## Auditing Committee report

**Olaine, 23 March 2021**

**JSC Olainfarm Auditing Committee report for the Council**

The composition of members of the Auditing Committee of Joint Stock Company Olainfarm (hereinafter – JSC Olainfarm) has remained unchanged since the previous extraordinary shareholders meeting on 1 April 2019. The Auditing Committee has taken the required actions for the performance of the tasks provided for in the laws and regulations of the Republic of Latvia. Meetings of the Auditing Committee have taken place regularly. Control mechanisms of JSC Olainfarm were reviewed selectively and other important tasks were performed.

The most important event of 2020, the Covid-19 pandemic, also affected the work of the Auditing Committee – in order to reduce epidemiological risk and follow the government's guidelines, most work took place remotely.

**Preparation of annual statement**

The Auditing Committee supervised the process of preparing of Annual statement for year 2020. There were several meetings with the auditor of annual Report for year 2020, PricewaterhouseCoopers, Ltd (hereinafter – the Auditors). The Auditing Committee has found, and the Auditors have confirmed, that JSC Olainfarm and its subsidiaries have provided complete information to the Auditors and cooperation with the Auditors been growing ever stronger.

This year once again the Auditing Committee emphasizes key issues and calls on the management of JSC Olainfarm to continue to pay attention to them – these include the valuation of goodwill, pharmaceutical licenses and premises lease agreements, and investments in subsidiaries and inventories.

**Changes in accounting procedures**

The Finance Department of the Company has prepared a new accounting policy that describes the current accounting procedures in accordance with International Financial Reporting Standards (IFRS) and the latest amendments thereto. At the time of the compilation of this report, the policy was not yet approved, although the Company is in fact already operating in accordance with it.

In 2020, the new accounting program M365 (an IT solution) was introduced. This introduction was not completed during 2020 and the implementation of some modules will continue during 2021. In the future, it is planned to integrate accounting procedures of the Group with the parent Company at the IT on software level.

**The Auditor's independence and the audit process**

The Auditing Committee of JSC Olainfarm has received assurances regarding the independence of the Auditor and its employees. The statutory audit being performed by the Auditor until 24th of March, 2021 is taking place without significant deviations from the planned schedule.

**The Auditor for annual statements for years 2021-2023**

Taking into account that 2020 is the last year of the three-year contract concluded with Ltd PricewaterhouseCoopers, the Auditing Committee has prepared and carried out a call for proposals for the selection of a new auditor. Three of the “Big Four” audit firms, which in the opinion of the Auditing Committee are independent according to the law and regulations, were invited to participate in the call for proposals. Proposals were received from all three invited bidders and discussions have been held with all of them in addition to the receipt of their proposals. The Auditing Committee developed the tender rules and proposal evaluation criteria, according to which the proposals were evaluated. Recommendations to the shareholder meeting regarding the selection of an auditor for annual statements for years 2021-2023 have been prepared as a separate document.

Another criterion in the evaluation of bidders was their inclusion of an offer to audit the electronic annual accounts prepared in accordance with the Commission Delegated Regulation[[1]](#footnote-1) supplementing Directive[[2]](#footnote-2) of the European Parliament and of the Council with regard to regulatory technical standards on the specification of a single electronic reporting format.

Recommendation has been prepared for the shareholder meeting regarding the selection of a sworn auditor to review the annual statements for years 2021-2023.

**Internal control system**

The Internal Audit was reorganized and expanded in 2019. During 2020, the Internal Audit was expanded to four to five employees and assumed several additional functions, such as JSC Olainfarm GMP self-inspection, the implementation of business ethics procedures, the implementation of whistleblowing and internal reporting systems, as well as the implementation of a control and monitoring system for holders of internal information. In the view of the Auditing Committee, these functions have improved in comparison with the previous periods; however, in the long term it would be advisable for the Supervisory Council to establish controls over the executive functions that have been delegated to the Internal Audit so that the Internal Audit is not the sole control mechanism.

In addition to the Internal Audit activities, which have continued to improve in terms of professionalism, scope and quality of work, the Auditing Committee also examined other important changes in the internal control system of JSC Olainfarm in 2020.

In 2019, the Auditing Committee selected areas for in-depth examination and focused on the cross-border marketing activities of JSC Olainfarm. During 2020, the implementation of the drafted recommendations on internal controls in marketing and the activities of the commercial department was continued. The principal internal controls that the Auditing Committee focused on were: creating a suitable product profitability assessment system and planning the corresponding marketing and advertising, the cost-effectiveness of cross-border operations and the economic justification of control systems geographically and by product, as well as taking internal control over changes in the marketing structure, processes and functions in Russia, Ukraine and Kazakhstan.

Significant improvements of the weaknesses in the accounting and control over marketing expenses made by the previous management were implemented.

Recommendations have been prepared for improving the internal control systems in the area of marketing, including the representation and management of affiliate (subsidiary) marketing companies. Recommendations have been prepared for improving the budgeting process to appropriately account for investments in various products and marketing channels.

In 2019, the Auditing Committee predominantly focused on foreign subsidiaries and representative offices of the Company that provide marketing services, including getting acquainted with their activities in person. It was discovered that under the system allowed or established by the previous management there was no internal control over the management of foreign representative offices of the Company by the Marketing Manager. In some of the key markets relevant to the Company – Ukraine, Russia and partially in Kazakhstan – the Company also had no control over the marketing activities performed by the external service provider in these countries. In 2020, these controls were implemented and are operational.

In 2019, it was established that a unified administrative management system for subsidiaries and representative offices is lacking. The Auditing Committee had recommended that the Company improve the governance of subsidiaries by introducing efficient corporate governance, including a common policy, and performance standards for subsidiaries and the management. According to information provided by the Management Board, this work was commenced in 2020.

The Covid-19 pandemic has had a far more profound effect on some subsidiaries than on JSC Olainfarm. For this reason, it is currently difficult to assess the results of the changes in the management of subsidiaries.

The Auditing Committee recommends the management of Ltd Kiwi Cosmetics be improved significantly. Ltd Kiwi Cosmetics has been operating at a loss comparable to its turnover for many years running. The Auditing Committee draws the Supervisory Council's attention to the need to resolve this issue and the insufficient work of the Management Board to address it so far.

**Asset management**

The Auditing Committee recommends further evaluating the return on investment of each asset, including the probable potential and development potential of assets in order to increase the value of those assets in the future. In the view of the Auditing Committee, the management of some assets – subsidiaries – started to improve in 2020. The Auditing Committee points out that there has been a significant increase in the amount of funds available and that increased attention should be paid to the good and successful management of this asset.

**Risks and risk management**

In 2021, JSC Olainfarm started to develop a centralized risk identification and management system.

In 2019-2020, the Auditing Committee carried out a risk mapping procedure for JSC Olainfarm in order to pinpoint the key risk areas for the operations of the Company.

Among the identified risks, the Auditing Committee identifies the following as being the most significant in the medium or long term:

* future regulatory (registration) requirements and the risk of clinical trials and product registrations;
* product and business portfolio management;
* efficiency (relatively high costs), cost calculation reporting and the control system;
* a new previously underestimated risk is political risk abroad (for example, the political situation in Belarus);
* exchange rate risks (or benefits from exchange rate fluctuations);
* the selection of business partners.

**Additional events in 2021, 2020 and 2019 that have affected or are expected to affect the performance of the Company in 2020 or in the future**

As already stated in the report of the Auditing Committee to the Supervisory Council for 2019, in late 2019 there were additional deliveries to the Russian market amounting to several months of turnover in connection with the expected change of regulatory requirements in early 2020. This significantly increased the profits of JSC Olainfarm and the amount of receivables in the 2019 annual statements. Accordingly, in 2020, deliveries decreased as a result of this. Because of this, it may be expected that in 2021 the performance figures of the Company will increase compared to 2020.

While in 2019 Russian currency exchange rate fluctuations generated additional profits, in 2020 it resulted in substantial losses. In the opinion of the Auditing Committee, there is a possibility that exchange rate fluctuations may generate additional profits in 2021 as well.

As already stated in the Auditing Committee report for 2019, when the marketing agreements with marketing service providers in Russia, Ukraine, and Kazakhstan were terminated in 2019 (and no marketing activities took place in these markets for the remainder of 2019), the marketing costs decreased, increasing the profit for 2019. In 2020, the resumption of marketing activities in these markets resulted in marketing-related expenses. The Covid-19 pandemic prevented a rapid launch of full-scale marketing activities in these countries, and such activities were only started in late 2020 or early 2021. If the established marketing structures work successfully and the marketing work is continued, there is reason to expect that marketing expenses in 2021 should be higher and sales volumes should also increase. The turnover changes resulting from the interruption and resumption of the marketing activities in these markets will have to be assessed in 2021 or 2022.

**Covid-19**

In the opinion of the Auditing Committee, JSC Olainfarm did not suffer directly from risks related to the pandemic in 2020. Nevertheless, this risk caused indirect losses related to exchange rate fluctuations. The Covid-19 pandemic has affected the operations of several subsidiaries, reducing demand for their products and services. With the increased prevalence of the pandemic in Latvia in 2021, the lack of reasonable Covid-19 forecasting tools from the Latvian government and responsible institutions, and the unsuccessful launch of the vaccination campaign, the Auditing Committee believes that, at the time of drafting this report, there is an increased risk that the pandemic may have a direct impact on the production operations of JSC Olainfarm, hindering or even temporarily suspending production at some locations.

In the opinion of the Auditing Committee, the Management Board of JSC Olainfarm is taking appropriate actions to reduce the risk posed by Covid-19 to the Company and to prepare for possible consequences.

**Belarus**

The internal conflict in Belarus has continued since the autumn of 2020; its impact on the operations of JSC Olainfarm in this market has not yet been particularly pronounced. At the time of drafting this report, it is not clear how further developments in Belarus will affect the operations of JSC Olainfarm.

**Management salaries and an examination of the terms of the variable salary component of the Supervisory Council**

The variable salary component of the Supervisory Council established by the 1 April 2019 resolution of shareholders was calculated and paid in 2020. According to a decision during the shareholders meeting of 1 April 2019, the Auditing Committee was instructed to assess the appropriateness of the justification of the salary of the Supervisory Council. “The justification for the payment of the bonus shall be decided on by the Auditing Committee of the Company, which prepares an opinion after the completion of the audit of the annual statement of the Company and the approval of the annual statement at the regular shareholders meeting.”

“A bonus for members of the Supervisory Council for achieving the objectives set by the Supervisory Council amounting to 12 months’ fixed salary, considering:

1. The new five-year business strategy of the Company was reviewed and approved in accordance with Article 6.9 of the regulations in 2019;
2. The Company has achieved the key operations objectives of the financial year and the Supervisory Council has prepared a report in accordance with Article 6.3 of the regulations;
3. During the reporting year, the net profit and cash flow of the operations of the Company ensures a sufficient amount of funds for the payment of dividends amounting to at least 20% of the net audited profit for the reporting year;
4. The justification for the payment of the bonus shall be decided on by the Auditing Committee of the Company, which prepares an opinion after the completion of the audit of JSC Olainfarm annual statement and the approval of the annual statement at the regular shareholders meeting.”

In the autumn of 2020, the Auditing Committee examined the compliance with this justification in several meetings and found that the conditions were complied with partially, i.e., the strategy was partially approved in 2019 and the full strategy was approved in May 2020. The key operational goals of the Company set forth in the approved budget of JSC Olainfarm for 2019 have been achieved. Therefore, the Auditing Committee recommended the payment of the variable salary component of the Supervisory Council amounting to six months’ fixed salary.

In 2020, the variable salary component of the Supervisory Council for 2019 was paid. According to accounting principles and the opinion of the sworn auditors from Ltd PricewaterhouseCoopers, this remuneration should have been applied to 2019, and therefore the annual statement for year 2019 has been adjusted and this component of the Supervisory Council salary has not been included in the annual statement for year 2020.

The Internal Audit has examined the Management Board and Supervisory Council salary for year 2020 and has not found any irregularities between the compliance of the Management Board salary and the decisions of the Supervisory Council or between the Supervisory Council salary and the decisions of the shareholders meeting on the Supervisory Council salary.

The salary of other management and executive officers of the Company is determined by the Management Board of the Company and has not been separately examined. In the opinion of the Auditing Committee, in the long run it should examine whether the operational performance and productivity of JSC Olainfarm in relation to salary are sufficient and in line with the industry average.

**Examination of transactions**

With the strengthening and improvement of the Internal Audit internal control mechanism component of JSC Olainfarm, the Internal Audit has taken over the examination of certain transactions. The Regulations of the Auditing Committee contain provisions for the activities to be supervised by the Internal Audit in this area.

**Further action plans**

The Auditing Committee intends to continue its supervision of the preparation of financial statements. The Auditing Committee intends to participate in the work on the development of the newly implemented risk management system at the Company and to continue monitoring the risk management control mechanisms of the Company. With the development of the Internal Audit and the expansion of its functions, the Company planned to continue cooperation with the Internal Audit and to continue supervising it.

The supervision of cooperation with the sworn auditor, as well as other activities contributing to the achievement of the objectives of the Auditing Committee, are going to continue.

**Disclaimer**

The report of the Auditing Committee was prepared on 24th of March, 2021. At the time of compiling the report, the JSC Olainfarm annual statement for year 2020 was in the process of preparation. The findings and recommendations of the Auditing Committee have been based on the information available to the Committee as of 24th of March, 2021.

Auditing Committee

Head of Auditing Committee Agris Auce

Member of Auditing Committee Viesturs Gurtlavs

Member of Auditing Committee Kārlis Krastiņš

1. (EU) 2018/815 of 17 December 2018 [↑](#footnote-ref-1)
2. 2004/109/EC [↑](#footnote-ref-2)