The following significant features of the system of internal controls over financial reporting have been implemented within the Schaeffler Group as part of this process:

- An accounting manual sets out uniform accounting policies, taking into account new IFRS financial reporting standards required to be applied for the first time.
- Closing instructions issued quarterly provide Schaeffler AG subsidiaries with information on all relevant issues regarding the content as well as the processes and deadlines for compiling the financial statements.
- Tasks and responsibilities regarding the compilation of the separate and consolidated financial statements are clearly defined and assigned.
- The operating units and the various staff members involved in the process stay in close contact on matters concerning accounting, financial statement compilation, and quality assurance with respect to financial statement compilation.

The process for compiling the separate and consolidated financial statements itself is secured by numerous control activities, taking into account materiality. In particular, these include extensive systems-based reasonability checks, controls using reviews (by a second member of staff) performed on a regular basis, and analyses and reasonability checks of the quarterly and annual consolidated financial statements at the corporate level.

As at each year-end, management assesses the appropriateness and effectiveness of the ICS in place. To this end, the Schaeffler Group uses a standardized methodology to identify the group companies and processes relevant to ICS, define the required controls and document them in accordance with uniform requirements. This is then followed up with a review of the effectiveness of the defined controls that is performed using a risk-based approach, either by the reporting unit itself, by internal audit, or as part of the audit of the consolidated financial statements.

These arrangements as well as their continuous improvement are designed to provide reasonable assurance that the ICS prevents significant misstatements of the financial statements and consolidated financial statements and to ensure quality standards are maintained in compilation, preparation, and issuance.

The Board of Managing Directors considers the system of internal controls over the compilation of the annual and consolidated financial statements of Schaeffler AG to be effective for 2016.

4.3 Risks

The risks set out below could take on a medium or high impact on the Schaeffler Group's earnings, financial position, and net assets within the planning horizon. Risks are divided into strategic, operating, legal, and financial risks and are described in decreasing order of the magnitude of their impact on Schaeffler's net assets, financial position, and earnings. Unless the extent to which one or both divisions are affected by these risks is explicitly described, the discussion of the risks relates to both of the Schaeffler Group's divisions.

Strategic risks

The key operating risks of the Schaeffler Group are described below.

Electric mobility

Electrification is progressing, and as a result, the further development of conventional drive trains is coming under pressure. Firstly, improvements to conventional drive trains will become less relevant, and secondly, existing products/applications will be replaced. The Schaeffler Group has established its electric mobility business field with the intention of creating a portfolio of products for this field designed to offset any potential future losses in revenue from conventional drive trains. Should the initiatives undertaken not have the desired effect, this could have a medium impact on the Schaeffler Group's financial position and earnings.

Digitalization

Digitalization is progressing rapidly and has already completely transformed certain sectors. The Schaeffler Group recognized the issue of digitalization early on, has developed a digitalization strategy – its "Digital Agenda" – and is in the process of implementing it at a rapid pace. The pace of implementation and adaptation represents an important success factor in this regard and, therefore, also a risk. Digitalization is also affecting the work place and will lead to changes in the working environment. As part of the "Digital Agenda", employees with varying skills and qualifications are increasingly confronted with new products, processes, and structures requiring extensive training and also re-qualification. The Schaeffler Group has focused on this issue early on. However, should the Schaeffler Group nevertheless be unable to overcome these challenges as quickly as necessary, this could have a medium impact on the group's financial position and earnings.

Strategic market risks

The markets for the products the Schaeffler Group offers are subject to significant technological change, continuously developing technological standards, changing customer preferences, and constantly emerging innovative products. Existing technologies and products may be entirely replaced by newly developed and marketed technologies and newly introduced products. For instance, the Schaeffler Group holds an excellent competitive position with respect to drive trains based on the internal combustion engine. This exceptional position may be jeopardized by the loss of the competitive advantage as well as by expiry of key patents.

The Schaeffler Groups high-margin component business is facing considerable pricing pressure driven by increasing demands for price reductions on the part of customers, purchasing cooperatives, and certain, more focused and leaner competitors, especially in the emerging markets. The company is currently not passing these demands for extensive price reductions on to its own suppliers and cannot fully absorb them with its existing structure.

The Schaeffler Group's competitiveness depends fundamentally on its ability to keep up with the technological developments discussed above, maintain its technology leadership, and continue to manufacture innovative products cost effectively. Not achieving this objective would represent a medium risk to the Schaeffler Group's financial position and earnings that would last beyond the planning horizon.

Operating risks

The key operating risks of the Schaeffler Group are listed below.

Market developments

As the Schaeffler Group is a global supplier in the automotive and industrial sector, demand for Schaeffler products is to a large extent driven by global economic conditions. The demand for products of the Automotive division depends considerably on the overall economic trend. This also applies to the engineering sector and industrial growth markets such as renewable energy. In addition, demand is subject to cyclical fluctuations.

In the Automotive division, demand is not only affected by global economic conditions, but also by other factors such as changes in consumption patterns, fuel prices, interest rate levels, and others. The large number of economic factors affecting global demand for automobiles leads to significant volatility in automobile production, which makes forecasting sales exactly considerably more difficult. Demand for Industrial products is influenced by a wide range of factors due to the large variety of business fields in which the Schaeffler Group operates. Renewable energy depends heavily on government subsidies. Sales of production machinery, on the other hand, depend on new developments and the resulting need for capital expenditures. Aerospace benefits from various new technological developments. Individual drivers can be identified for each sector. Adverse trends in individual markets could have a medium impact on the Schaeffler Group's financial position and earnings.

Loss of market share

The Schaeffler Group operates in a highly competitive and technologically fast-paced environment. As a result, the company is exposed to the risk of being displaced by existing or new competitors and of its products being replaced by product innovations or by new technological features. Especially the automotive supply sector is characterized by a high level of capital expenditures, a high rate of technological change, constant progress in production technology and high pressure on pricing from OEMs. The Schaeffler Group's key customers include well-known OEMs and suppliers who are themselves subject to significant competitive pressure with respect to innovation and costs and, therefore, strive to obtain price reductions both during the bidding process and throughout the term of supply agreements. To prevent constant price adjustments from impairing margins, the Schaeffler Group is forced to continually improve its production process and reduce expenditures. The Schaeffler Group mainly competes with other international suppliers, and to some degree also with regional suppliers, on price, quality, reliability of supply, and design, as well as on the ability to offer technological support and service worldwide. Should the company become no longer able to compete on one of these factors, customers may decide to obtain products and services from competitors. As a result of the intense competition in the automotive supply sector, Schaeffler considers the risk of losing market share in the Automotive division higher than in the Industrial division. Besides the price, another deciding factor in the Industrial division and in the Aftermarket business is the ability to deliver, which is constantly being enhanced by systematic improvements in production and delivery logistics.

Loss of market share could have a medium impact on the Schaeffler Group's earnings and financial position. Close cooperation with the Schaeffler Group's key customers on product development and strict product quality control measures reduce the likelihood of substitution and, at the same time, help maintain price levels.

Dependence on customers

The Schaeffler Group's key customers represent a substantial proportion of the Schaeffler Group's revenue. Despite this, the company's dependence on individual OEMs or suppliers is limited, since Schaeffler provides a large variety of products to various regions and applications. Thus, individual Schaeffler products may be substituted, but the probability that the customer will completely terminate the relationship is low and such a termination would require a longer period of time. Nevertheless, substitution of individual products can also have a medium impact on the Schaeffler Group's financial position and earnings.

Production risk

As the Schaeffler Group's production is very capital-intensive, a large proportion of its costs are fixed. At several locations, ensuring the best-possible utilization of capacity requires having only one of a given type of machine available. The failure of one of these bottleneck machines can lead to a bottleneck in supply to internal and external customers. The period between failure of the bottleneck machine and when alternative means of production are set up is key. Alternative means of production can either be set up by a Schaeffler Group plant with comparable production lines or provided by an alternative supplier. Establishing safety stock can also help reduce losses. To minimize the probability of occurrence, the risk is mitigated by extensive maintenance. However, failure of a bottleneck machine represents a medium risk to the Schaeffler Group's financial position and earnings.

Warranty and liability risks

One significant factor in customers' decision to purchase the products offered by the Schaeffler Group is their high quality. To secure this level of quality for the long-term, the Schaeffler Group employs a certified quality management system, supported by additional quality improvement processes. However, there is a risk that poor quality products end up getting delivered, causing product liability risk. The use of defective products can lead to damage, unplanned repairs, or recalls on the part of the customer which can result in liability claims or reputational damage. Furthermore, deteriorating product quality can result in increased warranty and liability risk vis-à-vis the Schaeffler Group's customers. The Schaeffler Group responds to such risks by adopting strict quality control measures and continually improving its production processes in order to minimize the probability of warranty and liability risks materializing. Individual risks becoming reality could have a medium impact on the Schaeffler Group's financial position and earnings. All product liability risks are insured. The extent of actual reimbursements that can be claimed from insurers can only be assessed on a case-by-case basis.

Product piracy risks

The Schaeffler brands INA, LuK, and FAG are associated with a high standard of quality, making them increasingly susceptible to product piracy. Counterfeit products are normally sold at significantly reduced prices, which can lead to increased pressure on the Schaeffler Group's prices. Combating product piracy is a high priority for the Schaeffler Group. The Schaeffler Group protects intellectual property not only using global patents and industrial property rights but also by actively combatting counterfeit products, which damage its image as well as its revenue. Based on the large number of counterfeit products seized, the Schaeffler Group estimates the impact of this issue on its earnings and financial position to be medium.

Legal risks

The Schaeffler Group's operations give rise to legal risks, for instance those resulting from non-compliance with relevant regulations. Legal risks are reflected in provisions recognized in accordance with financial reporting standards and are not quantified further within risk management system.

Antitrust proceedings

Current and future investigations and proceedings regarding violations of antitrust law could have an adverse impact on the financial position and earnings of the Schaeffler Group as well as on its reputation. Possible payment obligations in connection with these investigations and proceedings may result in unplanned cash outflows. The Schaeffler Group cooperates with the investigating authorities in current and future investigations as a matter of principle. The imposition of penalties cannot be ruled out. In Spain and Korea, the company has appealed judgments imposing penalties.

In addition, claims for damages have been filed against Schaeffler Group companies as a result of known antitrust proceedings. These claims could have a medium impact on the Schaeffler Group's financial position and earnings. The Schaeffler Group has recognized appropriate provisions for possible charges to earnings.

Litigation

Certain Schaeffler Group companies are involved in various legal cases or could become involved in additional litigation. These could lead to claims for damages or to other claims. In addition, the company's or their opponents' legal expenses could be significant. These legal cases are mainly related to the Schaeffler Group's sales and purchases of goods and services. Existing legal cases could have a medium impact on the Schaeffler Group's financial position and earnings.

Compliance risks

As a company with operations worldwide, Schaeffler has to comply with varying laws and regulations around the globe. It is possible that violations of existing law occur despite careful observance of such legal requirements. The consequences of such instances of non-compliance could have a negative impact on the Schaeffler Group's net assets, financial position, and earnings as well as on its reputation. The Schaeffler Group will cooperate with the authorities with respect to any current or future instances of non-compliance and will respond appropriately to weaknesses identified.

See chapter entitled "Governance structure" for a discussion of the company's compliance management system.

The company uses a material compliance management system to help it meet its commitment to using only components and raw materials that comply with the applicable laws and regulations. However, there is a risk that legal requirements and changes therein are not identified in time and that products are distributed in the market in violation of the law. This could have a medium impact on the Schaeffler Group's financial position and earnings.

Financial risks

Financial risks include tax risks and pension risks as well as the impact of changes in foreign exchange rates and liquidity risks.

Tax risks

The Schaeffler Group is subject to tax audits worldwide. Tax authorities' interpretation of the tax law or of relevant facts made in current or future tax audits may differ from that of the Schaeffler Group. This may lead to adjustments to tax bases and increases in the tax liability. An adjustment to the tax base can have a high impact on the Schaeffler Group's financial position.

Pension risks

The Schaeffler Group has extensive pension obligations, particularly in Germany, the U.S., and the United Kingdom. The obligations in the Anglo-Saxon countries are financed by pension funds. Pension obligations are measured using actuarial valuations based on assumptions regarding possible future events, such as the discount rate, increases in wages, salaries, and pensions, and statistical life expectancy. Plan assets may be invested in various asset classes, such as equity instruments, fixed-income securities, or real estate, which are subject to fluctuations in value. A change in the parameters listed above can have a medium impact on the Schaeffler Group's net assets, particularly in Germany and the United Kingdom.

Currency risks

The Schaeffler Group is exposed to a wide range of currency risks due to its international reach. The largest such currency risks from operations result from fluctuations in the U.S. Dollar and Chinese Renminbi exchange rates.

Currency risks from financing activities arise mainly from the impact of changes in the U.S. Dollar exchange rate on the portion of bonds issued in U.S. Dollars that is not hedged.

Currency risks from operations and from financing activities are continually monitored and reported. Currency risk is managed at the corporate level. Currency risks are aggregated across the group and hedged using hedging instruments. Hedging instruments used include forward exchange contracts and cross-currency swaps. Currency risks, market values of foreign currency derivatives, and developments in foreign exchange markets are continuously monitored and managed as part of the risk management system.

To the extent competitors from other currency areas can offer lower prices due to movements in exchange rates, changes in foreign exchange rates can adversely affect the Schaeffler Group's competitive position. The Schaeffler Group's manufacturing locations are spread around the world, enabling the group to reduce the impact of changes in exchange rates on its competitive position. However, exchange rate trends can have a medium impact on the Schaeffler Group's earnings and financial position.

Liquidity risks

The risk that the Schaeffler Group will not be able to meet its payment obligations as they come due is referred to as liquidity risk. The Schaeffler Group differentiates between short-, medium- and long-term liquidity risks.

Liquidity risks can arise if financing needs cannot be met by existing equity or debt financing arrangements. The Schaeffler Group's financing requirements were met throughout the year 2016 by existing financing instruments and by the refinancing arrangements completed.

To avoid unforeseen short- or medium-term liquidity needs to the extent possible, short- and medium-term liquidity risk is monitored and managed using a rolling liquidity budget with a forecasting period of up to twelve months. Short-term fluctuations in cash flow are monitored daily and can be offset using lines of credit. To this end, the Schaeffler Group has a revolving credit facility of EUR 1.3 bn and other bilateral lines of credit held by various subsidiaries.

The Schaeffler Group's loan and bond agreements, which are generally long-term, contain certain constraints including a requirement to meet certain financial covenants. The creditors are entitled to call the debt prior to maturity under certain circumstances, including if covenants are not met, which would result in the debt becoming due immediately. Compliance with financial covenants is monitored on an ongoing basis and regularly reported to the lending banks. To date, the company has complied with the financial covenants as stipulated in the debt agreements. The Schaeffler Group also expects to comply with these covenants in the future.

Any non-compliance with the covenants contained in the debt agreements as well as any liquidity requirements exceeding those that can be covered by the existing lines of credit can have a medium impact on the Schaeffler Group's net assets, financial position, and results of operations. It is considered improbable that these situations will actually occur.

Risk assessment No. 065

	Amount of damage in €	Probability of occurrence in %	Impact	Change from prior year
Strategic risks				
• Electric mobility	high	improbable	medium	new
• Digitalization	medium	possible	medium	new
• Strategic market risks	medium	possible	medium	→
Operating risks				
• Market developments	high	improbable	medium	new
• Loss of market share	high	improbable	medium	↗
• Dependence on customers	low	highly probable	medium	new
• Production risk	high	improbable	medium	→
• Warranty and liability risks	high	improbable	medium	→
• Product piracy risks	low	probable	medium	→
Legal risks				
• Antitrust proceedings	low	probable	medium	→
• Litigation	medium	possible	medium	↗
• Compliance risk	high	improbable	medium	new
Financial risks				
• Tax risks	high	highly probable	high	→
• Pension risks	high	possible	medium	→
• Currency risks	medium	possible	medium	↘
• Liquidity risk	high	improbable	medium	→

4.4 Opportunities

The responsibility for identifying and utilizing opportunities lies with operating management. Opportunities are discussed with the Board of Managing Directors during the regular Strategy Dialog and, based on these discussions, strategies are derived to determine the future direction of the Schaeffler Group.

An aggregated overview of the opportunities identified in the Strategy Dialog is included in the reports regularly provided to the Board of Managing Directors and the Supervisory Board of Schaeffler AG. Opportunities are documented in the risk management tool.

The Schaeffler Group's most significant opportunities lie in strategic trends and in changes to the legal environment that may lead to increased demand for Schaeffler products.

Strategic opportunities

The Schaeffler Group with its range of products and services and its global presence is in a good position to participate in the expected megatrends of the future.

The Schaeffler Group's strategic and operational opportunities specifically result from the following factors:

Globalization

Shifting activities to local markets could enable the Schaeffler Group to tap opportunities for reducing cost and to improve proximity to the customer. The company also identifies and realizes additional potential worldwide. This also bolsters the company's competitive position vis-à-vis competitors from low-wage countries.

Potential in emerging countries

Increasing affluence in the emerging countries results in the development of a growing middle class there. The newly emerging group of buyers can lead to increasing demand for automobiles and industrial goods. The Schaeffler Group is a supplier to all well-known OEMs and suppliers, generally providing an opportunity to participate in increased demand. The company has invested in significant additional resources in order to increase its local presence in the emerging countries, and plans to continue to pursue this growth strategy.

Electric mobility

Increasing demands on OEMs to reduce fuel consumption and emissions as well as increased safety requirements provide the Schaeffler Group with an opportunity to increase its revenue per vehicle. A related issue is the increasing complexity of systems, which provides the opportunity to add new functionalities to its