Risks and opportunities 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 identifying risks at an early stage, evaluating the exposure and introducing effective countermeasures. We have incorporated these instruments within a risk management system as described below.

Entrepreneurial activity also involves identifying and exploiting opportunities as a means of securing and extending the corporation's competitiveness. The reporting aspect of our risk management system, however, does not encompass entrepreneurial opportunity. Early and regular identification, analysis and exploitation of opportunities is performed at the Group level and within the individual business units. 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.

Risk management system

The risk management system at Henkel is integrated into the comprehensive planning, controlling, and reporting systems used in the subsidiaries, in the business units, and at Group level. Our early warning system and Internal Audit function are also important components of our risk management system. Within the corporate governance framework, our internal control and compliance management systems support our risk management capability. The risk reporting system encompasses the systematic identification, evaluation, documentation and communication of risks. We have defined the principles, processes and responsibilities relating to risk management in a corporate standard that is binding on the Henkel Group. With the continuous development of our corporate standards and systems we take into account updated findings.

Within our risk strategy framework, the assumption of calculated risk is an intrinsic part of our business. However, risks that endanger the existence of the company must be avoided. When it is not possible to avoid these critical risks, they must be reduced or transferred, for example through insurance. Risks are controlled and monitored at the level of the subsidiaries, the business units, and the Group. Risk management is thus performed with a holistic, integrative approach to the systematic handling of risks.

We understand risks as potential future developments or events that could lead to negative deviations from our guidance. Risks with a probability of occurrence of over 50 percent are taken into account in our guidance and short-term planning. As a rule, we estimate risks for the one-year forecast period.

The annual risk reporting process begins with identifying material risks using checklists based on defined operating (for example procurement and production) and functional (for example information technology and human resources) risk categories. 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 subsequently the net risk after taking countermeasures into account. Initially, risks are compiled on a decentralized, per-country basis, with the assistance of regional coordinators. The locally collated risks are then analyzed by experts in the business units and corporate functions. In particular areas such as Corporate Treasury, risks are determined with the support of sensitivity analyses including value-at-risk computations. Risk analyses are then prepared for the respective executive committees of the business units and corporate functions, and finally assigned to an area-specific risk inventory. The risk situation is subsequently reported to our Compliance & Risk Committee, the Management Board and the various supervising boards. Material unforeseen changes are reported immediately to the CFO and the Compliance & Risk Committee. Corporate Accounting is responsible for coordinating the overall process and analyzing the inventoried exposures.

The risk reporting process is supported by a web-based database which ensures transparent communication throughout the entire Group. Our Internal Audit function regularly reviews the quality and function of our risk management system.

Within the framework of the 2013 audit of our annual financial statements, our external auditor examined the structure and function of our risk early warning system in accordance with Section 317 (4) of the German Commercial Code [HGB] and confirmed its 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 HGB. Corresponding 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. Accordingly, the internal control system's function is to implement relevant principles, procedures and controls so as to ensure the financial statement closing process is regulatory compliant. 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. These are assessed by regular and comprehensive effectiveness tests performed by our Internal Audit function. Of the multifaceted control processes incorporated into the accounting process, several are important to highlight.

The basis for all our accounting processes is provided by our corporate standard "Accounting," which contains detailed accounting and reporting instructions covering all material circumstances. It covers, for example, clear procedures for inventory valuation or how transfer prices applicable for intra-group transactions should be determined. This corporate standard is binding on the entire Group and is regularly updated and approved by the CFO. The local Presidents and Heads of Finance of all consolidated subsidiaries must confirm their compliance with such corporate standards on an annual basis.

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 segregation of duties in our accounting systems between transaction entry on the one hand, and checking and approval on the other. Documentation relating to the operational accounting and closing processes ensures that important tasks – such as the reconciliation of receivables and payables on the basis of account balance confirmations – are clearly assigned. Additionally, binding authorization regulations exist governing the approval of contracts, credit notes and the like, with strict adherence to the four-eyes principle as a mandatory requirement. This is also stipulated in our Group-wide corporate standards.

The significant risks for Henkel and the corresponding controls with respect to the regulatory preparation of our annual and consolidated financial statements are collated in a central documentation pack. This documentation is reviewed and updated annually by the respective process owners. The established systems are regularly reviewed with regard to their improvement and optimization potential. We consider these systems to be appropriate and effective.

The accounting activities for subsidiaries included in the consolidated financial statements are performed either locally by the subsidiary or through a shared service center taking the corporate standards into account. The ERP systems in use are based on Group-wide standardized SAP systems. The individual subsidiaries' financial statements are transferred to our central consolidation system and checked at corporate level for correctness. After all consolidation steps have been completed, the consolidated financial statements are prepared by Corporate Accounting in consultation with the specialist departments. Preparation of the Group management report is coordinated by Investor Relations in cooperation with each business unit and corporate function. The Management Board then compiles the Group management report and consolidated financial statements, as well as the management report and annual financial statements of Henkel AG & Co. KGaA, and subsequently presents these documents to the Supervisory Board for approval.

Major risk categories

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

Classification of risks in ascending order

Probability	
Low	1 – 9 %
Moderate	10 – 24 %
High	≥ 25 %
Potential financial impact	
Minor	1 – 49 million euros
Moderate	50 – 99 million euros
Major	≥ 100 million euros

Major risk categories

The risks are presented from a net perspective, where their respective risk mitigation measures are taken into account.

Operating risks

Procurement market risks

Description of risk: Moderate price increases in our procurement markets are expected in 2014. Due to geopolitical and global economic uncertainties, we expect prices to fluctuate throughout the course of the year. As a result of this uncertainty as it relates to the development of raw material prices that cannot always be passed on in full, we see additional risks arising beyond our guidance in relation to important raw materials and packaging which could impact our profitability. The segments in the industrial goods sector are affected to a greater extent by these price risks than the individual segments in the consumer goods sector. Additional price and supply risks exist due to possible demand or production-related shortages in the procurement markets. Continued unrest in the Africa/Middle East region, in particular, could lead to rising material prices and supply shortages.

Measures: The measures taken include active supplier portfolio management through our globally engaged, cross-divisional sourcing capability, together with strategies aimed at securing price and volume both through contracts and, where appropriate and possible, through financial hedging instruments. (Further information relating to the risks arising from derivative financial instruments used for hedging purposes can be found in the notes to the consolidated financial statements on pages 140 to 152.) Furthermore, we work in interdisciplinary teams within Research and Development, Supply Chain Management and Purchasing on devising alternative formulations and packaging forms so as to be able to respond flexibly to unforeseen fluctuations in raw material prices. We also avoid becoming dependent on individual suppliers so as to better secure the constant supply of the goods and services that we require. Finally, close collaboration with our strategic suppliers plays an exceptionally important role in our risk management. Further details regarding the assessment of supplier financial stability can be found in the section on “Procurement” on pages 69 and 70. The basis for our risk management approach is a comprehensive procurement information system that ensures permanent transparency with respect to our purchasing volumes.

Impact: Low probability rating, possible major impact on our earnings guidance.

Production risks

Description of risk: Henkel faces production risks in the event of low capacity utilization due to volume decreases and unplanned operational interruptions, especially at our single-source sites.

Measures: We can offset the negative effects of possible production outages through flexible production control and, where economically viable, insurance policies. Such production risks are minimized by ensuring high employee qualification, clearly defined safety standards, and regular plant and equipment maintenance. Capital expenditure decisions on property, plant and equipment are made in accordance with defined, differentiated responsibility procedures and approval processes. They incorporate all relevant specialist functions and are regulated in an internal corporate standard. Investments are analyzed in advance on the basis of detailed risk aspects. Further auditing accompanying projects provides the foundation for project management and risk reduction.

Impact: Moderate probability rating, possible moderate impact on our earnings guidance.

Macroeconomic and sector-specific risks

Description of risk: We remain exposed to macroeconomic risks emanating from the uncertainties of the current geopolitical and economic environment. A decline in the macroeconomic environment poses a risk to the industrial sector in particular. A downturn in consumer spending is especially relevant for the consumer segments. A prolonged debt and financial crisis would affect our markets in Southern Europe in particular. A further significant risk is posed by an increasingly competitive environment, as this could result in stronger price and promotional pressures in the consumer goods area. As consolidation in the retail sector continues and private labels occupy a growing share of the market, crowding-out competition in consumer goods could intensify. The risk of product substitution inherent in this could in principle affect all business units.

Measures: We focus on continuously strengthening our brands (see separate risk description on pages 96 and 97) and consistently developing further innovations. We consider innovative products as a significant success factor for our company, enabling us to differentiate ourselves from the competition. Furthermore, we also pursue specific sales and marketing initiatives, for example advertising and promotional activities. In addition, we have the capability to react quickly to potential sales declines through flexible production control.

Impact: High probability rating, possible major impact on our sales and earnings guidance.

Functional risks

Financial risks

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

For the description of credit risks, liquidity risks, currency risks and interest rate risks, please refer to the notes to the consolidated financial statements on pages 140 to 152. For the risks arising from our pension obligations, please see pages 128 to 136.

Measures: Risk-mitigating measures and the management of these risks are also described in the notes to the consolidated financial statements on the pages mentioned.

Impact: We classify the financial risks as follows:
- Credit risk with a low probability of a major impact on our earnings guidance
- Liquidity risk with a low probability of a minor impact on our earnings guidance
- Currency risk with a high probability of a major impact on our earnings guidance
- Interest rate risk with a moderate probability of a minor impact on our earnings guidance
- Risks arising from our pension obligations with a low probability of a major impact on our earnings guidance, but with a high probability of a major impact on our equity

Legal and regulatory risks

Description of risk: As a globally active corporation we are exposed, in the course of our ordinary business activities, to a range of risks relating to litigations and other actions, including government agency proceedings 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, competition and cartel law, infringement of proprietary rights, patent law, tax law and environmental protection and soil contamination. We cannot rule out the likelihood of negative rulings on current litigations and further litigations being initiated in the future.

Our business is subject to various national rules and regulations as well as – within the European Union (EU) – increasingly harmonized pan-European laws. In addition, some of our operations are subject to rules and regulations derived from approvals, licenses, certificates or permits. Our manufacturing operations are bound by rules and regulations with respect to the registration, evaluation, usage, storage, transportation and handling of certain substances and also in relation to emissions, wastewater, effluent and other waste. The construction and operation of production facilities and other plant and equipment are governed by framework rules and regulations, including those relating to the decontamination of soil. Violation of such regulations may lead to legal proceedings or compromise our future business activities.

Measures: Our internal standards, guidelines, codes of conduct, and training measures are geared to ensuring compliance with statutory regulations and, for example, the safety of our manufacturing facilities and products. These requirements have also been incorporated into our management systems and are regularly audited. Ensuring compliance with laws and regulations is an integral component of our business processes. This includes the early monitoring and evaluation of relevant statutory and regulatory requirements and changes. Henkel has established a Group-wide compliance organization 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 33). In addition, our corporate legal department maintains constant contact with local counsel. Current proceedings and potential risks are collected 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. However, the outcome of proceedings are inherently difficult to foresee, 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 may result from litigation and proceedings that are not covered by our insurance policies or provisions.

Impact: Low probability rating, possible major impact on our earnings guidance.

Supplementary information on selected proceedings: 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 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 paid the amount and filed an action against the decision of the French antitrust authorities. In our opinion and that of our legal counsel, the French antitrust authorities' decision is not legally correct. We cooperated extensively with the relevant 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 opinion, 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 and in respect of which we were granted full exemption from said sanctions. It would be contradictory if the French antitrust authorities were able 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 litigation 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 litigation and amount of any fine that might be levied is not possible at present.

Information technology risks

Description of risk: Information technology has strategic significance for Henkel. Our business processes rely to a great extent on IT services, applications, networks, and infrastructure systems. The failure or disruption of critical IT services and the loss of confidential data constitute material risks for Henkel. The failure of computer networks or disruption of important IT applications can impair critical business processes. The loss of confidential data, for example formulations, customer data or price lists, could benefit Henkel's competitors. Henkel's reputation could also be damaged by such loss.

Measures: Henkel's information security strategy is based on the international standards ISO 27001 and 27002. Major components include the classification of information, business processes, IT applications, and IT infrastructure elements with respect to confidentiality, availability, integrity, and data protection requirements, as well as measures for avoiding risk.

Our critical business processes operate through redundantly configured systems designed for high availability. Our data backup procedures reflect state-of-the-art technology practice. We regularly review our restore and disaster-recovery processes. We develop our systems using proven project management and program modification procedures.

Access to buildings and areas containing IT systems, access to computer networks and applications, as well as user authorizations for our information systems, are strictly limited to the minimum level necessary. For critical business processes, the required segregation of duties is enforced by technological means.

Our networks are protected against unauthorized external access where economically viable. Operating systems and anti-virus software are automatically updated to their latest version on a continuous basis.

We inform and instruct our employees in the proper and secure use of information systems as part of their regular duties.

The implementation of our security measures is continuously reviewed by our Internal Audit function, other internal departments, and independent third parties.

Impact: Low probability rating, possible major impact on our earnings guidance.

Personnel risks

Description of risk: The motivation and the qualification of our employees are key drivers of Henkel's business success. Therefore, it is strategically important to recruit highly qualified professionals and executives and ensure they stay with the company. In selecting and employing talent, we compete globally for qualified professionals and executives, and we are acutely aware of the effects of demographic change in many of our markets.

Measures: We combat the risk of losing valuable employees through specifically developed personnel development programs and incentive systems. Supporting this is an established thorough annual review process from which we derive individually tailored and future-viable qualification programs as well as performance-related remuneration systems. We also provide a health management and consultation service on a global scale for our employees, aligned to their age and circumstances.

We reduce the risk of not being able to recruit qualified professionals and executives by expanding our employer branding initiatives and through targeted cooperation with colleges and universities in all regions where we conduct business. Our attractiveness as an employer is reinforced by our focus on promoting talent and specialized development programs.

Further information relating to our employees can be found on pages 66 to 68.

Impact: High probability rating, possible minor impact on our earnings guidance.

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

Description of risk: As a globally operating corporation, Henkel is exposed to the potential damage of its image in the event of negative reports in the media – including social media – regarding Henkel's corporate brand or individual product brands, particularly in the consumer goods sector. These could lead to a negative impact on sales.

Measures: We minimize these risks through the measures described under the statutory and regulatory risks (see page 94) and pro-active public relations management. The former ensures that our production facilities and products are safe. The latter reinforces our corporate brand and individual product brands. These measures are supported by a global communication network, and international and local crisis management systems with regular training sessions and crisis response planning.

Impact: Low probability rating, possible major impact on our sales and earnings guidance.

Environmental and safety risks

Description of risk: Henkel is a global manufacturing corporation 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 reputational damage. Soil contamination and the associated remediation expense as well as leakage or other technical failures could give rise to direct costs for the corporation. Furthermore, indirect costs such as fines, claims for compensation or reputational damage may also be incurred.

Measures: We minimize these risks through the measures described under statutory and regulatory risks (see pages 94 and 95), and through our auditing, advisory, and training activities. We update these preventive measures continuously in order to ensure that our facilities, assets, and reputation are properly safeguarded. We ensure compliance with high technical standards and relevant statutory requirements as a further means of preserving our operational capability.

Impact: Low probability rating, possible major impact on our earnings guidance.

Business strategy risks

Description of risk: Business strategy risks can arise from the expectations we set for internal projects, acquisitions, and strategic alliances failing to materialize. The associated capital expenditures may not be recouped. Individual projects could also be delayed or even halted by unforeseen risks coming to light.

Measures: We combat these risks through comprehensive project management. We limit exposure through financial viability assessments in the review, decision, and implementation phase. These assessments are performed by specialist departments, supported by external consultants where appropriate. Project transparency and control are supported by our management systems.

Impact: Moderate probability rating, possible moderate impact on our earnings guidance.

Major opportunity categories

Entrepreneurial opportunities are identified at Group level and in the individual business units, evaluated, and duly incorporated into the strategy and planning processes. We understand the opportunities presented in the following as potential future developments or events that could lead to a positive deviation from our guidance. We also assess price-related procurement market and financial opportunities.

Macroeconomic and sector-specific opportunities

Description of opportunities: Additional business opportunities would arise, should the uncertain geopolitical and macroeconomic situation in some regions such as Africa/Middle East or the economic conditions in individual sectors such as the electrical industry develop substantially better than expected.

Impact: The opportunities described could have a major impact on our sales and earnings guidance.

Procurement market opportunities

Description of opportunities: Countervailing the procurement market risks listed on pages 92 and 93, opportunities may also arise in which the influencing factors described in this section develop in a direction that is advantageous to Henkel.

Impact: Low probability rating, possible major impact on our earnings guidance.

Financial opportunities

Description of opportunities: Countervailing the credit risks, liquidity risks, currency risks, interest rate risks, and risks arising from our pension obligations listed under the financial risks on pages 93 and 94, opportunities may also arise in which the influencing factors described in this section develop in a direction that is advantageous to Henkel.

Impact: We classify financial opportunities as follows:

- Currency opportunities with a moderate probability of a major impact on our earnings guidance
- Interest rate opportunities with a moderate probability of a minor impact on our earnings guidance
- Opportunities arising from our pension obligations with a low probability of a major impact on our earnings guidance, but with a high probability of a major impact on our equity

Acquisition opportunities

Description of opportunities: Acquisitions are an essential component of our strategy. Only acquisitions that have been concluded are included in our guidance.

Impact: Large acquisitions could have a major impact on our earnings guidance.

Research and development opportunities

Description of opportunities: Opportunities arising from our predominantly continuous innovation process are an essential component of our strategy and are already accounted for in our guidance. There are additional opportunities in the event of product introductions that exceed our expectations of market acceptance, and in the development of exceptional innovations that have not yet been taken into account.

Impact: Innovations arising from future research and development could have a major impact on our sales and earnings guidance.

Risks and opportunities in summary

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 a material subsidiary included in the consolidation, or 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.

Compared to the previous year, our expectation of the likelihood and/or of possible financial impact of individual risk and opportunity categories has slightly increased. Nevertheless, the overall risk and opportunities 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. The Management Board remains confident that the earning power of the Group forms a solid foundation for future business development and provides the necessary resources to leverage our opportunities.