Corporate governance, risk management, financial policy and related functions

Organization

Royal DSM N.V. is a company limited by shares listed on the Euronext Amsterdam Stock Exchange, with a Managing Board and an independent Supervisory Board. The Managing Board is responsible for the company's strategy, its portfolio policy, the deployment of human and capital resources and the company's financial performance. The Supervisory Board supervises the policy pursued by the Managing Board, the Managing Board's performance of its managerial duties and the company's general state, taking account of the interests of all the company's stakeholders. The annual financial statements are approved by the Supervisory Board and then submitted for adoption to the Annual General Meeting of Shareholders, accompanied by an explanation by the Supervisory Board of how it carried out its supervisory duties during the year concerned.

The company is governed by its Articles of Association, which can be consulted at the DSM website, www.dsm.com. The General Meeting of Shareholders decides on an amendment to the Articles of Association by an absolute majority of the votes cast. A decision to amend the Articles of Association may only be taken at the proposal of the Managing Board, subject to approval of the Supervisory Board.

Members of the Managing Board and the Supervisory Board are appointed (and, if necessary, dismissed) by the General Meeting of Shareholders.

DSM fully informs its stakeholders about its corporate objectives, the way the company is managed and the company's performance. Its aim in doing so is to pursue an open dialogue with its shareholders and other stakeholders.

DSM has a decentralized organizational structure built around business groups that are empowered to carry out all short-term and long-term business functions. This structure ensures a flexible, efficient and fast response to market changes. At the corporate level, DSM has a number of staff departments to support the Managing Board and the business groups. Intra-group product supplies and the services of a number of shared service departments and research departments are contracted by the business groups at arm's length basis.

Dutch corporate governance code

DSM supports the current Dutch corporate governance code (Tabaksblat Code) and applies all but one of its 113 Best Practices. The only exception is Best Practice III.5.11, which stipulates that the remuneration committee shall not be chaired by the chairman of the Supervisory Board. DSM considers remuneration to be an integral part of its nomination and retention policy and hence of its human resource management policy for its senior management. DSM therefore considers it desirable for the Chairman of the Supervisory Board to be directly involved in preparing decisions taken by the full Board, also in view of the role played by the Supervisory Board Chairman vis-á-vis the Managing Board. This exception to the code was discussed in the Annual General Meeting of Shareholders in 2005, where it met with no objections.

With respect to Best Practice provision II.1.7 it is to be reported that in the course of 2007 Mr. Nico Gerardu, member of the Managing Board, assumed the duties of chairman of the Supervisory Board of a listed company (see section on Corporate organization). This is a temporary arrangement pending the appointment of a successor as chairman of the Supervisory Board of this listed company.

With respect to the appointment of members of the Managing Board for a period of at most four years (Best Practice II.1.1) it should be noted that DSM has adhered to this Best Practice since the introduction of the corporate governance code in 2004. Since DSM respects agreements made before the introduction of said code, two current members of the Managing Board will remain appointed for an indefinite period.

In respect to the Dutch corporate governance code it should be noted that any substantial change in the corporate governance structure of the company and in the company's compliance with the code shall be submitted to the General Meeting of Shareholders for discussion under a separate agenda item.

All documents related to the implementation at DSM of the Dutch corporate governance code can be found in the Governance section of the corporate website (www.dsm.com).

DSM has taken note of the amended Dutch corporate governance code as published on 10 December 2008. In its 2009 annual report DSM will include a chapter on the company's compliance with the amended code and present this chapter to the Annual General Meeting of Shareholders in 2010 for discussion as a separate agenda item. During 2009 DSM will review the code and implement the amended principles and best practices where appropriate.

Annual General Meeting of Shareholders

On 26 March 2008 the Annual General Meeting of Shareholders was held. The agenda was to a large extent similar to that of previous years. A special item on the agenda was a resolution for the annual report and financial statements for the financial year 2008 and subsequent years to be drawn up in English. All resolutions that were tabled were passed.

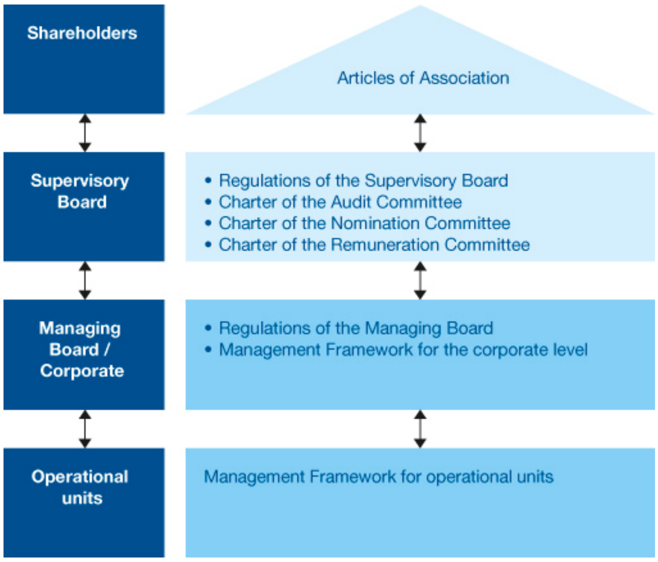
Governance framework

DSM's business-steering model remained unchanged in 2008, after having been adapted to the *Vision 2010* strategy in 2006. The business groups are the main building blocks of the organization; they have integral long-term and short-term business responsibility and have at their disposal all functions that are crucial to their business success. In order to facilitate selective leveraging of expertise and implementation capabilities in the approach to markets, products and technologies, business groups with the most important commonalities in these areas are grouped into clusters. The business groups within a specific cluster report to a member of the Managing Board. This Board member has the responsibility of managing synergy within the cluster. In order to ensure sufficient independence with regard to financial management, the Chief Financial Officer has no business groups reporting to him.

The Management Framework for the corporate level provides a description of the relations between the main building blocks mentioned above and geographical and functional management. It also describes the most important (decision) processes, responsibilities and 'rules of the game' at the Managing Board and corporate staff levels and includes the governance relations with the next-higher levels (Supervisory Board / shareholders) and the operational units.

In 2008, the framework was adapted to reflect the transition from four to five clusters (Nutrition, Pharma, Performance Materials, Polymer Intermediates and Base Chemicals and Materials) that was implemented on 1 January 2008 in order to facilitate the planned disposal of activities in the Base Chemicals and Materials cluster.

The following figure depicts DSM's overall governance framework and the most important governance elements and regulations at each level.



Note: all internal regulations apply in addition to applicable national and international laws and regulations. In cases where internal regulations are incompatible with national or international laws and regulations, the latter prevail.

For the sake of clarity, a short summary of the main aspects of the framework at Managing Board / corporate level and operational level is given here:

- The Managing Board adheres to the Regulations of the Managing Board.
- In addition, the Managing Board and corporate staff departments / services work according to the Management Framework for the corporate level. This implies amongst other things that they adhere to the DSM Values and applicable corporate policies and requirements, and set the company's strategic direction and objectives in the Corporate Strategy Dialogue (CSD). The framework further defines the roles of clusters, corporate staff departments, shared-competence and business-support functions, the China Governance function, the DSM Innovation Center and the charters of several Boards. Together they define the basic organizational structure and the division of responsibilities between the Managing Board, these corporate and central functions and the business groups and clusters.
- The operational units conduct their business within the parameters of the Management Framework for operational units. This implies amongst other things that the operational units establish the strategy and objectives of their business according to the Business Strategy Dialogue (BSD), in which process various scenarios and related risk profiles are

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investigated. The framework further stipulates that the strategy implementation must take place in line with corporate policies and multi-year plans in several functional areas and in compliance with the Corporate Requirements. Whenever a special situation calls for it, the Corporate Requirements are extended to include so-called Corporate Directives (for example a travel ban for security reasons).

Compliance with the Corporate Requirements and the effectiveness of the risk management and internal control system are monitored by the entities themselves and discussed regularly between the Managing Board and the operational units. On average once every three years, the units are also audited by Corporate Operational Audit (COA). The director of the COA department reports to the chairman of the Managing Board and has the authority to consult with the chairman of the Audit Committee of the Supervisory Board. Furthermore, the director of COA acts as the compliance officer with regard to inside information and is the chairman of the DSM Alert Committee, which implements the whistle-blower policy.

Risk management system

On this page the main risks as well as the functioning of the risk management system are described. This section gives a general description of the system and its developments. A full description of the risk management system can be found on the DSM Internet site (www.dsm.com, governance section).

The DSM risk management system is based on the COSO-ERM Framework. It aims to achieve maximum integration of the risk management process in the normal business processes. It provides for risk assessment tools, controls for risks that commonly occur in the company and monitoring and reporting procedures and systems. The internal controls for the goods and money flows have been 'built into' standard business processes and tools have been developed to support their implementation and to monitor their effectiveness in operation. In this way, a high level of internal control can be achieved efficiently.

Based on developments within and external to the company, as well as findings from the various monitoring efforts as described above, the risk management system is regularly adapted and optimized. The most important developments are listed below.

The growth, diversity and acquisition policies of DSM lead to an increased influx of senior managers from outside the company. In order to ensure their familiarity with the DSM Values and the DSM governance and risk management system, a Corporate Directive was instituted which stipulates that they have to acquaint themselves with a number of key documents and discuss them with their superior.

To better accommodate a first introduction of management to the risk management system, an intranet-based e-learning module was developed. The risk management training activities were considerably expanded, amongst other things to service specific target groups such as risk management professionals in China and business controllers. The Corporate Requirements were made available in Chinese.

During the year under review a number of areas were identified where the risk profile had increased or where the existing risk management and control processes showed weaknesses. These areas include the security of payment processes, hedging of commodities, protection against product liability issues and safeguarding against the loss of intellectual property. In these areas measures were taken to enhance the risk management system.

Risks

The following list gives an overview of risks that have been identified as potentially important. A description of the nature of these risks is given on the DSM website (www.dsm.com, governance section). Furthermore, information on financial risks is provided in the financial statements on page 131. The main risks as mentioned in this section are asterisked.

Generic risks
- Global financial and economic developments*
- General market conditions and commoditization*
- Political risks
- Currency risks and interest risks
- Risks of derivatives used for hedging purposes

Strategic risks
- Divestments*, acquisitions*, and joint ventures
- Innovation (new markets, products and technologies)*
- People, organization and culture*

Specific risks
- Corporate-reputation risks
- Customer risks
- Production-process risks
- Raw material / energy price and availability risks*
- Product-liability risks
- Non-insurable risks
- ICT risks
- Intellectual Property protection risks
- Project risks
- Financial risks
- Pension risks
- Control failures

See www.dsm.com, Governance section.

For the management of all risks mentioned, strategies, controls and/or mitigating measures have been put in place as part of DSM's risk management practices. These nevertheless involve uncertainties that may lead to the actual results differing from those projected. There may also be risks that the company has not yet fully assessed and that are currently qualified as 'minor' but that could have a material impact on the company's performance at a later stage. The company's risk management and internal control system has been designed to identify and respond to these developments on time, but 100% assurance can never be achieved, of course.

Financial policy

As a basis for and contribution to effective risk management and to ensure that the company will be able to pursue its strategies even during periods of economic downturn, DSM retains a strong balance sheet and limits its financial risks.

One of the key targets of *Vision 2010* is to achieve a cash flow return on investment (CFROI) which exceeds the weighted average cost of capital (WACC) by at least 100 basis points. DSM further aims for a net debt which is between 30 and 40% of equity plus net debt in normal times (currently the objective is to stay below 30%) and an operating profit before amortization and depreciation (EBITDA) which is at least 8.5 times the balance of financial income and expense. This underlines the company's aim of maintaining its single-A long-term credit rating.

An important element of DSM's financial strategy is the allocation of cash flow. DSM primarily allocates cash flow to investments aimed at strengthening its business positions and to dividend payments to its shareholders. The cash flow is further used for strengthening the Life Sciences and Materials Sciences businesses by means of selective acquisitions. As the occasion arises, the company may choose to buy back shares, if excess cash is available in the context of a medium-term analysis of primary cash-flow-allocation requirements and a sustained single-A rating.

DSM aims to provide a stable and preferably rising dividend. In order to avoid dilution of earnings per share as a result of the exercise of management and employee options, DSM buys back shares insofar as this is desirable and feasible.

An important acquisition criterion is that the business concerned should be compatible with DSM in terms of technological and/ or market competencies. Acquired companies are in principle required to contribute to DSM's cash earnings per share from the very beginning and to meet the company's profitability and growth requirements. In some cases, for instance in the case of small innovative growth acquisitions, this requirement may not be appropriate and will therefore not be applied.

DSM's policy in the various sub-disciplines of the finance function is strongly oriented towards solidity, reliability and optimum protection of cash flows. The finance function plays an important role in business steering.

The accounting and control function is responsible for transaction accounting, financial reporting and making assessments and providing advice regarding business processes geared to the company's financial targets. The main policy aim in this function is to obtain and make available reliable financial information that is adequate for business-steering purposes and to meet statutory and other governance requirements.

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The treasury function's tasks include financing the group and its units, managing the cash held by the company and managing currency risks and interest-rate risks. To ensure that its policy in these fields is properly implemented and produces the best possible results, DSM has a set of stringent internal regulations, procedures, organizational measures and market-related benchmarks in place. DSM's treasury policy is mainly geared to managing the financial risks to which the group and its units are exposed and to optimizing the balance of financial income and expense.

The tax function is responsible for the management of the company's position with regard to taxes. As part of this task, it handles or reviews the main tax returns and reviews acquisitions, disposals and liquidations of business components and/or joint ventures, as well as restructuring programs and reorganizations. It also examines the tax consequences of cross-border activities between business components such as transfer pricing, cross-border activities that lead to some permanent form of foreign establishment, and changes in the shareholdings in legal entities. DSM's tax policy is aimed at realizing an optimal position in the field of taxes, and at maintaining such a position for the long term.

The investor relations function's primary task is to maintain contacts with current and potential shareholders of DSM and with analysts who advise shareholders. The objective of this function is to provide quality information to investors and analysts about developments at DSM, ensuring that relevant information is equally and simultaneously provided and accessible to all interested parties.

The insurance function has the task of achieving a proper balance between self-financing corporate (hazardous) risks or having these risks transferred to external insurers, based on the relative costs involved and DSM's risk appetite. The underlying premise is the company's risk management philosophy, which is that group-wide risk awareness will ultimately lead to a proper insight into the risks that a company such as DSM may be confronted with, and to the control, prevention and mitigation of such risks. An insurance policy is therefore viewed as a last-resort instrument for the management of these risks. The choice as to whether or not to obtain external insurance coverage also depends on the scope of the risk exposure in relation to the financial parameters that are relevant for a listed company such as DSM. Such parameters determine the amount of risk that the company is willing to bear itself.

All DSM units have to report their results periodically and comply with Corporate Requirements in the field of finance. Compliance with the requirements for accounting and reporting is confirmed by means of a quarterly written statement signed by management. During the drafting of the annual report, the report is first discussed by the Managing Board with the Supervisory Board's Audit Committee and the external auditor, and subsequently with the full Supervisory Board. Quarterly financial reports are discussed by the Managing Board with the Audit Committee and the external auditor. The company uses a release calendar for financial results.