

Thematic Review - Debt issuers
Supervision of Financial Reporting

October 2011



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Disclaimer

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The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

1 Conclusion and summary

On the basis of the thematic review it has conducted, the impression of the Netherlands Authority for the financial markets (AFM) is that companies have made an effort to apply the standards with respect to financial reporting properly. Three-quarters of the analysed financial reports of debt issuers gave no ground for further investigation. Compliance with the statutory provisions regarding the report of the board of directors and the disclosure requirements applying specifically to Dutch companies, such as the disclosures relating to statutory reserves and directors' pay, was satisfactory. The AFM conducted a further investigation of the remaining quarter of cases. The issues addressed included the classification of receivables and payables as non-current, the valuation of payables and receivables at fair value, pensions and the cash flow statement.

The AFM identifies further improvement in the financial reporting by debt issuers in the following areas:

- Disclosure of information regarding the creditworthiness of the group companies and the issuer of the guarantee in case of provision of a guarantee by a group company (see 4.5.1);
- The inclusion of the directors' true and fair view statement as prescribed in the Financial Supervision Act (see 4.3);
- The diversity of permitted standards means that the reports are not directly comparable in all cases. The disclosure requirements are more extensive under application of IFRS¹ than under Title 9 Book 2 of the Dutch Civil Code (*Burgerlijk Wetboek*, or BW, hereinafter 'BW2') and/or the DASB Guidelines. The AFM appeals to the debt issuers to apply IFRS in their financial reporting, to improve the comparability of the reporting (see 4.1);
- A number of debt issuers apply the exemptions in Section 2:403 BW and/or Section 2:408 BW in their reporting. Transparency is not enhanced by these exemptions, especially if the parent company is not subject to supervision. In addition, the AFM is of the opinion that Section 2:408 BW is no longer appropriate for listed companies in the light of the EU's Modernisation Directive. The AFM therefore calls on debt issuers not to continue to apply these exemptions, in anticipation of the necessary changes to the legislation (see 4.2).

General

The AFM has conducted a thematic review of the quality of the financial reporting for 2010 of companies that issue bonds with a public listing and only have to prepare separate financial statements (debt issuers). This review was conducted as part of the AFM's supervision strategy. The review population consisted of 70 debt issuers. No financial statements were available for nine of these issuers. The financial reporting of the other 61 issuers was reviewed.

¹ Reference to IFRS in this report is to IFRS as permitted in the European Union.

The vast majority of the issuers are financing companies belonging to national or multinational groups (85 percent). Most of the issuers are domiciled in the Netherlands (87 percent). A notable feature is that most of the (ultimate) parent companies are domiciled abroad (79 percent).

Quality of the financial reporting by debt issuers

In three-quarters of the cases reviewed, an analysis of the financial reporting of debt issuers gave no reason for further investigation. This would appear to some extent to be due to the rather simple structure of these issuers, whereby the issuer operates as a funding vehicle that lends the capital raised to group companies. For users of the financial reporting of these debt issuers, it is not always clear where and how these monies are applied in the group, and whether a group company will actually be able to repay the loans the debt issuer has granted it.

Additionally, the review shows that the statutory provisions regarding the report of the board of directors are largely observed, albeit not extensively in some cases. Compliance with the specific requirements for Dutch companies stated in Section 2:362 (9) BW (various disclosures that are also mandatory under IFRS) was satisfactory. The disclosures in question mainly relate to statutory reserves and directors' pay.

Transparency and comparability sometimes at issue due to statutory and regulatory framework

It is difficult to make a direct comparison between the financial reports of the various debt issuers, partly because different standards can be applied. Debt issuers may compile their financial statements on the basis of IFRS or BW2, possibly in combination with the Guidelines of the Dutch Accounting Standards Board (DASB), or on the basis of US GAAP. The diversity of the standards used makes it difficult to compare the financial position and results of the debt issuers, mainly because the disclosure requirements are different. This does not further the cause of transparency.

Further investigation

The AFM has to conduct its review on the basis of publicly available information. For this reason, the AFM cannot establish the cause of some of the review findings. After the publication of this report, the AFM will conduct a further investigation of the financial reporting of 15 debt issuers, and may possibly approach them with a request for further information. If the results of this give reason to do so, the AFM will publish a follow-up to this report at a later date.

2 Introduction

By conducting a generic review of certain aspects of financial reporting, the AFM's intention is to raise awareness of important issues. In this context, the AFM has researched the quality of the financial reporting of debt issuers in 2011, focusing on the reports prepared for the 2010 financial year.

Companies which are domiciled in the Netherlands or whose country of origin is the Netherlands and which have issued bonds that are listed on a regulated market are subject to the supervision of their financial reporting by the AFM. The nominal value of an individual bond in this case must be €50,000 or less. These companies were the subject of the AFM's review and are referred to further in this report as 'debt issuers'.

The thematic review focused on the financial reporting of debt issuers which prepare separate financial statements only. Companies issuing bonds that have to prepare consolidated financial statements were not included in the review. These consolidated financial statements are included in the regular review.

3 Objectives of the thematic review, design and population

The AFM's intention with the thematic review of debt issuers is to encourage debt issuers to improve the quality of their financial reporting. Its supervision further contributes to increasing public knowledge of this specific group of companies and thereby to improving the operation of the capital markets. Various studies have shown that bond market analysts in particular explicitly consider financial reporting to be an important source of information when considering investment decisions.

The responsibility for the quality of the financial reporting rests primarily with the debt issuers themselves. Compliance with the reporting standards contributes to investor confidence in the management of debt issuers.

The review population consisted of 70 debt issuers. No financial reporting was available for nine of these issuers. The financial reporting of the other 61 issuers was reviewed. The AFM's review included filings up to 31 August 2011. The financial reports of the nine debt issuers mentioned above that had not yet been filed will be assessed by the AFM when available. The AFM cannot offer any statement regarding the completeness of the review population. Companies which are domiciled in the Netherlands or whose country of origin is the Netherlands and which have issued bonds that are listed on a regulated market are not obliged to notify the AFM of a listing. The total size of this group of companies is therefore difficult to determine.

In its review, the AFM has identified the following information regarding the characteristics of the population:

- Country of origin of the debt issuer and the ultimate parent company (if applicable);
- Application of the exemptions in Sections 2:403 BW and 2:408 BW;
- The provision of guarantees if applicable, and the company providing the guarantee;
- The type of debt issuer (the AFM made a distinction between financing companies, intermediate holding companies and issuers of asset-backed securities (ABS));
- The reporting standards applied.

The AFM additionally assessed the financial reporting of debt issuers for the 2010 financial year in the following respects:

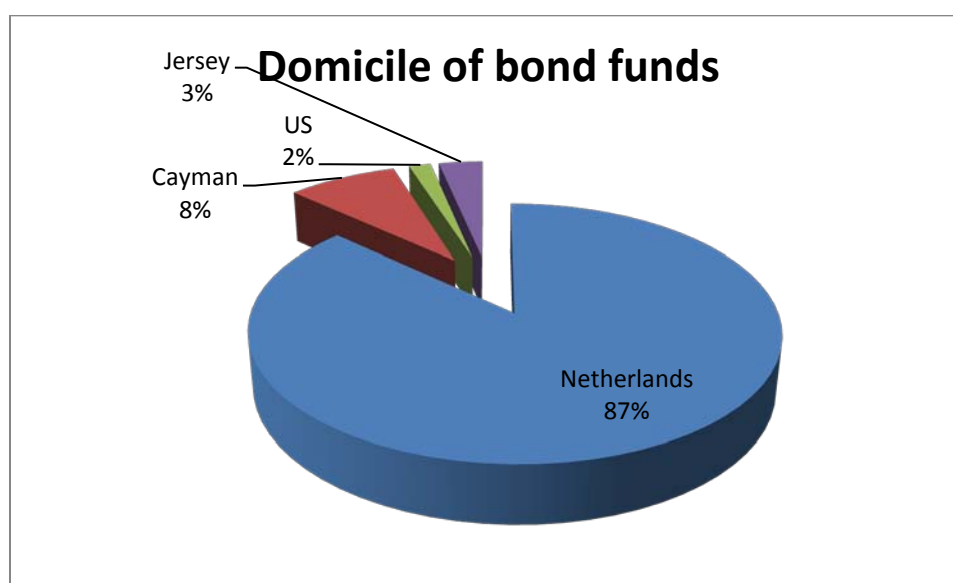
- Completeness of the documentation: Annual report, financial statements with notes, other information;
- Compliance with the provisions for annual reports in BW2 and the management's true and fair view statement as described in Section 5:25c of the Financial Supervision Act (*Wet op het financieel toezicht*, or Wft);
- Specific items which are relevant to the assessment of the reporting, such as receivables from group companies, financing and the treatment of interest flows in the income statement. The focus here was on classification, disclosure and accounting policies;

- Compliance with specific provisions in BW2 on items such as statutory reserves and directors' pay.

The AFM's review provides a view of the degree of compliance with financial reporting standards and therefore the quality of the financial reporting, as well as of the composition of the reviewed population.

The vast majority of the issuers are financing companies belonging to national or multinational groups (85 percent). As evidenced for example by a recent article in *Het Financieele Dagblad*², many multinational companies have a financing vehicle in the Netherlands because of the favourable tax treatment of such vehicles here. The authors of this article say that the amount involved in this market in the Netherlands rose to more than €10 trillion in 2010. Additionally, to the extent we can estimate, only a very small proportion (approximately 70) of the 13,000 companies mentioned fall under the AFM's supervision. The proportion of intermediate holding companies with funding characteristics and issuers of ABS in the population is much smaller, each amounting to only seven percent. The remaining one percent of the population is a bank.

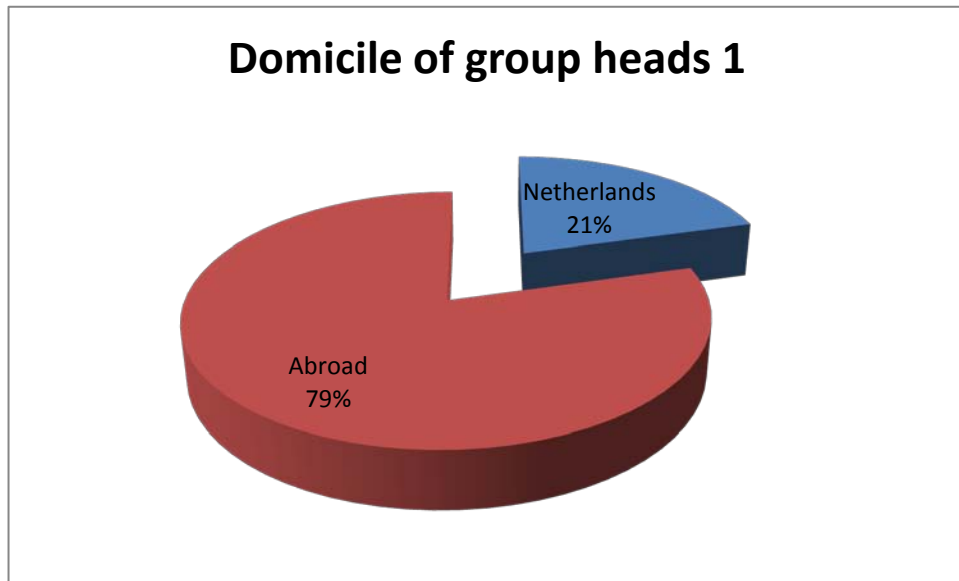
Figure 1: Domicile of the debt issuers



For the country of domicile, the AFM looked at both the debt issuers themselves and the ultimate parent company. Figure 1 shows that the majority of the debt issuers are domiciled in the Netherlands (87 percent). Figure 2 however shows that this does not apply for the ultimate parents. 79 percent of the parent companies are domiciled abroad.

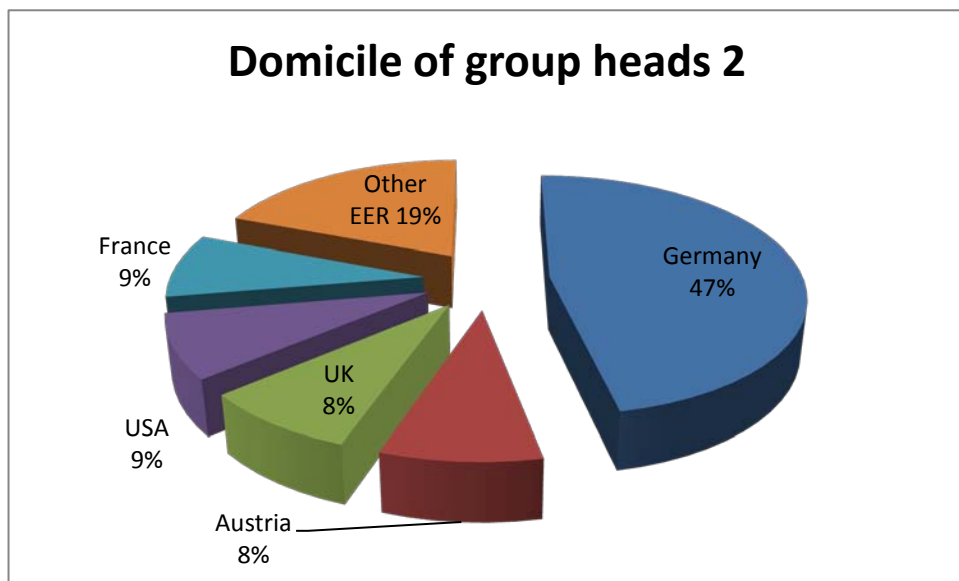
² See 'Het Financieele Dagblad' 12 September 2011, 'Nederland fiscaal zeer in trek' (The Netherlands is tax-friendly)

Figure 2: Domicile of group heads



In Figure 3, the AFM has further analysed the distribution of group heads. It is notable that a large proportion of the debt issuers belong to a group whose group head is domiciled in Germany.

Figure 3: Further analysis of the domicile of group heads



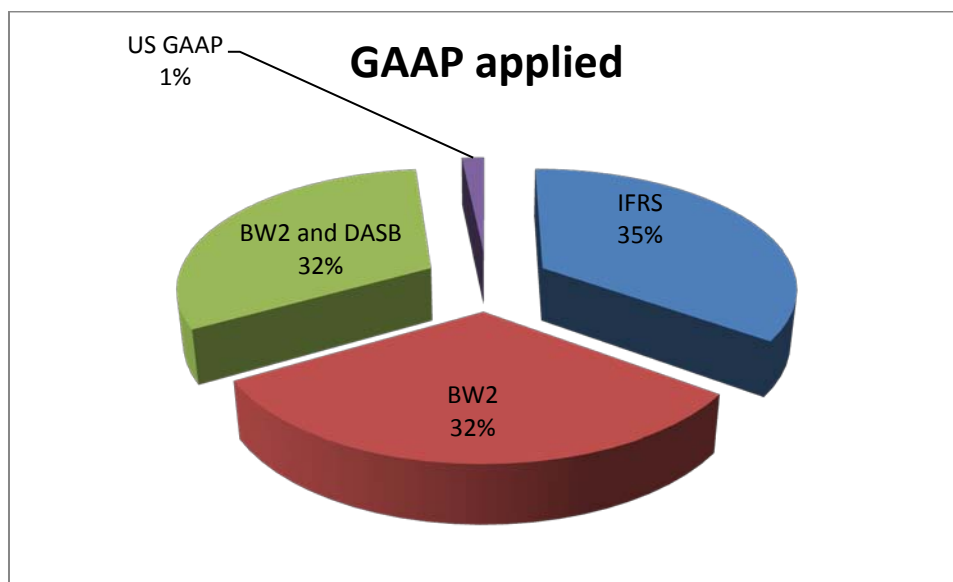
4 Findings

4.1 Various standards are applied

In the preparation of their financial reporting, debt issuers can choose from a number of standards, such as the statutory provisions in BW2³. A number of issuers explicitly state that they have also applied the DASB Guidelines in the preparation of their financial reporting. BW2 further offers the possibility of application of IFRS⁴. As a last option, if justified on the basis of the international structure of its group, a debt issuer may apply standards that are permitted in an EU Member State⁵.

From the AFM's review, the distribution of standard usage is as shown in Figure 4.

Figure 4: Types of GAAP applied in the financial reporting of debt issuers



One debt issuer from a third country chose US GAAP. US GAAP is a permitted standard in the EU Member States as a result of the equivalence decision of the European Commission for issuers from third countries and is therefore permitted for a debt issuer with an international compass.

The diversity in the standards permitted makes comparison of the financial position and results of debt issuers difficult, especially because the disclosure requirements under the application of IFRS differ from those under BW2, either in combination with the DASB Guidelines or not. The AFM appeals to the debt issuers to apply IFRS in their financial reporting, to improve the comparability of the reporting.

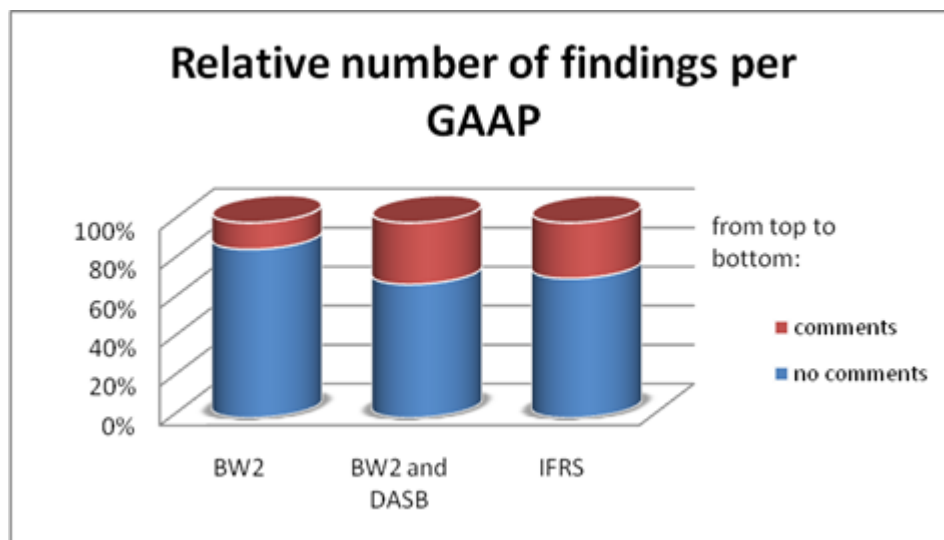
15 debt issuers will be investigated further by the AFM and may be requested to provide further information. The distribution across the various permitted standards is as follows (see figure 5).

³ See the Financial Supervision Act (*Wet op het financieel toezicht, or Wft*), Section 5:25c and further.

⁴ See Section 2:362 (8) BW

⁵ See Section 2:362 (1) BW

Figure 5: Findings per standard



4.2 Application of exemptions: group exemption (403 exemption) and exemption from interim consolidation (408 exemption)

Seven debt issuers applied the group exemption. Among other things, this means that a liability statement - also known as a 403 statement - has been issued by another consolidating company within the group to which the debt issuer belongs. In this situation, an abbreviated balance sheet and income statement by the debt issuer will suffice. The debt issuer obtains an exemption from the requirement to include an annual report and other data and to have an audit conducted: the 403 exemption.

Application of the 403 exemption however conflicts with the requirement to make regulated information generally available and simultaneously provide this information to the AFM, as stipulated in the Financial Supervision Act (*Wet op het financieel toezicht*, or Wft). A review of the history of the development of the Wft shows that no attention was paid to the concurrence of the requirements pursuant to the Wft and the exemption in Section 2:403 BW. It is therefore not clear which statutory provisions prevail. In view of this ambiguity, the AFM has taken the view that financial statements compiled under application of the exemptions in Section 2:403 BW will be accepted as financial reporting by the AFM, even though these statements do not observe the provisions of the Wft.

The AFM has encountered two debt issuers which - despite a 403 statement being issued - have compiled and published full financial reporting, with the inclusion of an auditor's report. The AFM considers this decision to put transparency about the issuer before the maximum usage of exemptions to be an example of good practice.

The group exemption is also used in combination with the consolidation exemption for interim holding companies as stated in Section 2:408 BW. The Modernisation Directive (2003/51/EC) states that the consolidation exemption for interim holding companies (and others) as included

in the Seventh EC Directive may no longer be applied by listed companies. So far however, this provision has not been implemented in Dutch law, and more specifically in Section 2:408 BW. The consequence is that if a listed interim holding company meets the conditions stated in this Section, the preparation of separate financial statements will be sufficient.

The AFM has requested the Ministry of Finance to amend the law with regard to the operation of Sections 2:403 and 2:408 BW and to prohibit the use of these exemptions by issuing companies. This will improve transparency for investors. The AFM therefore calls on debt issuers not to continue to apply these exemptions, in anticipation of the necessary changes to the legislation.

4.3 In most cases, the annual report meets the relevant requirements

The AFM has assessed the annual reports of debt issuers established in the Netherlands against the statutory standards for annual reporting. While the content of the report could be described as summary in some cases, most of the reports complied with the standards. To some extent, this was due to the limited activities of some of the debt issuers concerned. In addition, risk management and other activities of these debt issuers are carried out by group companies, in which case reference is made to this in the annual report. Table 1 shows our findings regarding the annual report, to the extent that specific provisions apply. For instance, certain provisions may not apply as a result of the 403 exemption.

Table 1: Findings with regard to the annual report

Requirement	Complies	Does not comply
True and fair picture, balanced and complete analysis, description of principal risks.	100%	0%
Statements regarding expectations with respect to: <ul style="list-style-type: none"> • Investments • Financing • workforce 	91%	9%
Objectives and policy for risk management regarding use of financial instruments	94%	6%
Annual report does not conflict with financial statements	98%	2%
Inclusion of management's true and fair view statement pursuant to Section 5:25cWft	85%	15%

The disclosure in the annual report regarding the risk associated with financial instruments varies.

The disclosure regarding the objectives and policy with regard to financial instruments and the current associated risks is included in the financial statements rather than in the annual report in some cases. In eight cases, reference is made in the annual report to the financial statements for this information. Although BW2 states that this passage is a mandatory element of the annual report, the AFM did not decide to initiate further investigation in the cases where reference to the financial statements is made for this information. For our comments regarding the content of the risk disclosures, see section 4.5.1 of this report.

In two cases, no section on risk was included in the annual report. The AFM will further investigate the financial reporting of these two debt issuers.

In the financial reporting of one debt issuer, the annual report appears to conflict with the financial statements. The Report of the Board of Directors states that all accounts receivable and payable are due and payable immediately because the parent company and the financing company have breached the agreements. However both the receivables and payables are classified as non-current.

Lastly, nine debt issuers failed to include a management's true and fair view statement in the annual report, as required by the Wft⁶. This is a statement by the directors that the financial

⁶ See Section 5:25c (2)(c) Wft.

statements and the annual report present a true and fair view of the state of the company's affairs. Improvement is required here.

4.4 Going concern

Nearly all the debt issuers include a clear statement whether and for what reason their report is or is not on a going-concern basis. In only one case, in which the debt issuer and its guarantor parent company are in default, was there no clear disclosure regarding the going-concern assumption.

4.5 The AFM will not conduct further investigation in the majority of cases

The AFM states a number of specific elements below that, in its view, justify further investigation of the debt issuers, concerned in 15 cases. In view of the basically simple business models of debt issuers, most of the financial statements are not particularly complicated, regardless of which standard is applied. In most cases, the debt issuer's financial position, results and risks can be clearly understood from the financial reporting.

4.5.1 Receivables and payables are in general clearly explained

The degree of transparency provided by the reporting debt issuers varies widely. While some issuers give a brief description of the contractual provisions and associated risks for each outstanding instrument, others go no further than the minimum disclosure required.

Credit risk

One important risk for financing companies is credit risk. For these companies, this moreover concerns a concentration of risk at exclusively group companies. The disclosures range from a simple statement that the financing company is exposed to credit risk to a disclosure of the creditworthiness of the group debtor company or companies by stating the associated credit rating(s).

Nine debt issuers disclose the credit risk, taking account of the guarantees issued by the parent company. In two cases, this actually relates to guarantees on group receivables. In seven cases, however, this concerns a guarantee of the outstanding bonds of the debt issuers themselves. This latter guarantee is a mitigating factor with regard to liquidity risk, but not with regard to credit risk. The credit risk is generally closely connected to the liquidity risk of the debt issuer, meaning that this information is of great important to investors in these issuers.

In those cases where the sections on risk for the financing companies contain little information on the creditworthiness of the group companies and the provider of the guarantee, there is room for improvement in the financial reporting.

Guarantees

The AFM's review shows that the listed debt of 44 debt issuers is guaranteed by a different entity. In most cases, the guaranteeing company is the immediate or the ultimate parent company of the debt issuer concerned. In one single instance, the guarantee is provided by a

third party. Eight issuers state the guarantor's credit rating in their disclosure, or include other information on the guarantor's creditworthiness.

The other financial statements state that a guarantee has been provided and the identity of the provider, as required.

In addition, the AFM has established that most accounting policies – taking account of the basis for preparation of the financial statements chosen by the debt issuer – are clearly stated and comply with the standard chosen.

Issues on which the AFM may request further information include:

- the classification of receivables and payables as non-current, while these are also immediately due and payable;
- the measurement of group receivables and payables at current cost;
- the de-recognition of receivables and payables in the balance sheet;
- the accounting policies for financial instruments.

4.5.2 Comments on other issues limited to five issuers

In the analysis of the financial reporting of debt issuers, the treatment of receivables and payables received the most attention. Given the nature of debt issuers, these are usually the most important items. In just five cases, the AFM had findings that relate to less common items, such as one non-cash transaction in the cash flow statement, the pension provision and taxation.

4.6 Satisfactory compliance with specific requirements as stated in Section 2:362 (9) BW

Regardless of which standards are applied in the preparation of the financial reporting, all Dutch debt issuers are obliged to include a disclosure with respect to their equity, sub-divided into statutory and other reserves and directors' pay. The AFM's review revealed that in many cases (ranging from 100 percent for the reserve for intangible non-current assets, to 48 percent for directors' pay) these mandatory disclosures do not apply, since no corresponding items are included in the financial reporting. Based on the disclosure requirements of Section 2:362 (9) BW, the AFM found that no disclosure on directors' pay was included in only four cases, while such disclosure was, however, deemed to be expected.

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