

## **Risk Report 2009**

One of the fundamental management tasks is to establish and operate an effective internal control system (ICS) and a risk management system (RMS) in accordance with applicable corporate governance requirements and best practice principles.

Like many other companies, Pfleiderer too is exposed to a large number of risks connected with entrepreneurial activities. The uncertainties and continual changes in various laws and regulations that apply to Pfleiderer AG are counteracted by means of a Group-wide uniform system of control and risk management and the internal auditing process. These instruments are regularly further developed and adapted to changing conditions.

As part of the existing process, the Executive Board and the Supervisory Board are regularly informed about the risks that could significantly influence the business development of the business units or of the Group.

### **Risk Management System**

A risk management system that complies with legal requirements is used for the early identification, assessment and appropriate management of significant risks and risks threatening Pfleiderer's continued existence. This risk management system is an integral component of the entire management and reporting process. Its framework is defined in a risk management manual.

The risk management manual provides instructions on:

- risk identification and assessment,
- deciding on the management of current risks and on new or supplementary
- measures of risk management, and
- tracking risk developments and the measures taken.

External and internal risks are systematically identified for all of the Group's business units and subsidiaries. Risk management is coordinated and continually enhanced by a central unit of Pfleiderer AG. Particular attention is paid to the regular exchange of experience with other companies so that new ideas and methods can be integrated into the own risk management. The management of the operating units is responsible for the early detection, full identification and management of risks. For this purpose, each operating unit and central unit has appointed risk managers who ensure compliance with the risk management system for each area of the Group.

The Group's risk situation is systematically re-evaluated each month. Risks are assessed in terms of their extent of damage and probability of occurrence. In addition, special reports are submitted if the risk situation changes suddenly. The results are consolidated into quarterly reports, which are submitted to the Executive Board, the Chairman of the Supervisory Board, and the Audit Committee.

The Internal Auditing department and the external auditors perform reviews of the risk management system's suitability and effectiveness in order to recognize at an early stage any risks which could pose a threat to Pfleiderer's continuing existence.

In addition to its own measures for minimizing risk, Pfleiderer always takes the necessary precautions to cover foreseeable substantial risks using insurance policies with appropriate deductibles in line with standard market conditions. However, it cannot be ruled out that the

insurance cover may not be adequate in individual cases or that adequate insurance cover for certain risks may not be available on the market, or may not be available at commercially reasonable terms. Pfleiderer regularly reviews its existing insurance cover and optimizes it annually in cooperation with external insurance brokers and risk experts.

## **Key Risk Areas**

### **Macroeconomic and political risks as well as industry risks**

As a global player, Pfleiderer is exposed to changes in its global business conditions. In fiscal 2009, Pfleiderer was indirectly affected by the financial crisis. The ongoing development of the global crisis and its impact on the world economy cannot yet be finally assessed.

Pfleiderer's business environment is subject to extremely intensive price competition. The Company is faced with strong, internationally active competitors, some of which are larger in certain business segments. In addition to product innovations, Pfleiderer meets this challenge by means of suitable measures for reducing costs and increasing productivity.

The development of business in 2009 was affected by moderate price increases in the international energy and raw material markets. Further price increases for individual raw materials cannot be ruled out in 2010. Pfleiderer uses a large variety of raw materials in its production processes; but since there are sufficient numbers of suppliers of those materials, there is virtually no dependency on individual suppliers. Supply is secured with a multi-sourcing purchasing policy. Supplier failures, supplier delays or quality problems could lead to disturbances of production and thus have a negative impact on profitability. Pfleiderer counteracts these risks by entering into long-term supply agreements and has a highly efficient purchasing organization, which constantly secures the timely availability of raw materials in appropriate quality. The high energy needs with prices often influenced by taxes and other levies for political reasons is a risk in particular for the German sites. We counteract these risks through process optimization and the use of our own power-heat cogeneration plants.

The development of the world economy and of future growth markets has been slowed down considerably by the ongoing global crisis. In this context, it is quite possible that further market consolidation will take place with a sustained effect on Pfleiderer's market position. Another factor is that further customer insolvencies cannot be ruled out in the relevant markets.

### **Operating risks**

Pfleiderer operates production facilities in which machines are mainly kept running continuously in multi-shift operation. The resulting high level of organizational and technical complexity means that in the event of disruptions to the value chain, there is a risk of production interruptions and quality problems, as well as environmental and occupational safety risks. Despite our maintenance management, the risk of fire and explosion can never be entirely ruled out in the wood processing industry. Resulting damage to plant and machinery as well as possible losses due to downtime are covered to the commercially viable extent by appropriate insurance. However, any fire, explosion or environmental damage can also lead to serious personal injury, which cannot be completely covered by insurance policies. The required technical and organizational precautions have been taken to prevent such incidents, and appropriate action and emergency plans have been prepared to deal with any possible occurrences.

**Personnel risks**

Pfleiderer counteracts possible personnel risks arising from staff fluctuation, loss of know-how, demotivation, insufficient qualification, and competition for specialists and executives with modern human resources tools. Attractive remuneration systems as well as a wide range of training and further training programs have been installed to promote employee

loyalty to the Group. Close contacts with selected universities support the recruitment of qualified new talent. Pfleiderer ensures that it has highly qualified talent at all levels, especially skilled production workers, thanks to its vocational training program that is widely recognized for its quality and trains more people than the Company actually needs.

**Financing risks**

Pfleiderer defines financial risks as liquidity risk, foreign currency risk and interest rate risk, arising in particular from business operations and corporate financing. Managing all the Pfleiderer Group's financial risk by applying appropriate financial monitoring instruments tools is the responsibility of the Corporate Finance department of Pfleiderer AG. The operating units are responsible for managing accounts receivable. In general, business transactions have to be carried out within the insurance limits of the overall credit insurance policy. These framework agreements are negotiated by Corporate Finance.

Following successful negotiations in 2009, Pfleiderer agreed with its banks on new credit conditions at the beginning of 2010. As a result, credit facilities of approximately 800 million euros is available to us until 2013. The package includes a loan of 140 million euros from the Germany fund of the state-owned support bank, KfW. In addition, Pfleiderer's subsidiary listed on the Polish stock exchange reached an basic agreement with its banks covering further loans in zloty amounts equivalent to about 300 million euros. As a result of the new agreements, financing costs will be higher than in 2009 by a small double-digit million amount.

The new credit agreements include financial covenants usual in the market which have to be fulfilled during the term of the loans. As the ongoing development of the global crisis and its effects on the world economy cannot be finally assessed at present, the risk that credit lines might fall due because of the agreed financial covenants not being fulfilled cannot be entirely ruled out. This situation is continuously monitored in order to take timely countermeasures if required.

Risks arising from significant changes in interest rates can be largely ruled out during the planning period due to existing credit lines and additionally agreed interest rate hedges. The Corporate Finance department of Pfleiderer AG regularly monitors developments on financial markets.

Foreign currency risks are of particular importance for the Pfleiderer Group due to the growth of its international operations. The currencies with a fairly major impact are the Polish zloty, the Canadian dollar, the US dollar, the Swedish krona and the Russian ruble. Pfleiderer limits its currency risk through the local procurement of raw materials and equipment (natural hedges) and by means of specific currency hedges.

Derivative financial instruments are used to hedge interest rate and currency exposures with the aim of minimizing risks resulting from fluctuations in exchange rates and market interest rates. The Company's guidelines on risk management and on the application of hedges require that these types of risk are generally hedged. Only marketable interest rate derivatives and currency futures with prime-rated banks are used for this purpose. Derivative financial transactions are limited to hedging the operating business and the related financing. The Company does not enter into derivative financial transactions for speculative purposes.

The Pfleiderer Group's risks from derivative financial instruments are mainly limited to defaults by counterparties ("counterparty risk"). The Group's maximum default risk is the positive fair value of the derivatives. In the case of currency futures, the maximum risk corresponds to the change in the exchange rate of the hedged amount.

Further information, in particular relating to the significance of financial instruments for the net assets, financial position, and results of operations, is provided in the consolidated financial statements according to IFRSs, primarily in the notes on financing instruments and risks.

### **Regulatory and legal risks**

Changes in the legal environment can result in risks for the Group, can increase costs and restrict sales possibilities. We attempt to react to such changes in good time by means of an intensive information policy.

Pfleiderer's legal department is responsible for ensuring that legally relevant matters are dealt with correctly in terms of both form and content, especially when drafting contracts and conducting litigation; external legal counsel is obtained if necessary. Pfleiderer has recognized appropriate provisions to cover warranty claims, which the Group is almost inevitably confronted due to its business activities and as a result of the sale of companies in recent years.

On March 4, 2009, as with other companies in the engineered wood sector, the premises of Pfleiderer were searched due to suspicion of anticompetitive behavior. On March 9, 2010, notifications of accusations and hearings involving Pfleiderer AG and its subsidiaries were received from Germany's Federal Antitrust Authority, with reference to proceedings for alleged violation of antitrust regulations by companies in the particleboard industry and their responsible persons. A renowned firm of attorneys has been commissioned to act in these proceedings. Due to the current stage of the proceedings, no reliable estimate can be made of any possible damage. Apart from this, Pfleiderer AG and its subsidiaries are not involved in any in legal or arbitration proceedings which, according to current assessments, could have a material negative impact on the financial situation of the Group.

### **IT risks**

Major disruptions of IT systems can lead to data losses and negative effects on business and production processes, despite backup actions. Potential IT risks such as unauthorized data access or data misuse are limited with a number of measures such as authorization concepts, internal IT security guidelines and IT infrastructure standards, which involve employees, organizations, applications, systems and networks. In addition, technical protection measures such as firewalls or virus scanners are reviewed annually in the context of an internal IT security audit.

### **Environmental risks**

As a company in the engineered wood industry, Pfleiderer is exposed to process-related risks within the framework of its existing production processes. Environmental protection measures and environmentally compatible investments in our production plants make an important contribution towards minimizing environmental pollution and conserving resources sustainably.

In order to minimize potential environmental risks, environmental officers have been trained and deployed at the Group and in the business units, and appropriate guidelines have been issued. According to expert opinions, contamination is to be anticipated at certain production sites, for which we have recognized sufficient provisions. Due to continuous changes in the regulatory environment and advances in research and development, additional expenditure in the areas of the environment and product quality cannot be ruled out for the future.

### **Risks from buying, selling and restructuring**

In connection with restructuring measures, risks can arise from the sale or acquisition of property, companies or other business activities. Appropriate risk strategies are in place for such risks.

### **Project risks**

The processing of major projects is always connected with risks. Technical problems and quality problems with subcontractors can lead to higher costs than planned and cause missed deadlines, as happened in Moncure/USA for example. Pfleiderer is constantly improving its control instruments in order to limit these risks.

### **Internal Control System (ICS)**

The ICS at Pfleiderer AG is based on key guidelines, procedures etc., which determine the ICS environment. These are communicated throughout the Group in the following rules for example:

- Code of Conduct, Legality Guidelines
- Manuals (Accounting Manual, Treasury Manual)
- Guidelines (Guidelines for signatures and power of attorney, Guidelines for the prevention
- of corruption with regard to Compliance, Guidelines on dealing with Non-cash Benefits
- for customers and employees)
- Rules of procedure

The sets of rules of Pfleiderer AG listed above pursue the following goals:

- Providing instructions for acting daily in business operations in order to adhere to laws and regulations relevant to the Group and to establish internal Group guidelines.
- Ensuring identification with and the management of significant operating, strategic, compliance-relevant and accounting-relevant risks.
- Securing the quality of financial reporting including the development and Implementation of processes which quickly generate relevant and reliable information.

SAP software features prominently in the system landscape of Enterprise Resource Planning at Pfleiderer AG. The ICS includes both automated and manual controls.

With regard to the accounting process, the clear allocation of responsibilities and controls (e.g. closing schedule/accounting manual) with regard to preparation of financial statements, based on the ICS environment and the SAP landscape, results in other key elements for risk monitoring and control. This includes the “four-eyes principle,” sensible separation of functions and/or compensating controls as well as access rules for IT systems, e.g. by the regular review of authorization concepts. Manual controls (e.g. IFRS package review) and automated controls (e.g. reconciliation checks in the SAPSEM consolidation) firmly anchored in the financial statements process have preventive and detective effects, ensuring the completeness, validity and accuracy of transaction data and master data. This makes sure there is sufficient security, so that the consolidated financial statements are prepared in accordance with applicable law despite the potential risks.

Within the context of the audits performed in 2009 by the internal auditing department, in line with professional standards, there was a focus on the ICS as well as on compliance-relevant issues. For the deficits identified during the audit, action plans were prepared and the relevant bodies were informed (Executive Board/Audit Committee/External Auditors). In the context of so-called follow-up audits, the implementation of the action plans was supervised. By regularly reviewing the current ICS for its appropriateness internal auditing and the

external auditors ensure that the system is effective in recognizing at an early stage any risks that might jeopardize the existence of the Company.

### **Responsibility for the ICS – interaction with the Pfleiderer management**

A management principle at Pfleiderer is the delegation of entrepreneurial responsibility and authority to the operating units. This principle of subsidiarity draws a clear line between the responsibilities of headquarters and the business units. The Pfleiderer headquarters determine the Group's general strategic and operational targets and bear overall responsibility for the process. The business units are responsible for all operating issues and activities, and are subject to regular monitoring by the Executive Board in the context of the monthly business reviews or by internal auditing.

In the fulfillment of its tasks related to the ICS, the Executive Board is served by local management, which is commissioned with the performance and monitoring of the ICS. The local management is obliged to ensure the transparency and effectiveness of its local sub-ICS systems and their compliance with the goals defined by the Executive Board of Pfleiderer AG. The management of the business units and the headquarters departments is responsible for the implementation of suitable offsetting measures to reduce the probability of occurrence and the effects of risks.

### **Development in 2009**

In the context of the Pfleiderer's Group-wide compliance program, a number of measures were further developed in 2009.

On the one hand, additional Group-wide guidelines and manuals were prepared or updated ("Minimum Internal Control Standard", "Guidelines for Signatures and Power of Attorney"), and Group-wide workshops were carried out to ensure that these guidelines were implemented as effectively and efficiently as possible.

The "Minimum Internal Control Standard" ensures that in all operating units and at the headquarters of the Pfleiderer Group, there is a sufficient extent of standardized internal controlling instructions, and that they are regularly reviewed.

The standards cover all significant processes, such as:

- Purchasing, from ordering to paying
- Accounting & controlling
- Bank & liquidity management
- Wages and salaries payroll
- Fixed assets
- Sales, from ordering to paying
- Inventory management
- Travel expenses
- IT security and controls

On the other hand, Group-wide risk management and ICS workshops were held. Furthermore, a concept was developed and implemented for management evaluation in terms of compliance. These measures serve to ensure that in future assessments of the top managements of Pfleiderer AG, important risk management, ICS and compliance issues are given even more consideration.

### **Overall Risk Assessment**

At present, no risks have been identified at the Pfleiderer Group that could jeopardize the continued existence of the Group. A consolidated consideration of all material risks has been performed to arrive at an overall assessment. However, like any other company, Pfleiderer AG is confronted with potential risks, especially with the uncertainty of global economic

developments, which could materially affect the course of its business and its net assets, financial position, and results of operation.