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## Preventing irregularities in accounting, including fraud

### Working Group of German Accounting and Auditing Law Professors<sup>1</sup>: reform proposals regarding statutory audit, financial reporting enforcement and corporate governance

#### Executive Summary

1. The dual system of financial reporting enforcement by the BaFin and the DPR has proven itself to be reliable in the vast majority of cases for the large number of cases. We therefore regret that the Federal Government has - in our opinion prematurely - terminated the contract with the DPR.
2. However, it has to be conceded that the current system shows weaknesses in cases where there is reason to suspect irregularities or even fraud. If there are respective hints, ample forensic examination powers and adequate personnel and financial resources are required at the level of the enforcement body. We recommend a three-pillar model:
  - a. The DPR should continue to be responsible for the regular random enforcement of accounts.
  - b. Enforcement regarding the DAX30 companies in case of specific hints on possible irregularities (“Anlassprüfung”) should be entrusted to an EU enforcement agency to be established for this purpose.
  - c. BaFin should be responsible for any so called “Anlassprüfung” regarding all other companies (without the DPR as a first stage).
3. BaFin and the EU enforcement agency should set up a “rapid task force” that would be able to quickly and effectively investigate more prominent and larger cases. The task force should be reasonably equipped in terms of staff members, training and resources.

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4. If hints on possible irregularities or fraud arise during the final audit, the responsible authorities must be involved at an early stage. In this regard, the auditor's confidentiality obligations must be reformed. Confidentiality towards investigative authorities is not appropriate.
5. The auditor's liability (section 323 German Commercial Code [HGB]) should be more strict.
6. Section 317 HGB should be tightened up in three points.
  - a. First, it should be made clear that the audit aims at detecting irregularities, including fraud. If there are any indications, corresponding forensic examination procedures must be carried out.
  - b. Second, the requirement of a general critical attitude (professional scepticism) of the auditor during the audit should not only be stipulated in professional law (section 43 par. 4 Public Accountant Act [Wirtschaftsprüferordnung, WPO]), but also in the audit law itself (namely in section 317 HGB), to highlight the importance of a professional ethical attitude.
  - c. Third, section 317 par. 4a HGB should be deleted. The assessment of whether the continued operation of the company could be endangered is of paramount importance for the addressees of the annual accounts. Although the profession's interest in not being held liable for negligent or incorrect forecasts is justified, it is, nevertheless, necessary to carefully examine the underlying circumstances.
7. Attention to possible irregularities including fraud ("fraud awareness") and forensic examination procedures should be given more weight and attention in education and training of auditors.
8. A break-up of the Big 4 auditing firms and a nationalization of the audit process is, at the current state, not recommended.
9. However, it should be considered to entrust a central, possibly governmental body with the appointment of the auditor. The appointment should be made on the basis of a recommendation from the supervisory board or the general meeting.
10. It should be considered whether the auditors fees should be paid by a fund, financed based on contributions from all listed entities, similar to the system already in place as to the financing of enforcement by BaFin and DPR.
11. The establishment of an audit committee (section 107 III 2 Stock Corporation Act [AktG]) should be mandatory for listed companies regardless of the size of the supervisory board.