

# Risk Report

## A responsible approach to risk

Business success is based not least of all on a forward-looking approach to identifying and controlling risk. Our comprehensive risk management system guarantees the security we require in managing our activities.

In this chapter, we first explain how the Volkswagen Group updates the risk documentation it uses. The Group's risk situation is documented annually in accordance with the requirements of the Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG – German Act on Control and Transparency in Business); the adequacy of this documentation is also assessed. We then describe the risk management system - an operational element of our business processes that enables risks to be identified in a timely manner, the extent of those risks to be assessed and appropriate countermeasures to be introduced. In the Report on Expected Developments from page 170 to 176, we outline the opportunities arising from our activities.

### UPDATING THE RISK DOCUMENTATION

The results of the standardized surveys by the risk managers of the individual divisions and the managing directors of investees provide an overall picture of the potential risk situation that is updated on an annual basis. Every risk that is identified is assessed to determine the likelihood of its occurrence; the probable extent of the loss in the event of its occurrence is then measured. In addition, guidelines and organizational instructions are assigned together with the countermeasures that are to be

taken to manage the risk in question. The revision of the risk documentation is coordinated centrally by Group Controlling in conjunction with Group Internal Audit. With the auditors in overall charge, the plausibility and adequacy of the risk reports are examined on a test basis in detailed interviews with the divisions and companies concerned. Based on this information, the auditors assessed the effectiveness of our risk management system and established both that the risks identified were presented in a suitable manner and that measures and rules were assigned to the risks adequately and in full. This means that we conform to the requirements of the KonTraG. In addition, the Financial Services Division is subject to regular special audits by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin – the German Federal Financial Supervisory Authority) in accordance with section 44 of the Gesetz über das Kreditwesen (KWG – German Banking Act) and controls by association auditors.

Workflow rules, guidelines, instructions and descriptions are systematically recorded and can for the most part be accessed online. Internal controls by the heads of the Group Internal Audit, Quality Assurance, Group Treasury, Brand Controlling and Group Controlling organizational units ensure that these rules are adhered to.

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## GOALS AND FUNCTIONING OF THE RISK MANAGEMENT SYSTEM

The purpose of the Group's risk management system is to identify potential risks at any early stage so that suitable countermeasures can be taken to avert the threat of loss to the Company, and any risks that might jeopardize its continued existence can be ruled out. By using an efficient risk management system, we are able to identify risks promptly, to assess them and to counter them.

The risk management system is an integral part of the Volkswagen Group's structure and workflows and is embedded in its daily business processes. Events that may entail a risk are identified and assessed on a decentralized basis in the divisions and at the investees. Countermeasures are introduced immediately, their effects are assessed and the information is incorporated into the plans in a timely manner. This means that the Board of Management always has access to an overall picture of the current risk situation through the documented reporting channels.

We are prepared to enter into transparent risks that are proportionate to the benefits expected from the business.

## INDIVIDUAL RISKS

The following information on individual risks relates to the 2008 to 2010 planning period.

### Macroeconomic risk

High energy and commodity prices, growing protectionism and ongoing imbalances in foreign trade pose significant risks to global economic growth. In particular, these factors could result in higher inflation rates, rising interest rates, sharper fluctuations in exchange rates and consequently a significant reduction in global economic growth. A possible recession in the USA would further exacerbate these trends. Changes in legislation, taxes or customs duties in individual countries may also result in significant risks for the Volkswagen Group. In the following sections on the individual risk categories, we explain how we manage these threats.

### Sector-specific risk

In 2007, the growth drivers of the global passenger car markets were Asia, South America and Central and Eastern Europe. However, in some of the countries in these regions, there are high customs barriers or minimum local content requirements for domestic production. These factors make it difficult to achieve a larger increase in sales volumes. Our substantial market coverage in traditional markets entails risks that relate mainly to price levels. For example, massive discounts, mainly in the US automotive market, but also in Western Europe and China, continue to place the entire sector under pressure. Faced with these conditions, we felt compelled to maintain our sales promotion activities at the previous year's level. As a supplier of volume models, we would be particularly affected if competing manufacturers were to step up their sales incentives again. We continue to approve loans for vehicle finance on the basis of the same cautious principles applied in the past, taking into account regulatory requirements of section 25a(1) of the Kreditwesengesetz (KWG – German Banking Act).

We would be especially hard hit by a fall in demand or prices in Western Europe since we sell the majority of our vehicles in this market. We counter this risk with a clear, customer-oriented product and pricing policy. Overall however, our delivery volume outside Western Europe is widely diversified across the markets of North America, South America/South Africa, Asia Pacific and Central and Eastern Europe. We hold, or intend to attain, a leading position in a number of established and emerging markets. This means that we are well able to balance shifts in volumes between the individual markets. In addition, we are able to meet regional requirements by forming strategic partnerships.

Ever tougher lending conditions make it difficult for our dealerships and sales companies to finance their operations via bank loans. We have minimized the risk of their insolvency by setting up our own system of support, whereby we offer automotive dealers and outlets financing on attractive terms via our financial services companies.

#### Research and development risk

With the help of extensive trend analyses, customer surveys and scouting activities, we counter the risk that customers might not embrace our new products. By taking these measures, we ensure that trends can be recognized at an early stage and that their relevance for our customers is verified in good time.

Another risk is that products or modules cannot be developed in accordance with the specified deadlines, costs or quality standards. We therefore continuously and systematically monitor the progress of all projects and make changes to reflect the original targets. If there are deviations from targets, countermeasures can be taken in good time. Furthermore, our project organization supports all areas involved in the process, ensuring that they work together effectively. This enables requirements to be presented and activities planned in good time.

Risks are not concentrated on particular patents or licenses due to our wide variety of research and development activities.

#### Procurement risk

2007 saw a continuation of the global increase in commodity prices. In addition to the ongoing price inflation in individual commodities, price increases driven by speculative trading, particularly in exchange-traded commodities, also had a major impact. We counter these trends by means of targeted hedging strategies. The use of materials is continually being optimized in cooperation with Research and Development and Production. In addition, intensive studies are carried out to determine whether alternative or recycled materials can be used.

Our cooperation with suppliers can also give rise to risks. We are therefore organizing our portfolio of suppliers for the coming years strategically, bearing in mind local procurement opportunities in particular. These activities continue to focus on Asia and Eastern Europe. The installed risk management system, in which we record information on the creditworthiness of our suppliers, protects us against the effects of insolvency on the part of individual suppliers.

#### Production risks relating to demand

Changes in global demand for passenger cars can affect the number of vehicle types produced. If our production plants are working largely to capacity at a time of above-average demand, there is a risk of supply shortages, for example. We counter this risk by means of our flexible production management. This is achieved primarily through our turntable concept. Flexible working time models offer further opportunities to make adjustments.

#### Risks arising from changes in demand

Consumer demand depends not only on real factors such as disposable income, but also to a significant extent on psychological factors that are impossible to plan for. A combination of higher commodity prices and the uncertainty surrounding future CO<sub>2</sub> emission taxation may lead to unexpected consumer reluctance to spend, which may in turn be exacerbated by media reports. This is particularly the case in saturated markets such as Western Europe, where demand may plummet as a result of owners keeping their vehicles for longer periods. We attempt to counter this consumer reluctance to spend through our fuel and drivetrain strategy, by offering attractive new models and by maintaining an intense customer focus.

Furthermore, if the final details of a CO<sub>2</sub> tax for Europe are worked out, this may cause a shift in demand towards certain types of engine within the range and thus have a detrimental effect on our financial results.

In the rapidly expanding markets of Asia and Eastern Europe, risks can also arise due to government intervention when lending restrictions and tax increases have an adverse effect on private consumption.

Demand risks can also arise owing to further increases in oil prices. We counter these risks by developing fuel-efficient vehicles and alternative fuels as part of our fuel and drivetrain strategy.

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### Dependence on fleet customer business

The Volkswagen Group's share of the fleet customer segment, which is considerably less dependent on the macroeconomic environment than the private customer segment, remained unchanged at 44% in 2007. Fleet customer business therefore helped the Group to attain a record market share in Germany. Given the large number of new models, the positive trend in fleet customer business is expected to continue in 2008. With the Golf Variant available for the first time for the full twelve months of the year and the Audi A4 Avant available from spring 2008, we are in a good position going forward. In its activities in the corporate fleet segment, the Škoda brand succeeded for the first time in becoming one of the leading German importers in 2007.

Fleet customer business continues to be marked by increasing concentration and internationalization. Thanks to its extensive product range and target group-oriented customer care, the Volkswagen Group was also able overall to extend its market leadership in Europe. Default risks are not concentrated on individual corporate customers.

### Quality risk

The ever increasing complexity of the vehicles and the introduction of new environmentally-friendly technologies such as hybrid drives present hitherto unknown challenges for the quality assurance function. In this context, new expertise and more extensive safety mechanisms are being developed and built up in close cooperation with Procurement and our suppliers, thereby minimizing quality-related risks from the outset.

### Personnel risk

The Volkswagen Group has an established position in the global marketplace where it competes for specialist and management personnel. The knowledge and expertise of our employees constitute one of our most important success factors. There is a risk that knowledge – and therefore market advantages – will be lost as a result of employee turnover and the part-time scheme for employees near to retirement. Through intensive

knowledge management, we are endeavoring to retain existing know-how in the company and to transfer it to other employees. We do so using suitable tools such as the “knowledge relay”, whereby the practical knowledge of leaders and experts leaving the company is systematically transferred to their successors. In addition, we offer our employees, management and leaders a broad and tailored range of development programs and incentive systems. Our aim here is to position the Volkswagen Group as a top employer and build employee commitment. As well as this, our wide range of training ensures that we have highly skilled new employees.

### Environmental protection regulations

On July 1, 2002, the European End-of-Life Vehicles Directive was transposed into German law by way of the *Altfahrzeuggesetz* (German End-of-Life Vehicles Act). This act guarantees that end-of-life vehicles will be disposed of free of charge through the collection points designated by manufacturers and importers. This initially applied only to vehicles registered after the law came into force, but as of January 2007, it was extended to all end-of-life vehicles. At present, we are unable to conclusively assess the impact of the EU's eastward enlargement on the collection of end-of-life vehicles. As a result, no clear forecast can be made regarding the likely financial burden on the Volkswagen Group in individual EU member states. We have reviewed our existing provisions. In addition, our systems and cooperation arrangements for disposing of end-of-life vehicles offer us the opportunity to manage this risk.

Conventional air conditioning systems still contain hydrochlorofluorocarbons (HCFCs) as a cooling agent. EU legislation stipulates that, as of January 1, 2010, only recycled material may be used in existing systems for the purpose of maintenance. Since there is no market for recycled cooling agents at the present time, bottlenecks may occur in Volkswagen AG's systems as of 2010. As of January 1, 2015, the use of all HCFCs will be prohibited in Europe. Without sufficiently early investment in alternatives, this could lead to production facilities being shut down temporarily, which in turn would lead to loss of production. In view of this, Volkswagen will develop and

implement a program in the coming years in order to phase out the use of this agent. At the Group's environmental conference in December 2007, a working group elaborated the main elements of a phase-out strategy. The measures required to implement that strategy will be incorporated into future investment plans.

Chlorine-free fluorocarbon refrigerants (F gases), which were introduced in the past to replace the aforementioned HCFCs, are also subject to restrictions owing to their damaging effect on the earth's climate. As of 2007, there have been increased requirements for maintaining systems and verifying the absence of leaks. This means that, depending on their size, systems must be inspected several times a year by certified refrigeration specialists. In order to meet these requirements, "LEC" (Leakage and Energy Control) software was introduced at Volkswagen AG's plants, thereby enabling stationary air conditioning systems to be managed and controlled.

As regards emissions legislation, the EU decided on a wide range of stricter requirements, primarily affecting diesel technology. However, in the case of light and medium passenger cars, these requirements will be met by optimizing current technology. In the case of heavy passenger vehicles, the rules as they currently stand require that an aftertreatment system for nitrogen oxide be introduced. As the automotive industry has no experience of nitrogen oxide emissions aftertreatment for diesel vehicles and as the technology that must now be developed will require additional equipment and servicing, it is not possible to predict how customers will accept heavy passenger cars in future. The cost difference compared with petrol engines will also increase further. In future, diesel engines will also have to reposition themselves with regard to the obligation to add biofuels to fossil fuels, since diesel particulate filter technology does not permit any significant increase in the amount of biofuels added.

Reductions in greenhouse gas emissions are being intensively pursued by the global community and in particular by the EU and the Federal Republic of Germany. The climate and energy plan decided by the EU in March 2007 states that, by 2020, it aims to reduce greenhouse gas emissions by at least 20% compared with 1990 levels and to expand renewable energies to 20%. The Federal Republic of Germany aims to reduce greenhouse gas emissions by 40% over the same period. The key issues paper on an "Integrated climate and energy program" decided by the federal government in September 2007 lists individual measures that are intended to help increase energy efficiency and expand renewable energies. Key elements of this package, such as expanding renewable energies in the heat and electricity markets and updating the Energieeinsparverordnung (EnEV – German Energy Conservation Regulation), may lead to new requirements regarding the construction and renovation of buildings. In future, energy tax relief for industry is to be linked to the introduction and implementation of the planned energy efficiency improvement processes (energy management systems). There is also the risk of further price rises in the energy sector, for example as a result of supply shortages and tax increases to finance individual measures in the key issues paper. Volkswagen is using an energy management system and energy conservation programs to counteract the possible financial repercussions and risks to its image. Furthermore, there is a general risk of increased environmental protection regulations with a view to limiting global carbon dioxide emissions.

The Umweltschadensgesetz (USchG – German Environmental Damage Act), which came into force on November 14, 2007, increases the liability of companies for damage to flora and fauna, irrespective of whether the operator is guilty of any misconduct. Previously, liability extended only to incidents that caused third parties to

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suffer personal injury, damage to property or loss of financial assets. In order to assess the risk, the Group needs to establish which animal or plant species receiving special protection under EU law are native to the area of each of its European locations and under what conditions they might be at risk. This information will provide the basis for appropriate insurance protection. The investigation began in October 2007 with a pilot project at the Emden plant, which was successfully completed in the same month. These investigations will be rolled out to our other German locations in early 2008. The environmental management systems introduced and certified at all Volkswagen locations will help to reduce the risks.

#### Legal cases

In the course of their operating activities, Volkswagen AG and the companies in which it is directly or indirectly invested become involved in legal disputes and official proceedings in Germany and internationally. In particular, such proceedings may occur in relation to suppliers, dealers, customers, or investors.

For the companies involved, these may result in payment or other obligations. Particularly in cases where US customers assert claims for vehicle defects individually or by way of a class action, cost-intensive measures may have to be taken and substantial compensation or punitive damages paid.

Where transparent and economically viable, adequate insurance cover is taken out for these risks and appropriate provisions recognized for the remaining identifiable risks. The Company does not believe, therefore, that these risks will have a sustained effect on the economic position of the Group.

However, as some risks cannot be assessed or can only be assessed to a limited extent, the possibility of loss or damage above and beyond the insured and recognized amounts cannot be ruled out.

The lawsuit challenging the resolutions adopted by the Annual General Meeting of Volkswagen AG on June 7, 2001 relating to approval of the actions of the then members of the Board of Management and of the Supervisory Board for fiscal year 2000 and to the authorization to acquire treasury shares issued on that occasion has been settled. The plaintiff, Liverpool Limited Partnership, Bermuda, and Volkswagen AG together notified the Braunschweig Regional Court on June 4, 2007 that the matter has been settled. The action to set aside the shareholder resolutions does not therefore affect the validity of the resolutions by the Annual General Meeting. This, together with the corresponding agreement between the parties, was published in the electronic *Bundesanzeiger* (Federal Gazette) on June 8, 2007.

The public prosecutor's office in Braunschweig has carried out investigations following criminal charges filed by Volkswagen AG in June 2005 relating to the establishment of front companies, false expenses claims and privileges for works council members. At the beginning of July 2005, Volkswagen AG had also commissioned auditors KPMG to conduct internal investigations. As not all of the investigations and legal proceedings have been completed with a final and non-appealable decision reached, it has not been possible to conclusively examine the possibility of recourse against the persons in question. Based on the findings in the KPMG report, Volkswagen AG had already received insurance settlements in the amount of €4.5 million in fiscal year 2006.

### Risks arising from financial instruments

The Executive Committee for Liquidity and Foreign Currency approves risk limits, authorized financial instruments, hedging methods and horizons, and decides on the introduction of country risk limits. Risk management and control activities are the responsibility of Group Treasury. The Group Board of Management is informed of the current risk situation on a regular basis.

Our business activities entail financial risks that may arise from changes in interest rates, exchange rates, commodity prices and fund prices. We manage these risks by employing primary and derivative financial instruments. Financial transactions are only entered into with prime-rated counterparties. Interest rates and currencies are mainly managed centrally by Group Treasury. The Group guards against interest rate risk and risks arising from fluctuations in the value of financial instruments by means of interest rate swaps, cross-currency swaps and other interest rate contracts. Financing extended to subsidiaries within the Volkswagen Group is usually hedged by matching the amount and maturity of the refinancing.

We reduce currency risks primarily through natural hedging, that is to say through the flexible management of production capacity at our global locations. The remaining currency risk is hedged by means of financial hedging instruments such as currency forwards, currency options and cross-currency swaps. We use these transactions to limit the currency risk associated with forecasted cash flows from operating activities and intra-Group financing in currencies other than the respective functional currency. These contracts may have a term of up to five years. The transactions are mainly used to hedge the euro against the US dollar, the pound sterling, the Swiss franc, the Japanese yen, the Russian rouble and the Swedish krona. Together, these six currencies represent around 90% of our foreign currency risk from forecasted cash flows.

The purchasing of raw materials gives rise to risks relating to availability and price trends. We limit these risks by entering into forward transactions. We have used appropriate contracts to hedge some of our requirements for commodities such as aluminum, copper, platinum, rhodium and palladium over a period of up to 60 months.

### Liquidity risks

By means of a liquidity forecast with a rolling planning horizon and the maintenance of sufficient liquidity reserves, we ensure that the Company is solvent at all times.

We cover the capital requirements of the growing financial services business mainly through borrowings at matching maturities raised in the national and international financial markets. This will remain our preferred financing option in future. Loan finance will be used only for short-term working capital requirements and as a backup for debt issuance programs. We manage risks arising from cash flow fluctuations through liquidity reserves and confirmed credit lines. This extensive range of options rules out the possibility of any liquidity risk to the Volkswagen Group.

A rating downgrade could adversely affect the terms attached to the Volkswagen Group's borrowings.

Since 2004, Volkswagen Bank GmbH has been given a separate rating by Moody's Investors Service. In 2006, we were also able to obtain a separate rating for Volkswagen Bank GmbH from Standard & Poor's. The rating given to Volkswagen Bank GmbH by both Standard & Poor's and Moody's Investors Service is one notch higher than that of Volkswagen AG and Volkswagen Financial Services AG. The ratings of both agencies are thus oriented more on Volkswagen Bank GmbH's own business and financial situation. This provides a good opportunity for Volkswagen Bank GmbH to secure attractive borrowing terms. For the current ratings of Volkswagen AG, Volkswagen Financial Services AG and Volkswagen Bank GmbH, plus information

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on our new issues in the capital market in fiscal year 2007, please see the Shares and Bonds chapter on page 128 of this report.

The Treasury department of Volkswagen Financial Services AG safeguards the liquidity of the Financial Services Division as well as managing credit, default and market risks. Risk Controlling is responsible for measuring, analyzing and monitoring market risk positions.

In the Notes on pages 240 to 249, we explain our hedging policy, the hedging rules and default and liquidity risks, quantify the hedging transactions mentioned and outline the market risks within the meaning of IFRS 7.

#### Residual value risk in the financial services business

In the financial services business, we agree to buy back selected vehicles at a residual value fixed at inception of the contract so that we are able to realize market opportunities. We evaluate these lease contracts at regular intervals. We take the necessary precautions in the event of potential risks.

#### IT risk

We use redundant firewall systems to protect our IT systems against unauthorized access from outside. Virus scanners and restricted physical and data access rights offer additional protection. We are constantly checking

and updating the information security systems in use and back up all data resources daily. Thanks to the measures taken, we consider the likelihood of a threat to our information systems and the security of our data to be very low.

#### Other factors

In addition to the risks already outlined, there are other factors that cannot be predicted and are therefore difficult to manage. These could have an adverse effect on the further development of the Volkswagen Group. These factors include natural disasters, epidemics and terror attacks.

#### SUMMARY OF THE RISK SITUATION OF THE GROUP

The Company's overall risk situation results from the individual risks described above. Our comprehensive risk management system ensures that these risks are controlled. Furthermore, taking into account all the information known to us at present, no risks exist which could pose a threat to the continued existence of the Volkswagen Group.

#### REPORT ON POST-BALANCE SHEET DATE EVENTS

No significant events other than those already mentioned occurred after the end of the fiscal year.