



German Cooperative and Raiffeisen Confederation

**Auditing of
German Cooperative Banks**
2nd edition

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ABBREVIATIONS

BA	German Banking Act (KWG – Kreditwesengesetz)
CC	Commercial Code (HGB – Handelsgesetzbuch)
CSA	Cooperative Societies Act (GenG – Genossenschaftsgesetz)
FFSA	Federal Financial Supervisory Authority (BaFin – Bundesanstalt für Finanzdienstleistungsaufsicht)
FREP	Financial Reporting Enforcement Panel (DPR – Deutsche Prüfstelle für Rechnungslegung)
ICAAP	Internal Capital Adequacy Assessment Process
MLA	Money Laundering Act
SRP	Supervisory Review Process

AUDITING OF GERMAN COOPERATIVE BANKS

A. BACKGROUND

1. Historical Development

The cooperative movement in Germany started in the middle of the 19th century. As more and more people organised themselves in cooperatives, soon from within the movement the desire for competent external help and assistance in business-related matters arose. Today, this has to be seen as the starting-point for cooperative auditing in Germany.

At that time, auditing was still voluntary. However, it came to the fore as a part of the self-administration of credit cooperatives, although Friedrich-Wilhelm Raiffeisen and Hermann Schulze-Delitzsch had different thoughts about the performance of the audit.

Later, first cooperative federations were created which took up the standing rule for external revision in their statutes. By the years the principles of auditing were developed corresponding to the changing and more demanding cooperative needs.

In the 1870ies, several cooperatives in Germany experienced serious financial trouble. At that time honourable but rather inexperienced persons were often managing cooperatives. This resolved into internal organisational weaknesses that remained undetected due to a lack of external audit and caused losses for the members of cooperatives. This development initiated discussions first within the cooperative movement (Raiffeisen, Schulze-Delitzsch, etc.), later between the cooperative leaders and the national government, aiming at setting common standards for all cooperatives in Germany. Beginning in 1884 cooperative federations offered basic audits to member-cooperatives on a voluntary basis. The audit was executed by the cooperative federations and comprised both financial audit as well as management audit. These led to a stabilisation of the sector and to an enhancement of the members trust.

As a result of the development, the Cooperative Act of May 1, 1889 took up the obligation for auditing of cooperatives. This was the first legally prescribed audit for companies in Germany. Cooperatives had to undergo regular audits either executed

by cooperative auditing federations or by free-lance auditors.

The new regulations led to a significant improvement of the performance of cooperatives in the following years. However, in the depression of the late 1920ies, some cooperatives faced difficult times. Interestingly those cooperatives were more affected which had not joined an auditing federation but had decided to be audited from outside the sector.

In 1931, preparations for a first major amendment of the Cooperative Act started. In 1934, the revisions finally went into force. The important change in the cooperative movement was that membership in an auditing federation became mandatory for every cooperative; the auditing procedures were more precisely and thoroughly defined. Since that time, in Germany the auditing federation is responsible for the correct and timely audit of its member organizations.

The compulsory cooperative auditing serves the interests of the members, the clients and the management of the cooperatives as well as the interests of the public.

2. Legal Framework of Auditing

As cooperatives, the German Volksbanken and Raiffeisenbanken are subject to the Genossenschaftsgesetz (GenG), the Cooperative Societies Act (CSA). The CSA defines the framework for all aspects of cooperative activities in Germany. Basic principles, for instance as regards cooperative audit, are specified.

As financial intermediaries, all Volksbanken and Raiffeisenbanken are subject to the Kreditwesengesetz (KWG), which is the German Banking Act (BA), as well as to the Handelsgesetzbuch (HGB), the German Commercial Code (CC). The BA sets the rules which are compulsory for all banks in Germany (regulations for business activities, auditing, etc.), the CC defines regulations which apply to all business activities in Germany (bank as well as non-bank/ cooperative as well as non-cooperative).

Both BA and CC are amended – if necessary – in order to guarantee full implementation of European law and international regulations. At any point in time, all German laws which concern banks (thus including cooperative banks) fully meet EU requirements. The Cooperative Law has been extensively amended in 2006 and thereby adapted to the new European statutory provisions, in particular to the provisions of the European Cooperative (SCE). Before, the responsibilities for external

quality assurance (peer review) of the cooperative auditing federations have already been integrated into the CSA. With these amendments, the high standard of CSA within Europe has been preserved.

In addition to the laws, all banks in Germany are subject to the same public authorities, the Federal Financial Supervisory Authority, FFSA (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Bonn), and the Central Bank of the Federal Republic of Germany (Deutsche Bundesbank, Frankfurt/Main). Both institutions cooperate in the banking supervision.

As regards the yearly audit, all three laws, CSA, BA, and CC are the basis for the auditing activities in the cooperative banking group. Here again, CSA sets the frame, i. e. the general organisation of the audit; and both BA and CC define the audit process.

It is important to notice that the Volksbanken and Raiffeisenbanken in Germany receive no special treatment as banks. A specific cooperative banking law or a specific cooperative banking supervision does not exist. All banks and banking groups in Germany are treated equally (“level playing field”).

B. COOPERATIVE AUDITING FEDERATIONS

In Germany, the auditing federations are responsible for organising and maintaining the auditing structures in compliance with the relevant laws. The organisation of the cooperative auditing federations (also called auditing associations) gradually developed over the time. At the end of the 19th century the rural (later Raiffeisenbanken) and urban (later Volksbanken) cooperative banks established their own federations with a particular emphasis on auditing.

Today, the German Cooperative and Raiffeisen Confederation in Berlin/Bonn (DGRV – Deutscher Genossenschafts- und Raiffeisenverband e. V.) is the national legal apex federation with the authority to conduct audits nationwide according to the CSA. The DGRV emerged in 1972 in the course of a restructuring of the cooperative sector. Members of DGRV are 6 regional (sub)-federations and 5 specialised auditing federations (special cooperatives). Each of these 6 regional federations has the audit-authority within its respective region. The specialised auditing federations have

the authority to audit their member cooperatives. The auditing federations have the same licence like any other auditing company.

In accordance with § 54 CSA, each cooperative bank must be member of a federation which is officially entitled to conduct audits. Hypothetically speaking, a cooperative bank can terminate its membership of its auditing federation by decision of the general assembly, but within a period of time imposed by the register court, a new membership in another federation has to be verified. However, this did not happen so far.

The federation can only fulfil all tasks and duties as assumed if the preconditions, i. e. a sufficiently sized staff of specially (bank)-trained federation auditors and an adequate administrative apparatus are secured.

The training of auditors is organised within the cooperative group. It is one of the responsibilities of DGRV to set the common standards for this training and the examination of cooperative auditors.

Federation auditors start their training as assistants for three years. A bank-apprenticeship and/or a university-degree are initial requirements. Auditors-to-be are trained both on-the-job as well as theoretically in the cooperative academies (located at regional and national level). Having passed a final examination after a three-month-seminar at the Academy of German Cooperatives (Akademie Deutscher Genossenschaften, ADG) in Montabaur, candidates can start as federation junior-auditors. This training system fulfils the requirements of § 55 (1) CSA.

The rationale behind the system of cooperative auditing federations is that like this an accumulation of a high amount of detailed, deeply specialised know-how is achieved. This results in a higher quality of audit. Furthermore, the system of auditing federations assures an independent audit. The cooperative auditor can perform his work non-regarding any private business aspects. He and the auditing federation are independent as they have secure revenues.

The Federal Financial Supervisory Authority is at any time entitled to execute on-spot audits in credit institutions without prior notice (§ 44 (1) BA). A specific suspicion is not necessary.

C. MANDATORY COOPERATIVE AUDIT IN GERMANY

As mentioned above, § 54 CSA requires that every cooperative is obliged to be member of a cooperative auditing federation. The timely and correct audit is in the responsibility of the federation.

The CSA prescribes in § 53 that "the facilities, the financial position and the management of the cooperative" are to be audited yearly (or all two years if the balance sheet total is below two million euro). The audit of cooperative banks is not only a financial assessment (like in other private companies) but also an assessment of the management. This guarantees a high degree of information in the auditors report.

In essence, it is an audit not only for the proper compilation of the annual accounts, but a comprehensive management audit as well. The cooperative audit is a service audit, effective for the future. It is not merely a stock-taking of the past.

The certification of the financial statement for credit cooperatives is provided in connection with the auditing of the year-end statement (§29 (1) BA). The auditing procedures are determined in the CC (§ 316 (3), §317 (1) and (2)) like for any other audit.

The auditing federation has the right and the obligation to point out serious shortcomings in the economic position, in organisation and in management. It will make recommendations accordingly and at a later date evaluate and control whether the recommendations have been put in place.

The group of German Public Savings Banks have similar regulations for their audit. The audit of this group is performed by the auditors of the savings bank association. The third banking group in Germany, the commercial banks, are audited by private auditing companies. Only cooperative banks have the management audit. Therefore, the report by the auditor has a very high quality and provides the banking supervision authority as well as the general assembly with important information going far beyond a mere evaluation of the financial situation.

Therefore, the auditing federation can be regarded as a knowledgeable adviser of the organs of the affiliated cooperative in questions of management and accoun-

tancy. This also requires a high degree of mutual trust and respect between the auditor and the bank managers. This experience of continuous advice and service is also useful for the audit itself.

1 General Areas and Principles of Auditing

The Banking Act defines a set of primary topics for auditing for credit institutions in general and thus also for cooperative banks. These topics comply with § 25a BA and with the minimum risk management requirements of credit institutions. They include:

- Adequate and orderly organisation of business of the bank
- Adequacy and effectiveness of risk management:
 - Strategies based on procedures for evaluating and securing of the risk-bearing capacity
 - Internal control procedures with the internal control system and the internal audit:
 - Arrangements for the organisational and operational structure, distinguishing areas of accountability
 - Processes for the identification, evaluation and controlling as well as monitoring and communication of the risks according to the European Banking Directive
- Capital and liquidity requirements
- Large exposure regulations
- Special reporting requirements
- Licensing
- Safe-custody account audits
- Anti money laundering requirements
- Deposit guarantee scheme

The auditing process is guided by the auditing principles and instructions issued by the auditing federation in accordance with professional guidelines set by the Chamber of Certified Public Accountants and the Institute for Certified Accountants.

In addition, the Federal Banking Supervisory Authority requires to incorporate statements on specific topics into the annual or the intermediate financial statements of credit institutions. Some of these are:

- The above listed specific organisational responsibilities of banks; the risk management system has to comply with all the qualitative and quantitative requirements taking into account the individual size and scope of business of the institution;
- The stage of development of the accounting system and the EDP-configuration; recognised defects;
- Provisions for actual and contingent loan losses;
- Observance to § 18 BA; disclosure of the financial circumstances of a single borrower unit owing more than 750.000 € or 10% of the liable equity to the credit institution;
- Reports to the Central Bank of the Federal Republic of Germany for loans to a single borrower unit which in total are greater than or equal to 10 percent of the banks equity (large exposures).

If the auditor reveals important findings that instantly require the board to take measures, he must notify the chairman of the supervisory board immediately..

If in the course of the audit, the auditor learns of facts which might threaten the final certification of the audit, or which might even endanger the existence of the bank or gravely impair its development or which indicate that the managers have seriously violated the law or the articles of the association. He has to immediate report to the FFSA and Bundesbank on subsequent finding according to § 29 (3) BA.

2 Financial Assessment

The audit of the financial position is based on accountancy; the audit itself includes the totality of assets and liabilities at their full value, hidden reserves, actual and latent risks, uncertain payables and expenses, imminent losses from pending transactions and the formation of sufficient provisions. Conclusions and evaluations concerning the structure and suitable application of equity result from this, along with observations and assessments of the financial situation, structure and liquidity. Considering and evaluating the revenue situation, the auditor must direct his formal observations to a certain degree to how the board has pursued the cooperative promotion principles.

3 Management Assessment

The management assessment must ascertain both the formal and the substantive regularity of the management. It must be evaluated if the necessary personnel and material measures have been undertaken in accordance with relevant laws and regulations and the business policy, and whether these measures can be viewed as appropriate in the framework of the cooperative principles and business structure. The assessment is concerned with the management mechanism and its activity. The management functions include organisation, planning, information, auditing, internal control, accounting, human resource policy and technical capacity. The organisation as a component of this functional mechanism includes both the internal and external organisation of the cooperative. The audit also encompasses the management policy, planning and supervision. In particular, the fulfilment of the promotional policy and the observation of the principles regarding equal treatment of all members are to be studied.

The audit also assesses the personal dependability and the specialised qualifications of the management, which are to be measured on the level of their responsibility according to § 34 CSA.

4 Other Specialised Audits

There are three additional points the auditor has to observe:

(1) Deposit guarantee scheme

The deposit guarantee schemes of the banking groups in Germany can require additional audits. If one of those has taken place, the auditor shall submit his report on this audit to the FFSA and the Bundesbank immediately (§ 26 (2) BA).

The National Federation of German Volksbanken and Raiffeisenbanken e. V. (BVR) is responsible for the administration and management of the so-called "cooperative guarantee fund". The fund was established in 1937 and has guaranteed ever since not only the deposits of members and customers of the Volksbanken and Raiffeisenbanken but covered institutional protection. With this scheme the demands of the EEC-Directive 94/19 of May 30, 1994 are more than fully implemented. If, during a regular audit, an auditor recognises the possibility for serious losses in a cooperative bank which might require actions by the guarantee-fund, he is obliged to inform – besides the banking supervision – the BVR about it, too.

(2) Money Laundering Act (MLA) of 2008

The auditor has to criticise the arrangement by the bank to prevent money laundering, the way how suspicious cases have been handled by the bank, and whether all relevant information has been given to the prosecuting attorney. The result of the examination has to be taken down in the report (§ 14 (2) MLA).

(3) Safe-custody account audits

Pursuant to § 30 BA, safe custody account audits have to be carried out once a year if banks conduct securities business or safe custody business. Volksbanken and Raiffeisenbanken act as universal banks and will be audited in the above mentioned way.

5 Reporting

Having finished the audit, the auditor presents an oral report to both the managing board and the supervisory board. He informs about the presumable results of the audit (§ 57 (4) CSA). Later, the auditing federation writes a report on the results of the examination (§ 321 (1) CC). This report is certified by the auditor if no objections have been raised within a certain period of time (§ 322 (1) CC). Additional comments to the financial statement or even its refusal are possible if particular reasons are given.

The final certified auditing report is sent to the FFSA.

D. INTERNAL CONTROL

1. Supervisory Board

Under § 38 CSA, the supervisory board is required to supervise the managing board on its business methods in all branches of the administration. At any time, it may ask for information by the managing board and inspect the books and records. The supervisory board has to examine the annual financial statement, the management report and the proposal for the annual surplus / annual deficit.

The general assembly has to be informed about the results of the examination before the final determination of the annual financial statement. This cooperation by the

supervisory board is part of an advanced internal supervision, especially in those cases when large loans (large exposures) are granted by the managers (§ 13 (2) BA).

2. Internal Audit as a part of Risk Management Systems

Besides the external audit each financial institution in Germany is required to have an internal audit. In the cooperative sector, as in all other banking groups, the system of internal control is individually organised.

In December 2005 FFSA published the minimum requirements for risk management of credit institutions. Therewith, not only the requirements of the present body of rules and regulations including the settlement for the design of the internal audit have been summarized but also the guidelines of Basel II for the Supervisory Review Process (SRP) and in particular for the Internal Capital Adequacy Assessment Process (ICAAP) have been concretised. According to this, body of rules and regulations, the duties and the auditing activities of the internal audit basically range over all activities and processes of the credit institution. The focus thereby is on the audit of the organisation and on the risk management system. Every credit institution is obligated to implement such a system where also the internal audit is a part of. Nevertheless the flexible settlement framework allows the institutions to adjust the risk management system individually to the scope, the size, the complexity and the risk of its business. The entire organisation and the business activities of the credit institution have to be documented in an organisational directive (e.g. manuals, work instructions or descriptions of processes). This documentation forms an important basis for the operations of the internal audit.

The function of the internal audit has to be based on a comprehensive and yearly updated audit plan. The audit planning has to be carried out in a risk oriented manner. The activities and processes of the credit institutions have to be audited in adequate intervals, basically annually.

The internal auditor is directly responsible to the board of managing directors. He has to be sufficiently trained and must not be drawn to such working positions where interest conflicts with the auditing functions could arise. Working papers are to be filled out completely and audit reports have to be made. These reports have to be sent to the managing board. They have to be kept available for the (external) auditors at any time.

In addition, each bank has to report monthly on its recent activities and its performance to the Central Bank and the FFSA.

3. The General Assembly

The members of the cooperative exercise their rights in the general assembly (§ 43 CSA). Among others, the general assembly determines the annual financial statement (§ 48 CSA). Before doing so, the members can ask the chairman of the supervisory board or the auditor for explanations about the annual financial statement, managing statement and on the final report of the auditing federation.

E. STATE SUPERVISION AND ENFORCEMENT

1. Peer Review

Since 2001, the cooperative auditing federations are according to § 63e CSA, obligated to regularly undergo a quality check at intervals of three (henceforth six) years. The monitoring and the organisation of the quality check procedure are incumbent on the professional organisation (Chamber of Chartered Certified Accountants). These activities are conducted by a member of this profession especially qualified for this purpose. The objective of the quality check is to review whether the cooperative auditing federations comply with the legal and professional principles and whether they appropriately manage the quality of their audits and reports according to CSA. Thus the quality check finally enhances the trust of the public in the auditing services of the auditing federations and therewith also strengthens the confidence in the correctness of the annual financial statements provided by the cooperative companies.

2. Inspections

The inspections occur henceforth as independent audits besides the rotational proceeding quality checks according to § 63e CSA. The inspections will be randomly carried out by inspectors without being given actual reasons. The inspections solely concern those auditing federations whose audit cooperative entities are of public interest. The inspections extend to the specific responsibilities which have to be observed in the legally mandatory annual audits of these entities.

3. Enforcement of accounting

In 2004, a two tier system of enforcement for the implementation of the standards of accounting was introduced in Germany for companies of public interest. On the first step, the Financial Reporting Enforcement Panel (FREP) organised under private law acts, while on the second step FFSA intervenes, which disposes of sovereign rights. The FFSA will normally only act when a company refuses its cooperation in an audit of FREP or does not agree with their audit results. The DPR has to verify whether the lastly assessed/approved annual or consolidated accounts, respectively, correspond with the employed legally mandatory provisions. An examination of the enforcement is initiated on demand of the FFSA or without special cause as a random examination, if concrete evidence for an essential violation of accounting provisions exists. Aim of this enforcement is the strengthening of trust in accounting.

If fundamental deficiencies in the quality of the audit or violation of the standards of accounting are assessed by the institution of enforcement (peer review, inspections and FREP), this can possibly have extensive consequences for the cooperative auditing federations (up to the deprivation of the right to audit).

F. SUMMARY

The German cooperative sector has for more than 120 years a system of compulsory membership in federations and compulsory audits for cooperatives.

The audit and the control of cooperative banks in Germany are organised in a two-fold manner. There is both the external audit by auditing federations and in each bank a system of internal control and audit.

Mandatory external auditing is determined by three laws:

§§ 53, 54 CSA

§§ 26 (1), 27 BA

§§ 316, 317, 340k CC

Additional audits are executed according to:

§ 26 (2) BA Deposit-guarantee-scheme audit (Guarantee-fund)

§ 44 BA Special audit

§ 14 (2) MLA Money laundering audit

Internal audit is determined by:

§ 38 CSA Supervision by the supervisory board

§ 48 CSA Determination of annual financial statement

Regulations by the FFSA on Internal Control

Monthly reports to the Central Bank / Banking Supervision

It is to stress that the CC limits itself to a mere audit of the annual statement.

To these regulations the BA adds the requirement that an (external) auditor comments on the general situation of a bank, the management of the loan portfolio, etc.

The CSA goes even further and obliges credit cooperatives to undergo an annual audit of their management (business structure, assessment of the institution, the organisation of internal procedures, management mechanisms and activities, management policy etc.). This specific form of additional annual audit exceeds all other requirements and contributes significantly to the successful performance of the cooperative banking group.