Risk report

Risks and opportunities

In the pursuit of our business activities, Henkel becomes exposed to a multiplicity of risks inherent in the global market economy. We deploy an array of effective monitoring and control systems aligned to identifying risk at an early stage, evaluating the exposure and introducing 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. Rather, we continuously examine and evaluate the opportunities available to us under the auspices of our business sectors, as an elementary component of our strategy. Major opportunities have been included in our forecast report on AR pages 93 to 95.

Risk Management System

The Risk Management System (RMS) at Henkel is an integral component of the comprehensive planning, control and reporting regime practiced in the individual 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 Group. New knowledge, intelligence and findings flow into our guidelines and systems as they are continuously developed. At Henkel, risk management is performed on a holistic, integrative basis involving the systematic assessment of our exposure. We understand risk as the likelihood 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 occurrence likelihood and potential loss. Included in the reporting remit 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 occurrence likelihood is considered greater than zero.

We initially determine the gross risk and then, in a second stage, the net risk after taking into account our countermeasures. 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 an intranet-resident database which ensures transparent communication throughout the entire corporation. Within the framework of its 2011 audit of our financial statements, the auditor examined the structure and function of our risk early warning system, confirming its adequacy and regulatory compliance.

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] as amended by the German Accounting Law Reform Act [BilMoG]. 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 those 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 spheres of 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 efficacy reviews performed by our Internal Audit function.

Of the many and varied control processes incorporated into the accounting regime, some 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 activities and material eventualities. It specifies, for example, the procedure to be adopted in 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 reviewed and re-released by the CFO. In particular, further globally binding procedural instructions affecting our accounting practice are contained in our corporate standards "Treasury" and "Investments."

With appropriate organizational measures in conjunction with restrictive control of access to our information systems, we ensure the effective 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 closure processes ensures that important tasks – such as the reconciliation of receivables and payables on the basis of balance statements and confirmations – are clearly assigned. Strict authorization regulations also exist governing the approval of contracts, credit notes and similar, and we practice the double-check security principle right across the board. This is also stipulated in our Group-wide corporate standards.

We consider our systems to be fit for purpose and functionally efficient. They are regularly reviewed in order to determine their potential for further development and optimization. Once identified, such potential is duly utilized.

Major risk categories

Operating risks

Procurement market risks

On the procurement markets, we expect prices to rise further in 2012, albeit not to the same degree as encountered in 2011. As uncertainties will continue to prevail in the development of raw material prices, we see additional price risks arising in relation to important raw materials

Major risk categories

Risk category	Likelihood	Potential financial impact
Operating risks		
Procurement market risks	Possible	Major
Production risks	Unlikely	Major
Economic and sector-specific risks	Likely	Major
Functional risks		
Financial risks		
Credit risks	Unlikely	Major
Liquidity risks	Unlikely	Minor
Currency risks	Possible	Major
Interest rate risks	Possible	Minor
Risks from pension obligations	Possible	Major
Legal risks	Unlikely	Major
IT risks	Unlikely	Major
Personnel risks	Possible	Minor
Environmental and safety risks	Possible	Major
Business strategy risks	Possible	Moderate

and packaging. Further price and supply risks ensue from the possibility of supply shortages in the procurement markets for reasons of demand or production restrictions. 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 AR pages 128 to 138.)

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 regime. We deal in detail with the assessment of vendor risk with respect to vendor financial stability in the section on "Procurement" on AR pages 67 and 68. 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

Risks in the field of production arise in the Henkel case not only from low capacity utilization due to volume decreases, but also in the possibility of 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, risks in the field of production 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 mitigate concomitant risk. 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 at the assessment and implementation stage 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 economic environment. Specifically, declining market growth combined with intensifying competitive pressures constitutes risk in both our branded consumer goods and our industrial businesses. We are currently observing an ongoing process of consolidation within the retail trade, resulting in increased pressure on both prices and terms of business relating to the trade's own private labels. 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 Note 21 on AR pages 128 to 138.

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, the pension obligations arising in the most important countries are therefore almost fully funded. They are managed on the basis of a two-track portfolio approach: The main portion of the portfolio is invested in interest-bearing plan assets (liability-driven investments), reducing the interest rate and inflation risk. In order to cover the risks arising from trends in wages, salaries and life expectancies, and to close the potential deficit between plan assets and pension obligations over the long term, additional investments are made in a return-enhancing portfolio as an add-on instrument that contains assets such as equities, private equity investments, hedge funds, real estate and commodity investments.

The pension funds 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. Major pension funds are administered by external fund managers in Germany, the USA, the UK, Ireland and the Netherlands. All these countries follow the above-described standard investment strategy and are centrally monitored. The funds covering our pension obligations are invested on the basis of asset-liability studies aligned to the expected cash flows arising from the country-specific pension obligations. Further information on the development of our pension obligations can be found in Note 15 on AR pages 120 to 124.

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.

We counteract legal risks by issuing corresponding binding guidelines and codes of conduct and by instituting appropriate training measures. We address current actions and the associated exposure by maintaining constant contact between the corporate legal department and local attorneys, and also through our separate reporting system. For certain legal risks, we have concluded insurance policies that are standard for the industry and that we consider to be fit for purpose. We form provisions for litigations where it is likely in our estimation that obligations may arise which are either excluded from or not fully covered by our insurance policies and where 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. Given these imponderables, we are unable to predict what obligations may arise from such litigations. Consequently, major losses can emanate from litigations and proceedings that are not covered by our insurance policies or our 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 with respect to all such actions.

On April 13, 2011, the European Commission imposed fines on a number of international laundry detergent manufacturers for reason of infringements that had occurred in various countries in Western Europe between 2002 and the beginning of 2005, which 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 EU 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 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 deposited the monies and filed an action against the decision of the French antitrust authorities. This action has no suspensive effect with regard to lodgment of the fine. In our opinion and in that of the attorneys from whom we are seeking advice, 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 West 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.

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 2011 – 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.

Moreover, 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 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 their efficacy and efficiency by external specialists.

Personnel risks

The future economic development of Henkel is essentially dependent upon the commitment and capabilities of our employees. We respond to the increasing competition for well qualified technical and managerial staff by maintaining close contacts with selected universities and by conducting special recruitment campaigns. Our new employer branding campaign is serving to position us even more effectively as an employer of choice. We combat the risk of failing to retain valuable employees over the long term through specifically aligned personnel development programs. The basis for these is provided by regular potential and performance analyses leading to attractive qualification and further training opportunities linked to performance-related compensation arrangements. You will find further information relating to our employees on AR pages 64 to 66.

Environmental and safety risks

Henkel is a global manufacturing company and is therefore exposed to risks pertaining to environment, safety, health and social standards, manifesting in the form of personal injury, physical damage to goods and reputational damage. We minimize these risks by applying the appropriate management systems and processes, and also through our auditing, advisory and training activities. We update these preventive and precautionary measures on a continual basis 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 faithful implementation of relevant statutory directives.

Business strategy risks

Business strategy risks can arise from the expectations that we have invested in 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 by unforeseen risks. We endeavor to minimize these business strategy risks through regular and intensive analysis of the market and our competition.

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 of writing this report, there are no identifiable risks relating 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 emanate from such a source. Aggregation of the most significant individual risks is not appropriate due to the unlikelihood that such risks would occur simultaneously. Our risk analysis indicates that our exposure to risk does not represent any lasting endangerment to the net assets, financial position and results of operations either of Henkel AG & Co. KGaA or of the Group. The overall picture shows no underlying change to the risk situation compared to the previous year. The system of risk categorization undertaken 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.

Forecast

Macroeconomic development

Overview: Gross domestic product growth below 3 percent with mixed regional developments expected

We expect 2012 to bring a general slowdown in economic growth, but without a global collapse such as experienced in the crisis year 2008/2009. Based on the data provided by Feri EuroRating Services [1], we expect gross domestic product to rise by less than 3 percent.

2012 should again see the emerging regions undergo robust economic expansion, supported in particular by developments in Russia and China. For Asia (excluding Japan) we expect an increase in economic output of around 6 percent, while that of Latin America is likely to be about 4 percent. Eastern Europe should grow by around 3 percent, while expansion of the economies in the Africa/Middle East region is anticipated at roughly 4 percent.

We expect the industrialized countries to grow 1.5 percent. North American GDP is likely to expand 2 percent. Western Europe's growth should be less than 1 percent, that of Japan 2 percent.

[1] As of January 2012.

Raw material prices: Moderate rise in price level

With raw material prices having consolidated at a high level during the second half of 2011, we expect them to rise moderately in 2012. In the previous year, we were confronted with a high degree of volatility in the procurement markets. For 2012, we expect uncertainties in relation to raw material price developments. We also anticipate that logistics services will become more expensive.

Currencies: No major changes

We do not expect any material change in the euro exchange rate versus the US dollar, with the annual average for 2012 likely to be around 1.41 US dollars. However, this is based on the assumption that the debt crisis in Europe will not increase in severity and that a political solution will be found. Moreover, based on these assumptions, we expect that currencies of importance for Henkel from the emerging regions, such as the Russian ruble, the Mexican peso and the Polish zloty, will moderately appreciate in this economic climate.

Our forecasts are based on the following exchange rates:

Average exchange rates versus the euro

	2011	2012 [1]
Chinese yuan	8.99	**8.69**
Mexican peso	17.31	**16.40**
Polish zloty	4.13	**3.91**
Russian ruble	40.91	**40.30**
US dollar	1.39	**1.41**

[1] Forecast.

Inflation: Slight increase in global price indices expected

According to data supplied by Feri EuroRating Services, global inflation is forecasted to be around 4 percent. While we can expect a continuing high degree of price stability for the industrialized countries with the figure at 2 percent, the inflation rate of the emerging regions is likely to average around 6 percent.

Sector development

Consumption and the retail sector: Growth at 2011 level

Based on data provided by Feri EuroRating Services, we anticipate that worldwide private consumption – and, linked to this, retail sales – will expand in 2012 at approximately the same rate as in 2011 (about 3 percent). Consumers in