Risk report

Risks and opportunities

In the pursuit of our business activities, Henkel is exposed to multiple risks inherent in the global market economy. We deploy an array of effective monitoring and control systems aligned to identify risks at an early stage, evaluate the exposure and introduce effective countermeasures. We have incorporated these instruments within a uniform risk management system as described below.

Entrepreneurial activity also involves identifying, developing and exploiting opportunities as a means of securing and extending the company's competitiveness. The reporting aspect of our risk management system does not extend to entrepreneurial opportunity. The early and regular identification, analysis and exploitation of opportunities is performed at the Group level and within the individual business sectors. It is a fundamental component of our strategy. We perform in-depth analysis of the markets and our competitors, and study the relevant cost variables and key success factors. The major opportunities have been included in our forecast report on pages 98 to 101.

Risk Management System

The Risk Management System (RMS) at Henkel is an integral component of the comprehensive planning, control and reporting system used in the affiliated companies, in our business sectors and at corporate level. It encompasses the systematic identification, evaluation, management, documentation, communication and monitoring of risks. Risk control and monitoring combined with our Internal Control System (ICS) support our risk management capability within the corporate governance framework.

We have defined the principles, processes and responsibilities relating to risk management in a corporate standard that is binding on the Henkel Group. As we continuously develop our corporate standards and systems, we take into account updated findings and knowledge. Risk management is thus performed on a holistic, integrative basis involving the systematic assessment of our exposure. We understand risk as the probability of a negative deviation from a financial target or key performance indicator (KPI) resulting from an event or change in circumstances.

Our annual risk reporting process begins with identifying major risks using checklists based on predefined operating risk categories (e.g. procurement and production) and predefined functional risk categories (e.g. information technology and human resources). We evaluate the risks in a two-stage process according to the probability of occurrence and potential loss. Included in the risk report are risks with a loss potential of at least 1 million euros or 10 percent of the net external sales of a country, where the probability of occurrence is considered greater than zero.

We initially determine the gross risk and then, in a second stage, the net risk after taking countermeasures into account. Initially, risks are recorded on a decentralized, per-country basis, with the assistance of regional coordinators. The locally collated risks are then analyzed by the experts in the business sectors and corporate functions, classified in the appropriate corporate management committees, and finally assigned to a segment-specific risk inventory. Corporate Accounting is responsible for coordinating the overall process and analyzing the inventoried exposure.

All the risk management processes are supported by a web-based database which ensures transparent communication throughout the entire company. Within the framework of the 2012 audit of our financial statements, the auditor examined the structure and function of our early warning risk system, confirming its adequacy and regulatory compliance.

Major risk categories

Risk category	Probability	Potential financial impact
Operating risks		
Procurement market risks	Possible	Major
Production risks	Possible	Major
Macroeconomic and sector-specific risks	Likely	Major
Functional risks		
Financial risks		
Credit risks	Unlikely	Major
Liquidity risks	Unlikely	Minor
Currency risks	Likely	Moderate
Interest rate risks	Possible	Minor
Risks from pension obligations	Likely	Major
Legal risks	Unlikely	Major
IT risks	Unlikely	Major
Personnel risks	Possible	Minor
Risks in connection with our brand image or reputation of the company	Unlikely	Major
Environmental and safety risks	Possible	Major
Business strategy risks	Possible	Moderate

Classification of risks in ascending order

Probability
Unlikely
Possible
Likely
Potential financial impact
Minor
Moderate
Major

The following describes the main features of the Internal Control and Risk Management System in relation to our accounting processes, in accordance with Section 315 (2) no. 5 of the German Commercial Code [HGB]. In accordance with the definition of our Risk Management System, the objective of our accounting processes lies in the identification, evaluation and management of all risks that jeopardize the regulatory preparation of our annual and consolidated financial statements. Consequently, it is the task of the Internal Control System implemented in order to combat such discrepancies, to put in place corresponding principles, procedures and controls that will ensure a regulatorily compliant process for the preparation of such financial statements.

Within the organization of the Internal Control System, the Management Board assumes overriding responsibility at Group level. The duly coordinated subsystems of the Internal Control System lie within the responsibility of the functions Risk Management, Compliance, Corporate Accounting, Corporate Finance and Financial Operations. Within these functions, there are a number of integrated monitoring and control levels, ensuring multi-point stability of the Internal Control and Risk Management System. This is further attested by regular and comprehensive effectiveness tests performed by our Internal Audit function.

Of the many and varied control processes incorporated into the accounting process, several are worthy of particular mention. The basis for all our accounting processes is provided by our “Accounting” corporate standard, which contains detailed accounting and reporting instructions covering all major circumstances. It specifies, for example, clear procedures for inventory valuation and how the transfer prices applicable for intra-group transactions are to be determined. This corporate standard is binding on the entire Group and is regularly updated and approved by the CFO. Further globally binding procedural instructions affecting our accounting practice are contained in our corporate standards “Treasury” and “Investments.”

Through appropriate organizational measures in conjunction with restrictive access to our information systems, we ensure separation of responsibilities in our accounting systems between transaction entry on the one hand, and checking/auditing and approval on the other. Documentation relating to the operational accounting and closing process ensures that important tasks – such as the reconciliation of receivables and payables on the basis of account balance confirmations – are clearly assigned. Additionally, a strict authorization regulation exists governing the approval of contracts, credit notes and the like, and we have implemented our Four-Eyes (dual control) principle globally. This is also stipulated in our Group-wide corporate standards. We consider our systems to be appropriate and effective. They are regularly reviewed in order to determine potential for improvement and optimization. Once identified, we implement these improvements.

Major risk categories

Operating risks

Procurement market risks

We expect moderate price rises in our procurement markets in 2013. In light of geopolitical uncertainties, and the uncertainty surrounding global economic development, we expect prices to fluctuate on the procurement markets throughout the course of 2013. As uncertainties will prevail in the development of raw material prices, we see additional price risks arising in relation to important raw materials and packaging. Further price and supply risks ensue from the possibility of supply shortages in the procurement markets due to demand or production restrictions. Continued unrest in the Africa/Middle East region, in particular, could lead to rising material prices and supply shortages.

We combat these risks by adopting a comprehensive risk management approach. This involves the pro-active management of our vendor portfolio and utilization of our globally engaged, cross-divisional sourcing capability, together with strategies aimed at securing both price and volume through the conclusion of contracts. Where appropriate and possible, we also make prudent use of effectively tailored financial safeguards and hedging instruments. For further information relating to the risks arising from derivative financial instruments used for hedging purposes, please refer to Note 21 on pages 138 to 148.

We also work within interdisciplinary teams (Research and Development, Supply Chain Management and Purchasing) on devising alternative formulations and different forms of packaging to be able to respond flexibly to unforeseen fluctuations in raw material prices. We also avoid becoming dependent on individual vendors so as to better secure the constant supply of the goods and services that we require. Close collaboration with our strategic suppliers plays an exceptionally important role in our risk management system. More detail regarding to the assessment of supplier financial stability can be found in the section on "Procurement" on pages 71 and 72. The basis for our successful risk management approach in this domain is a comprehensive procurement information system that ensures permanent transparency with respect to our purchasing volumes.

Production risks

In the area of production, Henkel faces the risk from low capacity utilization due to volume decreases and possible operational interruptions, especially at our so-called single-source sites. The negative effects of possible production outages can be offset through flexible production control and, where economically viable, appropriate insurance policies. Generally, production risks are minimized by ensuring a high level of employee qualification, establishing clearly defined safety standards, and carrying out regular plant and equipment maintenance. Decisions relating to capital expenditures on property, plant and equipment are made in accordance with defined, differentiated responsibility matrices and approval procedures in order to ensure effective risk mitigation. The procedures implemented incorporate all the relevant specialist functions and are regulated in an internal corporate guideline requiring that such investments be analyzed in advance on the basis of a detailed risk appraisal. Further auditing and analytical procedures accompanying projects provide the foundation for successful project management and effective risk reduction.

Macroeconomic and sector-specific risks

We remain exposed to macroeconomic risks emanating from the uncertainties of the current geopolitical and economic environment. Specifically, a deterioration of the consumption climate and a weakening of market growth constitute risk in both our Branded Consumer Goods and our industrial businesses. A continuation of the debt and financial crisis would primarily affect our markets in Southern Europe.

A further key risk is posed by the increasingly fierce competitive environment which could result in stronger price and promotional pressures. As consolidation in the retail sector continues and private labels occupy a growing share of the market, crowding-out competition could intensify. Our focus therefore is on achieving a steady increase in our brand equities and developing further innovations. We see innovative products as enabling us to differentiate ourselves from the competition, this being a significant prerequisite for the success of our company.

Functional risks

Financial risks

Henkel is exposed to financial risk in the form of credit risks, liquidity risks, currency risks, interest rate risks, and risks arising from our pension obligations.

For information relating to our credit risk, liquidity risk, interest rate and currency risk, including the risk-limiting measures applied and the management approach to such exposure, please refer to the financial instruments report under Note 21 on pages 138 to 148.

Risks from pension obligations relate to changes in interest rates, inflation rates, trends in wages and salaries, and changes in the statistical life expectancy of pension beneficiaries. To minimize exposure and improve risk management, Henkel strives to ensure 90 to 100 percent coverage of the projected defined pension benefit obligations.

Plan assets can be adversely affected in the event of a downturn in the capital markets. We mitigate this risk by investing in widely diversified classes of assets and different instruments within each asset class. The risks inherent in the pension plan assets are continuously monitored and controlled on the basis of risk and return criteria. Risks are quantified using sensitivity analyses. Further information on the management of risks arising from pension obligations and the associated developments can be found in Note 15 on pages 129 to 134.

Legal risks

As a globally active corporation, we are also exposed in the course of our ordinary business activities to a range of risks relating to litigations and other proceedings or actions, including those brought by governmental agencies, in which we are currently involved or may become involved in the future. These risks arise, in particular, in the fields of product liability, product deficiency, laws relating to competition and monopolies, the infringement of proprietary rights, patent law and tax law, and environmental protection and land contamination issues. The possibility cannot be discounted that the final decisions taken in some of these litigations and proceedings will go against us.

Ensuring compliance in the sense of obeying laws and adhering to regulations is an integral component of our business processes. We counteract legal risks by issuing corresponding binding guidelines and codes of conduct and by instituting appropriate training measures. Henkel has established a Group-wide compliance organization for this purpose, with locally and regionally responsible compliance officers led by a globally responsible General Counsel & Chief Compliance Officer (for detailed information, see the corporate governance report on pages 25 to 32). In addition, our corporate legal department maintains constant contact with local attorneys; current actions and potential risks are collated in a separate reporting system. For certain legal risks, we have concluded insurance policies that are standard for the industry and that we consider to be appropriate. We form provisions for litigation when it is likely in our estimation that obligations may arise that are either excluded from or not fully covered by our insurance policies and a reasonably accurate estimate of the potential loss is possible. However, predicting the results of actions is beset with considerable difficulties, especially in cases in which the claimant is seeking substantial or unspecified damages. In view of this, we are unable to predict what obligations may arise from such litigation. Consequently, major losses can result from litigation and proceedings that are not covered by our insurance policies or provisions.

We do not currently foresee risks arising from litigations or proceedings, either pending or threatened, that could have a material influence on our net assets, financial position or results of operations.

Supplementary information on pending actions:
Henkel is involved in litigations being brought by various antitrust authorities in Europe. These relate to infringements, some of which occurred more than ten years ago. Henkel has cooperated with the authorities in all such actions.

On April 13, 2011, the European Commission imposed fines on a number of international detergent manufacturers for reason of infringements that had occurred in various countries in Western Europe between 2002 and the beginning of 2005 that were discovered by Henkel in the course of internal compliance audits carried out in 2008. Henkel then immediately informed the relevant authorities and contributed materially to investigations into the matter. Due to our extensive cooperation with the European Commission, Henkel was granted full immunity from fines.

On December 8, 2011, the French antitrust authorities imposed fines totaling around 360 million euros on several international laundry detergent manufacturers on account of antitrust violations in France in the period from 1997 to 2004. Henkel received a fine of around 92 million euros. We have paid the fine and filed an action against the decision of the French authorities. In our opinion and the opinion of the attorneys advising us, the French antitrust authorities' decision is not legally correct. We cooperated extensively with the antitrust authorities throughout the entire proceedings and, on the basis of our own internal investigations, supplied important information that assisted in establishing the key facts of the matter in France. In addition, we were the first company to disclose the European dimension of the case. In our understanding, the case in France is directly related to the antitrust violations concerning heavy-duty detergents in various Western European countries – including France – that led to sanctions being imposed by the European Commission on April 13, 2011. We were granted full exemption from any fines in relation to these antitrust violations. It would be contradictory if the French antitrust authorities were to impose separate sanctions on us in respect of these infringements.

In addition to other retail companies and manufacturers, Henkel is involved in an antitrust action involving consumer goods (cosmetics and detergents) in Belgium relating to violations in the period from 2004 to the beginning of 2007. The action relates to a possible collusion between various Belgian retail companies to raise consumer prices (including prices for products in Henkel's portfolio) with the involvement of Henkel. Henkel has received a corresponding statement of objections; a conclusive assessment of the outcome of the action and amount of any fine that might be levied is not possible at present.

Information technology risks

The risks associated with our IT operations relate primarily to the potential for unauthorized access and data loss. Appropriate approval procedures, authorization profiles and defensive technologies are deployed in order to guard against such eventualities. Daily data back-up runs are conducted to shadow all critical databases, and the resultant files are transferred to another site. We also carry out regular restore tests. External attacks that took place in 2012 – for example in the form of hacking, spamming or viruses – were successfully repelled by the security measures implemented and therefore had no disruptive effect on our business processes.

Henkel has put in place a globally binding internal IT guideline to which our external service providers are also bound. Major components of this code include the classification of information with respect to confidentiality, availability, integrity and data protection requirements, measures for avoiding risk, and descriptions of escalation processes and best-practice technologies. Correct implementation is continuously monitored by our globally active Internal Audit function. In addition, our safeguards are examined for effectiveness and efficiency by external specialists.

Risks in connection with our brand image or the reputation of the company

As a globally operating company, Henkel is exposed to the potential damage of its image in the event of widespread negative reports in the media – including social media – regarding Henkel's corporate brand or individual product brands. A negative impact on sales could be the result. This risk is minimized by ongoing active and image-enhancing public relations work, a global communication network, and international and local crisis management systems with regular training sessions and workflow planning.

Personnel risks

Since the motivation and the skills of our employees are key drivers of business success at Henkel, it is important to recruit highly qualified professionals and executives and secure their loyalty over the long term. We combat the risk of losing valuable employees through specifically targeted personnel development programs and incentive systems. These include a thorough annual review process from which we derive individually tailored and viable qualification programs, and performance-related remuneration systems. Henkel combats the intensified competition for talented professionals by offering strong in-house training programs and attractive employer branding initiatives. We are constantly adding to our recruiting channels and sources, for example by optimizing our careers website and increased use of social networks. You will find further information relating to our employees on pages 68 to 70.

Environmental and safety risks

Henkel is a global manufacturing company and is therefore exposed to risks pertaining to the environment, safety, health and social standards manifesting in the form of personal injury, physical damage to goods and reputation damage. We minimize these risks by applying appropriate management systems and processes, and through our auditing, advisory and training activities. We update these preventive measures continuously with a view to safeguarding our facilities, assets and reputation. Integrity in this respect is further ensured by compliance with high technical standards and our rules of conduct, and by implementation of relevant statutory requirements.

Business strategy risks

Business strategy risks can arise from the expectations we set for internal projects, acquisitions and strategic alliances failing to materialize in part or in full. This may, in turn, mean that we are unable to recoup the associated capital expenditures. Individual projects could also be delayed or even stopped by unforeseen risks. We endeavor to identify these business strategy risks as early as possible through regular and intensive analysis of the market and our competition, and to take suitable countermeasures to mitigate or minimize them.

Our strategy of standardizing our processes on a global scale and concentrating our production facilities may give rise, for example, to strained relationships with employees and vendors. We limit exposure through early risk analyses performed by experienced specialist departments, supported by external consultants where appropriate.

Overall risk – Management Board appraisal

At the time this report was prepared, there were no identifiable risks related to future developments that could endanger the existence either of Henkel AG & Co. KGaA or of the Group as a going concern. As we have no special-purpose entities or investment vehicles, there is no risk that might originate from such a source. Aggregation of the most significant individual risks is not appropriate due to the improbability that such risks would occur simultaneously. Our risk analysis indicates that our exposure to risk does not represent any lasting danger to the net assets, financial position and results of operations either of Henkel AG & Co. KGaA or the Group. Although our assessment of the probability of occurrence and/or potential financial impact of individual risk categories has changed compared to the previous year, the overall risk situation has not changed to any significant degree. The system of risk categorization adopted by Henkel continues to indicate that the most significant exposure currently relates to the impact of macroeconomic and sector uncertainty and financial risk, to which we are responding with the countermeasures described above.

Forecast

Macroeconomic development

Overview: moderate gross domestic product growth of less than 3 percent

We expect global economic growth to remain moderate in 2013. Based on figures published by Feri EuroRating Services, we expect gross domestic product to increase by less than 3 percent.

We expect the mature markets to grow by just over 1 percent. The North American economy is likely to grow by around 2 percent, with Japan's expanding by less than 1 percent. In Western Europe, we expect a slight recovery, with growth of less than 1 percent following slightly declining growth in 2012.

The emerging markets will once again achieve comparatively strong economic growth of approximately 5 percent in 2013. In the case of Asia (excluding Japan), we expect economic output to increase by around 6 percent, with Latin America likely posting a plus of approximately 4 percent. Eastern Europe should grow by around 3 percent. For the Africa/Middle East region, we expect economic growth of approximately 4 percent.

Raw material prices: moderate rise in price level

We anticipate moderate price rises in all business sectors in 2013. In light of the geopolitical and global economic situation, we expect the procurement markets to remain highly volatile. Limited capacities in some supply areas may lead to shortages.