Consolidated financial statements as of December 31, 2017, and Group management report

TRANSLATION – AUDITOR'S REPORT

H&K AG
Oberndorf/Neckar

KPMG AG Wirtschaftsprüfungsgesellschaft

The English language text below is a translation provided for information purposes only. The original German text shall prevail in the event of any discrepancies between the English translation and the German original. We do not accept any liability for the use of, or reliance on, the English translation or for any errors or misunderstandings that may arise from the translation.

H&K AG

Consolidated Statements According to IFRS for the Financial Year 2017

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CONSOLIDATED STATEMENT OF FINANCIAL POSITION

AS OF

EUR '000	Note	31.12.17	31.12.16
Property, plant & equipment	17	43,428	39,194
Intangible assets - goodwill	16	5,149	5,149
Intangible assets - other	16	33,317	28,790
Other investments & derivatives	18	2,295	2,124
Deferred tax assets	15	13,953	15,970
Total non-current assets		**98,141**	**91,227**
Inventories	19	75,102	59,317
Prepayments for inventories	20	14	18
Prepayments for other current assets	20	738	604
Other loans, investments & derivatives	18,36	2,733	8,593
Current tax assets		370	745
Trade receivables	20	21,156	28,183
Other receivables	20	5,702	2,580
Cash & cash equivalents	21	18,812	24,648
Total current assets		**124,625**	**124,690**
Total assets		**222,767**	**215,917**
Equity			
Share capital		27,641	21,000
Additional paid in capital		53,025	9,920
Reserves & consolidated retained earnings		(189,986)	(177,304)
Total equity	22	**(109,320)**	**(146,384)**
Liabilities			
Loans & borrowings	25	182,235	219,503
Employee defined benefit obligations	23	62,101	65,230
Provisions	24	2,582	2,874
Deferred tax liabilities	15	20,853	19,443
Total non-current liabilities		**267,771**	**307,050**
Trade payables	26	21,180	12,915
Other payables	26	10,771	8,804
Advanced & stage payments received	27	6,910	5,535
Deferred income		46	51
Provisions for income taxes		5,958	7,198
Other provisions & accruals	24	19,452	20,748
Total current liabilities		**64,316**	**55,251**
Total liabilities		**332,087**	**362,301**
Total equity & liabilities		**222,767**	**215,917**

CONSOLIDATED INCOME STATEMENT

FOR THE PERIOD JANUARY 1 TO DECEMBER 31

EUR '000	Note	2017	2016
Revenue	6	182,038	202,357
Cost of sales	7	(112,415)	(119,572)
Gross profit		**69,623**	**82,785**
Research & development expenses	8	(5,724)	(5,884)
Sales, marketing & distribution expenses	9	(24,853)	(21,924)
Administration expenses	10	(21,301)	(18,246)
Other operating income	11	4,661	3,384
Other operating expenses	12	(1,440)	(1,296)
Results from operating activities		**20,965**	**38,819**
Interest income		108	39
Valuation of bond early repayment clauses		-	1,060
Profit on bond repurchases		-	1,108
Gains on translation of foreign currencies		52	1,982
Total financial income	**14**	**160**	**4,189**
Interest expense		(19,623)	(23,878)
Accretion of non-current liabilities		(2,507)	(3,349)
Valuation of bond early repayment clauses		(1,360)	-
Losses on valuation of investments		(51)	-
Losses on translation of foreign currencies		(5,056)	(1,321)
Other financial expense		(52)	(173)
Total financial expense	**14**	**(28,648)**	**(28,721)**
Net financial result	**14**	**(28,488)**	**(24,531)**
Profit / (loss) before income tax		**(7,523)**	**14,287**
Income tax expense	15	(5,862)	(7,088)
Profit / (loss) for the period		**(13,385)**	**7,199**
Attributable to the shareholders of H&K AG		**(13,385)**	**7,199**
Earnings per share (€)	**22.0**	**(0.59)**	**0.34**

CONSOLIDATED STATEMENT OF PROFIT OR LOSS
AND OTHER COMPREHENSIVE INCOME
FOR THE PERIOD JANUARY 1 TO DECEMBER 31

EUR '000	Note	2017	2016
Profit / (loss) for the period		**(13,385)**	**7,199**
Other comprehensive income			
DBO actuarial gains / (losses)	23	1,314	(4,943)
Related deferred tax	15	(369)	1,398
Items that will never be reclassified to profit or loss		**945**	**(3,545)**
Forex translation differences for foreign operations	22	(243)	(340)
Items that are or may be reclassified to profit or loss		**(243)**	**(340)**
Other comprehensive income / (expense), net of tax	**22**	**702**	**(3,886)**
Total comprehensive income for the period		**(12,683)**	**3,314**
Attributable to the shareholders of H&K AG		**(12,683)**	**3,314**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR DECEMBER 31, 2015 TO DECEMBER 31, 2017

EUR '000	Share Capital	Additional Paid in Capital	Translation Reserve	Reserve for Defined Benefit Obligations	Consolidated Retained Earnings	Shareholders' Equity
As of 31.12.2015	**21,000**	**9,920**	**361**	**(11,831)**	**(169,148)**	**(149,698)**
Total recognised income & expense	-	-	(340)	(3,545)	7,199	3,314
As of 31.12.2016	**21,000**	**9,920**	**21**	**(15,376)**	**(161,949)**	**(146,384)**
Issue of new shares	6,641	43,105	-	-	-	49,746
Total recognised income & expense	-	-	(243)	945	(13,385)	(12,683)
As of 31.12.2017	**27,641**	**53,025**	**(222)**	**(14,431)**	**(175,334)**	**(109,320)**

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE PERIOD JANUARY 1 TO DECEMBER 31

EUR '000	Note	2017	2016
Cash flows from operating activities			
Profit / (loss) for the period		(13,385)	7,199
Adjustments for:			
Depreciation	17	6,498	6,987
Amortisation of intangible assets	16	2,465	2,360
(Reversal of) impairment losses on intangible assets	16	39	-
Revaluation of investments	14,18	51	0
Net interest expense	14	22,074	27,360
Change in fair value of derivatives	14	1,360	(1,060)
(Gain) / loss on disposal of property, plant & equipment	11,12	762	57
(Gain) / loss on acquisition of own bonds	14	-	(1,108)
Income tax expense	15	5,862	7,088
		25,726	48,883
Change in inventories		(18,686)	18,796
Change in trade & other receivables		3,124	236
Change in prepayments		(156)	(108)
Change in trade & other payables		15,509	2,908
Change in provisions & employees' defined benefits		(4,510)	(2,971)
		21,008	67,744
Income tax paid	15	(3,933)	(1,948)
Net cash from / (used in) operating activities		**17,075**	**65,796**
Cash flows from investing activities			
Interest received	36	108	43
Proceeds from sale of property, plant & equipment		50	16
Acq'n of property, plant, equipment & intangibles	16,17	(12,888)	(4,997)
Net investment in loans and other	36	10	(4)
Movement in deposits with terms >3 months	18	4,214	(596)
Capitalised development expenditure	16	(6,466)	(3,208)
Net cash from / (used in) investing activities		**(14,972)**	**(8,747)**
Cash flows from financing activities			
Proceeds from issue of new shares	22	49,637	-
Proceeds from loans / issue of notes	25	185,688	-
Payment of transaction costs	25	(4,008)	-
Repayment / repurchase of own bond	25	(220,323)	(25,491)
Interest paid	25	(18,651)	(24,369)
Net cash from / (used in) financing activities		**(7,657)**	**(49,860)**
Net inc. / (dec.) in cash & cash equivalents		**(5,554)**	**7,189**
Cash & cash equivalents at January 1		24,648	17,838
Effect of exchange rate fluctuations on cash held		(283)	(378)
Cash & cash equivalents at December 31	**21**	**18,812**	**24,648**

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General disclosures

(1) Presentation of the consolidated financial statements

H&K AG, the parent company of the Group, is registered under HRB 748522 at the Stuttgart district court. The company's registered office is in Oberndorf/Neckar, Germany, and the postal address is H&K AG, Heckler & Koch-Str. 1, 78727 Oberndorf/Neckar, Germany. The articles of incorporation are from March 18, 2014 with an addendum from March 21, 2014 and last changed by a resolution on September 22, 2017; the registered name of the company is H&K AG. Since July 28, 2015 H&K AG's shares have been listed under ISIN DE000A11Q133 on the Euronext free market ("Marché Libre") in Paris; approx. 0.03% are tradable, the remaining 99.97% are held by our main shareholders. The financial year is the calendar year.

The purpose of H&K AG is to invest in any way in other domestic and foreign companies, to acquire other domestic and foreign companies, in particular to invest in and acquire Heckler & Koch GmbH (HKO), Oberndorf/Neckar, to hold, manage and sell companies and investments in companies, to determine the strategy of the company and the Group, and to manage and acquire land, buildings, leasehold rights and other assets for the above objectives.

The H&K AG Group is defined by both the defence and commercial business activities of HKO and its subsidiaries in the US, England and France. HKO develops, manufactures, markets and distributes, together with its subsidiaries, infantry and sidearms for governmental security forces and is one of the leading businesses in this market segment in NATO and Europe; the companies also provide related services. For the commercial market we are concentrating on the development and introduction of new products. In alignment with the "Principles of the German Federal Government governing the export of small arms and light weapons, corresponding ammunition and production equipment to third countries" from March 18, 2015 (the "Small Arms Principles"), the executive directors have focussed HK's sales strategy on so-called "green countries". For this purpose, "green countries" are defined by a company internal classification based on three publically available criteria: (i) Transparency International's Corruption Perception Index, (ii) membership of NATO or being a NATO-equivalent country (Australia, Japan, New Zealand and Switzerland), and (iii) the Economist Intelligence Unit's Democracy Index. As a consequence, most EU, NATO and NATO-equivalent countries are "green countries". Providing applicable valid export licences are received, the remaining contractual order book for other countries will be fulfilled, but we are not seeking to take part in new tenders in "non-green countries".

The consolidated financial statements have been prepared in euro. Unless otherwise stated, all financial information presented in euro has been shown to the nearest thousand (€k, EUR '000). As a result, the totals in this report may vary slightly from the exact arithmetic aggregation of the figures that precede them.

For the income statement, expenses have been classified by function. In order to enhance the clarity of presentation, various items in the balance sheet and in the income statement have been aggregated.

(2) Executive board approval

The board of directors of H&K AG finalised & approved the consolidated financial statements on April 20, 2018.

(3) Statement of compliance with applicable law and IFRS

The consolidated financial statements of H&K AG (H&K AG Group / Group) as at December 31, 2017, have been prepared in accordance with the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB) as applicable in the EU, together with interpretations of the International Financial Reporting Interpretation Committee (IFRIC) and the supplementary German commercial law regulations pursuant to § 315a (1) HGB. All IFRS's and IFRIC's which were effective for the financial year 2017 have been applied. Except for the changes below, the Group has consistently applied the policies described in Note 5 to all periods presented in these consolidated statements.

Certain amended standards and interpretations were mandatory in the EU for the first time in 2017 and where relevant were applied in preparing these consolidated financial statements; the nature and effects of those changes that are material for the Group are set out below:

Amendments to IAS 7 - Disclosure Initiative
The amendments are intended to improved disclosures on the changes in an entity's liabilities. The amendments will require disclosures on the changes in those financial liabilities for which cash inflows and outflows are shown within "Cash flows from financing activities" in the Statement of Cash Flows; related financial assets (e.g. assets from hedging activities) are also to be included in these disclosures. Disclosures are to include cash changes, changes due to the acquisition or disposal of businesses, exchange rate variances, changes in fair values and other changes. The IASB recommends that these disclosures take the form of a reconciliation from the opening to the closing positions, but permits other forms of disclosure. The group has complied with the amended disclosure requirements.

Changes due to other IFRS that were mandatory in the EU for the first time in 2017 are not material for the Group however and are therefore not detailed here.

A number of new or amended standards and interpretations are only mandatory for later accounting periods and have not been applied in preparing these consolidated financial statements. Those that may have a material effect on the Group's consolidated financial statements are set out below; unless otherwise indicated, the effects are currently being determined. The Group does not plan to adopt these standards early.

a) Endorsed by the EU

IFRS 9 Financial Instruments
IFRS 9 was published in July 2014 and will replace the current guidelines in IAS 39 - Financial Instruments: Recognition and Measurement. IFRS 9 has revised guidelines for the classification and valuation of financial instruments, including a new model of expected bad debts for calculation of the impairment of financial assets, together with new requirements for the recognition of hedging transactions. It retains the rules for the recognition and derecognition of financial instruments from IAS 39. The Group must apply IFRS 9 from January 1, 2018 onwards.

The actual impact of adopting IFRS 9 on the Group's consolidated financial statements in 2018 cannot be reliably estimated because it will be dependent on the financial instruments that we hold on December 31, 2018 and the economic conditions at that time. We have performed an assessment of the potential impact of adoption of IFRS 9 based on the position at December 31, 2017. On the basis of this assessment, we believe that the new classification requirements would not have had a material impact on the financial assets and liabilities at this time; however due to the new model for the assessment of potential credit risks we expect somewhat higher impairment allowances. We currently intend to take advantage of the exemption allowing us not to restate comparative information for prior periods with

respect to classification and measurement changes. Differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9 generally will be recognised in reserves and consolidated retained earnings as at January 1, 2018.

IFRS 15 - Revenue from Contracts with Customers

IFRS 15 provides a comprehensive framework for the determination of whether, with what value and when revenues may be recognised. It will replace the current guidelines for the recognition of sales revenues included in IAS 18 - Revenue, IAS 11 – Construction Contracts and IFRIC 13 – Customer Loyalty Programmes. The Group must apply IFRS 15 from January 1, 2018 onwards.

We have completed our implementation project for the recognition of revenue from contracts with customers. Apart from the recognition of any liquidated damages as a reduction in revenues rather than as other operating expenses as at present, we do not expect any material changes compared to the values under IAS 18. We have decided to use the modified retrospective transition method under which the cumulative adjustments will be recognised as at January 1, 2018 and therefore as permitted by IFRS 15 we will not apply the standard to all periods presented.

Amendments to IFRS 15 – Clarifications to IFRS 15 Revenue from Contracts with Customers

The amendments include both the clarification of various requirements of IFRS 15 and two additional simplifications to reduce the complexity and the expense of the transition to IFRS 15. The amendments will be effective for annual periods beginning on or after January 1, 2018.

The potential effects of these amendments to IFRS 15 were taken into consideration in the above assessment of the potential effects on our consolidated financial statements of applying IFRS 15.

IFRS 16 - Leases

IFRS 16 introduces a single, on-balance lease sheet accounting model for lessees. A lessee recognises a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. There are optional exemptions for short-term leases and leases of low value items. Lessor accounting remains similar to the current standard – i.e. lessors continue to classify leases as finance or operating leases. IFRS 16 replaces existing leases guidance including IAS 17, IFRIC 4, SIC-15 and SIC-27. IFRS 16 will be effective from the first reporting period of annual periods beginning on or after January 1, 2019. Early adoption would be permissible if the Group applies IFRS 15 before or from the date of initial application of IFRS 16. The Group does not plan to adopt IFRS 16 early.

We have completed an initial assessment of the potential effects of the implementation of IFRS 16 on our consolidated financial statements; a detailed assessment has not yet been completed. The actual effects on initial implementation will depend upon future economic conditions, including the Group's interest rate on January 1, 2019, the structure of the leasing portfolio at this time. our assessment of the utilisation of extension options, and the level to which we make use of exceptions and application exemptions The main effect identified so far is that we will recognise new assets and liabilities relating to our operating lease contracts for certain sites and vehicles. The outstanding obligations arising from binding operating leases (on a non-discounted basis) were €2,101k as at December 31, 2017 (Note 33). In addition the type of expense recognised for these leasing contracts will change, since IFRS 16 replaces the linear expenses for operating leases with amortisation of right-of-use assets and interest expenses for lease liabilities. The transition method to be used has not yet been finalised.

b) EU endorsement pending

At present the expected changes resulting from the current new or amended standards and interpretations for which an EU endorsement is still pending are not material for the Group and are therefore not covered here.

(4) Group entities

Apart from the single entity statements of H&K AG, the consolidated financial statements of H&K AG as at December 31, 2017, include the annual financial statements of seven (2016: seven) foreign and domestic subsidiaries. Subsidiaries are companies, which the parent enterprise can control due to voting rights or for other reasons and for which it is exposed to positive and negative variable returns and has the ability to affect such returns through its control position.

The following table shows a list of the subsidiaries included in the consolidation, together with their total equity and profit for the year figures from their financial statements, as prepared for consolidation purposes under IFRS, in their functional currencies:

			Ownership Interest					
				2017			2016	
	Abbreviation	Functional Currency	%	Equity	Profit	%	Equity	Profit
Direct holdings								
Heckler & Koch Management GmbH	HKM	EUR '000	100%	351,299	2,057	100%	351,232	38,126
Heckler & Koch GmbH	HKO	EUR '000	5.1%	115,931	6,221	5.1%	108,054	38,697
Indirect holdings								
Heckler & Koch GmbH	HKO	EUR '000	94.9%	115,931	6,221	94.9%	108,054	38,697
NSAF Limited, Nottingham, England	NSAF	GBP '000	100%	2,810	1,899	100%	2,861	1,049
Heckler & Koch France S.A.S., Paris, France	HKF	EUR '000	100%	2,841	1,237	100%	3,604	933
Small Arms Group Holding Inc., Ashburn VA, USA	SAGH	USD '000	100%	17,019	-	100%	17,019	-
Heckler & Koch Defense Inc., Ashburn VA, USA	HKD	USD '000	100%	(17,948)	(1,976)	100%	(15,972)	(557)
Heckler & Koch, Inc., Columbus GA, USA	HKI	USD '000	100%	15,635	(4,255)	100%	19,890	5,052

HKO and HKM, each located in Oberndorf a.N., have availed themselves of the German commercial law option §264 Abs. 3 HGB to not publish single entity accounts.

A fully allowed for 26% holding in a foreign company recognised at a net book value of nil (2016: nil) has not been included in the consolidation at equity due to lack of materiality; instead it is included in the other non-current investments (Note 18).

A fully allowed for 50% holding recognised at a net book value of nil (2016: €6k) in a foreign joint venture has not been included in the consolidation at equity due to lack of materiality; instead it is included in the other non-current investments (Note 18).

(5) Summary of significant accounting policies and basis of measurement

The consolidated financial statements have been prepared on a historical cost basis; where IFRS requires recognition at fair value, this has been applied.

The significant accounting policies and measurement methods applied in preparing the consolidated financial statements are described below:

Consolidation methods

The assets and liabilities of the domestic and foreign companies included in the consolidated financial statements are recognised and measured using the accounting and measurement methods that apply uniformly for the H&K AG Group.

On the acquisition of a company, the assets and liabilities of the subsidiaries concerned are measured at their fair value at the time of acquisition. If the acquisition costs for the participation exceed the net fair value of the identified assets and debts, the difference is capitalised as goodwill. If the acquisition costs are lower, the fair value of the assets and liabilities and the amount of the acquisition costs are reassessed. Any remaining negative goodwill (lucky buy) is recorded immediately in the income statement.

In subsequent periods, the associated fair value adjustments to assets and liabilities are maintained, written off or released in accordance with the corresponding assets and liabilities. Capitalised goodwill is not amortised, but is subject to an annual impairment test in accordance with IFRS 3 instead.

The financial year of all companies included corresponds to the financial year of the parent company.

All receivables, liabilities, sales revenues, other income and expenses, including interest and dividends, within the scope of consolidation are eliminated. Unrealised profits from intra-group supplies are eliminated from inventories or fixed assets as appropriate.

Currency translation

The H&K AG Group reporting currency is the euro (€).

Foreign currency transactions are translated in the individual financial statements of H&K AG and its consolidated companies at the rates pertaining at the time of the transactions. As at the balance sheet date, assets and liabilities in foreign currency are measured at the spot rate on the balance sheet date. Differences arising on translation are recorded in the income statement.

The financial statements of the foreign companies are translated from their functional currencies into euro. Since subsidiaries operate their business independently, their functional currency is their individual local currency. In the consolidated financial statements, income and expenses from the financial statements of subsidiaries that are prepared in foreign currency are translated at the average rate for the year calculated from the daily rates. This method is used for simplicity since usually the local currency income and expenditure involved are fairly evenly spread throughout the year and consequently any potential variances are not material. Assets and liabilities are translated at the spot rate on the balance sheet date. Foreign currency translation variances are taken directly to the foreign currency translation reserve in equity. In the event of the disposal of a consolidated entity, associated accumulated foreign currency translation variances are recorded as part of the profit or loss on disposal.

The rates used for currency translation are shown in the table below:

Currency	Abbr.	Rate on balance sheet date 31.12.2017	Rate on balance sheet date 31.12.2016	Average exchange rate 2017	Average exchange rate 2016
US Dollar (USA)	**USD**	1.1993	1.0541	1.1297	1.1066
Pound (Great Britain)	**GBP**	0.8872	0.8562	0.8767	0.8187

Significant accounting policies

Goodwill

Goodwill is an asset representing the future economic benefits that cannot be individually identified and separately recognised from the net assets obtained through a business combination. Goodwill is allocated to the following cash generating units (segments):

EUR '000	2017	2016
Site location: Germany	4,016	4,016
Site location: France	1,133	1,133
Total	**5,149**	**5,149**

Goodwill is capitalised and subjected to an annual impairment test. If the carrying value is no longer recoverable, impairment is charged. Otherwise the prior year carrying value is retained. Any impairment charge against goodwill is not reversed, even if the valuation exceeds the carrying value.

The Group conducts an impairment test of goodwill at least annually. The recoverable value – the value in use – of the cash generating unit is compared with its carrying value. The value in use of the cash generating units is determined by discounting future cash flows. The computation is based on the following material assumptions:

> A detailed plan is made of the cash flows for the cash generating unit for the forecast period of five years. Subsequent periods are accounted for by a terminal value determined on the basis of the final year, adjusted for material one-off events and effects in the current order book and applying a 1% growth rate. The key assumptions for the determination of the value in use are the composition and value of planned sales. Plans are based on past experience and available information over future requirements. The fulfilment of these plans assumes that the current regulation of market access continues and that the Group can maintain its strong competitive position. IAS 36.134(f) does not apply.
>
> The discount rate used for December 31, 2017 is a uniform pre-tax cost of capital of 9.5% (2016: 9.9%); due to the reduced indebtedness and interest rates following the refinancing in 2017 the discount rate was determined using the CAPM, based on the target capital structure, which includes a further reduction in indebtedness. Changes within the reasonably possible interest range at the balance sheet date would not lead to an impairment.

Goodwill from acquisitions is capitalised; negative goodwill from acquisitions prior to the IFRS transition on January 1, 2006 has been offset against reserves. On divestment of a consolidated company any goodwill relating to it, other than negative goodwill, is included in the computation of the deconsolidation result.

Intangible assets

Purchased intangible assets, mainly trademarks, patents, licences and software, are capitalised at acquisition cost. Internally generated intangible assets, with the exception of goodwill, are capitalised if it is sufficiently probable that a future economic benefit will flow from the use of the asset and the costs of the asset can be determined reliably. The manufacturing costs of internally generated intangible assets are determined on the basis of directly attributable individual costs as well as a proportion of directly allocated overheads. Financing costs are only capitalised to the extent that they are directly attributable to the acquisition or production of a qualifying asset.

With the exception of goodwill and trademarks, all intangible assets have finite useful lives and are amortised using the straight-line method over this period. The €8,393k (2016: €8,393k) trademark is allocated to the cash-generating unit (segment) Site Location Germany and is subject to an annual impairment test in line with that described for goodwill. Licences and software usually have useful lives of 1 - 10 years. Capitalised development costs usually have useful lives of 8 years from the date that sales of the developed product commence. If the expected useful life for an individual asset is materially longer or shorter than these standard periods, the expected useful life is used.

Property, plant and equipment

Tangible assets which will be used in the business for more than one year are capitalised and valued at acquisition or manufacturing costs less depreciation calculated using the straight-line, use-related method, together with impairment if appropriate. The manufacturing costs of internally generated tangible assets are determined on the basis of directly attributable individual costs as well as a proportion of directly allocated overheads. Financing costs are generally not capitalised. (Financing costs are only capitalised to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset). The permitted alternative method of revaluation is not applied.

The following useful lives are applied for scheduled depreciation Group-wide:

Category of tangible asset	years
Buildings	25 - 40
Plant and machinery	3 - 10
Tooling	3
Vehicles	3 - 9
Fixtures, fittings and office equipment	3 - 15

The useful lives and methods of depreciation are reviewed regularly in order to ensure that these are in line with the actual expected economic use.

Impairment of tangible assets and of intangible assets

As at each balance sheet date, if there are triggering events for impairment, material tangible assets and intangible assets are submitted to an impairment test in accordance with IAS 36. If the carrying value of an asset exceeds its recoverable amount, an impairment loss is recognised. The recoverable amount is the higher of (i) fair value less costs to sell and (ii) value in use. If the recoverable amount for an individual asset cannot be determined, an estimate is made of the recoverable amount at the level of next higher cash generating unit.

If, in the following periods the recoverable amount exceeds the carrying value, reversal of impairment is only made for the lower of the amount necessary to (i) bring the carrying value of the asset to its recoverable amount or (ii) to restore the asset to its pre-impairment carrying amount less subsequent depreciation or amortisation that would have been recognised.

The impairment and any reversal of impairment are recorded in the income statement.

Financial instruments

As defined by IAS 32 and used in IAS 39, a financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Original financial instruments

Financial instruments held by the Group are classified as one of the following:
- financial assets at fair value through profit or loss
- loans and receivables
- held-to-maturity investments
- available-for-sale financial assets
- financial liabilities at fair value through profit or loss
- other financial liabilities, valued at amortised cost using the effective interest method

The classification of a financial instrument is determined based on the intended principal purpose upon initial recognition. Financial assets include cash and cash equivalents, trade accounts receivable, loans receivable and derivatives that are assets held for trading. Financial liabilities include trade accounts payable, amounts owed to banks, derivatives that are liabilities held for trading and other financial liabilities. Trade accounts receivable / payable result from the provision / receipt of goods and/or services in the normal course of business. Securities include financial instruments in the form of shares or participation in funds.

An instrument is classified at **fair value through profit or loss** if it is **held for trading** or is designated as such upon initial recognition. For the periods covered by these financial statements, the only financial instruments designated by the H&K AG Group as held at “fair value through profit or loss” are derivatives that do not meet the requirements for hedge accounting. Upon initial recognition any attributable transaction costs are recognised in profit or loss. Financial instruments at fair value through profit or loss are measured at fair value, and any changes in the fair value are recognised in the financial result.

Financial assets

All regulated market acquisitions and disposals of financial assets are recognised on the date of settlement (IAS 39.38).

Financial assets are recognised initially at fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition.

The recoverability of financial assets that are not held at fair value through profit or loss is reviewed regularly. Objective evidence for an impairment loss is in particular the insolvency of contractual partners or their failing to comply with payment plans. If the carrying value is higher than the recoverable amount, impairment is recognised via the income statement. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be objectively linked to an event occurring after the

impairment was recognised, the previously recognised impairment loss shall be partially or completely reversed through the income statement.

The fair values of financial assets in the balance sheet are usually their market values. If market values are not readily available, the fair values are determined using recognised valuation techniques and current market parameters. Valuation methods available include using recent arm's-length transactions between knowledgeable, willing parties, recent market transactions in similar financial instruments, adjusted for factors unique to the instrument being valued, discounted cash flow analysis or option pricing models.

A financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire or are transferred. To qualify for derecognition, the transfer must transfer the risks and rewards of ownership of the financial asset or the contractual rights to receive the cash flows.

Loans and receivables are financial assets resulting from monetary transactions, the supply of goods or services to third parties, including loans to related parties. Current assets in this category are measured at cost and non-current assets are measured at amortised cost using the effective interest method.

Impairments to doubtful debts are mainly due to estimates and assessments of individual accounts receivable, based on the creditworthiness of individual customers. Impairment of accounts receivable is initially shown as a provision for doubtful debts. If individual debts are regarded as irrecoverable, the impaired accounts receivable are written off.

Financial instruments are classed as "**held to maturity**" if they are non-derivative financial assets with fixed or determinable payments and fixed maturity that the Group has the positive intention and ability to hold to maturity.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity financial investments or (c) financial assets at fair value through profit or loss.

Cash and cash equivalents include cash balances, cheques, bank balances on current accounts and short-term deposits, for which the original term is less than three months. These are valued at nominal value.

Financial liabilities

Financial liabilities are mainly trade accounts payable, amounts owed to lenders, bondholders or banks and other liabilities.

Financial liabilities are recognised initially at fair value less, in the case of a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the issue.

A financial liability is derecognised when the obligation specified in the contract is discharged, or cancelled, or expires.

Financial liabilities valued at amortised cost using the effective interest method, include trade accounts payable and interest-bearing loans or bonds. These are valued at amortised cost using the effective interest method. Any profit or loss is recognised in the income statement when the liabilities are derecognised or settled.

Derivative financial instruments and hedge accounting

A derivative is a financial instrument or other contract with all three of the following characteristics: (1) its value changes in response to a specified foreign exchange rate or other variable; (2) it requires no initial payment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (3) it is settled at a future date.

If the exchange rates and conditions offered are advantageous, the H&K AG Group uses derivative financial instruments to manage its exposure to foreign currency translation risk arising from normal business operations. During the periods covered in this report and on December 31, 2017 there were no currency forward cover contracts in place. An embedded derivative is only separated from its host contract and accounted for as a derivative if (i) the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract, (ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and (iii) the hybrid financial instrument is not measured at fair value through profit or loss.

In line with IAS 39, all derivatives are measured at fair value determined in accordance with IFSR13. The fair values of derivatives in the balance sheet are usually their market values. If market values are not readily available, the fair value may be determined using recognised pricing models or evidenced by bank confirmations. Changes in fair value are accounted for as described below:

Cash flow hedges

Changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognised directly in equity to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognised in profit or loss.

If the hedging instrument no longer meets the criteria for hedge accounting, expires or is sold, terminated or exercised, hedge accounting is discontinued prospectively. The cumulative gain or loss previously recognised in equity remains there until the forecast transaction occurs. When the hedged item is a non-financial asset, the amount recognised in equity is transferred to the carrying amount of the asset when it is recognised. In other cases the amount recognised in equity is transferred to profit or loss in the same period that the hedged item affects profit or loss.

Other derivatives not held for hedging

When a derivative financial instrument is not designated in a qualifying hedge relationship, all changes in its fair value are recognised immediately in profit or loss.

Inventories

The inventories are recognised at acquisition or manufacturing costs or, if lower, their net realisable value. Raw materials, supplies and consumables as well as merchandise are measured at their adjusted average acquisition costs. The manufacturing costs of work in progress and finished goods are determined on the basis of directly attributable individual costs as well as a proportion of production-related overheads. The manufacturing costs do not include selling expenses, general and administrative expenses or financing costs. The net realisable value is the estimated selling price less the estimated cost of completion and the estimated costs necessary to make the sale. Provisions are made to recognise impairment of slow-moving inventories or to reduce to net realisable value.

Non-current assets held for sale

Non-current assets (or disposal groups comprising assets and liabilities) that are expected to be recovered primarily through sale rather than through continuing use are classified as held for sale. These assets are held at the lower of their carrying values and their fair value less costs to sell. These assets are not depreciated.

Provisions for pensions and similar defined benefit obligations

The provisions for defined benefit obligations are computed using the projected unit credit method in accordance with IAS 19. Under this method, in addition to the pensions and vested rights known at the balance sheet date, expected future increases in pensions and salaries, with estimates of the demographic variances are also taken into consideration. The actuarial valuation is carried out by an actuary.

Actuarial gains and losses are recognised outside profit or loss, in the period in which they occur, in accordance with IAS 19. These are shown in the statement of comprehensive income.

In determining the discount interest rates in accordance with IAS 19, the actuaries refer to market yields on high quality corporate bonds at the balance sheet date.

Other non-current and current provisions

Other general liability provisions are recognised when a past event gives rise to a present obligation, it is probable that the obligation will be claimed and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the balance sheet date, or, if the effect of the time value of money is material, the present value thereof. Reimbursement claims are recognised separately if it is virtually certain that reimbursement will be received if the Group settles the obligation.

Leases

For leasing agreements under which the Group is lessee, if the lease transfers substantially all the risks and rewards incidental to ownership of the asset (finance leases), then the assets are capitalised by the Group in accordance with IAS 17. At the commencement of the lease term, finance leases are recognised as assets and liabilities in the balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. Any initial direct costs of the lessee are added to the amount recognised as an asset. The depreciation methods and useful lives used are in line with those of comparable owned assets; if there is no reasonable certainty that the leasee will obtain ownership by the end of the lease term, then the asset is fully depreciated over the shorter of the lease term and its useful life.

If the lease does not transfer substantially all the risks and rewards incidental to ownership of the asset, then the assets are capitalised by the lessor (operating leases). Leasing fees for operating leases are recognised in the income statement. Leasing expenses are recognised on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit or the variance between these methods and the actual leasing fees is immaterial.

Recognition of income and expense

Sale of goods and services

Revenues are measured at the fair market value of the consideration received or to be received and represent the amounts that are to be obtained for goods and services in the normal course of business. The revenues are shown after subtracting sales deductions, discounts and value added taxes.

Revenues are recorded when the associated supplies and services have been rendered, the risks and rewards of ownership have transferred to the buyer and the receipt of the payment is probable.

Interest and other income

Interest income is accrued based on the loan outstanding and the applicable interest rate. The applicable interest rate is specified in the loan agreement and discounts the estimated future inflows of funds over the term of the financial asset to the net carrying value.

Other income is recognised in the period to which it relates, in accordance with the associated contract.

Other expenses

Other expenses are recognised on the basis of a direct link between the costs incurred and the related income in the income statement, either when the benefit is used or when the costs are caused.

Expenses for research and development

Research costs are expensed as they are incurred. Development costs are also expensed as they are incurred, unless they satisfy the criteria for recognition as internally generated intangible assets according to IAS 38.

Borrowing costs

Borrowing costs as defined in IAS 23 are capitalised to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset; the remaining borrowing costs are recognised as an expense in the period in which they are incurred.

Income taxes and deferred taxes

The income tax expense represents the sum of current tax expense and deferred tax expense.

The current tax expense is determined on the basis of the taxable income for the relevant year. The taxable income is different from the pre-tax result shown in the income statement since it excludes expenses and income which will be tax deductible / taxable in other years or which will never be tax deductible or taxable. The liability of the group for current tax expense is computed on the basis of the valid tax rates or of tax rates which have been enacted by the balance sheet date.

Deferred taxes are the expected tax charge or relief arising from differences between the carrying values of assets and debts in the Group IFRS consolidated financial statements and their values in the tax accounts of the individual companies. The balance sheet oriented liability method is applied. In general, deferred tax liabilities are recorded for all taxable temporary differences, and deferred tax assets are recorded to the extent that it is probable that taxable profits will be available for which the deductible

temporary differences can be used. Such assets and liabilities are not recognised if the temporary difference arises from (i) the initial recognition of goodwill or (ii) from the initial recognition of other assets and liabilities in a transaction that affects neither the accounting profit / (loss) nor taxable profit / (loss). In addition, deferred taxes are recognised for the carry forward of unused tax losses to the extent that it is probable that it will be possible to utilise them in the future.

The carrying amount of deferred tax assets is reviewed each year at the balance sheet date and is reduced if it is no longer probable that sufficient taxable income will be available to allow the benefit of all or part of the deferred tax asset to be utilised.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

The changes in deferred taxes are recognised in the income statement as tax income or expense unless they relate to transactions recognised in other comprehensive income or directly in equity; in this case the deferred taxes are recognised in other comprehensive income and the associated equity position.

Contingent liabilities and contingent assets

Contingent liabilities are not recognised. If any are identified, they are disclosed in the notes unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent assets are not recognised. They are disclosed in the notes, where an inflow of economic benefits is probable.

The use of estimates and assumptions

The preparation of the consolidated financial statements in compliance with the pronouncements of the IASB requires estimates to be made affecting the values recognised in the balance sheet, the nature and extent of contingent assets and liabilities identified at the reporting date and the value of income and expenses in the reporting period. The main assumptions and estimates for the H&K AG Group concern the annual impairment test for goodwill, the setting of useful lives, the recoverability of accounts receivable, the valuation of inventories, the recognition and measurement of provisions and the probability of future utilisation of deferred tax assets. Changes in estimates are recognised in the income statement prospectively.

Guarantee and warranty obligations can arise from legal or contractual requirements. Provisions are recognised for the expected cost of meeting claims under guarantee or warranty obligations. Claims are particularly likely if the warranty period has not yet expired, if warranty costs have been incurred in the past or if particular warranty claims are known. The evaluation of the risk of warranty claims is based on past experience and is used in determining the level of provision required. (Note 24).

Provisions for litigation risks are recognised if a company in the Group is a defendant in a law suit and a judgement against the defendant is more likely than not. A provision is made for the amount likely to be incurred by the company if the judgement is against it. This figure includes the payments likely to be made by the company, in particular compensation, damages and settlements, as well as the expected legal expenses. If a company in the Group is a defendant in a law suit and a judgement for the defendant is more likely than not, or if the company is the claimant, only litigation fees are provided for. (Note 24).

The use of estimates in other positions in the Group balance sheet and income statement are described in the notes relating to the individual positions. In particular, these relate to: impairment of goodwill,

impairment of non-current tangible and intangible assets, provisions for doubtful debts, allowances for inventories, the valuation of deferred tax assets and of the pension provision.

Notes on the income statement

(6) Revenue

Net revenue decreased by €20,319k to €182,038k compared with revenue of €202,357k in 2016. The revenue of the Group was made up as follows:

EUR '000	2017	2016
Sale of goods	181,588	201,856
Sale of services	2,066	3,548
Gross revenue	**183,655**	**205,404**
Discounts, bonuses, etc.	(1,617)	(3,047)
Net revenue	**182,038**	**202,357**

Breakdown by customer location:

EUR '000	2017	2016
Domestic (Germany)	39,560	51,636
Foreign - other "green countries"	140,083	146,171
Foreign - rest of the world	4,012	7,596
Gross revenue	**183,655**	**205,404**
Discounts, bonuses, etc.	(1,617)	(3,047)
Net revenue	**182,038**	**202,357**

(7) Cost of sales

The cost of sales includes materials and production labour and overhead expenses relating to the revenue. The cost of sales decreased by €7,157k to €112,415k compared with €119,572k cost of sales in 2016, primarily due to the lower revenues.

(8) Research and development expenses

The research and development expenses comprise those personnel expenses and depreciation relating to these activities, together with the costs of test materials and tools that do not meet the criteria for capitalisation under IAS 38, together with the amortisation or retirement of capitalised development costs. These decreased by €161k to €5,724k compared with €5,884k in 2016; the higher level of capitalisation of development costs counteracted the increase in research and development activities and higher scheduled amortisation of capitalised development costs.

(9) Sales, marketing & distribution expenses

The sales, marketing & distribution expenses mainly comprise personnel expenses, material and marketing costs as well as depreciation relating to the sales function and project related costs. They increased by €2,930k to €24,853k compared €21,924k in 2016; primarily due to higher payroll and other costs, offset by lower project related expenses.

(10) Administration expenses

General administration expenses include personnel expenses and overheads as well as the depreciation relating to the administration function. They increased by €3,054k to €21,301k compared with €18,246k in 2016, primarily due to higher provisions for litigation and consultancy fees for various projects.

(11) Other operating income

EUR '000	2017	2016
Release and utilisation of provisions	112	89
Insurance benefits	1,050	142
Income from the provision of administration services	21	24
Profit on disposal of non-current assets	41	6
Licence fee income	404	797
Fuel sales to employees	1,120	1,078
Other	1,913	1,247
Total	**4,661**	**3,384**

The other operating income includes out-of-period income of €1,426k (2016: €867k). This is primarily due to income from refunds, expiries and insurance benefits €1,272k (2016: €772k), the reversal of impairment and the release of provisions and accruals €112k (2016: €89k) and gains on disposals of non-current assets €41k (2016: €6k).

(12) Other operating expenses

EUR '000	2017	2016
Provision for the possible calling of bank guarantees	4,690	519
Create prov. doubtful debts, write off bad debts, prior year credit notes	(320)	(170)
Loss on disposal of non-current assets	(803)	(63)
Other taxes	(306)	(363)
Liquidated damages and similar penalties	(3,237)	14
Petrol for employees and company vehicles	(1,098)	(1,068)
Other	(366)	(165)
Total	**(1,440)**	**(1,296)**

The other operating expenses include out-of-period net income of €3,342k (2016: €421k net income). These are mainly due to the partial release and the revaluation of the provision for the possible calling of bank guarantees that more than offset the net expenses for doubtful debts, losses on the disposal of non-current assets, credit-notes relating to prior years, together with the release of provisions for liquidated damages and for other operating expenses.

(13) Analysis of expenses by nature, showing EBITDA

The income statement shows operating expenses analysed by function; the following table shows operating profit, with expenses analysed by nature, and EBITDA:

EUR '000	2017	2016
Net sales	182,038	202,357
Material costs and movement in inventories	(67,687)	(77,073)
Capitalised costs	6,151	3,111
Other operating income	4,661	3,384
Payroll	(58,962)	(52,042)
Other operating expenses	(36,272)	(31,571)
EBITDA	**29,928**	**48,165**
Depreciation and amortisation	(8,963)	(9,346)
Results from operating activities	**20,965**	**38,819**

No definition of EBITDA is given in IFRS; various methods can therefore be used to determine EBITDA.

(14) Financial result

EUR '000	2017	2016
Financial income		
Interest income	108	39
Valuation of bond early-repayment clauses	-	1,060
Profits on bond repurchases	-	1,108
Gains on translation of foreign currencies	52	1,982
Total financial income	**160**	**4,189**
Financial expenses		
Interest expenses	(19,623)	(23,878)
Accretion of non-current liabilities	(2,507)	(3,349)
Valuation of bond early-repayment clauses	(1,360)	-
Losses on valuation of investments	(51)	-
Losses on translation of foreign currencies	(5,056)	(1,321)
Other	(52)	(173)
Total financial expense	**(28,648)**	**(28,721)**
Financial result	**(28,488)**	**(24,531)**

The profits on bond repurchases (2017: nil; 2016: €1,108k); are the discounts achieved when repurchasing our 2011-bond less the associated portions of the original bond transaction costs; (Note 25). The interest income includes interest on bank balances and tax refunds. The gains and losses on translation of foreign currencies include gains and losses on unhedged transactions together with translation differences for balance sheet positions held by Group companies in currencies other than their own functional currency. The results of the valuation of bond early-repayment clauses relate to changes in the current value of derivatives embedded in the 2011-Indenture; (Note 18, 25). The interest expenses are primarily due to interest on the bonds, on other long-term loans and on tax payments relating to prior

years. The accretion of non-current liabilities relates to defined benefit and other long-term provisions, the 2011 and 2017 bonds and the SFA-loan; (Note 25). Other financial expenses relate to guarantee costs, primarily for the provision of guarantees to our customers.

(15) Income taxes

Income taxes include German corporation tax ("Körperschaftsteuer"), trade income tax ("Gewerbesteuer") and associated reunification surcharges ("Solidaritätszuschlag") for the German companies, together with similar income taxes for the foreign subsidiaries. Through the German companies' fiscal unity, from 2013 income taxes are due from the top-level company, H&K AG.

The companies in Germany have a calculated statutory tax rate of 28.075% (2016: 28.075%). Foreign taxation is calculated at the rates valid in each country; these vary between 19.0% and 35.0% (2016: between 20.0% and 35.0%). Deferred taxes are calculated on the basis of statutory tax rates, or of tax rates which have been enacted as of the balance sheet date in each country, that are expected to be in place on realisation.

The income tax expense comprises:

EUR '000	2017	2016
Current tax income / (expense)	(3,134)	(5,242)
Deferred tax income / (expense)	(2,728)	(1,846)
Tax expense in income statement	**(5,862)**	**(7,088)**

Due to the significantly lower result before taxes of €7,523k loss (2016: €14,287k profit), the current income tax expense recognised has decreased to €3,134k (2016: €5,242k). Deferred tax expenses have increased, primarily due to the revaluation of deferred tax assets following the tax rate reduction in the USA, and also include the tax effects of the transactions costs for the equity increase (2017: €109k; 2016: nil).

The following table shows a reconciliation of the expected tax using the current statutory tax rate for the parent company of 28.075% (2016: 28.075%) and the actual income tax shown for the Group:

EUR '000	2017	2016
Profit / (loss) before income tax	(7,523)	14,287
Expected tax rate (current German statutory rate)	**28.075%**	**28.075%**
Expected tax expense / income	**2,112**	**(4,011)**
Adjustments to expected tax expense due to:		
- change in tax rates	(3,112)	(196)
- non-tax-deductible expenses	(4,037)	(2,650)
- non-taxable income	(51)	828
- taxes relating to other periods	(1,436)	394
- differences in foreign tax rates	232	(227)
- change in valuation adjustments for tax losses	704	943
- change in valuation adjustments for temporary diff.	0	(22)
- other effects	(274)	(2,147)
Actual tax expense / income	**(5,862)**	**(7,088)**
Effective tax rate	**-77.9%**	**49.6%**

Deferred tax relates to the following positions:

Balance Sheet Item EUR '000	Deferred tax assets 31.12.2017	Deferred tax assets 31.12.2016	Deferred tax liabilities 31.12.2017	Deferred tax liabilities 31.12.2016
Intangible non-current assets	-	-	15,373	14,464
Long term financial investments & derivatives	-	-	-	-
Tangible non-current assets	136	267	4,238	3,421
Inventories	1,425	5,537	186	133
Trade accounts receivable	-	-	15	14
Other current assets	691	4	-	696
Employee defined benefit obligations	7,605	8,243	-	-
Other non-current provisions	245	221	-	-
Non-current financial liabilities	-	-	1,041	715
Current provisions	134	311	-	-
Trade accounts payable	-	3	0	0
Other current liabilities	789	1,384	-	-
Carryforward of unused tax losses	2,927	-	-	-
Total	**13,953**	**15,970**	**20,853**	**19,443**

During 2017, a net decrease in deferred tax assets of €369k (2016: €1,398k increase) was recognised through other comprehensive income into equity since it related to the actuarial variances on defined benefit schemes. The variances due to the effects of changing exchange rates on the translation of deferred tax assets and liabilities in foreign subsidiaries' accounts are also recognised within "Forex translation differences for foreign operations" in other comprehensive income. Apart from these, all other changes in deferred tax assets and liabilities were recognised in the income statement.

Balance Sheet Item EUR '000	Deferred Tax 31.12.2015	Recognised in profit or loss	Recognised in other comprehensive income	Deferred Tax 31.12.2016	Recognised in profit or loss	Recognised in other comprehensive income	Deferred Tax 31.12.2017
Intangible non-current assets	(14,041)	(422)	-	(14,464)	(909)	-	(15,373)
Long term financial investments & derivatives	(83)	83	-	-	-	-	-
Tangible non-current assets	(3,450)	290	6	(3,154)	(992)	44	(4,102)
Inventories	5,525	(161)	41	5,404	(4,031)	(133)	1,240
Trade accounts receivable	(12)	(2)	-	(14)	(1)	-	(15)
Other current assets	(2,476)	1,784	(0)	(692)	1,383	-	691
Employee defined benefit obligations	6,984	(138)	1,398	8,243	(250)	(387)	7,605
Other non-current provisions	210	12	-	221	6	18	245
Non-current financial liabilities	(1,730)	1,016	-	(715)	(326)	-	(1,041)
Current provisions	785	(477)	3	311	(148)	(28)	134
Trade accounts payable	3	(0)	-	3	(3)	-	(0)
Other current liabilities	1,279	60	45	1,384	(454)	(141)	789
Carryforward of unused tax losses	3,890	(3,890)	-	-	3,107	(180)	2,927
Total	**(3,119)**	**(1,846)**	**1,493**	**(3,473)**	**(2,619)**	**(808)**	**(6,900)**

Potential deferred tax assets of €234k (2016: €1,021k) relating to tax-losses carried forward by US subsidiaries have not been recognised; this reduction was due to the lower tax rate in the USA together with the current valuation assessment. Potential deferred tax assets of the parent company amounting to €24,877k (2016: €29,372k) relating to the tax carry-forward of interest expenses, reduced as a result of the tax audit for the years 2007-2010 completed in 2017, have also not been recognised.

In 2017 income tax payments amounted to €3.9 million (2016: €1.9 million). Of these, €1.3 million (2016: €1.3 million) relate to advance payments for current year German income taxes, €1.8 million net payments (2016: €0.7 million net refunds) relate to German income taxes for prior years while foreign income taxes account for €0.8 million net payments (2016: for €1.3 million net payments).

Notes on the balance sheet

(16) Intangible assets

EUR '000	Development costs (self-generated) 0/1/1900	Goodwill (acquired)	Trade marks Patents, licences, software (acquired)	Total
Net carrying value at 01.01.2016	**18,670**	**5,149**	**8,916**	**32,736**
Acquisition / manufacturing costs				
Balance at 01.01.2016	**27,768**	**6,649**	**22,719**	**57,136**
Effect of movement in exchange rates	6	-	12	18
Additions	3,208	-	348	3,556
Disposals / retirements	-	-	(115)	(115)
Balance at 31.12.2016	**30,983**	**6,649**	**22,963**	**60,595**
Amortisation & depreciation				
Balance at 01.01.2016	**(9,098)**	**(1,500)**	**(13,802)**	**(24,400)**
Effect of movement in exchange rates	-	-	(11)	(11)
Amortisation for the year	(2,163)	-	(197)	(2,360)
Disposals / retirements	-	-	115	115
Balance at 31.12.2016	**(11,260)**	**(1,500)**	**(13,895)**	**(26,656)**
Net carrying value at 31.12.2016	**19,723**	**5,149**	**9,067**	**33,939**
Acquisition / manufacturing costs				
Balance at 01.01.2017	**30,983**	**6,649**	**22,963**	**60,595**
Effect of movement in exchange rates	(70)	-	(58)	(127)
Additions	6,466	-	643	7,109
Disposals / retirements	(39)	-	(17)	(56)
Balance at 31.12.2017	**37,340**	**6,649**	**23,531**	**67,520**
Amortisation & depreciation				
Balance at 01.01.2017	**(11,260)**	**(1,500)**	**(13,895)**	**(26,656)**
Effect of movement in exchange rates	-	-	50	50
Amortisation for the year	(2,224)	-	(241)	(2,465)
Disposals / retirements	-	-	17	17
Balance at 31.12.2017	**(13,485)**	**(1,500)**	**(14,069)**	**(29,054)**
Net carrying value at 31.12.2017	**23,855**	**5,149**	**9,462**	**38,466**

As described in Note 5, goodwill and other intangible assets with indefinite lives are subject to annual impairment testing. Goodwill is allocated to the individual companies within the Group, which represent the segments of the H&K AG Group and are also the lowest level within the Group at which goodwill is monitored for internal management purposes.

As shown in the above table, aggregate goodwill is unchanged from the previous year at €5,149k. This is the portion of the net book value of the goodwill, through acquisitions from independent third parties, at which it was held under German GAAP at the date of transition to IFRS (January 1, 2006) as shown in the Defence Technology Sub-Group's consolidated financial statements (excluding trademarks).

Originally, the parent company of this Sub-Group was called Heckler & Koch Wehrtechnik Holding GmbH. This company acquired the design, manufacturing and distribution company Heckler & Koch Gesellschaft mit beschränkter Haftung, at the end of 2003. In 2004 the two companies were merged and renamed Heckler & Koch GmbH. As a result, the Group has goodwill of €4,016k allocated to the merged company, Heckler & Koch GmbH. The balance of €1,133k is allocated to Heckler & Koch France SAS since this relates to its acquisition in 2004. On the acquisition of Heckler & Koch Gesellschaft mit beschränkter Haftung, at the end of 2003, the trademark was also recognised as an intangible asset (2017: €8,393k; 2016: €8,393k) and allocated to the merged company, Heckler & Koch GmbH. Since the Group's reputation is associated with this trademark, like goodwill, it is also treated as being of indefinite life. These individual intangible assets are material for the Group (IAS 38.22(b)).

Since only a small proportion of H&K AG's shares are traded on a stock exchange, and comparable companies have not been bought or sold regularly on an active market during the past year, it was not possible to base impairment tests on market value. Impairment tests were therefore based on value in use determined by discounting future cash flows projected based on the operating results of the annual five year business plans together with a terminal value. No impairment was determined.

Under a security assignment agreement certain patents, trademarks and domains have been pledged as security for a long-term financing loan (*Senior Facilities Agreement*, "SFA-loan") (net book value 2017: €8,393k; 2016: for a revolving credit facility that expired on June 30, 2017, €8,393k); (Note 25).

The amortisation and impairment of intangible assets is included in the following income statement positions; the impairments relate to the write-off of the capitalised development costs for projects that have been cancelled due to changed market conditions(2017: €39k; 2016: nil):

EUR '000	**2017**	**2016**
Cost of sales	58	29
Research and development expenses	2,310	2,194
Sales, marketing & distribution expenses	18	5
Administration expenses	118	132
Total	**2,504**	**2,360**

As at December 31, 2017 the Group had a balance of €35k (2016: nil) on order for intangible assets.

(17) Property, plant and equipment

EUR '000	Land and buildings	Plant and machinery	Fixtures, fittings and other assets	Assets under construction	Total
Net carrying value at 01.01.2016	**21,778**	**12,768**	**6,841**	**146**	**41,533**
Acquisition / manufacturing costs					
Balance at 01.01.2016	**32,690**	**56,408**	**53,322**	**146**	**142,566**
Effect of movement in exchange rates	(2)	33	(35)	14	10
Additions	314	1,826	1,997	513	4,650
Reclassifications	-	-	10	(10)	-
Disposals	-	(634)	(638)	-	(1,272)
Balance at 31.12.2016	**33,002**	**57,633**	**54,656**	**662**	**145,954**
Amortisation & depreciation					
Balance at 01.01.2016	**(10,912)**	**(43,640)**	**(46,481)**	**-**	**(101,033)**
Effect of movement in exchange rates	56	(31)	36	-	61
Depreciation for the year	(796)	(3,204)	(2,987)	-	(6,987)
Reclassifications	-	-	-	-	-
Disposals	-	634	565	-	1,199
Balance at 31.12.2016	**(11,652)**	**(46,242)**	**(48,867)**	**-**	**(106,760)**
Net carrying value at 31.12.2016	**21,350**	**11,392**	**5,790**	**662**	**39,194**
Acquisition / manufacturing costs					
Balance at 01.01.2017	**33,002**	**57,633**	**54,656**	**662**	**145,954**
Effect of movement in exchange rates	(601)	(271)	(330)	(20)	(1,221)
Additions	4,591	3,539	4,082	33	12,244
Reclassifications	271	74	9	(354)	-
Disposals	-	(1,421)	(1,048)	-	(2,469)
Balance at 31.12.2017	**37,263**	**59,555**	**57,369**	**321**	**154,508**
Amortisation & depreciation					
Balance at 01.01.2017	**(11,652)**	**(46,242)**	**(48,866)**	**-**	**(106,760)**
Effect of movement in exchange rates	129	120	272	-	521
Depreciation for the year	(818)	(3,162)	(2,518)	-	(6,498)
Reclassifications	-	-	-	-	-
Disposals	-	777	880	-	1,657
Balance at 31.12.2017	**(12,340)**	**(48,507)**	**(50,233)**	**-**	**(111,080)**
Net carrying value at 31.12.2017	**24,923**	**11,048**	**7,136**	**321**	**43,428**

Under various floating charges and other security agreements almost all of the Group's property, plant and equipment has been pledged as security for a long-term financing loan (*Senior Facilities Agreement*, "SFA-loan"); (Note 25).

None of the Group's property, plant or equipment was acquired on finance leases.

As at December 31, 2017 the H&K AG Group had a balance of €3,509k (2016: €2,269k) on order for tangible non-current assets.

(18) Non-current investments and derivatives, current loans, investments and derivatives

The “**other non-current investments & derivatives**” and the “**other loans, investments and derivatives**” include bank deposits of €2,295k (2016: €2,060k) recognised as non-current assets and bank deposits of €2,731k (2016: €7,233k) recognised as current assets since they have terms of more than three but less than twelve months. These deposits serve as security for certain bank guarantees and similar.

In 2016 the position “**other loans, investments and derivatives**” also includes embedded derivatives due to the prepayment options within the 2011 bond indenture, which were carried at a fair value through profit or loss of €1,360k; the bond was redeemed in full in 2017 and the embedded derivatives were written off(Notes 14, 25). The fair value of these embedded derivatives was determined using a valuation model based on the Black (1976) model. The valuation depends upon interest curves, the volatility of yields from our 2011 bond and on our 2011 bond price; this data was obtained from third parties at the balance sheet date.

A non-current investment of nil (2016: nil) relates to a 26% participation in a foreign company, which is not material and has therefore not been included in the consolidation at equity (Note 4). A further non-current investment of nil (2016: €6k) relates to a 50% participation in a foreign company, which is not material and has therefore not been included in the consolidation at equity (Note 4). These positions also include a loan to this company of €2k current (2016: €58k non-current) (Note 36). The H&K AG Group has loan receivables to other related parties that are impaired and therefore, as in prior years, fully allowed for.

(19) Inventories

EUR '000	31.12.2017	31.12.2016
Raw materials, consumables and supplies	24,666	15,642
Work in progress	39,968	24,396
Finished goods and merchandise	10,468	19,280
Total	**75,102**	**59,317**

Under inventories, provisions of €13,832k (2016: €25,701k) have been made to account for marketability risks and slow-moving items. These provisions reduce certain items of inventory to carrying values in line with their net realisable values as at December 31, 2017 of €7,627k (2016: €8,580k). Impairment losses of €308k (2016: €530k) were recognised as an expense. Impairment losses recorded in prior years have been reversed within cost of sales (2017: €11,751k; 2016: €9,309k) due to the disposal of related items (special sales etc.) and to improved inventory movements.

Under various floating charges and other security agreements almost all of the Group’s inventories have been pledged as security for the SFA-loan; (Note 25).

(20) Receivables, prepayments and other assets

EUR '000	31.12.2017	31.12.2016
Trade accounts receivable	21,156	28,183
Prepayments for inventories	14	18
Prepayments for other current assets	738	604
Other assets	5,702	2,580
Total	**27,609**	**31,387**

Trade accounts receivable are not interest-bearing; they usually have due dates between 30 and 60 days. Under various floating charges and other security agreements certain of the Group's pledgeable receivables have been pledged as security for the SFA-loan; (Note 25).

The other assets are mainly for VAT & other tax claims arisen in the normal course of business and receivables from employees & directors (travel and salary advances).

If there is an indication that a receivable may be impaired, at the latest if it is over 180 days overdue, the possibility of an impairment is reviewed by the finance, sales and legal departments. Provisions have been made for individual doubtful debt risks within trade accounts receivable. The provision account has had the following movements during the reporting period:

EUR '000	2017	2016
Opening balance January 1	3,569	3,487
Creations	27	83
(Release) / (utilisation)	(512)	-
Effects of foreign currency conversion	(1)	(1)
Closing balance December 31	**3,083**	**3,569**

All expenses from impairment of trade receivables or income from reversal of such an impairment is shown under other operating expenses or income.

The aging of financial instruments that are trade accounts receivable is as follows:

EUR '000	31.12.2017	31.12.2016
Neither overdue nor impaired:	**16,128**	**23,410**
Overdue, not impaired:		
- within 30 days	2,283	3,573
- between 30 and 60 days	831	457
- between 60 and 90 days	260	14
- between 90 and 180 days	987	223
- after more than 180 days	667	506
Total:	**5,028**	**4,773**
Impaired (net)	**-**	**-**
Book value	**21,156**	**28,183**

As at the balance sheet date, no evidence had been identified to suggest that any of the accounts receivable that were neither overdue nor impaired were doubtful.

(21) Cash and cash equivalents

The position cash and cash equivalents includes cash balances, cheques, bank balances on current accounts and short-term deposits, the original term of which is less than three months. These are valued at nominal value.

One of the prerequisites for the provision of certain guarantee lines is that we are required to maintain a varying level of deposits as security (Note 25). As at December 31, 2017 we had €0.1 million (2016: €3.9 million) such security deposits included in cash and cash equivalents. The remaining Group bank accounts have been pledged as security for the SFA-loan (2017: €18.7 million; 2016: nil); (Note 25).

(22) Shareholders' equity

The following table shows the changes in the individual items of equity in the Group:

EUR '000	Share Capital	Additional Paid in Capital	Translation Reserve	Reserve for Defined Benefit Obligations	Consolidated Retained Earnings	Shareholders' Equity
As of 31.12.2015	**21,000**	**9,920**	**361**	**(11,831)**	**(169,148)**	**(149,698)**
Total recognised income & expense	-	-	(340)	(3,545)	7,199	3,314
As of 31.12.2016	**21,000**	**9,920**	**21**	**(15,376)**	**(161,949)**	**(146,384)**
Issue of new shares	6,641	43,105	-	-	-	49,746
Total recognised income & expense	-	-	(243)	945	(13,385)	(12,683)
As of 31.12.2017	**27,641**	**53,025**	**(222)**	**(14,431)**	**(175,334)**	**(109,320)**

The H&K AG annual general meeting on August 15, 2017 resolved a capital increase for the company; in October 2017 the associated contributions in kind and in cash were completed at a price of €7.53 per share, based on a company valuation that was reviewed for plausibility by an independent expert. As a result the share capital increased by €6.6 million and the additional paid in share capital by €43.1 million; the €0.3 million net transaction costs were offset against the additional paid in share capital, consequently H&K AG has a share capital of €27.6 million (2016: €21 million), divided into 27.6 million (2016: 21 million) no-par shares. Since July 28, 2015 the H&K AG shares have been listed under ISIN DE000A11Q133 on the Euronext free market in Paris; approx. 0.03% are tradable, the remaining 99.97% are held by our main shareholders.

The calculation of the basic earnings per share of €0.59 loss (2016: €0.34 profit) has been based on the following earnings attributable to ordinary shareholders and weighted-average number of ordinary shares outstanding:

TEUR	2017	2016
Profit / (loss) for the year attributable to the owners of the parent company	(13,385)	7,199
of which not attributable to ordinary shareholders	-	-
Profit / (loss) attributable to ordinary shareholders	**(13,385)**	**7,199**

Thousands of shares	2017	2016
Issued ordinary shares at 01.01.	21,000	21,000
Effect of 6,638k shares issued related to a contribution in kind 04.10.2017	1,600	-
Effect of 3k shares issued related to cash contributions 04.10.2017	1	-
Weighted average number of ordinary shares at 31.12.	**22,601**	**21,000**

A calculation of diluted earnings per share would be based on the earnings attributable to ordinary shareholders and the weighted-average number of ordinary shares outstanding after adjustment for the effects of all dilutive potential ordinary shares. There were no dilutive effects for the reporting period.

The additional paid in capital arises from additional capital contributions from the shareholders.

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

The reserve for defined benefit obligations comprises the cumulative actuarial gains and losses arising on the employee defined benefit obligation provisions, net of tax. The net increase is due to actuarial gains of €1,314k (2016: €4,943k losses) net of €369k (2016: €1,398k) deferred taxes (2016: including the effects of the changed tax rate).

The consolidated retained earnings include a reduction of €62,333k arising from the effects of the transition to IFRS on January 1, 2008, mainly due to the valuation difference on the acquisition of treasury stock in November 2007. An additional reduction of €2,857k arose from the difference between the acquisition price and the associated net assets for each of the common control transactions involving the acquisition of Suhler USA, Inc., that took place in April 2009, and Suhler Jagd- und Sportwaffen Holding GmbH, that took place in May 2009, but have been shown as if they had taken place prior to the beginning of 2008.

The H&K AG Group shows a negative equity of €109.3 million (2016: €146.4 million) at the balance sheet date. The going concern status for the individual companies and therefore the Group is not, however, affected by the negative equity. The current H&K AG Group business plan shows an improvement in the equity position and assumes the reduction of debt.

Under the German companies act (AktG), the distributable dividend is determined by the retained earnings in the annual financial statements of the parent company, H&K AG, prepared in accordance with German accounting principles (HGB). The executive directors and supervisory board will propose that the shareholders' meeting resolve to carry forward that company's €124.7 million cumulative profits as at December 31, 2017.

(23) Provisions for pensions and similar employee defined benefit obligations

The pension schemes at the Group's foreign companies are defined contribution plans, while HKO has both defined benefit and defined contribution plans. The defined benefit schemes for employees were finally closed to new entrants in 2002. In addition contributions are made to the applicable state pension schemes.

Under the **Defined Contribution Plans** the company pays contributions to state or private pension schemes on the basis of statutory or contractual obligations or on a voluntary basis. Having paid the contributions, the company has no further obligations. The current contribution payments are shown as payroll expense for the relevant year: they amounted to a total of €3,819k (2016: €3,422k) for the Group.

The **Defined Benefit Plans** are accounted for in the Group by setting up provisions for pensions and death benefits determined by the Projected Unit Credit Method in accordance with IAS 19. Under this method, in addition to the pensions and vested rights known at the balance sheet date, expected future increases in pensions and salaries, with realistic estimates of the demographic variables are also taken into consideration. The value is obtained from an actuarial report calculated using biometric actuarial assumptions (Prof. Dr. Klaus Heubeck's 2005 G guideline tables). Together with the state pension, the company pension entitlement may not exceed 75% of the employee's average monthly salary for the final year.

Under the defined benefit schemes, on reaching the retirement age of 65, employees are entitled to benefits based on their length of service. The defined benefit schemes in operation before 1995 entitle members to benefits for the first ten years' service of 8% of the average monthly salary for the final year, plus 0.25% for each additional year of service. Increases are no longer possible since these schemes are closed and members' entitlements remain fixed.

Under the defined benefit scheme from January 1, 1995, members are entitled to benefits of a fixed sum per year of service depending on the member's grade. The relevant grade for active members is the grade on retirement. This scheme was closed to new entrants on November 30, 2002.

The following table shows the development of the defined benefit liability for asset-backed and non-asset-backed obligations:

- - - - EUR '000	Defined benefit obligation 2017	Defined benefit obligation 2016	Fair value of plan assets 2017	Fair value of plan assets 2016	Net obligation for defined benefit plans 2017	Net obligation for defined benefit plans 2016
Balance at 01.01.	**66,094**	**62,596**	**(865)**	**(840)**	**65,230**	**61,755**
Included in profit or loss						
Current service cost	506	455	-	-	506	455
Past service credit	-	-	-	-	-	-
Interest cost (income)	1,075	1,401	(14)	(19)	1,061	1,381
Total recognised in profit or loss	**1,581**	**1,856**	**(14)**	**(19)**	**1,567**	**1,837**
Included in other comprehensive income						
Actuarial loss (gain) arising from:						
- demographic assumptions	-	-	-	-	-	-
- financial assumptions	(972)	5,112	-	-	(972)	5,112
- experience adjustments	(402)	(171)	-	-	(402)	(171)
Return on plan assets exc. interest income	-	-	(5)	2	(5)	2
Total recognised in OCI	**(1,374)**	**4,941**	**(5)**	**2**	**(1,380)**	**4,943**
Other						
Contributions paid by employer			-	(7)	-	(7)
Contributions paid by employees			-	-	-	-
Benefits paid	(3,315)	(3,299)	-	-	(3,315)	(3,299)
Total other	**(3,315)**	**(3,299)**	**-**	**(7)**	**(3,315)**	**(3,306)**
Balance at 31.12.	**62,986**	**66,094**	**(885)**	**(865)**	**62,101**	**65,230**
represented by:						
Net defined benefit obligation for funded plan	893	944	(885)	(865)	9	79
Defined benefit obligation for unfunded plans	62,093	65,150	-	-	62,093	65,150
Balance at 31.12.	**62,986**	**66,094**	**(885)**	**(865)**	**62,101**	**65,230**

The current service costs are shown within functional areas and the annual net interest expense is shown within the interest result. Actuarial gains and losses are not recognised in the income statement but are shown in the statement of comprehensive income and taken to reserves.

The fair market value of the plan assets relates solely to asset values from reinsurance policies and associated credit balance. The expected long-term returns from these plan assets are calculated at 1.79% (2016: 1.67%). This is based on the discount rate for the associated pension obligations. The actual earnings from the plan assets were €20k (2016: €17k). Contributions of around €39k are expected to be offset against the credit balance in 2018.

The calculated average duration of the pensions schemes is 12.6 years (2016 12.7 years). The following table shows the principle actuarial assumptions at the reporting date:

	31.12.2017	**31.12.2016**
Discount rate	1.79%	1.67%
Future salary growth for active plan members	0.00%	0.00%
Future pension growth	1.50%	1.50%
Longevity rates according to	RT 2005 G	RT 2005 G
Invalidity rates according to	RT 2005 G	RT 2005 G

Reasonably possible changes at the reporting date to one of the relevant actuarial assumptions, holding other assumptions constant, would have affected the defined benefit obligation by the amounts shown below:

31.12.2017 Effect in EUR '000	Defined benefit obligation Increase	Decrease
Discount rate (0.5% movement)	(2,680)	5,335
Future pension growth (0.25% movement)	2,871	(592)

Although the analysis does not take account of the full distribution of cash flows expected under the plan, it does provide an approximation of the sensitivity of the assumptions shown.

(24) Other current and non-current general liability provisions

The current and non-current general liability provisions are as follows:

EUR '000	31.12.2017	31.12.2016
Current provisions & accruals	19,452	20,748
Non-current provisions	2,582	2,874
Total	**22,034**	**23,622**

The provisions comprise:

EUR '000	Personnel obligations	Warranty obligations	Other obligations relating to sales	Other risks	Total
Balance at 01.01.2017	**4,847**	**1,121**	**8,820**	**8,834**	**23,622**
Exchange rate difference / reclassification	-	(2)	(270)	(1)	(274)
Utilisation	(3,550)	(1,051)	(1,066)	(1,300)	(6,967)
Release	(210)	-	(4,451)	(38)	(4,698)
Creation	1,712	1,379	2,891	4,368	10,351
Balance at 31.12.2017	**2,799**	**1,447**	**5,924**	**11,864**	**22,034**

Provisions for the German early retirement scheme (“Altersteilzeit”) are included in the personnel obligations (€178k; 2016: €404k). These include the reduced pay taken by employees in this scheme during the working phase together with the accumulated additional costs to the company during the remainder of the early retirement period. The value is based on the associated contractual obligations and is obtained from actuarial reports, calculated using biometric actuarial assumptions (Prof. Dr. Klaus Heubeck’s 2005 G guideline tables), discounted at 2.80% (2016: 3.24%). There are no material uncertainties with regard to the value of these provisions. These obligations are secured by certain securities; these plan assets are offset against the associated provisions. The current early retirement scheme agreements are for between two and six years. In the working phase (first half of early retirement agreement term) the provision is created; the outflows of economic benefits occur in the non-working phase (second half). Accordingly the outflows of economic benefits for early retirement agreements are expected over up to six years, currently however primarily within the next five years.

Other personnel obligations also include provisions for long-service anniversary benefits, similar obligations and bonuses. These personnel provisions are determined based on the associated contractual obligations and the outflows of economic benefits are generally expected within twelve months, although the anniversary benefits (€558k; 2016: €530k) will be paid out over up to forty years and certain other personnel payments (€921k; 2016: €2,200k) will occur over up to two (2016: three) years. There are no material uncertainties with regard to the value of these provisions.

The provisions for warranties were recognised on the basis of past experience with regard to the Group liability for a warranty period of two years. Accordingly the outflows of economic benefits are expected within two years. There are no material uncertainties with regard to the value of these provisions.

Provisions relating to sales include provisions for offset obligations, onerous conditions, late delivery and other contractual penalties, costs to complete and price-audits on certain contracts. These provisions have been recognised in line with the probability of their incidence, based on the associated contractual obligations and the current status; the outflows of economic benefits are generally expected within twelve months. There are no material uncertainties with regard to the value of these provisions. The releases in 2017 relate to the partial release of the provision for the possible calling of bank guarantees following the expiry of a bank guarantee; in line with the original creation, this partial release was recognised in other operating expenses.

The provisions for other risks relate mainly to litigation risks, recognised in line with the probability of their incidence. The outcome of the litigation depends on the associated legal proceedings and accordingly these provisions are based on particular uncertainties. The outflows of economic benefits are generally expected within twelve months. The provision for legal risk includes the following cases:

On January 26, 2017 the US company Orbital ATK Inc. filed a complaint against HKO with the US District Court in Minnesota. In this complaint Orbital ATK Inc. is seeking damages in excess of $27 million together with the transfer of technology. Orbital ATK Inc. is the US Army's main contractor so it is our sole contractual partner. Following a reassessment of the legal position by the governmental authorities responsible, in May 2017 HKO delivered the missing prototypes to Orbital ATK Inc. Currently settlement negotiations are taking place to end this litigation amicably.

In October 2012, we commenced proceedings against Faxtech Pty Ltd (trading as "Point Trading"), an Australian entity demanding the return of a product owned by us. Point Trading raised a counterclaim against HKO and the Australian Commonwealth in December 2012 to assess damages for loss of opportunity and reliance loss. At present settlement negotiations are taking place; these are currently expected to be successful. The most recent expert report valued the loss of opportunity for Point Trading at a maximum of AUD 4.5 million. The court hearing set for April 4, 2018 has been suspended due to the settlement negotiations.

As a result of the Stuttgart Public Prosecutor's Office's preliminary investigation into former HKO employees, commenced in 2010, in which allegations of unauthorised export of rifles to Mexico between 2006 and 2009 are being probed, criminal charges have been made in the Stuttgart District Court against five former employees and the former agent in Mexico. On May 3, 2016 these charges were permitted and legal proceedings opened; these will begin on May 15, 2018. HKO has cooperated fully with this investigation and tasked an international audit company to carry out an independent forensic investigation into the facts of the case. The audit company's results were provided to the Stuttgart Public Prosecutor.

In addition to this, the Public Prosecutor initiated investigations into allegations of the bribery of domestic public officials and foreign decision-makers in Mexico. The first of these investigations, relating exclusively to a former director was officially discontinued by the Stuttgart Public Prosecutor's Office on January 20, 2017. However the investigation into the allegations of the bribery of foreign decision-makers is continuing. The risk for HKO resulting from this investigation is considered to be low.

Another preliminary investigation into unnamed employees and managers at Heckler & Koch is pending at the Stuttgart Public Prosecutor's Office. This preliminary investigation relates to an accusation of illegal transfer of technology to Mexico. The company engaged external lawyers to clarify the matter in detail and made the results available to the Stuttgart Public Prosecutor's Office. Their research report concluded that no laws had been contravened. The company expects the preliminary investigation to be closed based on the results of this research. The risk for HKO resulting from this investigation is considered to be low.

The effects of accretion and changes in discount rates were material for the valuations of certain non-current general liability provisions. The financial result includes €99k net expense (2016: €167k net expense) due to discounting and accreting these other non-current provisions; this led to a corresponding increase in the value recognised for these provisions.

(25) Financial liabilities and credit lines

As a result of the refinancing during 2017 the H&K AG Group has two material non-current financial liabilities: a €130 million financing loan and a €60 million unsecured bond listed on the Luxembourg Euro MTF. The €130 million financing loan relates to a private €150 million senior facilities agreement ("SFA-loan") from July 24, 2017, maturing on August 21, 2022, under which a total of €130 million was drawn down on August 21, 2017 (€80 million by H&K AG and €50 million by HKO). The interest rate is 7.25% plus EURIBOR (if positive) and interest is payable half yearly. The €60 million financing relates to a private note purchaser loan that was converted into a listed bond on December 15, 2017. This bond, maturing April 30, 2023 has a fixed interest rate of 6.5% payable on April 30 and October 31. Together with a €50 million short-term shareholder loan that was converted into equity as a contribution in kind in October 2017, the funds from the refinancing were primarily used on August 24, 2017 for the early redemption of HKO's 2011 bond, due May 2018, with accrued interest (€226 million).

The bond and the SFA-loan are recognised in the statement of financial position at their amortised amounts totalling €182,235k (2016: 2011-bond €219,503k). The associated accrued interest liabilities totalling €3,640k (2016: net €2,616k relating to the 2011 bond) are recognised within other liabilities.

EUR '000	2017 Nominal	2017 Book value	2017 Associated interest liabilities	2016 Nominal	2016 Book value	2016 Associated interest liabilities
Balance at 01.01.	**220,323**	**219,503**	**2,616**	**247,090**	**244,310**	**2,934**
Accretion of 2011 bond	-	820	-	-	1,793	-
Repayment (2016: acquisition) of 2011 bond	(220,323)	(220,323)	-	(26,767)	(25,491)	-
Profit on the acquisition of own bond	-	-	-	-	(1,108)	-
Interest expense for bonds and SFA loan			18,471			22,638
Funds from refinancing	190,000	185,688	-	-	-	-
Transaction costs	-	(4,008)	-	-	-	-
Accretion of 2017 bond and SFA loan	-	555	-	-	-	-
Associated interest payments	-	-	(17,447)	-	-	(22,955)
Balance at 31.12.	**190,000**	**182,235**	**3,640**	**220,323**	**219,503**	**2,616**

Under the SFA-loan agreement H&K AG and its subsidiaries are subject to strict limitations on certain transactions; the Group must also meet specified ratios for net debt / contractually defined EBITDA ("Financial Covenant") and make partial repayments dependent upon for example the annual contractually defined "Excess Cashflow". H&K AG is permitted to partially or fully redeem its SFA-loan liability. Once the SFA-loan to H&K AG has been fully redeemed, HKO will be permitted to partially or fully redeem its SFA-loan liability. However the voluntary redemptions must comply with contractual conditions, including in some cases prepayment premia. Interest is payable half yearly starting on February 21, 2018; interest periods are fixed by H&K AG prior to each interest payment.

As security for liabilities under the SFA-loan, the direct and indirect subsidiaries of H&K AG have also entered into the agreement as guarantors. In addition all shares in HKM and all of its direct and indirect subsidiaries together with, through floating charges and other security agreements, certain non-current assets, inventories, receivables and bank accounts (all other bank accounts serve as security deposits for bank guarantees and similar) are pledged to the agent for the lenders; (Notes 16, 17, 19, 20, and 21).

See Note 40 for amendments to the SFA-loan agreement in 2018.

Other Group credit lines

On December 31, 2016 the H&K AG Group had a €30 million revolving credit facility from a lender, available until June 30, 2017; after mid-December 2015 there was no further utilisation of this facility. The lender had made a commitment, under certain conditions agreed with us in advance, to provide a follow-on credit line of €20 million with better terms; we did not accept this line.

The other credit lines are only for the issue of advance payment or performance guarantees, including bid bonds and similar. The value of guarantees currently outstanding is not recognised in the statement of financial position. As of December 31, 2017 a total of €6.9 million (2016: €13.2 million) guarantees to customers were outstanding. As a prerequisite for the provision and maintenance of these and other guarantee lines, deposits must be provided as security. As at December 31, 2017 there were €0.1 million (2016: €3.9 million) such pledged security deposits included in cash and cash equivalents. Additional security for these lines is provided through bank deposits with terms in excess of three months recognised within other current investments (2017: €2.7 million; 2016: €7.2 million) (Note 18), within other non-current investments (2017: €2.3 million; 2016: €2.1 million) (Note 18).

See Note 40 for information on a new €30 million bridging loan in 2018.

(26) Trade and other payables

Trade and other payables include outstanding liabilities from trade and operating costs, together with interest payable on the SFA-loan and the bond.

EUR '000	31.12.2017	31.12.2016
Trade payables	21,180	12,915
Interest payables	3,640	2,616
Other liabilities	7,131	6,188
Total	**31,951**	**21,719**

With the exception of normal trading ownership retention clauses and the-security agreements for the SFA-loan, the trade payables and other liabilities are not secured.

(27) Advanced and stage payments received

The €6,910k (2016: €5,535k) advanced and stage payments received comprise payments received from customers in advance of the delivery of the associated products or services.

Other disclosures

(28) Financial risk management

Currency risk

The H&K AG Group is exposed to currency risk on sales and purchases that are denominated in a currency other than the respective functional currencies of Group entities, primarily the euro (EUR), but also US dollars (USD) and Sterling (GBP). The majority of both costs and sales are in euro, so we only have foreign exchange transaction exposure for those sales in currencies different to the associated costs. H&K AG Group policy is, dependent upon the exchange rates on offer and the conditions of potential forward cover contracts and taking expected USD developments into consideration, to cover a proportion of the expected USD ($) income and the associated foreign exchange transaction exposure with hedging transactions. During the periods covered by this reports and at December 31, 2017 there were no forward cover contracts in place.

Group policy is not to speculate with loans or deposits in foreign currencies. Financing and investing within the Group usually take place in the appropriate functional currency and any financial instruments are purely for operating purposes.

Four subsidiaries of H&K AG are outside the Euro zone. Since the H&K AG Group reporting currency is the euro, the income and expenses of these subsidiaries are converted to euro for consolidation. Through these subsidiaries the Group has assets and liabilities in local currencies outside the Euro zone that are also converted to euro for Group reporting. The conversion of these positions to euro is also affected by fluctuations in foreign exchange conversion rates. The change in valuation of these positions is reflected in the Group reserves.

The rates used for the consolidation are shown in the following table:

Currency	Abbr.	Rate on balance sheet date 31.12.2017	Rate on balance sheet date 31.12.2016	Average exchange rate 2017	Average exchange rate 2016
US Dollar (USA)	**USD**	1.1993	1.0541	1.1297	1.1066
Pound (Great Britain)	**GBP**	0.8872	0.8562	0.8767	0.8187

In order to quantify the possible effects of foreign exchange rate fluctuations on the Group EBITDA, sales and equity, a sensitivity analysis has been carried out:

If the euro had been 5% stronger against the US dollar compared to the rates used for the 2017 consolidation, (i.e. had been an average of €1 = $1.1862 and a spot of €1 = $1.2593), then 2017 sales would have been approximately €2.6 million lower, EBITDA would have been approximately €1.0 million lower and equity and reserves would have been approximately €2.3 million lower.

If the euro had been 5% stronger against the pound sterling compared to the rates used for the 2017 consolidation, (i.e. had been an average of €1 = £0.9205 and a spot of €1 = £0.9316), then 2017 sales would have been approximately €0.3 million lower, EBITDA would have been approximately €0.1 million lower and equity and reserves would have remained roughly unchanged.

Interest rate risk

Interest rate risk is the risk that the fair value or the future cash flows of a financial instrument may change depending on market interest rates. As at December 31, 2017 the Group's interest profile of its interest-bearing financial instruments consisted of a fixed-rate instrument with a nominal value of €60 million (2016: €220.3 million) and variable rate instruments with a total nominal value of €130 million (2016: nil).

The Group's €130 million SFA-loan has a variable interest rate of 7.25% plus EURIOBR (if positive); the applicable rate is set at the beginning of each interest period (currently six months). A 100 basis point (Bp) reduction in EURIBOR at the interest-fixing date (August 21, 2017) would not have affected equity or profit or loss. A 100 basis point (Bp) increase in EURIBOR at the interest-fixing date would have reduced equity and profit or loss by approx. €0.3 million. This analysis assumes that all other variables, in particular tax-deductibility, remain constant.

The Group's €60 million bond is an interest-bearing liability with a fixed interest rate of 6.5%. The fair value of the bond is dependent on market interest rates but it is not recognised as fair value and a changing in interest rates at the balance sheet date would therefore not have had an effect on profit or loss or equity. This analysis assumes that all other variables remain constant.

The advance payment and performance guarantees we procure from banks in favour of our customers are not interest-bearing.

Commodity risk

The element of material costs relating to commodities is relatively small so the H&K AG Group's exposure to changes in purchase prices for raw materials is limited: for example an increase in steel prices of 1% would have resulted in EBITDA being approx. €0.1 million lower while equity and reserves would have remained virtually unchanged.

Credit risk

Credit risk is the risk of financial loss to the H&K AG Group if a customer or counter-party to a financial instrument fails to meet its contractual obligations, and arises principally from the Group's trade receivables. Risk concentrations arise for financial instruments of a similar nature, which react similarly to economic and other changes. Risk concentrations are determined per counterparty.

Trade accounts receivable

Because the majority of the Group's accounts receivable at the balance sheet date relate to sales to customers that are federal, state or local governmental agencies of NATO countries and NATO-equivalent countries, Group exposure to credit risk is limited. Goods are sold subject to retention of title clauses so that, in the event of a customer failing to pay, the Group has a secured claim. Where management is of the opinion that the risk is not sufficiently secured by the retention of title clauses, we require letters of credit or prepayments. The Group has internal credit management processes to review and manage overdue positions and if necessary stop further deliveries or initiate legal action.

In addition, provisions are held for doubtful debts. The maximum risk is the value shown as trade accounts receivable in the balance sheet. The book values of trade accounts receivable analysed according to their aging, together with the associated provisions, are shown in Note 20. To assess risk

concentrations, all of a country's authorities are treated as a single counterparty. The largest risk concentration for trade receivables and other assets as at December 31, 2017 was €2.6 million owed by one counterparty; this receivable was not due and it was received in January 2018.

Cash and cash equivalents

Cash and cash equivalents include cash balances, cheques, bank balances on current accounts and short-term deposits. The H&K AG Group is exposed to credit risks if the banks holding our deposits default on their obligations. To minimise this risk, the banks are selected with care and deposits are held by several banks in Germany and abroad. The largest risk concentration for cash and cash equivalents as at December 31, 2017 is a German bank where the Group had accounts totalling €6.3 million. This bank is a member of the German banks' mutual fund to provide assurance of such accounts.

Liquidity risk

Liquidity risk is the risk that the H&K AG Group may not be able to meet its financial obligations as they fall due. The target of the Group's approach to managing liquidity is to ensure that there will always be sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation.

The Group mainly generates cash through its operating activities. The operating liquidity surplus is primarily used to finance fluctuations in working capital and capital expenditure, together with servicing the interest payment obligations from the SFA-loan and the bond.

The going concern status of H&K AG, and therefore that of the H&K AG Group, depends upon the underlying assumptions used for the liquidity plans materialising; this in turn depends upon the near-term, sustainable improvement of the operating subsidiary's production process to enable the achievement of the planned sales volume.

The following table shows the timing of contractual payments due for financial instruments that are accounts payable or loan interest or repayments.

EUR '000	Trade payables	Borrowings inc. interest	Other financial liabilities
Balance at 31.12.2017			
Book value	21,180	185,875	35
Related payments	21,180	259,245	35
Payments due:			
- within one month	17,326	-	0
- between one and three months	2,515	2,125	34
- between three & twelve months	933	10,766	-
- between one and five years	406	184,392	-
- after more than five years	-	61,961	-
Balance at 31.12.2016			
Book value	12,915	222,120	40
Related payments	12,915	251,719	40
Payments due:			
- within one month	8,908	-	0
- between one and three months	2,312	-	40
- between three & twelve months	1,228	20,931	-
- between one and five years	467	230,788	-
- after more than five years	-	-	-

Variances between book value and related payments arise where certain non-current liabilities, in particular the SFA-loan and the bond, are held at their amortised costs and cause additional interest payments. Additional information on the financial liabilities is given in Note 25.

Capital management

The objective is to secure the financing of current business activities and the regular interest payments, taking into account the obligations due to the SFA-loan and the bond, and in the medium-term to reduce the leverage significantly. The Group's internal policies require that return on capital is monitored on all investments and large contract bid decisions. The Group aims to have a simple corporate and capital structure, without off-balance sheet financing. In the normal course of business, performance and advance payment guarantees are issued to our customers by banks and insurers on our behalf (Note 25).

In 2017 the Group was refinanced through a €50 million equity increase, the draw-down of €130 million from the SFA-loan and the issue of €60 million fixed rate Notes. These proceeds were mainly used for the early redemption of the 2011-Notes with a maturity of May 2018 and accrued interest (€226 million); (Note 22, 25).

All legal capital requirements were complied with during the period covered by these statements.

The Group's capital structure is as follows:

EUR '000	31/12/2017	31/12/2016
Equity	**(109,320)**	**(146,384)**
as a percentage of total financing	-49%	-68%
Long-term liabilities	267,771	307,050
Short-term liabilities	64,316	55,251
Debt	**332,087**	**362,301**
as a percentage of total financing	149%	168%
Total equity & liabilities	**222,767**	**215,917**

(29) Additional disclosures on financial instruments

This note provides an overview of the significance of financial instruments and provides additional information on the balance sheet positions containing financial instruments. The following asset positions in the statement of financial position include financial instruments:

TEUR	31.12.2017	31.12.2016
Non-current assets		
Other investments & derivatives	2,295	2,124
Current assets		
Other loans, investments & derivatives	2,733	8,593
Trade receivables	21,156	28,183
Other receivables	5,702	2,580
Asset positions containing financial instruments	**31,885**	**41,482**
of which non-financial instruments	4,915	2,086
of which financial instruments	**26,970**	**39,396**

The following table shows the book values (BV) and fair values (FV) of the financial assets:

	Cash and equivalents		Trade accounts receivable		Loans including interest		Derivative financial instruments		Other financial instruments	
EUR '000	BV	FV	BV	FV	BV	FV	BV	FV	BV	FV
Balance at 31.12.2017										
Cash & equivalents	18,812	18,812	-	-	-	-	-	-	-	-
Loans & receivables	-	-	21,156	21,156	2	2	-	-	5,812	5,812
Held to maturity	-	-	-	-	-	-	-	-	-	-
Held at fair value	-	-	-	-	-	-	-	-	-	-
Total financial assets	**18,812**	**18,812**	**21,156**	**21,156**	**2**	**2**	**-**	**-**	**5,812**	**5,812**
Balance at 31.12.2016										
Cash & equivalents	24,648	24,648	-	-	-	-	-	-	-	-
Loans & receivables	-	-	28,183	28,183	58	58	-	-	9,794	9,794
Held to maturity	-	-	-	-	-	-	-	-	-	-
Held at fair value	-	-	-	-	-	-	1,360	1,360	-	-
Total financial assets	**24,648**	**24,648**	**28,183**	**28,183**	**58**	**58**	**1,360**	**1,360**	**9,794**	**9,794**

The fair values of accounts receivable are in line with their book values. This is mainly due to the short terms of these instruments. Loans relate primarily to loan receivables, for which the book values are in line with the fair values.

The derivative financial instruments are primarily embedded derivatives due to the prepayment options within the bond indenture, which are carried at a fair value through profit or loss of nil (2016: €1,360k). The fair value of the embedded derivatives for the 2011-bond was determined using a valuation model based on the Black (1976) model. The valuation depends upon interest curves, the volatility of yields from our bond and on our bond price; this data is obtained from third parties at the balance sheet date. The 2017-bond may not be redeemed until after the SFA-loan has been repaid in full; its repayment options are therefore currently not of material value.

The other financial instruments relate primarily to short and long-term bank deposits as security for certain bank guarantee lines etc. (2017: €5,025k; 2016: €9,294k).

The aging of financial instruments that are not trade accounts receivable (Note 20) is as follows:

	Loans and interest		Derivatives		Other financial instruments	
EUR '000	31.12.2017	31.12.2016	31.12.2017	31.12.2016	31.12.2017	31.12.2016
Neither overdue nor impaired:	2	58	-	1,360	5,812	9,794
Overdue, not impaired:	-	-	-	-	-	-
Impaired (net)	-	-	-	-	-	-
Book value	2	58	-	1,360	5,812	9,794

As at the balance sheet date, no evidence had been identified to suggest that any of the above financial instruments that were neither overdue nor impaired were doubtful. During the reporting period there were no reclassifications of financial assets between IAS 39 categories “held at fair value” and either “held at cost” or “held at amortised cost”.

The following liability positions in the statement of financial position include financial instruments:

TEUR	31.12.2017	31.12.2016
Non-current liabilities		
Loans & borrowings	182,235	219,503
Current liabilities		
Trade payables	21,180	12,915
Other payables	10,771	8,804
Liability positions containing financial instruments	**214,186**	**241,222**
of which non-financial instruments	7,097	6,148
of which financial instruments	**207,089**	**235,075**

The following table shows the book values (BV) and fair values (FV) of financial liabilities:

EUR '000	Trade payables BV	Trade payables FV	Bond and SFA loan BV	Bond and SFA loan FV	Other financial liabilities BV	Other financial liabilities FV
Balance at 31.12.2017						
Held at amortised cost	21,180	21,180	182,235	190,000	3,675	3,675
Held for trading	-	-	-	-	-	-
Held at fair value	-	-	-	-	-	-
Financial liabilities	**21,180**	**21,180**	**182,235**	**190,000**	**3,675**	**3,675**
Balance at 31.12.2016						
Held at amortised cost	12,915	12,915	219,503	224,162	2,656	2,656
Held for trading	-	-	-	-	-	-
Held at fair value	-	-	-	-	-	-
Financial liabilities	**12,915**	**12,915**	**219,503**	**224,162**	**2,656**	**2,656**

The fair values of the trade payables are in line with the book values. This is mainly due to the short terms of these instruments. The bond is held at amortised cost; its fair value at the balance sheet date is determined using its market price plus the fair value of the embedded derivatives. The SFA-loan is held at amortised cost; its fair value at the balance sheet date is its nominal value. The other financial liabilities mainly relate to the interest liabilities for the SFA-loan and for the bonds (2017: €3,640k; 2016: €2,616k).

The following table analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)
- Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

31.12.2017 EUR '000	**Level 1**	**Level 2**	**Level 3**
Derivative financial assets	-	-	-
Derivative financial liabilities	-	-	-

31.12.2016 EUR '000	**Level 1**	**Level 2**	**Level 3**
Derivative financial assets	-	1,360	-
Derivative financial liabilities	-	-	-

Net income / (expenses) due to financial instruments:

EUR '000	**2017**	**2016**
Loans and receivables and financial liabilities held at amortised cost	(5,151)	(2,439)
Held at fair value	(1,360)	1,060

The net income / (expense) from loans and receivables and financial liabilities held at amortised cost include exchange gains and losses, impairments and reversals of previous impairments. The net income /

(expense) from financial instruments held at fair value (derivatives) relates to the recognition of changes in the valuation of embedded derivatives in the bond indenture.

The total interest income and expenses relating to financial assets and liabilities not held at fair value through profit and loss, including guarantee fees, are as follows:

EUR '000	2017	2016
Interest income	29	(42)
Accretion of non-current financial liabilities	(1,375)	(1,793)
Other interest expenses	(19,140)	(24,034)

(30) Cash flow statement

The Group cash flow statement shows the change in the H&K AG Group's cash and cash equivalents due to cash inflows and outflows during the year. Cash and cash equivalents include cash balances, cheques and bank balances; these last also include amounts serving as security for certain forward-cover and guarantee lines and for the SFA-loan (Note 21, 25).

As required by IAS 7, cash flows are analysed between operating, investing and financing activities. Cash flows from investing and financing activities are determined directly while those from operating activities are calculated indirectly from the net results. The changes in balance sheet positions used in the indirect calculation are adjusted to exclude the effects of foreign exchange rate variances and changes in the companies consolidated into the Group. The changes in the balance sheet positions shown in the cash flow are therefore different to the euro changes in the Group balance sheet.

Interest received is classified as a cash flow from investing activities. Interest paid is shown as cash flows from financing activities. The interest payments to our bondholders are shown net.

(31) Segment reporting

The organisation and reporting structure of the H&K AG Group is marked by its operating activities being solely directed to the defence technology line of business. The investments in the other investment activities line of business ("holding activities" segment) suffered in the financial and economic crisis and consequently were recognised as being fully impaired in previous reporting periods.

The Defence division is organised around five (2016: five) operating companies, three of which serve customers in the defence and law enforcement sector, whilst the fourth (HKI) serves the US commercial market and the fifth (HKO) serves customers in the defence and law enforcement sector, the other Group companies and the commercial markets in certain other countries. Correspondingly, the segments analysed are the site locations in Germany Great Britain, France and the United States, split into Defence and Commercial. Since these segments mainly represent legal entities, the figures shown for each segment are the values for the companies as included in the H&K AG Group's consolidated figures.

The activities in reporting segment Germany relate to the design, manufacture and distribution of defence and security products together with the provision of associated services. Reporting segment Germany mainly supplies to NATO member states and NATO-equivalent countries in which no Group subsidiaries

are located and to Group companies and manufactures, sells and distributes commercial and security products to customers outside the US. The reporting segment “USA - commercial” has production, sales and distribution activities for commercial and security products and provides related services in the US.

The other reporting segments all have sales and distribution activities for defence and security products and provide related services. The sites located in the USA and France supply to these countries. The site located in Great Britain sells primarily to the United Kingdom; in the past it also served the British Commonwealth of Nations and certain other NATO allies. Due to the new strategic direction to focus on so-called “green countries” (Note 1), only the remaining order book for these countries will be served via site location Great Britain.

The “Other holding activities” reporting segment relates to H&K AG and HKM. As this reporting segment contains several companies, the figures reflect the amounts recognised for individual companies in the consolidated financial statements as well as certain consolidation adjustments within the segment.

Operating segments

Site Location	Germany		USA - Commercial		USA - Defence		Great Britain		France		Holding activities		**Total pre-consolidation**		Consolidation transactions		**H&K AG Group**	
EUR '000	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016
Net external revenues	85,164	89,226	50,192	76,484	3,065	3,885	15,703	13,835	27,913	18,927	-	-	182,038	202,357	-	-	182,038	202,357
Inter-segment revenue	51,494	74,666	367	533	406	133	111	70	-	-	-	-	52,378	75,402	(52,378)	(75,402)	-	-
Depreciation and amortisation	(8,422)	(9,032)	(406)	(202)	(117)	(140)	(12)	(12)	(5)	(13)	(1)	(5)	(8,963)	(9,403)	-	57	(8,963)	(9,346)
Interest income	10,398	17,867	-	0	1	1	0	1	7	24	2,534	5,196	12,941	23,089	(12,833)	(23,050)	108	39
Interest expense	(18,709)	(27,383)	-	-	(139)	(152)	-	-	-	-	(16,167)	(22,914)	(35,015)	(50,449)	12,833	23,049	(22,182)	(27,400)
Income taxes	150	1,017	836	(1,624)	(388)	838	(516)	(339)	(629)	(467)	(2,193)	(9,377)	(2,740)	(9,951)	(3,121)	2,863	(5,862)	(7,088)
Profit / (loss) after tax	6,221	38,697	(3,767)	4,565	(1,749)	(503)	2,166	1,281	1,237	933	(15,778)	80,814	(11,670)	125,788	(1,715)	(118,588)	(13,385)	7,199
Other material non-cash items																		
- Impairment of assets	(182)	(71)	-	-	-	(530)	(204)	(12)	-	-	-	32,956	(385)	32,344	-	(32,956)	(385)	(612)
- Impairment losses reversed	71	11,788	-	-	-	-	8	67	-	-	24	-	103	11,855	-	(10,680)	103	1,175
Non-current assets other than deferred taxes and financial instruments	146,070	145,265	9,128	961	1,295	1,486	79	54	16	19	8	-	156,596	147,785	(74,702)	(74,653)	81,894	73,132
Capital expenditure, excluding capitalised development costs	(4,740)	(4,353)	(8,282)	(601)	(108)	(1)	(39)	(33)	(2)	(9)	(9)	-	(13,180)	(4,997)	292	-	(12,888)	(4,997)
Provisions and liabilities	173,481	328,923	19,807	15,223	22,297	23,331	2,695	3,198	5,025	1,780	187,636	203,481	410,942	575,936	(78,855)	(213,635)	332,087	362,301

The above table shows the revenues and results together with the assets and liabilities of the individual Group segments. With the exception of sales from the German segment to the other segments, trading between segments is minimal. The trade relationships between segments have been consolidated. Trade between the segments is conducted at 'arm's-length' prices, as would have been agreed with informed and willing parties outside the Group. Due to the fiscal unity ("Organschaft"), the German taxes are all incurred by the parent entity, H&K AG.

Geographical and product group segments

The value of revenues from customers in different regions of the world and the proportions of revenues due to the different product groups are shown in the following tables:

Region	Revenues		%
Germany (Domestic)	**2017**	**39,361**	**22%**
	2016	**51,441**	**25%**
USA	2017	53,202	29%
	2016	80,971	40%
UK	2017	14,666	8%
	2016	13,002	6%
France	2017	29,203	16%
	2016	19,949	10%
Other "green countries"	2017	41,594	23%
	2016	29,398	15%
Rest of world	2017	4,012	2%
	2016	7,596	4%
Total export	**2017**	**142,677**	**78%**
	2016	**150,916**	**75%**
Total	**2017**	**182,038**	**100%**
	2016	**202,357**	**100%**
of which "green countries"	2017	178,025	98%
	2016	194,760	96%

Product group		Revenues
Rifles	2017	26%
	2016	18%
Sub-machine guns & machine guns	2017	23%
	2016	20%
Pistols	2017	34%
	2016	43%
Development services	2017	0%
	2016	0%
Other products & services	2017	16%
	2016	19%
Total	2017	100%
	2016	100%

Major customers

IFRS requires customers known to be under common control to be treated as one customer. Since the H&K AG Group sells to government agencies, which include law enforcement agencies and armed forces, in various countries this requirement leads to all governmental agencies in a particular country being treated as one single joint customer.

On this basis the H&K AG Group's major customers, to whom more than 10% of sales were made in 2017, are the German governmental authorities (2017: €33 million; 2016: €41 million) shown in the segment Germany and the French governmental authorities (2017: €28 million; 2016: €18 million) shown in the segment France.

(32) Contingent liabilities and pledged assets

There are no material contingent liabilities as of December 31, 2017 or December 31, 2016. For information on bank guarantees for customers and the related security deposits see Note 25. Almost all of the other Group assets are pledged for the SFA-loan from July 24, 2017 under various floating charges and other security agreements. For details of pledged assets see Notes 16, 17, 18, 19, 20, 21 and 25.

(33) Operating leases

Our expenses include €521k (2016: €620k) due to rental and €276k (2016: €269k) due to other operating leases.

As at the balance sheet date, the group had outstanding obligations arising from binding operating leases that fall due as follows:

EUR '000	31.12.2017	31.12.2016
Up to one year	495	489
More than one and up to five years	1,141	1,345
More than five years	465	642
Total	**2,101**	**2,476**

(34) Full-time equivalent number of employees

The workforce in the H&K AG Group, as an annual average of full-time equivalents ("FTE"), was as follows:

	2017	2016
Manufacturing	496	422
Research & development	97	76
Sales, marketing & distribution	85	92
Administration	75	68
Total FTE employees excluding apprentices	**753**	**657**
Apprentices	37	33
Total FTE employees including apprentices	**789**	**691**

(35) Personnel expenses

Personnel expenses in 2017 were €58,962k (2016: €52,042k). Of these expenses, €3,819k (2016: €3,422k) relate to employer's contributions to social security pension funds and similar defined contribution plans for pensions.

(36) Related party disclosures

Parent and ultimate controlling party

H&K AG is the parent of the H&K AG Group and is owned by private investors. It holds 94.9% of HKO indirectly and the 5.1% balance directly.

Other related party transactions

Transactions between the parent company and related parties that are its subsidiaries were eliminated in the course of consolidation and are not described in these disclosures in the Notes. Transactions with members of the governing bodies are covered in Note 38.

In addition, there are arm's-length business relationships between H&K AG Group companies and related parties as defined by IAS 24, as follows:

- On October 11, 2016 NSAF made an unsecured loan of £50k to its joint venture for an indefinite period, in accordance with the joint venture agreement. During 2017 it was decided to end the joint venture and the loan was partially repaid (£9k) and the balance written down to the amount received in January 2018 (£2k). The investment in this joint venture was fully written down in 2017 (net book value 2017: nil; 2016: £5k).

Transactions with related parties are generally carried out as if between willing, informed and independent third parties.

(37) Governing bodies of the Group

Executive Board of H&K AG

Wolfgang Hesse	CFO
Norbert Scheuch	CEO (until August 29, 2017)
Hanns-Friedrich Begemann	Director (until January 14, 2016)

On August 29, 2017 H&K AG the supervisory board revoked the appointment of Norbert Scheuch as Chairman of the H&K AG Executive Board with immediate effect. Until the appointment of a successor Wolfgang Hesse, the sole executive board member of H&K AG, will take over these duties. On January 29, 2018 it was announced that from May 1, 2018 Dr.-Ing. Jens Bodo Koch, currently Spokesman for the Executive Board of ATLAS ELEKTRONIK GmbH based in Bremen, will take over the leadership of the H&K AG Group as Chairman of the Executive Board. Herr Hesse will continue in his previous role. The already initiated strategic realignment of the Group, the operational transformation process and the product innovation initiative will be continued unchanged.

Supervisory Board of H&K AG

Dieter John	Board Member (from January 26, 2016) and Chairman (from February 16, 2016)
Nicolaus Bocklandt	Board Member (from June 9, 2015) and Deputy Chairman (from February 16, 2016)
Jean-Christoph Arntz	Board Member (from October 2, 2017)
Keith Halsey	Board Member (until October 12, 2017)

(38) Transactions with the members of the governing bodies

In 2017 the remuneration recognised for the supervisory board's services, including expenses was €108k (2016: €142k). The net balance due for these services was €108k (2016: €108k) at the year-end. In accordance with §314 paragraph 3 Sentence 2 HGB (German Commercial Code) in conjunction with §286 paragraph 4 HGB, the executive board's remuneration in 2017 remains undisclosed.

(39) Auditor's remuneration

EUR '000	2017	2016
Audit of the financial statements	192	208
Tax services	185	205
Other services	2,273	291
Total	**2,650**	**704**

The "Other services" were primarily fees for support on the refinancing projects (2017: €1,431k; 2016: €105k) and relating to a national law suit (2017: €598k; 2016: nil) and an international law suit (2017: €179k; 2016: €146k).

(40) Subsequent events

On January 29, 2018 it was announced that from May 1, 2018 Dr.-Ing. Jens Bodo Koch, currently Spokesman for the Executive Board of ATLAS ELEKTRONIK GmbH based in Bremen, will take over the leadership of the H&K AG Group as Chairman of the Executive Board. Herr Hesse will continue in his previous role; (Note 37).

On March 2, 2018 an amendment of the SFA-loan agreement was agreed covering the one-off extension of due dates for certain reports. Another amendment was agreed on March 29, 2018 including an obligation to maintain minimum cash resources of €10 million, consent for an unsecured bridging loan from one of our main shareholders to be drawn, and adjustments to the ratios of net debt to contractually defined EBITDA (Financial Covenant) for the quarters ending December 2017 through June 2018.

On March 28, 2018 one of our main shareholders agreed a €30 million interest-free bridging loan to H&K AG with a term until July 15, 2019; funds were received in late April; (Note 28).

No other material operating or structural changes or transactions have occurred in the H&K AG Group between December 31, 2017 and the approval of these consolidated financial statements.

Oberndorf/Neckar, April 20, 2018

The Executive Board

Wolfgang Hesse

Group Management Report 2017

H&K AG, Oberndorf/Neckar

1. Trend in business and overall situation

1.1 Trend in business and corporate structure

The H&K AG Group with its parent company H&K AG is defined by both the military & law enforcement and the commercial business areas of Heckler & Koch GmbH (HKO), its subsidiary in Oberndorf/Neckar, Germany, and HKO's subsidiaries in the US, England and France. US law enforcement and military customers are served by Heckler & Koch Defense Inc., Ashburn/Virginia, USA, while Heckler & Koch, Inc., Columbus/Georgia, USA, serves the American commercial market.

HKO develops, manufactures and, together with its subsidiaries, markets and distributes infantry and sidearms for governmental security forces, in particular in NATO countries and the EU, and is one of the leading businesses in this market segment; the operating companies also provide related services. In both business areas, we are concentrating on the development and introduction of new products.

H&K AG was formed in March 2014 through the change in legal status of the former Heckler & Koch Beteiligungs GmbH; this was entered into the commercial register on April 7, 2014.

Since July 28, 2015 the shares in H&K AG (ISIN DE000A11Q133) were listed on the Euronext stock exchange in Paris (free market); of these approx. 0.03% are tradable, the remaining 99.97% are held by our main shareholders. The financial year is the calendar year.

The product portfolio comprises portable infantry weapons such as pistols, machine pistols, assault rifles and machine guns as well as grenade launchers and specialist equipment, together with numerous training systems in various construction variants for almost all weapon categories enabling realistic training. This provides a complete and flexible product range for military and police personnel that is specifically tailored to suit a large number of user scenarios and is unique worldwide in covering all military and police small calibre small arms at this high quality level.

H&K AG Group stands for state-of-the-art products and the highest quality. To secure this position, 11% (prior year: 10%) of our employees worked in Quality Assurance and 13% (prior year: 12%) in Research and Development. HKO and its quality management system are certified to DIN EN ISO 9001:2015 and take account of the requirements of NATO AQAP quality standards.

As members of the defence industry located in Germany, due to manufacturing and selling fire arms and fire arms components, H&K AG and its German subsidiaries are subject to current German weapons and export regulations. All exports of controlled goods, including manufacturing and technology documentation, are governed by Germany's Foreign Trade and Payments Act (AWG) and Foreign Trade and Payments Regulation (AWV). If deliveries include weapons of war, authorisation pursuant to the Military Weapons Control Act (KWKG) must be obtained in addition to the authorisation pursuant to the

AWG and the AWV. Compliance with these regulations is of existential importance to the company. For more information on the associated organisational processes, please see section 3.3.5 'Legal risks'.

1.2 Group entities

H&K AG's consolidated financial statements comprise the following companies:

- H&K AG, Oberndorf/Neckar, Germany (H&K AG)
- Heckler & Koch Management GmbH, Oberndorf/Neckar, Germany (HKM)
- Heckler & Koch GmbH, Oberndorf/Neckar, Germany (HKO)
- NSAF Ltd, Nottingham, United Kingdom (NSAF)
- Heckler & Koch France S.A.S., Paris, France (HKF)
- Small Arms Group Holding Inc., Ashburn, Virginia, USA (SAGH)
- Heckler & Koch Defense Inc., Ashburn, Virginia, USA (HKD)
- Heckler & Koch, Inc., Columbus, Georgia, USA (HKI)

1.3 Internal planning and control system

H&K AG Group is managed on the basis of a detailed five-year plan, which is updated each year. In addition there is a monthly budget for each current financial year. Current results are compared to target figures. Any differences and their reasons are analysed with a view to defining and taking any necessary mitigation measures.

The H&K AG Group is primarily managed on the basis of financial ratios. Non-financial performance indicators are also used for the individual entities.

1.3.1 Financial performance indicators

The main objectives are to meet the planned revenue and earnings targets and to manage both working capital and available cash and cash equivalents. To this end, monthly status reports are prepared for the Group’s executive board. This information is also used as a basis for the monthly management meetings where current business developments and potential budget variances and their causes are analysed and decisions are made on any necessary measures.

The key internal planning and control measures for H&K AG Group are revenue and, in particular, earnings before depreciation, amortisation, financial result and taxes (EBITDA).

H&K AG Group also uses order intake and order book as performance measures. These figures are updated regularly. They provide an indication of expected production capacity utilisation and revenue trends.

As part of the Group's liquidity management, working capital (defined as inventories, trade receivables and prepayments net of trade payables and advances received) is monitored.

The analysis and control of cash flows for operating activities are a central element of liquidity management.

1.3.2 Non-financial performance indicators

Besides the financial measures, non-financial performance indicators are used for decision-making in the manufacturing (e.g. inventory turn and manufacturing lead time), HR (e.g. number and structure of employees) and environmental (e.g. power consumption and efficiency) departments.

Within the performance measurement system, the non-financial performance measures for the purchasing, logistics, quality and sales departments are differentiated between profit and control measures so that the individual areas can control their performance more precisely.

To improve control of revenues, the performance measures output quantity, scrap, rework and backlog are used.

Further information about non-financial performance indicators can be found in the ‘Research and development', ‘Non-financial performance indicators’ and ‘Opportunities and risks report’ sections.

1.4 Research and development

By always moving forward in the development of its products, the H&K AG Group is one of the most innovative players in the small arms business in the world. This contributes significantly to the Group's strong market position. The R&D department is correspondingly pivotal to safeguarding the Group's future and essential to the corporate strategy.

Heckler & Koch is a leading developer of infantry weapons systems technology with a focus on long firearms, grenade launchers and grenade launcher modules, machine guns and sidearms. The need to push for further development is evident from the competition in the market in general as well as the specific requirements of the military and law enforcement agencies, and in particular the special armed forces and special operation forces, in the EU and the US. The needs of the commercial market have to be met as well, which calls for the constant development of products specifically for this market. All in all, our aim is to offer our customers products of the greatest reliability, safety and utility. The H&K AG Group is therefore investing increasingly in research and development.

The primary factors for success in the market are specialist know-how and the motivation and commitment of our employees. At year-end, around 13% (prior year: 12%) of our employees worked in Research and Development.

As an innovative group, Heckler & Koch protects key developments against copying by registering patents and trade mark rights so as to contribute to ensuring technological advancement.

2. Business situation

2.1 Macro-economic situation and business trends

The German economy grew significantly in 2017 compared to previous years: The positive economic situation in Germany in 2017 continued to be characterised by solid growth in the domestic economy, boosted by foreign trade. Germany benefited from the improving global economic environment which contributed to an increase in foreign trade and in investments.

The German defence budget for 2018 amounts to around €39 billion (previous year: €37 billion). Changes in the overall economic environment generally have a delayed effect on our business activities. In addition, the military and law enforcement part of our business hinges on public spending. Public sector customers usually have planning and implementation horizons stretching over many years and their tenders are therefore largely unaffected by short-term economic trends.

The market environment is defined by the defence policies of the Western nations and the resulting requirement for state-of-the-art weapons systems on the one hand but existing budget restrictions on the other hand. In addition, our market access is limited by weapons export regulations. Armed forces have to be highly mobile and carry the best possible weapons in order to make an effective military contribution, from humanitarian aid, stabilisation operations, monitoring missions and advice and support right up to combat missions. The increasing destabilisation of the Middle East and North Africa, the conflict in Ukraine and the terrorist attacks in Europe call for security forces to refocus their equipment and training. The only way to ensure the most effective protection for a country's own soldiers during foreign deployment and peacekeeping missions is to keep investing in equipment. Because of the changed security situation, especially in Europe, we expect the relevant budgets to remain stable.

Access to the US market in general, and the sale of weapons in the USA in particular, subject to both greater restrictions on export licences from Germany and changing legislation in the USA and individual US states. It cannot be ruled out that the regulations for this market will be tightened in the future as well, making it more difficult to sell our products in this market - which is the largest commercial market in the world by far - from Germany.

2.2 Business trend

In 2017, in order to prepare the H&K AG Group for the future, the implementation of new production and assembly lines for HKO was necessary. Consequently HKO’s deliveries were delayed; this had a negative effect on Group revenues. In the medium-term however, the positive effects of this restructuring will lead to a sustained increase in efficiency and therefore to an improved delivery situation.

Business development in the US commercial market was affected by lower demand and the delayed market launch of the VP9SK pistol. Additional negative effects resulted from delays in the supply of commercial products from HKO. 2017 was also affected by the construction of a production facility in the USA for the manufacture of commercial products specifically for the US commercial market.

The €182.0 million revenue generated in 2017 was lower than the €202.4 million generated in 2016 and lower than forecast in the prior year report for the reasons given in 2.3.2. As forecast the order intake increased moderately. However the order book increased more than the moderate increase forecast.

The concentration on so-called “green countries” continued to have a positive effect on orders received and the resultant predictable and low export licence risk order book at the end of 2017. "Green countries" are defined by a company internal classification based on three publically available criteria: (i) Transparency International’s Corruption Perception Index, (ii) membership of NATO or being a NATO-equivalent country (Australia, Japan, New Zealand and Switzerland), and (iii) the Economist Intelligence Unit’s Democracy Index. As a consequence, most EU, NATO and NATO-equivalent countries are "green countries".

The EBITDA of €29.9 million (prior year: €48.2 million) was lower than in the prior year and was therefore lower than the prior year forecast, primarily due to the lower revenue. The EBIT also reduced by €17.9 million to €21.0 million (prior year: €38.8 million).

The result before income tax worsened from a profit of €14.3 million in the prior year to a loss of €7.5 million in 2017.

The working capital prior to allowances was reduced again by €13.1 million from the prior year figure of €98.9 million to a year-end 2017 figure of €85.8 million (prior year reduction: €33.8 million) and was lower than forecast.

As forecast, unrestricted cash and cash equivalents (after deduction of security deposits for bank guarantees) reduced from €20.8 million to €18.7 million at the end of 2017.

Contrary to forecast, the number of employees (FTEs) including trainees as at the balance sheet date increased by 171 from 690 for the prior year to 861 for the current year. Due to the build-up of the US production facility and the US sales department, the US headcount increased by 36 to 102 employees (prior year: 66). The HKO headcount increased by 135 from 603 to 738 at the end of 2017; of the increase, 111 have joined the production, logistics and quality assurance departments and 17 the research and development department. In 2017 in order to increase capacity, an extended shift model was introduced; this was also a primary contributory factor for the personnel increase in production and related areas such as quality assurance, warehouse and logistics.

The number of agency staff in the Group increased during the year by 42 to 99 (prior year: 57).

2.3 Financial performance

2.3.1 Overview

Overall, due primarily to delivery delays, the H&K AG Group’s 2017 revenue and EBITDA were lower than projected and lower than in the previous year.

2.3.2 Trend in revenue and orders received

In 2017, H&K AG Group recorded revenue, after sales deductions, of €182.0 million (prior year: €202.4 million).

Group revenue (after sales deductions) can be analysed as follows:

Region	Revenues		
			%
Germany (Domestic)	**2017**	**39,361**	**22%**
	2016	**51,441**	**25%**
USA	2017	53,202	29%
	2016	80,971	40%
UK	2017	14,666	8%
	2016	13,002	6%
France	2017	29,203	16%
	2016	19,949	10%
Other "green countries"	2017	41,594	23%
	2016	29,398	15%
Rest of world	2017	4,012	2%
	2016	7,596	4%
Total export	**2017**	**142,677**	**78%**
	2016	**150,916**	**75%**
Total	**2017**	**182,038**	**100%**
	2016	**202,357**	**100%**
of which "green countries"	2017	178,025	98%
	2016	194,760	96%

Domestic revenue decreased year-on-year by approximately 23% and formed 22% of total revenue in the period under review (prior year: 25%). The reduction is primarily due to delivery delays in our military business.

The market in the USA, which is mainly served by our subsidiaries HKD and HKI, generated 29% (prior year: 40%) of revenue. The reduction was mainly due to delayed deliveries from HKO; this affected both standard products and the series production of new products (for example VP9SK or VP9 PB).

Sales to the UK market increased from 6% to 8% of total revenue.

Due to the AIF project, sales to the French market increased from 10% to 16% of total revenue.

Sales in “green countries” made up 98 % of total revenue in 2017 (prior year: 96 %).

Of the total revenues of €182 million (prior year: €202 million), 53% (prior year: 44%) were to the military market, 14% (prior year: 11%) to the police and law enforcement agencies market and 33% prior year: 45%) to the commercial market.

In 2017, H&K AG Group had an order intake of €215 million (prior year: €212 million).

The resultant 2017 closing order book, excluding contracts with export licence risks, was €156 million (prior year: €124 million). Of this order book, €132 million is scheduled for delivery in 2018 (prior year: €109 million scheduled for delivery in 2017).

2.3.3 Trend in earnings, variances and significant changes

Net revenue was down by 10.0% to €182.0 million compared to €202.4 million in the prior year, while EBITDA of €29.9 million (prior year: €48.2 million) was achieved.

The items in the income statement can be presented as follows:

Revenue (after sales deductions) decreased by €20.3 million to €182.0 million in the period under review compared to €202.4 million in 2016 (-10.0%), this reduction was primarily due to temporary delivery delays.

The cost of sales includes the costs of materials, direct labour costs and overheads incurred to achieve the revenue. Cost of sales decreased from €119.6 million in the prior year to €112.4 million in the year under review (-6.0%). The ratio of cost of sales to revenue increased to 61.8% (prior year: 59.1%). This negative effect was due to the reorganisation of the production and assembly lines together with several suppliers' problems, resulting in rework costs and lower productivity levels.

The research and development expenses comprise those personnel expenses and depreciation relating to these activities together with the costs of test materials and tools, to the extent that these costs do not meet the criteria for capitalisation as intangible assets under IAS 38, together with the amortisation or retirement of capitalised development costs. In comparison with the previous period (€5.9 million), R&D expenses decreased by €0.2 million to €5.7 million. The gross expenses of €12.2 million (prior year: €9.1 million) less the capitalised development costs of €6.5 million (prior year: €3.2 million) result in net research and development expenses of €5.7 million (prior year: €5.9 million). The increased capitalisation of development costs results in part from the commencement of development in the USA of products specifically for the US commercial market.

Sales, marketing & distribution expenses increased by €2.9 million to €24.9 million (prior year: €21.9 million), primarily due to higher payroll and other costs, offset by lower project related expenses.

General administration expenses increased by €3.1 million to €21.3 million (prior year: €18.2 million). They include personnel expenses and office material costs as well as depreciation relating to the administration function. The increase in costs is primarily due to higher provisions for litigation and consultancy fees for various projects; €1.3 million consultancy fees were incurred for an alternative refinancing project (prior year: €0.0 million).

Other operating income increased by €1.3 million to €4.7 million (prior year: €3.4 million), primarily due to insurance benefits.

Other operating expenses increased by €0.1 million to €1.4 million (prior year: €1.3 million).

The EBITDA of €29.9 million was lower than for the prior year (EBITDA: €48.2 million). In 2017 EBIT decreased by €17.9 million to a profit of €21.0 million compared with a profit of €38.8 million in the prior year.

The net financial expense in the year under review was €28.5 million (prior year: net financial expense of €24.5 million). 2017 primarily includes interest expenses of €18.5 million (prior year: €22.6 million) relating to the coupon for the bonds and the long-term financing loan (Senior Facilities Agreement, "SFA-loan") (€190 million; prior year €220 million). In 2017 we recognised €2.5 million accretion for the bonds, the SFA-loan, defined benefit and other obligations (prior year: €3.3 million). The net effect of foreign exchange gains and losses was a loss of €5.0 million (prior year: gain of €0.7 million).

In the year under review earnings before income tax decreased to €7.5 million loss (prior year: €14.3 million profit).

Income tax expenses (including deferred taxes) amounted to €5.9 million in 2017 (prior year: €7.1 million). Deferred taxes are calculated on the basis of statutory tax rates, or of tax rates which have been enacted as of the balance sheet date in each country, that are expected to be in place on realisation.

Due to the above developments, the Group recorded a consolidated result for the period of €13.4 million loss (prior year: €7.2 million profit).

The trends in the different segments are illustrated by the following table (prior to consolidation):

Site Location	Germany		USA - Commercial		USA - Defence		Great Britain		France		Holding activities	
€ millions	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016
Net revenues	136.7	163.9	50.6	77.0	3.5	4.0	15.8	13.9	27.9	18.9	-	-
Order Intake (inc. order book adjustments)	167.8	182.3	51.4	71.0	4.9	2.5	9.6	11.1	28.5	22.7	-	-
Order book	153.9	209.4*	4.5	5.0	2.3	0.9	12.5	32.5*	24.3	23.7	-	-
EBITDA	24.9	52.5	(4.1)	6.4	(1.1)	(1.1)	2.7	1.5	1.9	1.4	(1.7)	(0.3)
EBT	6.1	37.7	(4.6)	6.2	(1.4)	(1.3)	2.7	1.6	1.9	1.4	(13.6)	90.1
Employees (FTE) including trainees (At year-end)	738	603	86	50	16	16	15	14	3	4	2	3
* Including orders for which receipt of export licence is unlikely	-	86.4	-	-	-	-	-	13.7	-	-	-	-

2.4 Financial position

2.4.1 Capital management policies and aims

The 2011-bond with a maturity in May 2018 was redeemed early as part of the refinancing in 2017. Initially two refinancing options were under consideration. The chosen refinancing option resulted in a financing structure with a lower interest burden and a lower leverage. The consultancy expenses for the alternative financing option were €1.3 million.

The H&K AG Group's borrowings as at December 31, 2017 consisted of a €130 million long-term financing loan and a €60 million bond listed on the Luxembourg Euro MTF. The €130 million financing loan relates to a private €150 million SFA-loan agreement from July 24, 2017, maturing on August 21, 2022, under which a total of €130 million was drawn down on August 21, 2017 (€80 million by H&K AG and €50 million by HKO). The interest rate is 7.25% plus EURIBOR (if positive) and interest is payable half yearly. The €60 million financing relates to a private note purchaser loan that was converted into a listed bond on December 15, 2017. This bond, maturing April 30, 2023 has a fixed interest rate of 6.5% payable on April 30 and October 31. Together with a €50 million short-term shareholder loan that was converted into equity as a contribution in kind in October 2017, the funds from the refinancing were primarily used on August 24, 2017 for the early redemption of HKO's 2011-bond, due May 2018, with accrued interest (€226 million).

As security for liabilities under the SFA-loan, the direct and indirect subsidiaries of H&K AG have also entered into the agreement as guarantors. In addition all shares in HKM and all of its direct and indirect subsidiaries together with, through floating charges and other security agreements, certain non-current assets, inventories, receivables and bank accounts (all other bank accounts serve as security deposits for bank guarantees and similar) are pledged to the trustee for the lenders. In the case of a contractually

defined “Event of Default”, one of the options available to the trustee would be the disposal of the pledged shares and / or other assets to cover overdue principal or interest payments.

2.4.2 Funding sources and use of funds

For short term funding HKO had a credit facility available until June 30, 2017. The undrawn credit facility incurred 4% provision fees and any drawn amounts 10% interest.

The funds relating to the H&K AG Group's defined benefit obligations in the amount of €62.1 million (prior year: €65.2 million) are available to the company in the long term.

H&K AG Group's financial expenses are primarily interest expenses of €18.5 million (prior year: €22.6 million) relating to the bonds and the SFA-loan, €2.5 million accretion for the bonds, SFA-loan, defined benefit and other obligations (prior year: €3.3 million) and net foreign exchange effects of €5.0 million loss (prior year: €0.7 million gain).

2.4.3 Off-balance-sheet financing

In the period under review, as in the previous period, H&K AG Group did not make use of any significant off-balance sheet financing. Details of bank guarantees for customers and operating leases are explained in the notes to the financial statements.

2.4.4 Capital expenditure

The H&K AG Group's capital expenditure on property, plant and equipment and intangible assets (excluding capitalised development costs) amounted to €12.9 million in 2017 (prior year: €5.0 million).

Amortisation and depreciation (excluding amortisation of capitalised development costs) amounted to €6.7 million in the year under review (prior year: €7.2 million).

Capitalised development costs in 2017 amounted to €6.5 million (prior year: €3.2 million); the amortisation of capitalised development costs was €2.2 million (prior year: €2.2 million).

The capital expenditure was mainly in the segment Germany and, for the first time also in the segment USA - commercial.

The construction of the US production facility has affected capital expenditure on both capitalised development and on property, plant and equipment and other intangible assets in the segment USA - commercial.

2.4.5 Cash and cash equivalents

2.4.5.1 Cash inflows and outflows, including effects of particular factors

On December 31, 2017, the Group's cash and cash equivalents amounted to €18.8 million (prior year: €24.6 million).

The net cash inflow from operating activities in 2017 was not sufficient to fully fund our capital expenditure on property, plant and equipment and intangible assets and our net interest payments. The remaining capital expenditure utilised funds from the refinancing.

2.4.5.2 Solvency

The available cash and cash equivalents were sufficient so that the H&K AG Group companies were able to meet their payment obligations at all times during 2017. The unrestricted liquidity (cash and cash equivalents less security deposits) provides sufficient scope to cover payments that are due. On December 31, 2017, this amounted to €18.7 million (prior year: €20.8 million).

The business plan includes a cash inflow from operating activities for 2018, which is expected to be sufficient to cover capital expenditure and interest payments. To compensate for potential short-term liquidity gaps, a main shareholder has agreed a €30 million bridging loan. The loan is unsecured and interest-free and has a term until July 15, 2019. The agreement was signed on March 28, 2018; payment was received late April 2018 and repayment should occur in the first quarter of 2019 at the latest.

2.5 Financial position

2.5.1 Significant changes in financial position

Compared to December 31, 2016, net assets at December 31, 2017 increased by €6.9 million to €222.8 million.

Non-current assets as at the balance sheet date increased to €98.1 million (prior year: €91.2 million).

Current assets were €124.6 million; a decrease of €0.1 million compared to the prior year. Inventories and prepayments for inventories increased by €15.8 million to €75.1 million (prior year: €59.3 million). As at the balance sheet date, trade accounts receivable had decreased by €7.0 million year-on-year to €21.2 million (prior year: €28.2 million). This balance sheet item depends on the date of delivery and order-specific payment conditions and is therefore subject to significant fluctuations. Other loans, investments and derivatives decreased by €5.9 million to €2.7 million (prior year: €8.6 million).

Group equity at December 31, 2017 amounts to negative €109.3 million (prior year: negative €146.4 million). The improvement in equity was primarily due to the completed capital increase for H&K AG; in October 2017 the contributions in kind and in cash were completed at a price of €7.53 per share, based on a company valuation that was reviewed for plausibility by an independent expert. As a result the share capital increased by €6.6 million and the additional paid in share capital by €43.0 million; the €0.3 million net transaction costs were offset against the additional paid in share capital. The going concern status for the individual companies and therefore the Group is not, however, affected by the negative equity. The current H&K AG Group business plan shows an improvement in the equity position and assumes the reduction of debt.

Non-current liabilities decreased by €39.3 million to €267.8 million (prior year: €307.1 million). As a result of the refinancing during 2017, as at December 31, 2017 the H&K AG Group has two material non-current financial liabilities: a €130 million financing loan and a €60 million bond listed on the Luxembourg Euro MTF. The €130 million financing loan relates to a private €150 million SFA-loan agreement from July 24, 2017, maturing on August 21, 2022, under which a total of €130 million was drawn down on

August 21, 2017 (€80 million by H&K AG and €50 million by HKO). The interest rate is 7.25% plus EURIBOR (if positive) and interest is payable half yearly. The €60 million financing relates to a private note purchaser loan that was converted into a listed bond on December 15, 2017. This bond, maturing April 30, 2023 has a fixed interest rate of 6.5% payable on April 30 and October 31. Together with a €50 million short-term shareholder loan that was converted into equity as a contribution in kind in October, the funds from the refinancing were primarily used on August 24, 2017 for the early redemption of HKO's 2011-bond, due May 2018, with accrued interest (€226 million).

The bond and the SFA-loan are recognised in the balance sheet at their net amortised cost of €182.2 million (prior year: 2011-Anleihe €219.5 million). The associated accrued interest payables of €3.6 million (prior year: relating to the 2011-bond net €2.6 million) are recognised within other liabilities.

Current liabilities increased by €9.1 million to €64.3 million (prior year: €55.3 million). The increase was primarily due to the increase in trade payables.

2.5.2 Non-financial performance indicators

Ensuring the sustainability of its business model is a central strategic task at H&K AG Group. In addition to achieving our economic targets, this means being a responsible employer, a law-abiding member of society and a reliable partner for our customers and suppliers. Having a sustainable business model is essential for the Group, so as to be able to capitalise on business potential and minimise risks.

Our key activities in terms of sustainability are described in the following sub-sections.

2.5.2.1 Production and innovation

In order to improve business processes and reduce their complexity, it is important to Heckler & Koch to obtain the active involvement of our current employees and the input from new employees. The reduction of manufacturing throughput-times and the improvement of inventory turn as well as innovations and new technologies are the cornerstones of the Group's continued strategic development. Employees are always welcome to submit suggestions for process optimisation or innovative ideas for new products. To manage the following areas, ratios are available in the SAP system and sub-systems covering for example for production: inventory turn and range as well as throughput-times and machine utilisation.

2.5.2.2 Employees

At the H&K AG Group, sustainability also means taking responsibility for our employees. Qualified, highly motivated and committed employees are essential for achieving top performance and are therefore the bedrock of our economic success. Values such as honesty, legal compliance, fairness, acceptance and trust, helpfulness and regard for others, a sense of duty and reliability are understandably of utmost importance for the Group's workforce. In the light of our company's duties to society, whilst securing both facilities and jobs, our business activities across all company locations are shaped by the company's social, environmental and economic responsibilities. Besides profitability and efficiency, our corporate governance principles lay the basis for our actions and commitment.

2.5.2.3 Environment

Heckler & Koch aims to protect the environment through the prudent use of raw materials and by lowering energy consumption, and therefore CO_2 emissions, and has made this an integral part of its company targets.

In accordance with the energy policy defined in 2014, energy-efficiency levels are taken into account when acquiring new machinery.

In 2013, HKO put a cogeneration plant for the production of electricity and heat into operation on the Oberndorf site and implemented other energy efficiency measures, which led, and will continue to lead, to a reduction in energy consumption, and therefore CO_2 emissions. A cogeneration plant has a much higher overall efficiency factor than the conventional combination of local heating and central electricity supplies.

In 2013, the first steps were taken to establish an energy management system. The DIN EN 50001 certification for the energy management system was obtained in September 2014; however a recertification has not been sought. The energy monitoring system required for this certification put into place in 2014 and continues to be used for energy management. Since January 2015, the installed measuring points can be used to identify energy consumption and to collect a detailed record of this data. In the future, energy savings potentials can be determined and respective targets defined on the basis of this data. This system describes the activities to ensure that all the company's actions affecting energy efficiency are carried out properly, monitored and documented, so that the company's energy performance can be improved on an ongoing basis.

Due to the optimisation of the compressed air plant, the use of compressed air in the last few years decreased by 8%; the fitting of LED internal light sources and LED lamps for external lighting (2016) enabled a reduction in energy consumption of approx. 74%.

2.5.3 Conclusion on the overall assertion regarding the financial position, financial performance and cash flows at the time the management report was prepared

Overall, 2017 revenue was lower than in the prior year. As a result EBITDA was lower than in the prior year. The net asset and financial position improved due to H&K AG’s €50 million capital increase together with the refinancing and the resulting lower interest burden.

The liability for the bond and the SFA-loan (prior year: 2011-bond) was further reduced to nominal €190 million (prior year: €220 million). The lower level of liabilities together with lower interest rates reduced the interest burden.

The Group's revenue and operational earning power provide sufficient funds to service the €60.0 million bond and the €130.0 million SFA-loan.

A tight liquidity situation has resulted from the sub-optimal delivery situation at HKO. However potential short-term liquidity problems are covered by a medium-term €30 million bridging loan. The bridging loan agreement is dated March 28, 2018; it was paid out in late April, has a term until July 15, 2019 and is interest-free. The repayment of this bridging loan should occur in the first quarter of 2019.

3. Forecast and opportunities and risks report

3.1 Outlook

3.1.1 Introduction

This report contains forward looking statements on business trends, which are based on the judgements, estimates and assumptions of the management. A number of factors, many of which are beyond Heckler & Koch's control, have an impact on its operating activities, success, business strategy and results of operations. These forward-looking statements are based on current business plans, targets, estimates and projections and take into account the state of knowledge up to the date that this report was prepared, but not beyond. If the assumptions on which the projections are based prove to be incorrect, actual results may differ from these estimates. These elements of uncertainty include changes in the political and economic environment, changes to national and international laws and regulations, swings in the market, fluctuations in foreign currency and interest rates, the impact of competing products and prices, the effect of changes in customer structures as well as changes in the company's business strategy.

3.1.2 Economic outlook

According to IMF forecasts, in 2018 the global economy is expected to continue to gain momentum. Continuing growth is also forecast for Germany and the Eurozone.

The critical factor for the H&K AG Group will be the changing local security situations and the military engagements of the individual countries in our main customer nations and the impact on their budgets for the infantry arms for individual soldiers. The continuing conflicts round the world together with the threat of terrorism require for a large number of international military interventions and a higher level of police capabilities. This makes it imperative to modernise the armed and law enforcement forces' equipment and to ensure continuity of responsible security policies.

On September 22, 2016 Heckler & Koch was awarded a large contract by the French department of defence "Direction Générale de l'Armement (DGA)" for the delivery of the new French standard assault rifle HK416F. After over 30 years' service, the FAMAS assault rifle is being replaced by the modern HK416F from Heckler & Koch as the "Arme Individuelle Future (AIF)". From 2017 onwards members of the Army, Air Force and Navy are being equipped with the new service weapon. The contract calls for the supply of 102,000 HK416 assault rifles together with HK269 grenade launchers, accessories, ammunition, spares and support services over a period of up to fifteen years. The total volume of the contract is about €140 million.

Heckler & Koch supplies the Lithuanian armed forces with additional G36 and the new 40 mm grenade launcher attachment HK269. The contract was awarded by the Lithuanian defence ministry at the end of August 2016. The total volume of this contract is about €12.5 million and it was delivered in full in 2017.

In April 2016, Heckler & Koch was awarded the US Army's Compact Semi-Automatic Sniper System (CSASS) program. As a result the H&K product G28 E1 will be introduced in the US Army and will replace the M110. Once the required tests have been successfully completed, the US Army can exercise options for the delivery of up to 3,600 series weapons with an order value of up to $44 million.

Heckler & Koch has won the tender to provide the German Special Commando Forces and Naval Special Commando Forces with the HK416 A7 assault rifle. The new assault rifle is expected to be introduced by the Special Forces in early 2019. The HK416 A7 replaces the long-serving G36 K as the standard weapon for the German Special Forces. The HK416 A7 is a 5.56 mm x 45 NATO calibre gas operated weapon with a 14.5" barrel and weighs around 3.7 kg. The new weapon impresses with its high precision, secure function and reliability. The contract is for a total of 1,745 HK417 A7 including accessories.

To strengthen its alliance and self- defence capabilities, Latvia has awarded Heckler & Koch a major contract covering the complete product range. The Latvian Armed Forces signed a contract including the supply of G36 assault rifles to the country's National Guard and Border Guard. In 2018 under an order amounting to over €13 million, products from Heckler & Koch's full product range will be supplied. The G36 has proved itself for the Latvian Land Forces since 2006. In future the National Guard and Border Guard will also be able to trust the quality and reliability of the G36. This will result in Latvia having unified NATO standard equipment.

Heckler & Koch was able to beat the models offered by three competitors to win the Bavarian Ministry of the Interior's invitation to tender. By the end of 2019 around 40,000 pistols with accessories and training weapons are to be delivered. The SFP9 TR will replace the P7, also from Heckler & Koch, that has been in service in Bavaria since 1979. Heckler & Koch continues to be an important supplier and partner of the Bavarian police.

Heckler & Koch was also successful with the SFP9 TR for the invitation to tender for the Berlin police, a new customer. Heckler & Koch was awarded the contract for the delivery of up to 24,000 new service pistols; from the first quarter of 2018 these will gradually replace the previous pistols that were not from Hecker & Koch.

All in all, Heckler & Koch is well positioned to continue for the foreseeable future as the main supplier for spare parts for firearms and related services for the NATO and NATO-equivalent countries. However requirements may be lower, depending on actual deployment for foreign operations.

3.1.3 Expected financial performance in 2018 and forecast for non-financial performance indicators

Order intake and order book

For 2018 a slightly lower order intake and order book at year-end are expected.

Revenue and earnings

For 2018 a significantly higher level of revenue and profit are expected. The reorganisation of the production and logistics processes will lead to improved efficiency and performance and therefore to increased revenue and profits.

Working capital

Following the significant reduction already achieved, according to the budget for 2018, the total amount of working capital is expected to be slightly less than in the prior year.

Cash and cash equivalents

At the end of 2018, even without the €30 million bridge loan, cash and cash equivalents are expected to be slightly higher than at the end of 2017. We believe that we will be able to fulfil our payment obligations throughout 2018.

Number of employees

The number of employees in 2018 is expected to be slightly higher than in 2017 due to the required increase in capacity to achieve the planned sales together with the continued build-up of the US facility.

3.1.4 Overall assertion

For 2018 the executive board expects that compared to 2017 both revenues and EBITDA will improve again significantly.

3.2 Opportunities

The H&K AG Group's market potential depends, on the one hand, on the military procurement plans of customer countries. Opportunities arise from changes in military equipment required by the armed forces in “green countries”. The changing threats and deployment scenarios require better mobility and increased performance capabilities. High performance armament is central to affording soldiers the highest level of personal security and giving them the technical capability to accomplish their mission. As the leading provider of small arms technology, this development offers the H&K AG Group the opportunity to further develop its position as an industrial technological partner for highly developed armies and special forces and thus even, contrary to the overall trend, increase its revenue potential.

We believe that the sporting arms product segment has growth potential, particularly in the US commercial market, both for pistols and rifles. An optimised sales and service structure as well as new products specially developed for the US commercial market aim to continuously increase the sales volume. This theoretical market potential cannot currently be achieved. This is due to the large order book for the military and governmental authority customers. However preparatory activities are taking place, which the H&K AG Group can build-on at the appropriate time.

As a result of the reduction in leverage, in July 2017 Moody’s improved our rating from Caa1 outlook stable to B3 outlook stable. S&P upgraded us from CCC+ outlook stable to B- outlook stable in September 2017.

The overall opportunities for the H&K AG Croup are estimated as medium.

3.3 Risks

3.3.1 External risks

Heckler & Koch's market access is restricted both geographically - to Germany, the EU, the NATO countries and NATO-equivalent countries - and because its customers are government authorities. Continued expansion in and stronger concentration on the US market should ensure that cyclical as well as market- and industry-specific risks are reduced. It is paramount for the H&K AG Group to participate in

the future procurement programmes of NATO countries, and particularly those of the US authorities, with the right technological and economic product developments. In addition, it is also important to grow in the US commercial market.

Changes to the export licence approval policy can complicate or prevent the export of defence technology products and related realisation of revenue potentials and therefore significantly impair financial performance. However, this risk is anticipated to be low for the sales markets in the NATO countries.

In alignment with the “Principles of the German Federal Government governing the export of small arms and light weapons, corresponding ammunition and production equipment to third countries” from March 18, 2015 (the “Small Arms Principles”), the executive directors have focussed HK's sales strategy on so-called "green countries". For this purpose, "green countries" are defined by a company internal classification based on three publically available criteria: (i) Transparency International’s Corruption Perception Index, (ii) membership of NATO or being a NATO-equivalent country (Australia, Japan, New Zealand and Switzerland), and (iii) the Economist Intelligence Unit’s Democracy Index. As a consequence, most EU, NATO and NATO-equivalent countries are "green countries". Providing applicable valid export licences are received, the remaining contractual order book for other countries will be fulfilled, but we are not seeking to take part in new tenders in “non-green countries”.

The German federal government's strategy paper on strengthening the defence industry in Germany no longer considers small arms as part of the key defence industry technologies in Germany or the EU whose availability must be guaranteed in the interest of national security. Only those companies with key technologies will be supported, with research and technology activities, targeted industrial policies, support for exports (as decided case-by-case on the basis of the Federal Government’s Political Principles) and contracts awarded by the Federal Ministry of Defence. In future, the risk is that small arms requirements will be satisfied by looking more towards global or European technologies.

It cannot be ruled out that in the USA too, the regulations for this market will be tightened, making it more difficult to sell our products in this commercial market, which is the largest in the world by far; this applies particularly to semi-automatic rifles. This is also the case for the future development of the equally important German export licences. Heckler & Koch is currently working on suitable measures to mitigate this negative scenario.

As an internationally operating group, the company is exposed to risks arising from fluctuations in foreign currency exchange rates. The foreign currency risk in the company's operating activities arises primarily from USD-denominated invoices for sales in the USA. A renewed appreciation of the euro against the US dollar could have a negative effect on earnings from sales invoiced in US dollars. Heckler & Koch on a occasionally uses derivative financial instruments to partially hedge the expected receivables from these planned, but primarily not yet concluded, transactions from USD-denominated contracts against the exposure to changes in exchange rates. In its management of foreign currency risks, the group only uses generally accepted instruments to hedge existing transactions and planned sales, but never for speculative purposes. To reduce the risk of default, these hedges are contracted from prominent German financial institutions. The company had no forward exchange contracts at the year-end.

Procurement risks arise from the fact that the raw materials, parts and components needed for the manufacturing process may not be sufficiently available in the required quality or quantity, or cannot be obtained in a timely manner. To ensure the security of supply and enable a prompt response to any changes, a close watch is kept on the procurement markets. In addition, procurement risks are mitigated

by identifying alternative sources, monitoring supplier quality and reliability and holding suitable minimum inventory levels of raw materials.

Overall, the external risks for the H&K AG Group are considered to be lower than in the prior year.

3.3.2 Internal risks

The fulfilment of H&K AG's obligations depends on whether sufficient profits are transferred by HKO to H&K AG and thus on the continuing high operational earnings power of the companies. In our estimation, the internal risks for the H&K AG Group remain low.

3.3.3 Financial risks

As a result of the refinancing during 2017, as at December 31, 2017 the H&K AG Group has two material non-current financial liabilities: a €130 million financing loan and a €60 million bond listed on the Luxembourg Euro MTF. The €130 million financing loan relates to a private €150 million SFA-loan agreement from July 24, 2017, maturing on August 21, 2022, under which a total of €130 million was drawn down on August 21, 2017 (€80 million by H&K AG and €50 million by HKO). The interest rate is 7.25% plus EURIBOR (if positive) and interest is payable half yearly. The €60 million financing relates to a private note purchaser loan that was converted into a listed bond on December 15, 2017. This bond, maturing April 30, 2023 has a fixed interest rate of 6.5% payable on April 30 and October 31. Together with a €50 million short-term shareholder loan that was converted into equity as a contribution in kind in October, the funds from the refinancing were primarily used on August 24, 2017 for the early redemption of HKO's 2011 bond, due May 2018, with accrued interest (€226 million).

The bond and the SFA-loan are recognised in the statement of financial position at their amortised amounts totalling €182.2 million (2016: 2011-bond €219.5 million). The accrued interest liabilities totalling €3.6 million (2016: net €2.6 million relating to the 2011 bond) are recognised within other liabilities.

Under the SFA-loan agreement H&K AG and its subsidiaries are subject to strict limitations on certain transactions. The H&K AG Group must meet specified ratios for net debt / contractually defined EBITDA ("Financial Covenant") and make partial repayments dependent upon for example the annual contractually defined "Excess Cashflow". H&K AG is permitted to partially or fully redeem its SFA-loan liability. Once the SFA-loan to H&K AG has been fully redeemed, HKO will be permitted to partially or fully redeem its SFA-loan liability. However the voluntary redemptions must comply with contractual conditions, including in some cases prepayment penalties. Interest is payable half yearly starting on February 21, 2018; interest periods are fixed by H&K AG prior to each interest payment.

As security for liabilities under the SFA-loan, the direct and indirect subsidiaries of H&K AG have also entered into the agreement as guarantors. In addition all shares in HKM and all of its direct and indirect subsidiaries together with, through floating charges and other security agreements, certain non-current assets, inventories, receivables and bank accounts (all other bank accounts serve as security deposits for bank guarantees and similar) are pledged to the trustee for the lenders. In the case of a contractually defined "Event of Default", one of the options available to the trustee would be the disposal of the pledged shares and / or other assets to cover overdue principal or interest payments.

As at the balance sheet date, H&K AG holds an asset, in the form of its direct and indirect shares in HKO, which considerably exceeds the current intra-Group-internal loan commitment according to an earnings

calculation based on the current business plan. Therefore H&K AG has the possibility of procuring cash and cash equivalents by selling shares in its holdings.

As reported in the notes on the financial position in section 2.5.1, the H&K AG Group has negative equity of €109.3 million (prior year: €146.4 million). The going concern status for the individual companies and therefore the Group is not, however, affected by the negative equity. The current H&K AG Group business plan shows a further improvement in the equity position and assumes a reduction in leverage.

The going concern status of H&K AG, and therefore that of the H&K AG Group, depends upon the underlying assumptions used for the liquidity plans materialising; this in turn depends upon the near-term, sustainable improvement of the operating subsidiary's production process to enable the achievement of the planned sales volume.

3.3.4 Risks arising from organisation and structure

For the H&K AG Group, active risk management is important for the control and monitoring of business processes. The aim of our risk management and monitoring processes is to facilitate the timely identification of potential risks that could hinder the achievement of business targets and to implement suitable mitigating strategies and measures. Since October 2017 the registration and evaluation of opportunities has been added to our risk management to improve achievement of business targets.

The new Heckler & Koch Group Risk Management Policy issued on September 30, 2016 by the H&K AG executive board governs the Groups revised Risk Management System. This policy was adopted by H&K AG executive board and affirmed by the supervisory board in September 2016. The objective of this policy and the binding rules within it is to achieve a Group-wide standard approach for Risk Management, together with the related topics Compliance Management, Corporate Governance, Internal Control System and Internal Audit, for all companies within the H&K AG Group. At the same time as this policy was issued, the Group implemented a new risk management application ("RMS application") in order to ease the management of the diverse risks to which the Group is exposed. In October 2017 the system was expanded to include EBIT and liquidity.

The Compliance Management Policy is now included within the Risk Management Policy. The Compliance Management System ("CMS") includes the abidance with laws and regulations and the adherence to company policies and procedures. Compliance is a significant element of the management and supervisory responsibility of the executive and supervisory boards. Being a business in the defence sector, Heckler & Koch is subject to particularly strict compliance requirements. The CMS is divided into culture, targets, risks, programme, organisation, communication, surveillance and improvement.

We regard "Corporate Governance" as being "responsible business management". In addition to legislators and shareholders, the stakeholders influencing corporate governance include employees, customers, suppliers, investors, NGOs or overall society through politics and the media. The precise form of our corporate governance is the responsibility of the executive board in close cooperation with its governing body, the supervisory board. The supervisory board is responsible for monitoring the adequacy and effectiveness of the corporate governance. This is done on the basis of information from the executive board. Management regularly reports the current developments in the Group's material risks to the supervisory board.

Overall, the risks arising from organisation and structure for the H&K AG Group are considered to be low.

3.3.5 Legal risks

These risks mainly include risks arising from product liability, competition and anti-trust laws, export law, weapons law, anti-corruption regulations, patent law, tax law and labour law. Any cases of damage and liability risks arising from ordinary activities are recognised in the balance sheet.

Heckler & Koch is engaged in the manufacture and distribution of small arms, particularly for governmental customers such as the German federal and state police and customs authorities, and domestic and foreign armed forces. The sale of small arms outside Germany takes place largely in the Member States of the European Union, NATO countries and NATO-equivalent countries. Heckler & Koch does not intend to generate new business with countries outside NATO's sphere of influence; only so-called "green countries" should be served, i.e. those that are democratic, not corrupt and either NATO states or their equivalents.

The supply of weapons to the law enforcement agencies and armed forces of other foreign countries (so-called "third countries") only takes place – as is basically the case for all weapons sales – with the approval of the German government, whereby supply to critical countries is banned. In particular, when small arms are sold to foreign countries for military use, the recipient countries are required, before an export licence can be granted, to submit officially signed end-user certificates to the Federal Republic of Germany in which the recipient countries pledge not to re-export the proposed weapon supplies to other countries. In relation to the manufacture and sale of small arms, our company is subject to the constant control and regular monitoring of the following authorities: the Federal Ministry of Economics and Energy ("BMWi"), the Federal Office of Economics and Export Control ("BAFA"), the Wiesbaden Federal Office of Criminal Investigation, the Karlsruhe Regional Finance Office and the Rottweil District Administration Office. The underlying prerequisite for obtaining weapons and export approvals depends on the reliability of our company; for this reason complying with the law is a top priority. Absolute compliance with the weapons and export regulations forms the basis of our company. We have therefore implemented strict monitoring procedures and control systems to monitor the operating, production, supply and approval processes. In particular, this includes the careful selection of staff, regular training, continuous monitoring, precise operating instructions and the use of an IT-supported control system which is integrated into our working processes. In view of this, export risks are considered to be low.

On January 26, 2017 the US company Orbital ATK Inc. filed a complaint against HKO with the US District Court in Minnesota. In this complaint Orbital ATK Inc. is seeking damages in excess of $27 million together with the transfer of technology. Orbital ATK Inc. is the US Army's main contractor so it is our sole contractual partner. Following a reassessment of the legal position by the governmental authorities responsible, in May 2017 HKO delivered the missing prototypes to Orbital ATK Inc. Currently settlement negotiations are taking place to end this litigation amicably.

In October 2012, we commenced proceedings against Faxtech Pty Ltd (trading as "Point Trading"), an Australian entity demanding the return of a product owned by us. Point Trading raised a counterclaim against HKO and the Australian Commonwealth in December 2012 to assess damages for loss of opportunity and reliance loss. At present settlement negotiations are taking place; these are currently expected to be successful. The most recent expert report valued the loss of opportunity for Point Trading at a maximum of AUD 4.5 million. The court hearing set for April 4, 2018 has been suspended due to the settlement negotiations.

As a result of the Stuttgart Public Prosecutor's Office's preliminary investigation into former HKO employees, commenced in 2010, in which allegations of unauthorised export of rifles to Mexico between 2006 and 2009 are being probed, criminal charges have been made in the Stuttgart District Court against

five former employees and the former agent in Mexico. On May 3, 2016 these charges were permitted and legal proceedings opened; these will begin on May 15, 2018. HKO has cooperated fully with this investigation and tasked an international audit company to carry out an independent forensic investigation into the facts of the case. The audit company’s results were provided to the Stuttgart Public Prosecutor.

In addition to this, the Public Prosecutor initiated investigations into allegations of the bribery of domestic public officials and foreign decision-makers in Mexico. The first of these investigations, relating exclusively to a former director was officially discontinued by the Stuttgart Public Prosecutor’s Office on January 20, 2017. However the investigation into the allegations of the bribery of foreign decision-makers is continuing. The risk for HKO resulting from this investigation is considered to be low.

Another preliminary investigation into unnamed employees and managers at Heckler & Koch is pending at the Stuttgart Public Prosecutor’s Office. This preliminary investigation relates to an accusation of illegal transfer of technology to Mexico. The company engaged external lawyers to clarify the matter in detail and made the results available to the Stuttgart Public Prosecutor’s Office. Their research report concluded that no laws had been contravened. The company expects the preliminary investigation to be closed based on the results of this research. The risk for HKO resulting from this investigation is considered to be low.

Suitable provisions were created to cover legal risks. The H&K AG Group recognises provisions for legal actions when the resulting liabilities are probable and their amount can be reliably measured. Because of uncertainties and the difficulty of predicting the outcome of court decisions, there is always the chance of costs being incurred which exceed the provisions and can have an impact on the company and its results.

The results of tax audits could lead to the additional payment of taxes. There is also the risk that changes to tax law or case law could have a negative effect on Heckler & Koch's tax expense. Overall, these risks are considered to be medium.

3.4 H&K AG Group's accounting-related internal control system

Approval processes and internal audit

The company has had its own internal binding regulations and guidelines for the areas of procurement, capital expenditure, product development, tenders, order intake, IT-security, data protection, accounting and travelling expenses for many years. Policies pertinent to employees are posted on the intranet. An element of internal audit is the regular review of compliance with regulations by an external auditor.

Accounting-related IT-systems

Management controls in all areas require the timely availability of accurate information. The business information and reporting system is therefore very important. The SAP information system (VIS) provides numerous reports and performance indicators which can be accessed daily by the finance department as well as all operational areas.

One of the main reporting instruments in the finance department is the extensive monthly reporting package. As part of the Group reporting system, all Heckler & Koch companies provide detailed information on key items in their statement of financial position and income statement as well as ratios and explanations. These are requested, analysed and consolidated by the corporate finance department, which then reports them to Heckler & Koch's management.

Accounting organisation and policies

All subsidiaries within the H&K AG Group are independent legal entities. Apart from the management, who are responsible for business operations in the particular market, the head of finance is responsible for the subsidiary's accounting. The regular monitoring of key indicators, monthly reporting of financial results to the corporate finance department and the preparation of the five-year plan for each market are also part of the head of finance's remit.

Within the Group, besides supporting all group companies, HKO's corporate finance department is also responsible for developing and updating policies and job instructions for accounting-related processes. This mainly relates to the accounting manual and intercompany reconciliation instructions. Specific accounting or measurement questions of importance to the H&K AG Group are also centrally processed, analysed, documented and communicated.

Overall assertion

The aim of the internal control and risk management system in relation to the accounting process and preparation of the H&K AG Group financial statements, as highlighted above, is the proper recording, processing and valuation of transactions. The clear definition of responsibilities in the H&K AG Group's finance function and the appropriate training and further education of its staff, together with the use of suitable software and the issue of uniform accounting policies, form the basis for a sound, efficient and consistent accounting process.

Overall, it should serve to ensure that the assets and liabilities in the financial statements are completely and accurately recognised, measured and presented and thus to provide a fair and true view of the company's financial position, financial performance and cash flows.

3.5 Overall statement on the opportunities and risk situation

As in the previous periods, and as described in detail above, the Group's main risks arise from the volatility of revenue potentials and completely regulated market access opportunities, together with the interest payable and refinancing obligations due to the company's high leverage, combined with the limited cash reserves.

As a technological leader in the provision of small arms, the Group sees opportunities to expand its market position arising through the changing requirements for the deployment of military, law enforcement and special forces, due to its high-performance products, and in the US commercial market, with new product developments.

Oberndorf/Neckar, April 20, 2018

H&K AG

Executive board

Wolfgang Hesse

Auditor's Report

We have audited the consolidated financial statements prepared by the H&K AG, Oberndorf/Neckar, comprising the statement of financial position, income statement, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes, together with the group management report for the business year from 1 January to 31 December 2017. The preparation of the consolidated financial statements and group management report in accordance with International Financial Reporting Standards (IFRSs), as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315e Abs. 1 HGB [Handelsgesetzbuch "German Commercial Code"] are the responsibility of the parent company's management. Our responsibility is to express an opinion on the consolidated financial statements and on the group management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB [Handelsgesetzbuch "German Commercial Code"] and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the group management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the group management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements and group management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the consolidated financial statements comply with IFRSs, as adopted by the EU, the additional requirements of German commercial law pursuant to § 315e Abs. 1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The group management report is consistent with the consolidated financial statements, complies with the German statutory requirements, and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Without qualifying our opinion, we draw attention to the comments in the Group Management Report. Paragraph “3.3.3 Financial risks” includes the statement that the going concern status of H&K AG, and therefore that of the H&K AG Group, depends upon the underlying assumptions used for the liquidity plans materialising; this in turn depends upon the near-term, sustainable improvement of the operating subsidiary’s production process to enable the achievement of the planned sales volume.

Stuttgart, April 26, 2018

KPMG AG
Wirtschaftsprüfungsgesellschaft
[Original German version signed by:]

Feller Wirtschaftsprüfer [German Public Auditor]	Fink Wirtschaftsprüfer [German Public Auditor]