associated company and what characterizes a joint venture?

An associated company is referred to if a parent or subsidiary holds shares in another company but does not have a majority stake and, consequently, cannot normally control the other undertaking. The shareholder can only exercise a significant influence on the associate, i.e. participate in financial and business policy decisions, for example. Such influence is assumed for voting rights of between 20 percent and 50 percent.

Associated companies are not consolidated but are generally valued **at equity** in the consolidated financial statements. In doing so, the equity value will be updated on the basis of the acquisition cost of the investment by the changes in equity in the equity of the associated company in the year under review. If profits are withheld (accumulated) at the associated company, the equity value increases. On the other hand, if the company pays a dividend or the associated company generates a loss, it is reduced.

A **joint venture** is characterized by the fact that it is jointly managed by several partner companies. This means that decisions on relevant activities, i.e. activities that have a significant impact on the investment company's return, must be taken unanimously by the partners involved. In the consolidated financial statements of the partner company, the joint venture shall be included, depending on certain criteria, either using the **equity method** or a **pro rata accounting** of assets and liabilities as well as expenses and income equal to the parent's shareholding in the joint venture.

Does this consolidated balance sheet contain financial instruments?

As a rule, a significant part of the group's balance sheet consists of financial instruments. In addition to liquid and monetary assets, this includes marketable securities, receivables and liabilities arising from loans and services, minority interests (but not investments in associated companies), loans, financial liabilities and derivative financial instruments (such as forward foreign exchange contracts, stock options, interest rate swaps, etc.). Derivative financial instruments are to be measured at fair value in accordance with IFRS. They are reported either separately or often under the other short-term receivables or financial liabilities. Depending on, whether they serve to hedge future transactions or other purposes (e.g. trading), the fluctuations in value are presented in other comprehensive income or in the income. The background of the transaction or the underlying strategy of the group executive board are therefore of corresponding importance for the presentation of the data.

Statement of financial position

What are deferred taxes?

The carrying amounts in the IFRS financial statements differ from the tax-approved values in many areas. Some of these differences are differences which lead to tax relief or relief in later years. These future tax obligations (**deferred tax liabilities**) or tax objections (**deferred tax assets**) are to be included in the consolidated financial statements for the financial year, in which the differences between the values in the IFRS financial statements and the tax balance sheet arise or change.

Deferred tax assets on **loss carryforwards** are also recognized if it is probable that the loss carryforwards can be used tax-reducing due to future taxable profits. In particular, this right to a future tax reduction is embodied by the capitalized deferred tax assets on loss carryforwards. In the event of an unexpectedly adverse business development, in the case of deferred tax assets on loss carryforwards, further write-downs on the capitalized tax assets are threatened in addition to the losses from the operating business. This is due to the fact that the loss carryforwards may no longer be deducted with a tax effect if no or only small profits are expected in future reporting periods.

Can the group's reserves be distributed?

The starting point for a distribution is always the profit determined in accordance with commercial law principles or the reserves, if any, created in the individual trade regulations in accordance with the requirements of the stock corporation law. On the basis of the consolidated financial statement, this cannot in principle be the basis for a decision on a distribution of profits or from the reserves. However, insofar as the group's reserves reflect those of the group's parent company, a distribution may be decided at the level of that company on the basis of the annual financial statements.

What characterizes shares of non-controlling interest?

Shareholders who have a stake in a consolidated subsidiary in addition to the (dominant) parent company are described as non-controlling **interests**. From the group's point of view, however, the non-controlling interests are also shareholders, their share of the group's net assets is reported in group equity capital. This is the case, for example, where the parent company and other group companies have only 70 percent of the shares in a subsidiary included. Since the balance sheet and income statement of this subsidiary are included in the consolidated financial statements at 100 percent, the share of non-controlling **interests** in equity and the result of the respective subsidiary company is reported in a separate item in the consolidated equity at each balance sheet date. The group's earnings shares attributable to non-controlling shareholders are reported separately in the consolidated comprehensive income statement.

What are provisions for?

A provision is a liability that is uncertain as to its maturity or amount. Provisions are created, for example, for warranty obligations, process risks, recultivation obligations, possible tax repayments or pension commitments. A variety of assumptions often have to be made when it comes to the approach

Statement of financial position

of provisions – for example, the chance of comparison in an ongoing process, the occurrence of warranty cases, or the estimation of costs of environmental damage.

This discretion provides opportunities for **accounting policy measures** (or **earnings management**). For example, the financial sector is familiar with the phenomenon of the "**Big Bath**": companies whose earnings are already burdened by ongoing restructuring expenses occasionally use the scope offered by the provisions principles to create further provisions – with the aim of further reducing the already negative result even further. The calculation: If the operating business can be stabilized in the following years by the then effective efficiency measures and ideally expanded, the provisions can be dissolved again within the scope of the company's discretion. With the resulting return, the net profit for the period is further increased – the turnaround is clearly evident.

The notes to the consolidated financial statements provide information on such strategies: The accounting and valuation methods for provisions are to be presented here. In addition, for each group of provisions, an uncertainty must also be made as to the amount or maturity of the provisions.

What is under the wording "assets-held-for-sale and thus related liabilities" understood?

In order to show the final reader the economic impact of the sale of long-term assets, IFRS contain special presentation and measurement provisions for this group of assets and related liabilities. Assets intended for sale and related liabilities shall be deducted from the assets and liabilities of continuing operations in the consolidated balance sheet. This gives the balance sheet reader an impression of the magnitude of the change that comes with the planned sale for the group. For that separate statement, the sale must be very likely, which is linked to the existence of certain conditions. The liabilities associated with these assets must be shown separately on the liabilities side of the consolidated balance sheet. Balancing with the assets is not permitted.

Statement of financial position

Additional questions related to the statement of financial position

- Does the group have sufficient liquidity, timely realizable assets or refinancing opportunities to settle short-term liabilities?
- Under what conditions does the turnaround of a recently acquired company succeed, on which the value of goodwill depends? Had value adjustments have already been made?
- What value adjustments have been made and appear they appropriate for creditworthiness risks on customers and for unsaleable goods?
- Are there any material assets, such as deferred tax assets or goodwill, whose feasibility depends to a large extent on future development or is at risk from it?
- Are there credit agreements that are linked to financial measures and whose non-compliance leads to an immediate termination of the loans or other sanctions (so-called financial covenants)?
- Is the group exposed to significant foreign currency risks and how does it hedge against them?
- Are there any derivative financial instruments outstanding or has the group made speculative financial transactions? Are there any repurchase obligations that are not shown on the balance sheet?
- Are there contingent obligations, for example from legal or guarantee cases, that could affect the financial situation of the group?

3



Statement of cash flows



The (consolidated) cash flow statement provides insights into the liquidity of the group by drawing up a reconciliation of the cash and cash equivalents – the so-called cash funds – at the beginning of the financial year to the end of the financial year: The reconciliation is broken down by cash flow from operating, investing and financing activities.

What is cash flow?

The term "**cash flow**" is used inconsistently in practice. In general usage, it often refers only to the change in cash and cash equivalents from operating activities. On the other hand, cash flow is understood to mean the total change in existing funds. The consolidated statement of cash flows will make the change in the cash fund, which consists of cash and cash equivalents, comprehensible over a period.

What is the cash fund?

In addition to **cash** and sight deposits, the cash fund also includes **cash equivalents**. These are defined as short-term, highly liquid financial investments with a residual maturity of no more than three months from the date of acquisition. Another characteristic is that they are subject to only a low risk of fluctuation in value. Other marketable securities may not be shown as cash equivalents.

The cash and cash equivalents are generally presented gross. Current account loans are, however, to be netted if they are part of the cash disposition and are also repayable on demand.

What does cash flow from operating activities say?

The starting point for operating cash flow are the revenues from which cash outflows for procurement, production, administration and sales are deducted: The **operating cash flow** shows how the cash fund from the company's core activities could be increased – or, if operating cash flow is negative in exceptional cases, to what extent the core business had to be counter-financed. The (positive) operating cash flow therefore shows the internal financing power in the past financial year. The liquidity generated from the operational area can be used for the repayment of loans, distributions or investments.

In order to calculate cash flow from operating activities, companies use almost exclusively the so-called **indirect method**. Based on the annual result, non-cash expenses such as depreciation and provisions are added together. Non-cash income such as provision resolutions are deducted

The so-called **direct method**, in which the cash flow is derived directly from cash inflows and outflows, is also permitted. The direct method is rarely used in practice due to the high cost of determining total cash-inflows and outflows.

Statement of cash flows

What does cash flow from investing activity say?

The group's investment activities include payments for investments in property, plant and equipment, intangible assets and other financial investments, as well as proceeds from the sale of these assets. If subsidiaries are purchased (or sold), this is also reflected in the **cash flow from investing activities** in the amount of the purchase price paid (sales price).

What does cash flow from financing activity say?

Financing activities include, for example, cash increases or cash outflows to shareholders (dividends, etc.) as well as the borrowing and redemption of loans or bonds. Since treasury shares are presented as deductibles from equity, the purchase or sale of treasury shares must also be shown, such as a reduction in capital or an increase in financing activity.

What influence do foreign currency differences have on the consolidated statement of cash flows?

Cash and cash equivalents in foreign currencies are exposed to exchange rate risks. Changes to the cash and cash flow fund due to exchange rate shifts must be shown separately in the consolidated statement of cash flows.

What does "Free Cash Flow" say?

The term **free cash flow** is not defined under IFRS. Rather, it is a generic term for business indicators that are formed to measure the financial strength of an enterprise. In practice, free cash flow is calculated in many ways as the sum of operating and investing cash flow: the remaining amount is available to repay debt or to be able to make distributions to shareholders .

Why can't the information on the changes in balance sheet items in the consolidated cash flow statement be reconciled with the change in the balance sheet items as they result from the consolidated balance sheet?

The discrepancies may result from foreign currency differences, different allocations of parts of a change in balance sheet items to the areas of the consolidated statement of cash flows as well as changes in the scope of consolidation (purchases and sales of subsidiaries).

Statement of cash flows

Additional questions related to the statement of cash flows

- Is the group able to generate positive cash flow from operating activities in order to meet its required investments and to pay its debts, interest and dividends?
- What was the cash inflow from operating activities used for or how was negative cash flow financed? What were equity injections and borrowed debt used for?
- Are there any significant investment obligations (e.g. for property, plant and equipment or intangible assets) that will become accountable and und liquidity-effective in the near future?
- Were the right investments made at the right time and at a reasonable acquisition cost?



Statement of changes in equity



The (consolidated) statement of changes in equity in the annual report shows the increase or decrease in net assets during the financial year.

What is the equity of the company?

A detailed equity breakdown is not specified in accordance with IFRS. The main requirements for substructure are the company regulations to be used in the country of residence of the company. In the case of German listed companies, this is in particular the German Stock Corporation Act. Usually, the equity consists of the paid-in capital and the capital generated – reported as retained earnings in German equity companies. Group equity under IFRS also includes separately showing non-controlling interests – i.e. shares held by non-group third parties in subsidiaries of the group.

The **paid-in capital** typically comprises the **subscribed capital** of the parent company and the **capital reserves**.

The **subscribed capital** may be securitized in ordinary or preferred shares. It is very important for the investor to know which class of shares (e.g. ordinary shares or preferred shares) the paid-in capital consists of, because this entails different rights and obligations of the shareholder and, if necessary, distribution restrictions exist. Therefore, the group notes must mention the classes of shares and the rights associated with each class.

The **capital generated** consists of the **retained earnings** as well as **other reserves** to be reported separately. In these separate items, if required by the respective IFRS regulations, the individual components of the other comprehensive income are entered (e.g. currency allocation reserve, reserve from hedging transactions, revaluation reserve). Some of the other comprehensive income accrued in these reserves are to be reposted into the annual income in later years (e.g. currency translation reserve, reserve from hedging transactions – so-called **recycling**), while others remain permanently in the reserves (such as the **revaluation reserve**). If the group has carried out transactions with its own shares (**treasury shares**), these must be recorded directly in the reserve for its treasury shares.

Retained earnings include the accumulated and not distributed annual results as well as the components of the other comprehensive income, which do not need to be shown in a separate reserve (e.g. actuarial gains and losses from the valuation of pension provisions).

What are changes in equity?

Changes in an entity's equity between two balance sheet dates reflect the increase or decrease in net assets during the period. Changes in equity can result from two facts: firstly, the total comprehensive income generated and, secondly, capital transactions with the owners of the group, either in the form of dividend payments or through transactions that alter the capital paid in (such as capital increases or reductions).

Statement of changes in equity

How does the consolidated statement of changes in equity relate to the consolidated statement of comprehensive income?

The total result derived in the consolidated statement of comprehensive income represents a significant change in the size of group equity in the financial year under consideration. In the consolidated statement of changes in equity, the different components of earnings in the consolidated statement of comprehensive income are allocated to the individual equity items.

How do cumulative foreign currency differences arise?

Foreign subsidiaries usually account for in foreign currency. For the purposes of consolidating these financial statements into the consolidated financial statements of a German parent company, these foreign currency financial statements must be converted into the reporting currency, as a rule, the euro. Since the items on the balance sheet at the end of the year are converted at different rates than at the beginning of the year, and since the items on the balance sheet and those of the consolidated statement of comprehensive income are converted at different rates, foreign currency differences arise. These are recognized in the other income and reported in a separate reserve in equity. In the case of the sale of a foreign subsidiary, the accumulated foreign currency gains/losses must be attributed to or deducted from the disposal result by reposting them into net profit for the period. This transfer, which ultimately realizes the foreign currency differences, is called recycling.

Why are treasury shares deducted from equity in the consolidated financial statements?

Treasury shares are used to designate shares in the parent company acquired by the group itself. Treasury shares are acquired by companies for different reasons – for example, to prepare for a capital downgrade or as a distribution substitute. In general, the amount of shares that an undertaking may acquire in itself is limited under company law. In Germany, there are corresponding stock corporation regulations.

Treasury shares acquired by an entity are not considered an asset in the consolidated financial statements in accordance with IFRS. Rather, their acquisition is a repayment of capital and must be mapped accordingly, regardless of the purpose for which they were acquired. Therefore, they are reported in a separate reserve within the equity. A subsequent sale of treasury shares is recognized as a capital increase. In this process, an additional proceeds in comparison with the original cost of collection must not be recognized as a profit, but as an agio (addition to the capital reserve).

How do restatements influence the equity?

Restatements include changes to accounting methods and corrections to significant errors. In order to ensure the comparability of successive financial statements, the accounting policies applied must in principle be maintained consistently. **Changes to accounting methods** may only be made if required by a standard or interpretation (e.g. when a new standard or interpretation is published) or if the change results in a more meaningful presentation of the company's business. This could be, for example, the

Statement of changes in equity

decision to no longer value investment-held properties at cost of acquisition/production, but at fair value. In order to take account of changes in accounting policies, **retrospective adjustment** is generally provided for. Standards or interpretations may provide for an exception.

An error exists if the accounting rules have not been applied correctly, if a calculation has been miscalculated in the past, or if any information has simply been overlooked in accounting. **Significant errors** must be corrected by a **retrospective adjustment** of the previous year's figures.

The retrospective adjustment is effected by a **profit-neutral adjustment** of assets and liabilities to the initial reporting date of the previous year. The adjustment amounts must be determined as if the new accounting methods had always been applied or had been accounted for without errors in the past. The effects on each item of equity are to be disclosed in the consolidated statement of changes in equity. In addition, a third comparative column must be recorded in the consolidated statement of financial position at the beginning of the previous period ("**3rd balance sheet**"), provided that there have been significant results on this third balance sheet. In the notes to the financial statements there also is a description in detail about the impact on the individual items in the consolidated financial statements.

To what extent does equity correspond to the group's enterprise value?

The enterprise value is usually determined by a valuation according to the earned value method or the discounted cash flow, namely as the present value of all future net cash inflows related to the enterprise to the owners of the company. This assumes that the company will be continued and that any assets that are not necessary for the business will be disposed of. In the case of groups with listed parent companies, the enterprise value can be derived from the market capitalization (number of shares multiplied by the share price) daily.

If the equity capital under IFRS is also determined on the assumption that the entity will continue, it does not correspond to the enterprise value. Deviations between the enterprise value and the equity capital accounted for arise from **self-created goodwill** (such as know-how, market strength, customer base or competitive advantages). Although their usefulness can be considered in an enterprise valuation, they do not lead to such tangible assets in the accounts that they are likely to be capitalized. In addition, there are discrepancies due to the valuation methods in the IFRS financial statements. They result from the fact that some items are valued at continuing historical acquisition costs, even if IFRS already shows a progressive trend towards a broad valuation at fair value. Moreover, a full fair value measurement would not result in the equity accounted for being equal to the enterprise value, as most items in the IFRS financial statements are valued individually. Synergies through the sharing of assets are always not considered in the consolidated financial statements, which are based on a single analysis.

Statement of changes in equity

Additional questions relating to the statement of changes in equity

- Which types of shares (common, preferred or voting shares) make up the share capital and what rights and obligations of the shareholder are associated with it?
- What is the group's dividend policy and to what extent are distribution restrictions to be observed?
- For what reasons were transactions with treasury shares made (e.g. averting imminent damage from the company, issuance of employee shares, etc.) and is the stock of treasury shares earmarked for a specific purpose?



Notes to the financial statements



The notes to the consolidated financial statements explain, among other things, the principles applied to accounting, changes in the scope of consolidation and individual items in the consolidated financial statements.

What is the purpose of presenting accounting principles?

In the section on accounting principles, the group sets out, among other things, which accounting standards (HGB, IFRS) are applied. It also explains how the scope of consolidation is defined and which accounting policies are used in detail. For example, information on the exercise of voting rights or the extent of the valuation at fair values and the related effects on earnings is provided.

In this respect, the analysis of the accounting principles contributes to the understanding of changes in the consolidated statement of financial position and the consolidated statement of comprehensive income. This also makes the adjustments in the statement of changes in equity due to changes in accounting policies comprehensible.

Many IFRS are based on broad economic bases, which require interpretation in the concrete application. This applies, for example, to the standards for the scope of consolidation – i.e. the definition of the subsidiaries to be consolidated. In the context of the presentation of the accounting principles, it is also necessary to show how these discretionary margins have been exercised and which approach the company has chosen in the concrete implementation of the standards that require interpretation.

Accounting policies have to be applied steadily over the years. They may only be amended if required by a standard or interpretation or if this makes the accounting more meaningful. Changes in accounting policies must in principle be made retrospectively. This means that the opening balance sheet value of the period presented in the consolidated financial statements must be adjusted as if the accounting had always been made in accordance with the new rules. Transitional arrangements are sometimes formulated for the transition to new standards and interpretations, which differ from the principle described.

What is the purpose of the explanatory notes to the individual items in the consolidated financial statements?

The explanatory notes provide information on the combination and reasons for significant changes in individual items in the consolidated statement of financial position, consolidated statement of comprehensive income and consolidated statement of cash flows. For the analysis of the change in the balance sheet items, the presentations of the development in the financial year required by individual standards are helpful (e.g. investment and provision mirrors). For example, in the notes to the consolidated financial statements, the presentation of the development of intangible assets, property, plant and equipment, investment property, provisions and obligations arising from defined benefit pension plans is useful.

In the context of financial liabilities (including leasing liabilities), the existing conditions (interest rates, credit conditions) as well as maturities and collaterals are important information to assess future cash outflows, existing interest rate risk and the remaining scope for financing. Other information important

Notes to the financial statements

for the understanding of consolidated financial statements are the explanatory notes on pension provisions, income taxes and, in particular, financial instruments and derivatives.

What important additional information is included in the notes to the consolidated financial statements?

Part of the explanations is the information on so-called contingent liabilities and other financial obligations. This includes business incidents, some of which are still fraught with uncertainties and which have not (yet) been reflected in the consolidated statement of financial position. They must be specified in order to enable the users of the financial statements to identify the material risks and contractual obligations that the group is exposed to. They also provide guidance on how these risks can influence the consolidated financial statements, in particular earnings and liquidity, in the future. Examples of contingent liabilities still subject to uncertainty are obligations arising from guarantees as well as from warranty contracts or from litigation. Examples of other financial obligations include cash outflows of payments from non-cancellable leases (operating leases) and capital commitments.

In addition, the notes to the consolidated financial statements of companies whose shares or bonds are traded on a securities exchange or which have applied for admission to trading their securities on a stock exchange contain **segment reporting**. It provides an insight into the performance of the group's individual business units.

In addition to the IFRS notes, preparers of IFRS consolidated financial statements in accordance with Section 315a of the German Commercial Code (HGB) must provide further information that the German legislator considers to be important. These include information on the number of employees, personnel expenses, (supervisory and management) board remuneration, corporate governance declaration, auditor fees and group shareholdings.

What are related parties?

A related party, natural or legal, is defined as a person who may exercise a significant influence, directly or indirectly, on the financial or operational decisions of that company. This includes, for example, majority shareholders, supervisory board members and members of the management board, as well as companies controlled by them. In addition, this includes all companies over which the group may have at least one significant influence (i.e. subsidiaries, joint ventures and associates). Transactions with related parties cannot be automatically compared with those between the group and independent third parties, as the special relationships do not necessarily agree on market conditions. Therefore, transactions and outstanding balances with related parties must be disclosed in the consolidated financial statements. They make it possible to assess the extent to which the economic conditions of the group are influenced by business relations with this group of persons and companies. It should be borne in mind that the disclosures are only for transactions that have not already been "eliminated" in the context of consolidation.

Notes to the financial statements

What does the presentation of the development of intangible assets and property, plant and equipment say?

According to IFRS, the development of property, plant and equipment and intangible assets is to be presented in the notes to the financial statements. As a rule, the presentation is gross – that is, the development of **acquisition costs** and **accumulated depreciation** is shown. Additions through business acquisitions, investments, disposals (sale, disposal), scheduled depreciation and impairments as well as translation differences are reported separately. Investments and disinvestments (historical acquisition costs less cumulative depreciation to disposals) should be reconciled with the combined income and loss from disposals (which are corrected within the cash inflow from operating activities) and except for non-cash transactions (purchases or sales in the form of exchange transactions, Investments with purchase price deferral or financing leasing transactions).

What information does the depreciation item provide?

In addition to scheduled depreciation, this item also includes **impairment** charges. In accordance with IFRS, an entity must assess whether there are evidence of impaired assets at each balance sheet date. As soon as indicators of impairment are available, corresponding impairment tests must be carried out. If any, an impairment loss must be recorded. A value is overvalued if its **book value** is not covered by its **fair value less cost to sell** or by its future discounted cash flows, including disposal (**value in use**). The assessments of the value of goodwill are particularly complex, as this reflects the assessment of the future potential of acquisition. This value, which, unlike other assets, is not depreciated on schedule, requires an annual impairment test.

What do changes in financial resources from the sale or acquisition of consolidated companies mean?

Acquisitions can significantly change the assets, financial and earnings situation. They must therefore be explained in detail in the notes to the financial statements. The purchase price for company acquisitions less the acquired or newly fully consolidated cash and cash equivalents is reported as a cash outflow.

This amount is offset by the assets and liabilities transferred to the consolidation as well as goodwill. The breakdown of cash flow from acquisition activities can make the changes in the balance sheet items plausible compared to the cash flows shown in the consolidated statement of cash flows.

As a result, the impact of the acquisitions to the balance sheet becomes comprehensible. The sale of subsidiaries is proceeding in the same way, but with the opposite sign.

Notes to the financial statements

How are pension obligations calculated?

Long-term pension obligations are recognized under IFRS only for **defined benefit obligations**. These are obligations, where it is not the employee but the employer who bears the financial risk with regard to the benefit obligation entered into. Otherwise, there are **defined contribution plans**. In these cases, the employer contributes to the financing of the pension, but does not pay for pension payments in the long term.

The calculation of defined benefit obligations is carried out as a present value, which is calculated according to the projected unit credit method. This present value calculation depends on numerous demographic and financial approaches at the balance sheet date (e.g. duration of stay of the employer in the company, life expectancy or expected pension amount). As a rule, an interest rate for discounting is based on the interest rate on first-class fixed-income industrial bonds.

If there are pension assets, the income from this reduces the pension expense. In the meantime, the income from the pension assets is no longer individually estimated but is standardized on the interest rate on which the discounting of the pension obligation is based.

The annual update of these valuation assumptions to the actual ratios regularly results in so-called **actuarial gains and losses**. Only one method is now allowed to record these valuation changes. In this case, the actuarial gains and losses at the time of their creation are recognized in other comprehensive income.

Actuarial gains and losses may vary widely from year to year due to changes in valuation and can be reversed. The immediate recognition of other earnings meets the expectations of financial analysts in particular. These see the instant recording as a more transparent representation of the workload-related burdens on the company's assets.

In order to understand the information on operating pension systems in the consolidated financial statements, it is also important that the pension obligation shown in the consolidated balance sheet constitutes a net liability. At this size, there is a balanced statement between the present value of pension obligations accumulated at the end of the year and the pension assets. Not all assets are permitted as pensions assets for netting. Only the so-called plan assets can be netted. The standard sets strict requirements for the classification of assets as plan assets. Plan assets are defined only as those assets held in a legal unit separately from the group's productive assets. They must also be earmarked – that is, they must be used exclusively to finance pension obligations. A further requirement is that they are protected from access by third-party creditors in the event of insolvency.

When does the group have to repay its debts?

The maturity information on debt capital can be used to draw conclusions about the future burdens on the group's liquidity situation.

Notes to the financial statements

How much tax does the group pay?

The explanatory notes on income taxes include, among other things, a reconciliation from the expected tax rate to the effective tax rate (**tax rate reconciliation**) or from the expected tax expense to the reported tax expense. The expected tax rate is transferred either on the basis of the tax rates in the country of residence of the parent company or on the weighted average of all tax rates applied locally in the group. The effective tax rate is calculated from the income tax expense reported in the consolidated statement of comprehensive income in the ratio to earnings before taxes. Deviations may be attributable, for example, to tax-free income or non-deductible expenses or to unaccounted tax assets from loss carryforwards.

What do the information about risks from financial instruments contain?

Companies are obliged to provide extensive information on the nature and extent of risks arising from financial instruments in the notes to the consolidated financial statements or by means of cross-reference in other sections of the group report, such as in the management report. These are intended to provide information on the financial risks that a company is exposed to, in particular credit, liquidity and market risks, and how it handles them. This information is important for the balance sheet reader, as financial instruments such as trade payables, financial assets or derivatives often constitute significant items on the consolidated statement of financial position. They can therefore have a significant impact on the future development of a company. Market risks include, in particular, currency and interest rate risk. For this purpose, companies must disclose so-called sensitivity analyses in the notes to the consolidated financial statements. These include the possible future impact on financial results and equity, which may result from fluctuations in exchange rates or changes in interest rates. In order to assess liquidity risk, information on the contractual maturities of the financial liabilities must be provided. The information on credit risk is intended to show the extent to which the company has a significant concentration of default risks (e.g. in the case of claims arising from supplies and services).

What information does segment reporting provide?

The structure and scope of segment reporting are based on the composition of the group's internal reporting. IFRS segment reporting is based on the "**management approach**". This is based on reports which are to be submitted regularly to the responsible business body (**chief operating decision maker**). The chief operating decision maker is the body responsible for allocating resources in terms of business segments and the measurement of their profitability. In German corporations, the overall board or individual divisional directors of the highest parent company are particularly eligible for this.

The aim of this management approach is to provide the final addressee with the same information, which is also used for internal decision-making by decision-makers. The advantage of this method is above all the disclosure of additional information on internal control methods and the criteria used for measuring success.

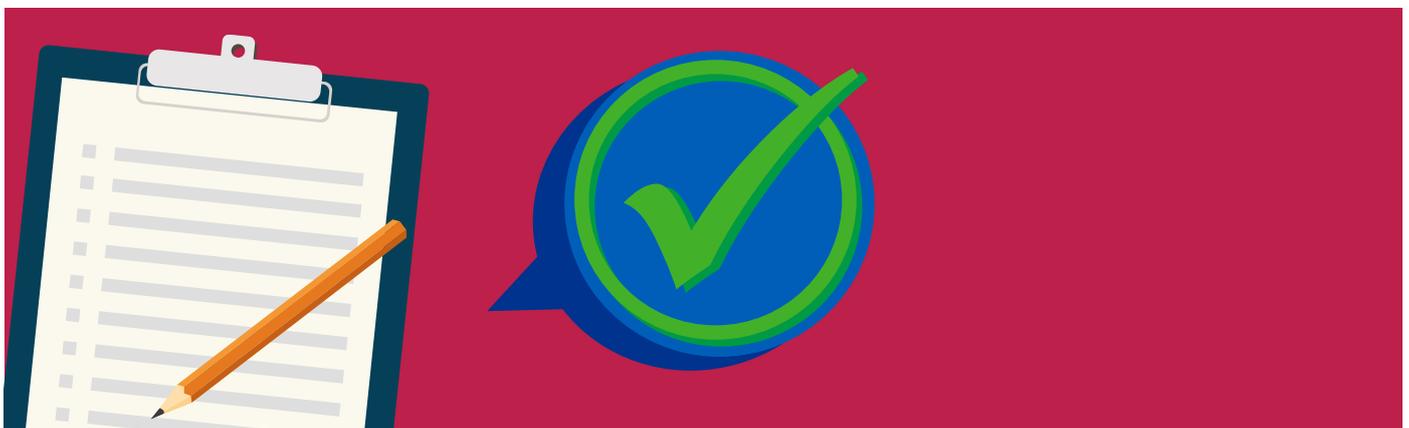
On the other hand, the company-specific way of presentation makes it difficult to compare several companies in an industry.

Notes to the financial statements

However, the primary objective of segment reporting is to provide an insight into the performance of the individual business activities. An analysis of the results of the segments, which are defined by product groups, regions or a combination of both, according to the individual company development, facilitates the identification of the main strengths and weaknesses of the group. For example, loss-making parts of the company can be easily identified.

Additional questions relating to the notes to financial statements

- What are the reasons for changes in accounting policies?
- Have corporate acquisitions resulted in high goodwill? What justifies these goodwills? What contribution to earnings did the acquired company make in the current financial year to the consolidated result?
- How was the impairment or the net realizable value of goodwill determined and what are the reasons for the impairment?
- Is there a risk of ageing and/or insufficient profitability of property, plant and equipment? Do the useful lives correspond to a realistic assessment of the lifetimes of these plants?
- Are reasonable provisions for warranty cases, process risks, loss orders, tax risks, etc. have been accounted for? Have provisions been redissolved to a greater extent?
- Are the fair value disclosures relating to financial statements and non-financial instruments for which fair value disclosures are also required (such as "investment property") complete?



Management report



The (group) management report contains comments on the course of business, the situation and the expected development of the company.

Who must draw up a group management report?

Under the HGB, parent companies that are not exempt from the consolidated financial statements have to draw up a group management report. The group management report is an independent reporting instrument that must be consistent with the consolidated financial statements. Companies that prepare liberating consolidated financial statements in accordance with international rules (IFRS financial statements) in accordance with Section 315a HGB are also obliged to prepare a group management report. The statutory requirements for group management reporting are specified by the German Accounting Standard No. 20 Group Management Report.

What is the role of the group management report?

In the group management report, management reports on the use of the resources entrusted to it in the past financial year. In addition to the analysis of the business performance, including the results of the business and the economic situation of the company, information on the expected development of the Group as well as on the associated opportunities and risks are required. In addition, the group management report contains forward-looking components with the prognose report and supplements the consolidated financial statements in this respect. The aim is to provide the addressee with decision-relevant and reliable information. In this respect, the group management report should contain all the information necessary for the overall economic assessment of the Group and for a better **understanding of the net assets, financial position and results of operations**. The group management report thus has both an information and an accountability function; it is the only instrument that provides the reader with forward-looking forecasts of the group's expected course of business, as well as its opportunities and risks.

What are the principles of group management reporting?

The DRS 20 contains the principles of completeness, reliability and freedom from bias, clarity and transparency, conveyance of group management's perspective, materiality and proportionality of information. In line with the basic principle of clarity and transparency, a summary of the group management report with the management report of the parent company ("**combined management report**") is possible if the consolidated financial statements are disclosed together with the annual financial statements of the parent company. The principle of proportionality of information clarifies that the detail and level of detail of the presentation in the management report depends on the business activity, size and capital market orientation of the company.

What is the structure of the group management report?

According to DRS 20, it is advisable to structure the Group management report into the following sections (not exhaustively):

1. Fundamental report about the group

1. Group's business model
2. Branches
3. Objectives and strategies
4. Internal management system
5. Research and development

2. Report on economic position

1. Macroeconomic and sector-specific environment
2. Course of business
3. Net assets, financial position and results of operations
4. Financial and non-financial key performance indicators

3. Report on post-balance sheet date events

4. Report on expected developments and on opportunities and risks

5. Supplementary reports

1. Internal control system
2. Management system relevant for the consolidated financial reporting process
3. Risk reporting relating to the use of financial instruments
4. and many others.

What are the comments on the group's fundamentals and the economic position?

The Chapter "Fundamentals of the group" contains excerpts on its business model, which are intended to serve a better understanding of the management report. The group's organizational structure, its segments, locations, products and services as well as sales markets must be addressed. In addition, research and development activities and, in the case of capital-market-oriented companies, also the control system are to be presented. Reporting on objectives and strategies may be voluntary in order to give the reader the opportunity to improve the course of business, the economic situation and the likely development of the group in the context of the objectives and strategies pursued.

The economic report provides an analysis of the business performance (including the results of the group) and the situation of the group, including the most important financial and non-financial performance indicators.

Management report

The earnings situation can be shown based on the sources of earnings, in particular significant changes compared to the previous year and their causes. The financial situation includes explanations of capital structure, investments and liquidity. In addition, the net assets must be addressed.



The role of the auditor



The auditor is expected to make a significant contribution to the confidence of the accounting users in the external reporting of a company. In addition, he makes an important contribution to the corporate governance of the company with the audit.

Status of the audit report and the "expectation gap"

The main task of the statutory auditor is to check the annual financial statements or consolidated financial statements for compliance with the relevant regulations (e.g. IFRS, HGB, The German Stock Corporation Act, rules of the Articles of Association). The management report shall be examined in order to determine whether it is consistent with the financial statements of the company, provides an overall accurate picture of the situation of the company or group and accurately presents the opportunities and risks of future development.

The audit must be carried out in such a way as to detect material inaccuracies and infringements in the jurisdiction. It should therefore be carried out with a critical attitude towards the company. However, this is not an audit aimed specifically at detecting fraud as deception and embezzlement. However, the public is often unaware that, even with conscientious professional practice, the possibility remains that even material errors will not be uncovered if they result from fraud (e.g. embezzlement) caused by the management of the company ("**expectation gap**").

Furthermore, the audit opinion does not constitute a "seal of approval" for the economic performance of the audited entity: since the audit opinion merely confirms compliance with the relevant accounting rules, an unsatisfactory economic situation presented in the financial statements has no influence on the audit report.

The previous comments on the financial statements have shown that legal representatives must make discretionary decisions when drawing up a financial statement. There must also be comprehensible assumptions about future developments

The aim of the financial statements is that the financial statements drawn up represent **the net assets, the financial position and the results of operations** of the company or group in accordance with the actual circumstances. Addressees of financial statements – in particular shareholders, lenders, employees, customers and suppliers – often make economic decisions on the basis of the financial statements. Therefore, this information must be reliable. The auditor's task is to increase the reliability of this information and thus also to ensure the accuracy of the accounts. An important prerequisite for this is the independence of auditors from the companies whose financial statements they audit.

Only in this way can they be impartial and neutrally assess the information presented in the financial statements and their determination in accordance with the underlying accounting rules. Once their audit has been completed, they must provide information in the form of the audit opinion and on the basis of an audit report as to whether the financial statements they have audited have been prepared in accordance with the relevant accounting rules.



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