

Diesel Issue

During the fiscal year, we reached extensive settlement agreements in the USA. The technical measures for all affected vehicles with type EA 189 engines in the European Union were approved without exception, and implemented in most cases. We also continued to work on resolving the diesel issue. Further special items amounting to €3.2 billion had to be accounted for in the fiscal year.

IRREGULARITIES CONCERNING NO_x EMISSIONS

On September 18, 2015, the US Environmental Protection Agency (EPA) publicly announced in a “Notice of Violation” that irregularities in relation to nitrogen oxide (NO_x) emissions had been discovered in emissions tests on certain vehicles of Volkswagen Group with type 2.0 l diesel engines in the USA. In this context, Volkswagen AG announced that noticeable discrepancies between the figures achieved in testing and in actual road use had been identified in around eleven million vehicles worldwide with type EA 189 diesel engines. On November 2, 2015, the EPA issued a “Notice of Violation” alleging that irregularities had also been discovered in the software installed in US vehicles with type V6 3.0 l diesel engines.

Numerous court and governmental proceedings were subsequently initiated in the USA and the rest of the world. During the reporting period, we succeeded in ending most significant court and governmental proceedings in the USA by concluding settlement agreements. This includes, in particular, settlements with the US Department of Justice (DOJ). Outside the USA, we also reached agreements with regard to the implementation of technical measures with numerous authorities. Detailed information on the individual settlement agreements as well as on the pending court and governmental proceedings can be found in the Report on Risks and Opportunities, starting on page 178.

EXTENSIVE INVESTIGATIONS INITIATED BY VOLKSWAGEN AG

After the first “Notice of Violation” was issued, Volkswagen AG immediately initiated its own internal inquiries and an external investigation.

The Supervisory Board of Volkswagen AG formed a special committee that coordinates the activities relating to the diesel issue for the Supervisory Board.

The global law firm Jones Day was instructed by Volkswagen AG to carry out an extensive investigation of the diesel issue in light of the DOJ’s and the Braunschweig public prosecutor’s criminal investigation as well as other investigations and proceedings which were expected at that time.

Jones Day was instructed by Volkswagen AG to present factual evidence to the DOJ. To resolve US-criminal law charges, Volkswagen AG and the DOJ entered into a Plea Agreement, which includes a Statement of Facts containing a summary of the factual allegations which the DOJ considered relevant to the settlement with Volkswagen AG. The Statement of Facts is based in part on Jones Day’s factual findings as well as the evidence identified by the DOJ itself.

Jones Day has completed the work required to assist Volkswagen AG in assessing the criminal charges against the company in the USA with respect to the diesel issue. However, work in respect of the legal proceedings which are still pending in the USA and the rest of the world is ongoing and will require considerable efforts and a considerable period of time. In connection with this further work, Volkswagen AG is being advised by a number of external law firms.

Furthermore, in September 2015, Volkswagen AG filed a criminal complaint in Germany against unknown individuals as did AUDI AG. Volkswagen AG and AUDI AG are cooperating with all responsible authorities in the scope of reviewing the incidents.

The diesel issue is rooted in a modification of parts of the software of the relevant engine's control unit – which, according to Volkswagen AG's legal position, is only unlawful in the USA – for the type EA 189 diesel engines that Volkswagen AG was developing at that time. The decision to develop and install this software function was taken in late 2006, below Board of Management level. None of the members of the Board of Management had, at that time and for many years to follow, knowledge of the development and implementation of this software function in the relevant engine control unit of the type EA 189 diesel engines.

In the months after the International Council on Clean Transportation (ICCT) study was published in May 2014, the test set-ups on which the ICCT study was based were repeated in-house at Volkswagen AG and confirmed the unusually high NO_x emissions from certain type EA 189 2.0l diesel engines in the USA. The California Air Resources Board (CARB) – a part of the environmental authority of California – was informed of this result, and, at the same time, an offer was made to recalibrate the type EA 189 diesel engines in the USA as part of a service measure that was already planned in the USA. This measure was evaluated and adopted by the Ausschuss für Produktsicherheit (APS – Product Safety Committee), which initiates necessary and appropriate measures to ensure the safety and conformity of Volkswagen AG's products that are placed in the market. There are no findings that an unlawful “defeat device” under US law was disclosed to the APS as the cause of the discrepancies or to the persons responsible for preparing the 2014 annual and consolidated financial statements. Instead, at the time the 2014 annual and consolidated financial statements were being prepared, the persons responsible for preparing the 2014 annual and consolidated financial statements remained under the impression that the issue could be solved with comparatively little effort as part of a service measure.

In the course of the summer of 2015, however, it became successively apparent to individual members of Volkswagen AG's Board of Management that the cause of the discrepancies in the USA was a modification of parts of the software of the engine control unit, which was later identified as an unlawful “defeat device” as defined by US law. This culminated in the disclosure of a “defeat device” to EPA and CARB on September 3, 2015. According to the assessment at that time of the responsible persons dealing with the matter, the scope of the costs expected by the Volkswagen Group (recall costs, retrofitting costs and financial penalties) was not fundamentally dissimilar to that of previous cases involving other vehicle manufacturers, and, therefore, appeared to be controllable overall with a view to the business activities of the Volkswagen Group.

This assessment by the Volkswagen Group was based, among other things, on the advice of a law firm engaged in the USA for approval issues, according to which similar cases in the past were resolved amicably with the US authorities. The publication of the “Notice of Violation” by the EPA on September 18, 2015, which, especially at that time came unexpectedly to the Board of Management, then presented the situation in an entirely different light.

Extensive inquiries were also conducted at AUDI AG in relation to the potential use of unlawful “defeat devices” under US law in type V6 3.0l diesel engines. The investigation conducted by Jones Day for Volkswagen AG also comprehensively covered this issue.

The AUDI AG Board of Management members in office back at the relevant time have stated that they had no knowledge of the use of unlawful “defeat device” software under US law in V6 3.0l TDI engines until they were informed by the EPA in November 2015.

Within the Volkswagen Group, Volkswagen AG has development responsibility for the four-cylinder diesel engines such as the type EA 189, and AUDI AG has development responsibility for the six-cylinder diesel engines such as the type V6 3.0l diesel engines.

Nothing from the publications made up to the time this report was prepared or from the ongoing investigations and interviews on the diesel issue has presented the Volkswagen AG Board of Management with any conclusive findings or assessments of fact that would result in a different assessment of the associated risks (e.g. investor lawsuits).

EA 189 VEHICLES IN THE EU/REST OF THE WORLD

Outside the USA and Canada, around 10 million vehicles with type EA 189 diesel engines were affected.

During the first quarter of 2017, the Kraftfahrt-Bundesamt (KBA – German Federal Motor Transport Authority) issued the final outstanding official approvals needed for technical measures of 14 thousand Volkswagen Group vehicles fitted with type EA 189 diesel engines falling within its remit.

The KBA ascertained for all clusters (groups of vehicles) that implementation of the technical measures would not bring about any adverse changes in fuel consumption figures, CO₂ emissions figures, engine power, maximum torque and noise emissions. Once the updates have been made, the vehicles will continue to comply with the legal requirements and the emission standards applicable in each case.

During the second quarter of 2017, the Vehicle Certification Agency in the United Kingdom issued the outstanding official approvals needed for technical measures to modify the ŠKODA and SEAT models with type EA 189 diesel engines falling within its remit.

The technical measures for all affected vehicles with type EA 189 engines in the European Union were approved without exception, and implemented in most cases.

In some countries outside the EU the technical measures have to be approved by the national authorities. With the exception of South Korea and Chile, we were able to complete the approval process in all countries. There, the majority of approvals were likewise granted; in relation to the pending approvals Volkswagen is in close contact with the authorities.

Based on current planning, implementation of the technical measures, which are free of charge for our customers, will run into 2018.

FURTHER RETROFIT PROGRAMS FOR TYPE V6/V8 ENGINES

For many months, AUDI AG has been intensively checking all diesel concepts for possible discrepancies and retrofit potentials. A systematic review process for all engine and gear variants has been underway since 2016. This was done in close cooperation with the authorities, which were provided with detailed reports, especially the German Federal Ministry of Transport and the KBA. In this context, AUDI AG announced on July 21, 2017 that it was going to improve the emissions performance of up to 850 thousand vehicles across Europe via service measures. The retrofit package comprises voluntary measures and to a small extent measures directed by the authorities; these are measures taken within the scope of a recall, which were proposed by AUDI AG itself, reported to the KBA and taken up and ordered by the latter.

AFFECTED VEHICLES IN THE USA/CANADA

In the USA and Canada three generations of certain vehicles with 2.0 l TDI engines and two generations of certain vehicles with V6 3.0 l TDI engines are affected, which come to a total of approximately 700 thousand vehicles. Due to NO_x limits that are considerably stricter than in the EU and the rest of the world, it is a greater technical challenge here to refit the vehicles so that the emission standards defined in the settlement agreements for these vehicles can be achieved.

The EPA and CARB have approved emissions modifications and issued resale approvals for the majority of the affected vehicles with 2.0 l TDI engines. The approved modifications relate to certain Generation 1 and Generation 2 vehicles, and the first part of a two-step modification for Generation 3 vehicles. The second part of this modification has been submitted for approval. We are working in close cooperation with the EPA and CARB to obtain the outstanding approval. We have withdrawn the emissions modification proposal for Generation 2 vehicles with manual transmissions.

The EPA and CARB have approved the modification measures for the Generation 2 vehicles with type V6 3.0 l TDI engines. We have submitted proposals for emissions modifications for Generation 1 vehicles with type V6 3.0 l TDI engines. These proposals are under review by the EPA and CARB.

The relevant US and Canadian companies of the Volkswagen Group have withdrawn the affected new and certified used vehicles from sale until the outstanding approvals are issued. The technical solutions that have been approved by the authorities have already been implemented.

LEGAL RISKS

Various legal risks are associated with the diesel issue. The provisions recognized for the diesel issue and the contingent liabilities disclosed as well as the other latent legal risks are partially subject to substantial estimation risks given the complexity of the individual factors, the ongoing approval process with the authorities and the fact that the facts have not yet been definitively clarified. Should these legal risks materialize, this could result in considerable financial charges.

A detailed description of these and other risks arising from the diesel issue as stated above can be found in the Report on Risks and Opportunities starting on page 178.

OPERATING RESULT

Special items recognized in operating profit relating to the diesel issue amounted to €-3.2 (-6.4) billion in fiscal year 2017, mainly due to higher provisions relating to the buy-back/retrofit programs.

The diesel issue led to total special items of €-25.8 billion in the years 2015 to 2017.

INDEPENDENT MONITOR

In June 2017, Larry D. Thompson was appointed as the Independent Compliance Monitor at Volkswagen under the terms of the Plea Agreement with the DOJ announced on January 11, 2017 and confirmed by a US federal court on April 21, 2017. He will also work as Independent Compliance Auditor under the Third Partial Consent Decree concluded separately with the EPA and the Third California Partial Consent Decree agreed with the State of California and CARB (for more information on these agreements, please see the Litigation section starting on page 178). Mr. Thompson will assess and oversee Volkswagen's compliance with the terms of the Plea Agreement and Consent Decrees for a period of three years, which includes taking measures to further strengthen the Company's compliance, reporting and monitoring mechanisms and the implementation of an enhanced compliance and ethics program.

TO OUR STAKEHOLDERS

The diesel issue prompted a process by which we strengthened our corporate culture, particularly in the areas of compliance and internal control mechanisms. This development led to the initiation of programs and projects designed to intensify Volkswagen's collective awareness of integrity.

We honed our internal control systems for the product development process and vehicle testing, overhauled our Code of Conduct and the whistleblower system, and increased the frequency of the training courses provided to staff on these topics.

The combination of integrity, compliance and culture is an important and indispensable part of the transformation process we are undergoing. We are renewing ourselves from the inside out and are evolving on a daily basis to merit our most important asset – the trust of our customers and stakeholders.