

# RISK MANAGEMENT

**DOING BUSINESS MEANS TAKING RISKS IN A RESPONSIBLE WAY. WE USE A RISK MANAGEMENT AND CONTROL SYSTEM THAT PROVIDES INFORMATION ON THE ACHIEVEMENT OF OUR OBJECTIVES, AND IDENTIFY, ENTER INTO AND WHERE NECESSARY MANAGE RISKS IN A STRUCTURED WAY.**

## **RISK MANAGEMENT AND CONTROL SYSTEMS**

Our risk management and control systems are in line with the COSO Enterprise Risk Management (COSO ERM) framework for risk management and control. We identify business risks, assess the likelihood of their occurrence and their potential impact and where possible take steps to manage or mitigate these risks and monitor their timely resolution. This approach is embedded in our organisation as follows.

## **CORE VALUES**

Integrity and openness are important core values within our organisation. We have incorporated these values in the company code “Mediq - the essence”. In 2010 we updated the Mediq management charter and the business incident procedure, in which these core values are developed in greater detail, and rolled them out within the organisation. A whistleblowers procedure is in place under which any incidents in the Netherlands, Poland, Denmark, Norway, United States and Hungary can be reported, anonymously if desired, to an external reporting line. It will be rolled out further within the group in 2011.

## **PLANNING & CONTROL CYCLE**

At set times in the year, all group companies draw up business plans, budgets and forecasts, which incorporate both financial and operational objectives. Discussions take place at regular intervals with the management of the group companies on the general business developments, including the attainability of forecasts issued and strategic choices, and the mitigation of business risks. We apply scenario analyses for developments with a potential significant impact on our financial results.

## INTERNAL GUIDELINES AND EXTERNAL STANDARDS

Uniform operational and financial guidelines and procedures are in place that apply to all group companies, such as guidelines for the operational design of business processes and financial reporting, investments, financing and – more generally – long-term liabilities.

We perform a due diligence review as a standard procedure for acquisitions. We have an integration plan ready at the time of acquisition. In addition, periodical evaluations are performed to establish to what extent the intended objectives of acquisitions have actually been attained.

We have a code for information and data security, both inside and outside the ICT environment. There is a business incident procedure for central reporting of incidents that could harm our patients' health, could cause financial damage or could threaten our reputation.

We are bound to stringent statutory and regulatory requirements for quality and safety on the storage and delivery of our products. The majority of our Dutch pharmacies have HKZ certification (harmonisation of quality assessment in healthcare). Many of our group companies are certified to ISO standards. Our wholesaling operations in the Netherlands and Poland meet GDP standards (Good Distribution Practices). In 2010 the number of group companies with official certification was further increased both in the Netherlands and abroad.

## INSURANCE AND TREASURY POLICY

We apply a group-wide policy on insurance of business risks, with guidelines for group companies. We prevent a substantial impact on results by means of insurance policies including policies for risks of professional, product, and general liability, business, transport and directors' liability, and financial loss in respect of assets. In 2010 we completed the integration of all insurance policies in our corporate insurance programme, as a result of which all insurable risks are insured worldwide under the same cover and with the same and acceptable limits for uninsured risks.

We apply a group-wide treasury policy for adequate management of our cash flows and financing flows and the financial risks relating to them, including (re)financing risks, currency risks and interest rate risks. In 2010 we integrated our foreign group companies in our cash pooling, which has enabled us to significantly reduce the capital required for operating activities and the related interest expense.

## RISK TOLERANCE

We stimulate the pursuit of new opportunities and accept the associated risks provided they contribute to the attainment of our strategic and operational objectives. The requirement we impose is that associated risks are identified and managed.

We apply stringent financial criteria for acquisitions and investments: acquisitions must not only satisfy strategic criteria but also generate a return on average capital employed of at least 15% before tax within a limited number of years. We are prepared to accept the risk of several concurrent acquisition processes, as long as these satisfy our targets in terms of returns, management and other criteria.

Our approach to risk is also influenced by a number of internal and external factors, such as our financial results and operating cash flows, our financing options, economic developments and statutory and regulatory requirements.

## ASSESSMENT

The group companies are themselves responsible for the design and operating effectiveness of the risk management and control systems in their company, within central group guidelines. As part of the annual planning process, they annually perform a self-assessment of the principal risks for business objectives, the results of which are discussed with the Executive Board. In addition, group companies report annually on the quality of their risk management and control systems by means of a letter of representation.

The group companies are responsible for the implementation of the Mediq control framework, which contains controls relating to their risk management process. This control framework is aimed in the present phase primarily at financial reporting risks, but will be gradually widened into a business control framework also including controls aimed at operational risks.

Our internal audit department regularly performs risk-based reviews at our group companies, which contribute to assessing and where necessary further improving the design and operating effectiveness of our risk management and control systems. Our external auditor assesses our risk management and control systems relating to financial reporting risks, as far as relevant for an efficient execution of their audit of the financial statements.

The results of our internal audit department's reviews and the progress of the improvement measures are discussed with the responsible management and at least twice a year with the Audit Committee.

Once a year we discuss the overall design and operating effectiveness of our risk management and control systems with the Audit Committee, as well as any significant shortcomings identified and improvement measures already implemented or intended. The most important specific improvement measures are disclosed in the 'Statement by the Management Board'.

## RISK PROFILE

Doing business means taking risks. The attainment of our objectives depends in part on external economic factors, market developments, local regulations and other factors. A summary is provided below of the main risks relating to our objectives, categorised as market risks, strategic and operational risks, financial risks and risks relating to financial reporting and compliance with statutory and regulatory requirements. We also state how we manage these risks.

### MARKET RISKS

#### Local regulations and price pressure

Government regulations play an important role in the markets in which we operate.

Pharmacies Netherlands has been subject to very substantial price pressure, particularly since mid-2008, as a result of the preference policy pursued by healthcare insurers. In some cases prices fell by more than 90%. This will be exacerbated by the Dutch Healthcare Authority's decision in December 2010 to reduce the dispensing fee, which has become the main source of income of Dutch pharmacies, in 2011. The market conditions and margins for pharmacies in the Netherlands have changed fundamentally in the past few years as a result, and further stepped up the pressure on the earnings capacity of Dutch pharmacies. Our efforts are directed at establishing a new business model that does justice to the role of pharmacists as both providers of healthcare and entrepreneurs.

The requirements for medical devices imposed by healthcare insurers in the Netherlands are likewise continually becoming more stringent in terms of documenting and monitoring their usage by patients.

We are also experiencing increasing pressure on our margins in the other countries in which we are active, owing to the accession of new market parties, increased purchasing power of healthcare insurers and government institutions, often originating in the political wish to reduce the costs of healthcare for the benefit of taxpayers or those paying the premiums. Accordingly, governments and insurers are increasingly inviting tenders, putting further pressure on prices.

We limit the potential negative effects of these risks as much as possible by improved purchasing terms with manufacturers, efficiency improvements, deploying private label products and investing in high-quality services at competitive prices. That is because patients who increasingly act as healthcare consumers will determine their choice of healthcare providers on the basis of the convenience and service on offer.

We are represented in various relevant national and international industry associations and umbrella organisations, which enables us to participate in establishing regulations and to position ourselves opportunely for future developments.

#### Economic conditions and financing

The above developments have led to pressure on prices and therefore on our results. By contrast, the effect of the current challenging economic conditions on our results was only limited. Our volumes continued to grow under the influence of increasing ageing and changing lifestyles.

A further economic downturn can adversely impact our results. This can arise from declining sales of self-care pharmaceuticals and products towards which customers are required to contribute a co-payment, especially in Poland and the USA. The economic downturn is also leading to increasing debtor risks, mainly at pharmacies in the Netherlands and Poland and Dutch healthcare institutions. To minimise the consequences, we have tightened the monitoring of our debtor positions and loans provided to customers, and apply more stringent procedures for cash management and working capital management.

In addition, our potential for acquisitions may be limited if our results decline. We will therefore assess any acquisition opportunities selectively.

We have a relatively healthy financing position to which, alongside a healthy cash flow, the sale & leaseback of a large number of business properties in the Netherlands, the sale of our stake in Anzag and the creation of a worldwide cash pool have contributed. At the end of 2010 a number of loans were refinanced at favourable terms and partly raised, providing sufficient financing headroom for funding acquisitions or temporary working capital fluctuations.

## STRATEGIC AND OPERATIONAL RISKS

### Growth of direct and institutional activities

We are aiming to reduce the dependence on the Dutch market by specifically growing internationally. We are actively seeking acquisition opportunities in the segment Direct & Institutional. Our prime focus with a view to acquisitions is on the countries in which we already have a presence. We see the greatest opportunities in Germany, the Nordics and the USA. As stated under the heading 'Economic conditions and financing', if our results decline, our potential for acquisitions may be limited. We will therefore assess the latter selectively, with acquisitions having to satisfy stringent criteria (as stated under 'Risk Tolerance'). There is moreover a risk that completed acquisitions will fail to match expectations. This risk is limited as much as possible by continual international market reviews, thorough screening of suitable acquisition targets and a focus on integrating newly acquired subsidiaries as quickly and thoroughly as possible, both in terms of control and in terms of commercial approach.

The administration of the ICT applications of the group companies acquired in 2010 in Sweden and Finland is still being carried out by the former owner at present. A plan is currently being developed to end this dependence as soon as possible.

The growth of the number of group companies entails an increase in the number of risks in terms of control in fields including IT, quality management, and reputation. This requires sound management of the group companies and an adequate project approach for change processes.

We have accordingly further strengthened our organisation with Corporate Directors in the fields of IT, logistics and quality.

The staffing of key positions in our business units is very important to achieving our objectives, at both existing and newly-acquired business units. Increasingly, systematic processes are being adopted to ensure appropriate succession in key positions and improve the availability of internationally deployable managers.

### Strengthening leading pharmacy formula

One of our strategic spearheads is the further strengthening of the Mediq Pharmacy formula. We expect our transparent, high-quality services to position us strongly towards patients and insurers. In the Netherlands in particular, we are also working on cooperation with patient associations, insurers, manufacturers and GPs, aiming to improve quality for patients. These measures are instrumental for Dutch pharmacies to switching successfully from a business model based mainly on purchasing margins to a model based on fees for services provided.



### NURSING SUPPORT

We not only provide medical devices and pharmaceuticals, but information, instruction and, where appropriate, nursing support as well.

We therefore signed contracts with a number of insurers in 2009, under which we retain responsibility for the purchasing and logistical handling of goods with a fixed fee for products and services provided.

There is a risk that we will not be sufficiently able to meet the needs of patients, other healthcare providers, manufacturers and insurers with our group-owned and franchise pharmacies. We limit this risk by expanding the brand recognition of our Mediq Pharmacy brand, optimising chain management and chain control, expanding the franchise model, developing pharmaceutical patient care programmes and further standardising our processes.

The increasing differentiation in policy at healthcare insurers and growing compliance requirements are continually increasing the number of accounting and administration and monitoring tasks at Pharmacies Netherlands.

The accounting, logistics and commercial systems in our Dutch pharmacies are not yet fully integrated. We have implemented various controls to reduce the associated operational and financial risks, including a further standardisation and centralisation of accounting processes. We expect to complete the implementation of a number of ICT applications and process improvements in 2011, following which the internal control of money-goods movements within pharmacies will be further improved.

### Efficiency improvement

Guided by integrated logistical concepts, we aim to improve our logistical performance and to mitigate margin erosion by price reductions, as there is a risk that price erosion cannot be compensated by efficiency measures and will eventually lead to margin erosion. To prevent this, we are working continually to realise efficiency improvements, for instance by optimising and integrating our logistics concepts, further standardising processes, group-wide purchasing of medical devices and expanding our range of private label products. We are also optimising cooperation and the exchange of knowledge between the various group companies.

We are working to sharply reduce our operating costs at Pharmacies Netherlands by further centralising and standardising our operations. In 2010 the processes relating to repeat medication and magisterial preparations were largely centralised. Since mid-2008 we have reduced the workforce by 417 fulltime equivalents (FTEs), and the overall reduction by 450 FTEs is expected to be completed by the end of 2011 as planned.

We use various ICT systems within the group. In order to reduce the risks associated with ICT systems that are not optimally integrated, we are continually working on further standardising our information processes and ICT systems as much as possible. ICT systems of acquired companies are integrated as quickly as possible in existing platforms. We are aiming to reduce the number of ICT platforms in due course; we will only do this when existing platforms are due for replacement, to avoid unnecessary costs. We will further tighten our IT strategy, in which the future IT landscape will be defined together with the migration process for reaching it in a systematic manner.

We closed a number of local distribution centres in Poland in 2010 and integrated them in the new nationwide distribution centre. This integration has proved to be more complex than originally expected, leading to temporarily higher costs. Initiatives are being taken to address the identified points for improvement.

#### FINANCIAL RISKS

Our financing structure is directed at maintaining a balance between the leverage of loan capital and sufficient available funding. The covenants applying to our loans and credit facilities are a maximum net debt/ EBITDA ratio of 3.5 and a minimum interest cover of 5.0 (EBITDA/interest charges). At year-end 2010 these ratios were 1.1 and 11.8 respectively.

Our total credit facilities, consisting of long-term loans from institutional investors and medium-term and short-term banking facilities, amounted to € 432 million (2009: € 445 million) at 31 December 2010, of which € 115 million was freely available under the committed facilities.

Our policy aims to consistently **hedge currency risks** arising from trading transactions or loans not denominated in the local currency of the group company concerned, usually by forward foreign exchange transactions. We do not hedge translation risks. We regard our positions in other countries (in this case outside the euro zone) as strategic and assume that, over the longer term, currency fluctuations will on balance be neutral. We have limited our **interest rate risks** by using interest rate swaps or other derivatives where necessary.

In the area of **tax**, we use facilities offered by tax legislation and regulations without incurring unnecessary risks. We are supported by external tax advisers in assessing the legal opportunities and reviewing our compliance with tax law. We consult regularly with the tax authorities on the interpretation of tax rules and the outcome cannot always be reliably predicted. Changes in the corporate income tax rate in the countries in which we are active could lead to favourable and/or adverse changes in the tax positions in our balance sheet.

As regards **pension risks**: our employees are entitled to either the defined benefit plans or defined contribution plans. The defined benefit plans mainly relate to Dutch entities that are members of Stichting Pensioenfond Mediq ('Mediq Pensionfund'). The number of participants concerned is around 4,600 (active and non-active). The pension obligations of Dutch group companies not falling within the scope of the Mediq Collective Labour Agreement and of international group companies are generally insured with separate industrial pension funds or insurance and reinsurance companies, or are insured via local governments. The boards of the pension funds are responsible for the policy pursued. The main risks of pension funds relate to longevity risks, interest rate risks, cash flow risks and investment risks. These risks are limited as much as possible, for instance by analysing life and mortality developments, performing Asset Liability Management studies and by optimum implementation of an adequate investment policy. In the event of underfunding at the Mediq Pensionfund, financing is arranged for this on the basis of the administration agreement with Mediq.

The Mediq Pensionfund suffered major asset losses in 2008 due to the fact that a large part of the assets had been transferred by the asset manager, without the pension fund's knowledge, to Lehman Brothers, which was declared bankrupt in September 2008. The pension fund drew up a recovery plan in 2008, under which Mediq made one-off contributions in 2008 and 2009 of € 5 million and € 2.5 million respectively. Further to the settlement agreed in January 2010 between the pension fund and the asset manager State Street the coverage ratio of the pension fund improved substantially and no further contributions were required from Mediq.

For a further discussion and quantification of the financial risks referred to above we refer to the notes to the financial statements 2010 under 'Other provisions' and 'Other disclosures: risk management and financial instruments'.

## **RISKS RELATING TO FINANCIAL REPORTING AND COMPLIANCE WITH STATUTORY AND REGULATORY REQUIREMENTS**

Reliable financial reporting is essential for internal management information and as a basis for external reporting. The financial reporting by the group companies is subject to group-wide guidelines, based on IFRS. Extensive checks and balances reduce the risk of errors.

Progress was achieved in the past year in implementing the Mediq control framework. The focus in 2011 will be on embedding these controls in the business processes, and in addition on the implementation of controls in the field of IT general controls and the tax control framework.

In view of the industry in which we are active, careful compliance with statutory and regulatory requirements and our code of conduct is of the utmost importance. We propagate its importance within the group through guidelines, including our company code, 'Mediq - the essence'. Employees are able to report (anonymously if desired) actual breaches or possible breaches under the whistleblowers procedure. In addition our 'business incident' procedure also informs the responsible managers at the most senior level of breaches of statutory and regulatory requirements. These tools help us to limit the risk of fraud as much as possible (alongside other controls).

As a logistics service provider we have distribution centres that are required to comply with local statutory and regulatory requirements in the field of safety (for instance working conditions) and the environment (for instance transport and waste). If regulations in these fields become more stringent, this may require us to make additional investments to ensure continued compliance with these laws and regulations.

In response to the counterfeit insulin needles that were found in 2009 we have taken various steps to prevent distribution of counterfeit medical devices in future, including tighter purchasing and product recall procedures, the drafting and start of the implementation of a Code of Ethics for suppliers, and recruiting a quality manager for the group. In 2010 the quality systems were improved further to enable early identification of any counterfeit products purchased.

We ourselves are responsible for the quality standards of private label products manufactured on our behalf. In view of the volume growth of these products we will further tighten our quality standards for this category in the coming year.

The number of compliance checks by healthcare insurers on the correctness of invoices is continually increasing, especially in the USA and the Netherlands. We have strict procedures and controls to limit compliance risks.