Risk and Risk Management

De La Rue's reputation is based on security, integrity and trust. This section therefore only summarises the types of risks which are either specific to the continuing businesses of De La Rue or which could have a material, adverse effect on the Group, following the disposal of the Cash Systems business. It also describes the risk management systems and processes in place and significant events during 2008/2009.

No business is risk free even if it has detailed processes and procedures for identifying and managing risks. The Combined Code on Corporate Governance requires the Board to maintain a sound system of internal control to safeguard shareholders' investment and the Company's assets and at least annually to conduct a review of the effectiveness of the Group's system of internal controls. The Board carried out its annual review which covered all material controls, including financial, operational and compliance controls and risk management systems. Additionally, the Board received information about the Group's operations throughout the year enabling it regularly to evaluate the nature and extent of the risks to which the Company is exposed. The Board is therefore able to confirm that its system of internal control has been in place throughout 2008/2009.

Internal Control and Internal Financial Control

The Board has overall responsibility for the Group's system of internal control and for reviewing its effectiveness. It relies on the Audit Committee and Risk Committee to assist in this process. Details of the Audit and Risk Committees are set out in the Corporate Governance Statement.

Management is responsible for implementing the controls which are designed to meet the particular needs of the Group, and the risks to which it is exposed, with procedures intended to provide effective internal control. Business Unit Managing Directors, to whom general managers of smaller businesses report, are responsible for establishing and maintaining these procedures.

The controls by their nature are designed to manage rather than eliminate risk and can only provide reasonable but not absolute assurance against material misstatement or loss. The processes used by the Board and, on its behalf, by the Audit and Risk Committees have been in place throughout the year, and include:

- reviewing:
  - monthly finance, operational and development reports;
  - internal and external audit plans;
  - significant issues identified by internal and external audits;
  - significant Group risks and risk mitigation actions reported by the Risk Committee including updates to the Group's risk register;
  - annual compliance statements in the form of self-audit questionnaires;
  - reports on other such matters as security, health and safety, environmental issues and fire risks; and
- discussing with management risks identified by management and/or the audit process and any changes from the previous review.

The financial control framework includes the following key features:

- an annual strategic planning process;
- an annual budget;
- a system of monthly reporting by each operating subsidiary which involves comparison of actual results with the original budget and the updating of a full year forecast;
- monthly reporting of performance to the Board;
- audited annual financial statements; and
- interim financial statements reviewed by the auditors.

The main control procedures which address the financial implications of the major business risks are centred on strict approval procedures. These are reviewed annually, approved by the Board and apply to all subsidiaries. They include:

- executive Directors' approval of all major non-routine revenue expenditure;
- Board approval of all major capital expenditure;
- Board approval of all acquisitions and disposals;
- a system of authorisation limits which cascades throughout the Group; and
- Board consideration of any matter having a material effect on the Group.

The operation of the Group Treasury department is discussed in the Financial Review on page 38.

Following the disposal of Cash Systems, the internal audit function was outsourced entirely to Ernst & Young who have, in conjunction with senior management and the Audit Committee, carried out a review of the focus of, and way in which internal audits will be carried out in the future with the objective of targeting resources better and improving the process.

Specific Risks

Strategy, Technology, Competition and Market Concentration

The Group's strategy and progress in implementing it is outlined on pages 20 to 33. The Board is responsible for strategy, carrying out an annual review based upon extensive, detailed reviews of individual businesses' plans.

De La Rue operates in niche markets principally based on the production and management of cash. The main strategic threat is perceived to be a technological revolution which renders cash obsolete, such as e-cash.

The business primarily operates in developing countries with approximately 85 per cent of its customer base outside Europe and the USA. Such developing countries are likely to be significantly behind any trend to e-cash technologies. Even in the UK, banknote volumes have not been significantly eroded by existing cashless payment methods such as debit and credit cards.

In addition, such technologies require critical mass to gain credibility and this in turn requires an established common infrastructure to support it. Finally, cultural factors in many countries maintain strong demand for cash as a method of transaction.

Operational issues

Currency

The Currency business operates within a defined market and the business is exposed to the short term ordering cycles of central banks. Significant year on year changes in volume or customer mix could affect profitability. The loss of key customers, either in banknotes or banknote paper, could have a major effect on the Group's results and prospects which the business mitigates by achieving as much diversity of customers as possible.

De La Rue seeks to mitigate the risk of counterfeiting by focusing on innovation in technologies, features and products to stay ahead of changing markets and the competition and in particular the counterfeiter. Failure to develop new technology to meet customers' needs, delays in bringing products to market or failure to protect material intellectual property rights may have an adverse impact upon the Group's prospects.

Cash Processing Solutions

The CPS business is exposed to long ordering processes of central banks and commercial banks, frequently for customers in the developing world. Significant year on year changes in volume or customer mix could affect profitability, which the business mitigates by achieving a diversity of its customer base.

One of the strengths of the CPS business is that a significant part of the business is annual service and maintenance of the installed base. These are very stable, long term contracts to maintain mission critical machine operation.

CPS' total solution package typically represents a major investment by its customers. Therefore, the profitability of the CPS business in any given period can fluctuate significantly, depending upon the customer demand and the specific solutions delivered in that period.

CPS continues to invest in and develop its product portfolio to ensure that the products continue to provide the flexible tailored solutions that De La Rue's customers demand.

Risk and Risk Management
Continued

Reputation
Damage to reputation may arise from an incident or event which is in monetary terms not material. Matters which could affect De La Rue's reputation would include significant breaches of security or a contravention of law, such as competition law or anti-bribery law, environment or health and safety law or a failure to maintain appropriate standards of corporate responsibility. De La Rue operates throughout the world and in areas where the local standards may not equate to the standards applicable in the UK or those that De La Rue requires all its subsidiaries and employees to follow as regards business behaviour. Any material damage to De La Rue's reputation could have a major effect on the Group's prospects. Details of these standards are set out in the Corporate Responsibility Report on pages 41 to 45.

On 27 July 2007 the Company announced that the Serious Fraud Office ('SFO') was investigating the Company. We believe this is in response to allegations of corruption made by a former employee against whom the Company has obtained and enforced a judgement for the recovery of monies stolen from it. The Company believes the allegations made by this individual, who has since pleaded guilty to theft from the Company and was sentenced to three years' imprisonment in February 2008, are false. The Company understands that these investigations are continuing and remains ready to co-operate with the SFO. At present, the Company is not able to quantify the impact of any action the SFO may take as a result of this investigation and is not yet in a position to comment further.

Significant effort is made to ensure that employees understand legal obligations. There is an established anti-trust compliance programme and the Company's Business Code of Conduct (accessible on the Company's website) defines what standards of behaviour are expected. Agents and distributors are also required to adhere to the Company's standards. The Board has accepted recommendations following a further review of its policies and procedures against the recommendations made by Lord Woolf as described in the Corporate Responsibility section on page 41.

Security
The nature of the Group's activities requires stringent security processes and procedures to minimise the consequences of possible breaches, some of which, such as changes in arrangements by carriers, may be outside the Group's control. Any material breach of security could have a major effect on the Group's prospects.

Overton Mill
The Group is highly dependent on its paper mill at Overton which is close to the River Test in Hampshire, UK. The business of Currency would suffer significant losses to its printing business if the mill were out of action for a sustained period of time, either by reason of fire or some other accident or because of environmental contamination of the River Test, which is a Site of Special Scientific Interest. The Group regularly reviews its physical protection systems and updates them as necessary to mitigate this risk. The consequences of fire or physical loss to any of its printing plants are less significant because the Group has the flexibility to switch production to different plants.

General Risks
Economic conditions
Significant changes in economic conditions, for example: the prices of commodities such as cotton, energy or inks; changes in interest rates, rates of inflation, economic growth and other factors could substantially and adversely affect the business, financial and operating performance of the Group notwithstanding the Group's normal policy of buying commodities at prevailing market prices under medium term supply contracts. A number of businesses are relatively energy intensive, either because of production processes or due to the proportionately high costs of transportation.

In addition, no one element of the above commodities represents more than 30 per cent of the total final cost element of a finished banknote. Vertical integration gives greater internal control with more than 60 per cent of costs now in house. Further mitigation is achieved through the rolling process of contract negotiation which provides the opportunity to update processes to reflect the cost base.

Security Products is more exposed to the economic cycle than Currency due to the proportion of commercial organisations that it serves.

Although the identity market is more insulated against the current economic climate than most, pressure on state finances may mean the cancellation or postponement of government identity projects. Passport and identity document issuance volumes are also expected to decrease as travel reduces or renewals are postponed. There are also risks around the supply of critical document and system components as the external supply chain struggles to deal with the limited availability of credit and working capital. Although these effects have not been significant to date, it is expected that the threat of these challenges will persist well into 2009/2010.

Legislation and regulation
De La Rue is subject to the laws and regulations of countries where it does business. Failure to comply with such laws and regulations could impose additional costs on or have an adverse impact on the performance of and/or damage the reputation of the business carried on by the Group.

Financial Risk Management
The Group's activities expose it to a variety of financial risks: market risk (including currency risk and fair value interest rate risk), credit risk, liquidity risk, cash flow interest rate risk and commodity price risk. Any material exposure could adversely impact the Group's earnings. This is not a material risk for the Company's sufficiency of working capital over the next 12 months. The Group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Group's financial performance. The Group uses derivative financial instruments to hedge certain risk exposures as soon as they arise but does not take speculative positions. Risk management is carried out by a central treasury department (Group Treasury) under policies approved by the Board. Group Treasury identifies, evaluates and hedges financial risks in close cooperation with the Group's operating units.

Group Treasury provides written principles for overall risk management, as well as policies covering specific risks, such as foreign exchange, interest rate, credit, use of derivative financial instruments and the investment of excess liquidity. The Board authorises all risk management instruments and policies.

(a) Market Risk
Foreign Exchange Risk
The Group operates internationally and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the US Dollar and Euro. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities and net investments in foreign operations. The Group aims to hedge such exposures where possible and practical. However, any material exposure to foreign exchange risk could have a major effect on the Group's profits. To manage their foreign exchange risk arising from future commercial transactions and recognised assets and liabilities, entities in the Group use forward contracts, transacted with Group Treasury. Foreign exchange risk arises when future commercial transactions or recognised assets or liabilities are denominated in a currency that is not the entity's functional currency. Group Treasury is responsible for managing the net position in each foreign currency by using external forward foreign exchange contracts transacted with financial institutions.

For segment reporting purposes, each subsidiary designates contracts with Group Treasury as fair value hedges or cash flow hedges, as appropriate. External forward foreign exchange contracts are designated at Group level as hedges of foreign exchange risk on specific assets, liabilities or future transactions on a gross basis.

The Group's risk management policy is to hedge firm commitments and between 60 per cent and 100 per cent of forecast exposures in each major currency for the subsequent 12 months. Forecast transactions must be highly probable for hedge accounting purposes. The Group has certain investments in foreign operations, whose net assets are exposed to foreign currency translation risk. Currency exposure arising from the net assets of the Group's foreign operations is managed primarily through borrowings denominated in the relevant foreign currencies and through foreign currency swaps.

(b) Credit Risk
The Group has no significant concentrations of credit risk. It has policies in place to ensure that wholesale sales of products are made to customers with an appropriate credit history. Derivative counterparties and cash transactions are limited to high-credit quality financial institutions. The Group has policies that limit the amount of credit exposure to any one financial institution.

(c) Liquidity Risk
Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions. Due to the dynamic nature of the underlying businesses, Group Treasury aims to maintain flexibility in funding by keeping committed credit lines available.

(d) Cash Flow and Fair Value
Interest Rate Risk
De La Rue's interest rate management policy is generally to borrow and invest cash at floating rates. The Group's interest rate risk arises from long term borrowings. Borrowings issued at variable rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed rates expose the Group to fair value interest rate risk.

The Group's exposure to cash flow interest rate risk arises principally from cash balances held. Current low levels of borrowings are all at floating rates. At higher levels of borrowings the policy is to manage the interest rate exposure through the use of floating to fixed interest rate swaps. Such interest rate swaps have the economic effect of converting borrowings from floating rates to fixed rates so as to achieve a target split.

Capital Management
The Group's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The Board of Directors monitors earnings per share, which the Group defines as the earnings attributable to ordinary shareholders by the weighted average number of Ordinary Shares outstanding during the year. The Board also monitors the level of dividends to ordinary shareholders.

The Group's strong cash generative characteristics and current low gearing has given the Board scope regularly to return to shareholders surplus cash flow through a combination of progressive dividends, share buy backs and special dividends.

There were no changes to the Group's approach to capital management during the year and the Group is not subject to any externally imposed capital requirements.