

Risk and risk management

Construction inevitably involves risks. For Royal BAM Group these risks are not exceptionally high and they are no different in nature from those that are customary in the industry. The Group applies a stringent policy designed to manage and limit both existing and future risks as far as possible. This policy is explained in the following section.

Financial risk factors (namely currency, credit, price, liquidity and interest risks) are addressed explicitly in the financial statements on page 115 et seq.

In addition to general management measures, such as internal procedures and instructions, the Group has also implemented specific measures aimed at controlling defined risks. These measures go hand-in-hand with an adequate reporting system and short lines of communication. As regards financial reporting risks, the Executive Board considers that the internal systems intended for managing and controlling risks provide a reasonable degree of assurance that the financial reports do not contain any material misstatements.

The risk management and control systems have operated properly during the year under review and no shortcomings were found in these systems, or how they operated, which might have material consequences in the 2009 financial year or the current financial year. The developments at AM are addressed below. It can accordingly be concluded that there are no indications that the risk management and risk control systems will not work properly in the 2010 financial year. No significant changes or improvements are therefore contemplated for these systems during the financial year. The Group cannot however guarantee that no such risks will arise. Similarly, it does not mean that the risk management and control systems do not require further improvement. Optimising internal risk management and control systems remains an important issue for the Executive Board. It may result in the systems being improved or expanded.

The property markets were hit hard by the economic crisis during the financial year. The crisis also had a major impact on the Group's property activities and the consequences at the operating company AM were especially severe. The difficult market circumstances resulted in write downs and provisions on property projects at AM.

However, although AM's losses were caused in the first instance by the extreme circumstances on the property markets, the valuation of land and projects remains to a large extent a question of market assessment.

The Executive Board responded to the developments at AM by implementing a number of substantial changes. With effect from 1 January 2010, for example, AM's property activities were merged with those of BAM Vastgoed to form a single organisation managed by BAM Vastgoed. The number of regions has also been reduced, and several reorganisations have taken place at both AM and BAM Vastgoed. The policy of the new AM organisation is primarily focused on area development through both small and large sustainable projects. The level of ambition has been adjusted in accordance with the possibilities offered by the current market.

The Executive Board believes that these measures will be sufficient to steer AM through the current difficult economic circumstances.

The principal risks and the organisation and operation of the internal risk management and control systems pertaining to these risks are described below. These matters have been discussed by the Executive Board with the Audit Committee and the Supervisory Board.

General management measures

The Group's risk management and control systems involve the use of various instruments. One general management instrument consists of instructions from Royal BAM Group to the management of the operating companies. These instructions set out such matters as limits for commitments to be entered into in connection with investments and the acceptance of new projects. These guidelines also define the powers invested in the operating company managers and lay down quality requirements for fundamental management measures. These management instructions are reviewed annually, and if necessary adjusted.

A second general management instrument consists of the guidelines for the design of the financial reports of the operating companies, and for the procedures to be followed in connection with those reports.

A third general management instrument employed by the Group involves budgeting, reporting and (internal) control systems. The entire Group uses uniform guidelines and accounting policies, which serve as the basis for all financial and management reporting. The existing support software for reporting was replaced during the course of 2008, and the implementation of associated management measures continued. The Group has implemented a uniform, COSO-based, internal control framework to support the financial reporting process.

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Market risk

Royal BAM Group generates income in various geographic markets and by carrying out a range of different types of activities. The Group's financial performance depends partly on the economic climate in the countries in which Royal BAM Group operates, but the effects of the economy on the Group's turnover are limited in many cases because the contracts in question are awarded by government bodies. This also seems to apply to the current crisis in the financial markets, during which the effects of the crisis on government contracts have been limited. The Group aims to limit its sensitivity to the economic climate by focusing even more emphatically on long-term contracts generating more predictable cash flows. This is shown by the increase in the number of PPP contracts in which the Group is involved.

Risk to reputation

The confidence that principals, shareholders, lenders, construction partners and employees place in Royal BAM Group is essential for ensuring the continuity of the enterprise. The Group accordingly adheres to generally accepted standards and values and complies with local statutory and other rules and regulations, particularly with respect to the acquisition and execution of contracts. This basic position is affirmed in the Code of Conduct for the Integrity of Royal BAM Group. All employees are required to act fairly, to honour agreements and to act with care in respect of principals and business partners, such as suppliers and subcontractors.

In order to make integrity a fundamental part of day-today activities, the subject is regularly revisited. The Executive Board has appointed a Central Compliance Officer. This officer promotes compliance with the code of conduct, and provides advice with respect to issues involving integrity.

The operating companies, too, have their own compliance officers, to whom breaches of the code of conduct can and must be reported. In addition to the code of conduct, the Group also has a 'whistle-blower scheme'. The Group believes it to be important that employees are able to blow the whistle on wrongdoing at work, and that they are able to report such matters without fear of reprisals. Employees have easy access to both the code of conduct and the whistleblower procedure. For example, they can be found on the Group's intranet site and on its website.

Safety risks

Royal BAM Group attaches a great deal of importance to safe and healthy working conditions for its employees. The Group is aware that there is a risk of injuries on construction sites in particular and therefore has a policy aimed at implementing the measures required to prevent accidents,

occupational illnesses and injuries. Safety and health risks are controlled as much as possible by using sensible designs, preparing projects systematically and providing employees with proper instructions about working methods. A Group-wide safety management guideline provides operating companies with a framework with which their own safety management systems must comply. Safety Awareness Audits are carried out in order to monitor whether the safety management systems of the operating companies are in accordance with the guidelines laid down by the Executive Board. The audits also highlight areas where the safety management system could be improved.

Project risks

Prior to any project, the operating companies assess the risk factors, both in qualitative and in quantitative terms. Uncertainties may be related to financial and contractual aspects, safety, construction materials, plant and equipment, location (including site conditions and building permits), the construction period and the work schedule as well as to clients, subcontractors and construction partners. A quantitative analysis is carried out of the risk factors, based on historical data. This analysis is used to make adjustments to the project planning or construction methods, in order to reduce the project risks. The analysis may also result in adjustments to the risk mark-up to the contract price. Bids for major projects or projects involving exceptional risks are submitted to the Executive Board for prior approval. During the implementation phase, the project team periodically and systematically assesses the opportunities and risks attached to the project. If necessary, the project team takes measures to mitigate newly identified risks with particular attention being paid to the quality of the construction work to be completed, avoidance of construction faults and timeliness of completion. Project managers submit reports on progress, the main possibilities and risks associated with the project, the quality and the financial aspects to their regional office manager who, in turn, reports at least on a monthly basis to the operating company managers. They, in turn, report to the Executive Board, through the information systems described above.

Whether or not projects, once taken on, are completed successfully depends to a great extent on the quality of the staff and the management. Royal BAM Group pays particular attention to its human resources policy – as described on page 60 of this annual report – in order to ensure that it consistently and effectively attracts talented employees and continues to provide them with challenges and development opportunities.

In order to limit legal risks, the legal documentation required for the projects is based on standard documents as far as possible. Where a non-standard contract is used, Royal BAM Group lawyers will assess the contract beforehand. Standard contracts include clauses stating that any increase in wage and plant and equipment costs during the construction period can be passed on to the client. Clients can also buy off these risks.

In the construction sector it is usual for the operating company of the construction company that has won the contract to have a guarantee issued as collateral for proper execution of the project. This guarantee may be provided by the parent company, or alternatively by external parties such as banks or surety institutions. Royal BAM Group has stringent procedures to guarantee that the contractual terms and conditions of guarantees comply with the company's specific guidelines.

Over 70 percent of Royal BAM Group's annual turnover comes from work done by suppliers and subcontractors. These parties have a major impact on the projects, both in financial and in technical terms. The Group aims to maintain good relations with suppliers and subcontractors in order to ensure that the construction process runs smoothly. Co-operation should also minimise the overall costs and at the same time produce a high quality product. For co-operation and management of project risks to work well, suppliers need to be involved in the project at an early stage. This co-operation is set out in framework contracts, which set out agreements about fees and conditions (such as times to delivery, invoicing, risks and bonus discounts). Project-specific orders can then be placed under the framework contracts.

The operating companies' broad range of expertise and experience allows Royal BAM Group to independently and successfully carry out large-scale projects. Nonetheless, it can be advantageous – including from the point of view of spreading the risks – to work in a joint venture when dealing with larger projects. In the Netherlands this usually involves establishing a general partnership. This is a legal form under which all parties are jointly and severally liable for mutual commitments connected with the performance of the project. Royal BAM Group mitigates the resulting risk associated with construction partners by only entering into joint ventures with solid and solvent partners. However, if the risk presented by the partner is still considered too great, either before or during the construction phase, the Royal BAM Group operating company will require other guarantees which can take the form of a bank guarantee or of the partner leaving sufficient cash invested in the joint venture.

Operating companies minimise the payment risks associated with the execution of projects by means of payment schedules that are contractually agreed in advance. These contracts ensure as far as possible that payments made by the client match at least the cost incurred on the completed portion of the work. In the case of projects carried out in emerging markets and developing countries, adequate security is agreed or export credit insurance is taken out before the start of the project to cover the political and payment risk. BAM investigates its customers' creditworthiness before entering into financing arrangements. The Group also focuses in particular on the security provided by banks and the payment systems used by government bodies.

Acceptance of project development risks requires the prior approval of the Executive Board in all cases. The Executive Board takes a decision regarding these risks, based on project proposals from the operating company concerned and an analysis by the Group's Property Investment Director.

For projects in the Netherlands, the general rule is that construction does not start on residential or other projects until a substantial number of units have been sold or a large part of the project has been let or sold. The AM order book, however, still includes a number of residential construction projects from the past where there is an unconditional obligation to build.

The general rules before starting construction work in the Netherlands also apply in Belgium and Ireland. In the United Kingdom – where BAM is only active in commercial property – pre-letting is not common practice. Instead, the inventory risk is minimised by implementing a system of phased project execution.

For projects in the Netherlands, the position is that the Executive Board's decision is based partly on the advice given by a central property committee, which operates in the Netherlands independently from the operating company concerned and assesses the specific risks of the project in question. In this risk assessment, Royal BAM Group applies the general rule that construction does not start on residential or other projects until a substantial number of units has been sold or a large part of the project has been let or sold. Also, the average price paid for development land, or the price at which it can be acquired, does not exceed market value (allowing for the time until the expected commencement of construction work).

No PPP or concession contracts may be accepted without the prior approval of the Executive Board. In its assessment of the risks attached to PPP and concession contracts, the Executive Board is assisted by the management of BAM PPP. This operating company was incorporated in 2004 to optimise the utilisation of the know-how and experience available within the Group, both for acquiring new projects and for properly assessing the specific risks connected with concessions.

Insurance

Insurance is an important part of Royal BAM Group's risk management strategy. A department of specialists ensures that all construction-phase risks that can be included in the central insurance policies are actually covered in those policies and that adequate liability cover is also taken out.

Royal BAM Group's insurance coverage is a frequent subject of discussion with professional insurance brokers.

Other risks

Companies working in the construction industry are involved in discussions about the financial arrangements for construction projects, e.g. less/more work, the completion date and the required quality level for the work. Most of these discussions are concluded to the satisfaction of all concerned. However, in some cases it is impossible to avoid a discussion ending in legal proceedings. Royal BAM Group, too, is involved in a number of legal proceedings. A provision is usually taken in the case of legal proceedings where a financial claim is made against the Group, unless the claim in question is completely lacking in substance. Financial claims that the Group has pending against third parties are in principle not capitalised unless it is reasonably certain that the amount in question will be paid.

The Group devotes a lot of effort towards avoiding such legal proceedings by implementing quality programmes and providing training for its employees. Some examples of major legal proceedings involving Royal BAM Group are given briefly below.

At the end of 1996 AGIV Real Estate sold the German construction company Wayss & Freytag to HBG. Part of the sale involved AGIV taking over rental guarantees given by Wayss & Freytag. These guarantees concerned Wayss & Freytag development projects from before 1997 where the buyers had been guaranteed a certain rental income. AGIV failed to fulfil its obligations towards Wayss & Freytag after 2003. In legal proceedings before the German court, Royal BAM Group – having owned HBG since November 2002 – successfully claimed fulfilment by AGIV of its commitments in respect of Wayss & Freytag. Early in 2005, AGIV was declared bankrupt. As a result, the legal proceedings pending against AGIV have been suspended. The receiver has commenced a number of legal actions, including one against a former shareholder of AGIV. The settlement of these proceedings and of AGIV's bankruptcy is expected to take several years. Based on current information, the Group believes that there will be no substantial negative financial consequences in the future.

In 2005, during the construction of a bored tunnel for the SMART North Tunnel in Kuala Lumpur, Wayss & Freytag Ingenieurbau was confronted by ground conditions at variance with the information supplied by the client. Wayss & Freytag terminated the contract at the start of 2006 as a result of the client's failure to fulfil its payment obligations and refusal to deal with Wayss & Freytag's claims for an extension of the construction period and reimbursement of costs. The client in turn also terminated the contract in January 2006. Wayss & Freytag lodged a claim against the client for more than €20 million as compensation for costs incurred. The client lodged provisional counterclaims amounting to €5 million. The independent dispute adjudicator, in the contractually prescribed procedure, has now held that Wayss & Freytag was entitled to terminate the contract. The proceedings are ongoing. Based on the present state of knowledge, the Group considers that the provision that has been made is adequate.

Two of the Group's operating companies, partly in combination with third parties, are claiming payment from the client, the State of the Netherlands, of invoices for insulating homes around Schiphol Airport. A dispute has arisen between the construction companies and the client in relation to the final settlement in the amount of more than €10 million. The construction companies are also claiming compensation for loss sustained as a consequence of reduced construction volume and increased construction site costs due to disruption of the construction process. The State is making a counterclaim of approximately the same amount. The dispute regarding the final settlement is in arbitration. The Group is assuming, as matters currently stand, that no substantial adverse financial consequences will result from these legal proceedings.

On 3 March 2009, during construction work on part of the metro system in Cologne, several adjacent buildings – including Cologne's municipal archives building – collapsed. Two residents were killed. Wayss & Freytag Ingenieurbau is a one-third partner in the consortium carrying out

this project but was not directly involved in the work being done at the site of the accident. The customer has instituted a judicial inquiry (known as a Beweisverfahren) before the district court (the Landgericht in Cologne). As part of these proceedings, a number of specialists are investigating the cause of the accident. Their investigation is not expected to be complete before the end of 2010. Only once their investigation is complete will it be possible to determine whether the consortium is in any way responsible for the accident. The German Public Prosecution Service is also carrying out its own investigation to determine whether any criminal offences may have been committed.

The damage to property is considerable and the parties involved have claimed under several different insurance policies. The Group is assuming, as matters currently stand, that no substantial adverse financial consequences for the Group will result from this event.

In 2002, the European Commission commenced an investigation into possible competition-law infringements in connection with the market conduct of several firms in the bitumen sector, both on the production side and on the procurement side. One of the company's operating companies is involved in this investigation, as a purchaser of bitumen. In September 2006, the European Commission confirmed infringements of competition law and imposed fines on the companies involved.

The fine pertaining to the Group operating company concerned amounts to €20.7 million and is fully covered by provision. An appeal has been lodged against the imposition of this fine.