



USP Treasurer's Report
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(as prepared for delivery)

2010 Convention
Washington, D.C.
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Good morning everyone, I am Larry Braden, USP's Treasurer and I too would like to welcome you to USP's every half-decade convention. Five years ago, you elected me to the position of Treasurer which honored me greatly. I was serving as a member of the Board and its Chair during the 2000 – 2005 revision cycle, the last time we were all together here in Washington, and was a volunteer for many years prior to that. In the role of elected Treasurer, my responsibility is to provide strong fiduciary oversight to the financial management of USP. While USP's Treasurer has specific duties defined in the by-laws, the real work of us volunteers charged with the organization's financial integrity is done through the Audit and Investment committees and I want to express my appreciation to each member with whom I have served over this past decade.

I am pleased to report USP's financial status to you Convention delegates, observers and guests and in reality, to the public at large. USP is a not-for-profit organization operating under provisions of the United States tax code which allow us to carry out our work around the world, striving to fulfill USP's mission, and to do so without the financial burden of paying taxes on our earnings. That tax-exempt status gives us a great opportunity to advance health care throughout the world, and consequently places an even greater sense of fiduciary and trustee duty upon each member of the Board.

The financial structure and results I am pleased to report are strong results, which demonstrate the fiscally prudent and successful delivery of public health outcomes that the world values. It is worth noting that USP is "on its own" in these uncharted and perilous economic times. To assure our independence, USP supports itself through the sale of our standards—USP does not accept government funding for the remarkable work of the Council of Experts, all of whom volunteer their time to this unique enterprise. It is also worth noting that the ability for me to speak and for USP to act from a strong financial position results from a combination of management principles, strong input from my fellow Board members, access to good advisors and consultants, and—good fortune.

As I reflect over my long association with USP, I marvel at the changes that have occurred over this past decade. We have a new headquarters building in Rockville, Maryland, just a few miles from where we meet today, sites in India, China, and Brazil, and a customer support office in Switzerland. The number and availability of our reference standards grows every year, and with the addition of each new reference standard, there is an additional safeguard built into the world's healthcare system.

New opportunities present themselves almost daily. This can be both a blessing and a challenge but we meet the challenges in a deliberate and prudent manner and have created a financial foundation for USP that will perpetuate the organization for many years to come.

SLIDE: Best of Times

To paraphrase Charles Dickens, this past decade was indeed the best of times and the worst of times. The 2000 – 2005 cycle produced significant revenue growth and the 2005 – 2010 cycle saw that growth rate increase even faster than before. Scientific excellence delivered in the interest of the public creates a strong and resilient business model for USP, a business model that funds our entire operations. That the world values good public standards, built through the wisdom and expertise of USP’s Council of Experts, is no surprise. It has been a fact of our lives since 1820. Probably what is more surprising is that we may forget this value—until adulteration crises such as heparin, melamine and diethylene glycol occur.

So, like much of the world, we were moving along, with great visions and plans for the future when the 2008 financial crisis occurred; an unprecedented form of financial crisis which exempted no one from its effects. USP saw its investment portfolio value fall from almost \$84 million to \$56 million during the crisis, a staggering decline. Revenue began to fall below the very reasonable budget that was established, and our bond covenants, which underpin the financing of our buildings, labs, and overall financial stability, were threatened. The final, and most disconcerting, blow came when our bond insurer company, AMBAC, collapsed and the interest USP was paying on the tax -exempt bond issue that funded the new headquarters building skyrocketed. For those of us keeping track, the board and staff, it seemed that everything that could go wrong did go wrong.

All of these forces impacting USP were and remain external. The solution, though, was internal. Management addressed these challenges head -on and embarked on a cost management effort, referred to internally as austerity, and reached into many categories of non-compensation expenses. Staffing was frozen with positions eliminated, and layoffs occurred. Another noteworthy sacrifice was when USP management and staff voluntarily sacrificed their bonus payments for FY2009 saving significant funds when the organization needed it the most. The management and staff response to these challenges impressed the Board greatly and deserves recognition and acknowledgement here at the 2010 Convention.

SLIDE: USP’s Bond Financing was challenged by the financial crisis

Perhaps the most significant external effect was the impact of the financial crisis on the tax-exempt bond issue that funded the headquarters expansion. In 2004, USP created a financing package that included bond insurance and an interest rate swap – a very commonplace but complex structure at the time. The financial crisis and failure of AMBAC, the company that issued the insurance, effectively nullified the entire structure of that transaction, and USP had to pay \$15 million to exit the financial swap agreement. Many other tax-exempt borrowers found themselves in the same situation with rising interest rates and financial markets that were effectively closed for business. USP management with oversight by the Board of Trustees acted astutely and prudently to mitigate the interest rates as effectively as possible and worked with investment advisory and financial institutions to refinance the tax-exempt debt, a significant accomplishment itself during such turbulent times.



The resulting financing package was as good as any organization could obtain – in fact, better than most could attain. The rating agency Moody’s reaffirmed USP’s A2 bond rating when many organizations were being downgraded, affirmative recognition of USP’s operating strength. The final debt structure included a provision that caps the interest costs for USP at 5%. This opportunity came about at the last minute through some very astute input from USP’s financial advisors. The structure provides more limited protection against rising interest rates than an interest rate swap but eliminates many of risks associated with a swap that we experienced with AMBAC. The new structure is operating well and has allowed USP to benefit from the current low interest rate environment. In fact, we currently pay less than ¼ of 1% for the tax-exempt rate debt. That low rate can’t last forever, but we will take advantage of it while we can and make provisions in future budgets for the inevitable increases that will occur.

I have described in just a few words what can be characterized as 18 months of turmoil for the USP Board and management. My hope is that no other Treasurer will need to endure such turmoil. But if you do, my hope is that successors ultimately weather it as well as we did during 2009.

SLIDE: Global financial and capital structure developed to support growth

So where did we end up after those challenges? USP now has a financial structure that reflects its size, international scope and complexity and enables growth in interesting ways.

When we began serving on USP’s Board in 2000, the organization had just over \$9 million in tax-exempt debt. Today, we have over \$122 million in a much broader capital structure that includes tax-exempt, taxable, and short-term debt instruments. In fact, USP is about to add another layer of debt to fund the expansion of the India laboratory site, which you will hear more about in the course of the meeting. While that level of debt may strike some as being very high, it is prudent and justified and accepted by the financial markets: the banks, rating agencies and State of Maryland authorities through which our long-term funding has been arranged. Supported by a robust economic model, the present financial structure enables USP to increase its standard setting capabilities and impact the public health in many ways.

USP management works closely with financial institutions including Bank of America to ensure transparency and good working relationships to support this capital structure. Those efforts will pay dividends both now and in the future and enable USP’s continued ability to address public health needs.

SLIDE: Operating Results 2000 – 2010

Let’s turn now to several graphs that show financial trends over time. The first shows operating results – revenue and expenses for the last two Convention cycles. It’s a strong story. The blue line shows revenue growth, and one can see a slight inflection point in revenue beginning in 2006. It’s a simple model – more standards available for sale create more revenue, providing more funding for support, so that USP can advance more standards – all of which work to benefit the public health by improving the quality of medicines and foods around the world. As a non-profit organization, USP returns every bit of its income into strengthening the availability and use of our documentary reference material standards. Thus, revenue is really a proxy for our impact on the public. Overall, USP’s financing allows USP’s Council of Expert to work independently to produce the most optimal science-based standards, with as great a freedom from any kind of political, economic, and other influence as possible.



It is important for us to recognize the shared efforts of some many individuals and businesses that help make all of this possible, and I want to particularly express appreciation to the many pharmaceutical manufacturers who work so closely with us and so frequently provide reference standards materials; contributions which in turn serve to help assure the highest quality of medicines for hundreds of millions of persons worldwide.

Operating expenses shown by the red line tells an equally interesting story. Over time, we have maintained a positive margin from operations – revenues covered expenses and USP never reached into its portfolio to fund operations – except for 2008. That year, USP proposed a budget that reached into the portfolio in order to invest into the operations of the company. Of course, that decision was less than fortuitous given the financial crisis that came later in that year, although some have argued that we spent the money wisely given that it would have lost substantial value by remaining in the portfolio. That downward jog that the red line of expenses takes between 2008 and 2009 represents the effects of the staff reductions, bonus sacrifice, and other austerity measures taken by management to address the financial crisis. We weathered the storm and we continue to carefully manage expenses while we invest in the organization’s future.

SLIDE: Investments and Net Assets Comparison

This graph shows the investment portfolio in blue and the other assets of the organization – inventory, equipment, real estate and such in red. The effects of the financial crisis are immediately apparent in these bars – especially in FY08 and FY09 when the investment portfolio dropped significantly. But what is also immediately apparent is just how quickly USP is recovering from the current crisis. In only one fiscal year, USP will recover to near its pre-crisis levels. Some of that recovery has come from increases in the investment markets, as these markets began to climb back up. Most, however, has resulted from USP’s strong operating results – continued steady revenue growth combined with disciplined management of expenses.

SLIDE: Reserve Change Analysis

USP maintains a strategic reserve which includes the investment portfolio and other liquid assets. This graph shows how that reserve changes over time through the results of operations and the investment portfolio returns. This graph shows the effects of the decision to use reserve funds to invest into the organization in 2008 and how these were aggravated by the financial crisis. One can also see the effects of management’s austerity programs, supported by the Board, and their effects on operations between 2008 and 2009. Thankfully, in FY10 stellar operating results and recovering financial markets have allowed us to add a record amount to reserves, returning us to the trend that we saw throughout the last decade.

SLIDE: Strategic Reserve

Like many not- for -profit organizations, the USP Board has established a strategic operating reserve policy. Ours is somewhat different because it was tailored to reflect the reality of our business model and debt structure. This policy is a strategic, forward-looking policy which focuses on enabling USP to pursue public health opportunities while ensuring sufficient reserves to protect the organization. Our ability to comply with the policy was certainly strained by the effects of the financial crisis but USP has now returned to compliance through strong operations and now exceeds the policy guideline by a comfortable margin.



SLIDE: Debt Service Ratio

The debt service ratio is one of two bond covenant ratios USP must satisfy to be in compliance with the bond documents and the credit guarantee from Bank of America. The covenant is a rolling 12-month calculation and the result has steadily increased as the higher interest rates of the old bond structure have been replaced with the lower interest costs of the new bond structure achieved via the 2008 refinance. The upward trend will now level off and will move based on changes in the interest rates paid by USP, and will move from any additional factors that result from plans for future expansion issued by USP. The 12-month rolling nature of this calculation effectively dampens the effect of individual monthly movements and trends over time.

SLIDE: Liquidity Ratio

The liquidity ratio is the second of the two bond covenants and focuses on the availability of liquid assets to satisfy USP's obligations. It is a point-in-time calculation and is quite sensitive to changes in the investment portfolio value. During the financial crisis, USP came very close to falling below the requirement for this covenant. In difficult financial markets, prudent investment management is an absolute necessity to ensure that this covenant is achieved. Strong operating results and the recovery of the investment portfolio have allowed USP to now build a solid cushion to satisfy this covenant.

SLIDE: Audit Committee Activities

You can tell a lot about a person by the company that they keep, and an organization is no different. All of USP's financial advisors are top rate professional firms who provide value-added advice. In particular, Grant Thornton, our audit firm, provides excellent audit services around the world. Early in this cycle, management proposed changing the audit firm both to rotate auditors and to obtain global audit services and risk management capabilities which the former auditor lacked. A request for proposal was developed and Grant Thornton was selected from a list of fine candidates. We Audit Committee members have been quite pleased with the oversight and advice provided by GT.

Other Audit Committee activities included extensive work in the corporate ethics and conflict of interest areas. These efforts resulted in policies that address USP's unique situation and needs and also demonstrate best practices under the Sarbanes Oxley law, today's federal standard for most areas of financial reporting and conduct.

And the Audit Committee conducted several inquiries on behalf of the Board during the cycle. The latest, associated with the recall of *USP33 – NF28* engaged the services of both Grant Thornton and an external law firm to conduct an Audit Committee inquiry into the factors that led to the recall. That inquiry is proceeding in conjunction with a Board directed Task Force and Senior Management Group evaluation. The goal will be to identify the lessons to be learned from this regrettable situation and to identify ways to prevent the need for such a recall in the future.



SLIDE: Investment Committee Activities

In 2005, USP management recommended professional investment management to actively manage USP's growing investment portfolio. A request for proposal process led the committee to choose then Smith Barney, now Greystone Consulting, as the portfolio manager. Greystone and USP management developed and the Investment Committee implemented a diversified portfolio structure with guidance and oversight from the Investment Committee.

This portfolio structure and flexible investment policy proved wise as the financial crisis unfolded. Both allowed USP to move deliberately and move some equity holdings into certificates of deposit as the crisis reached its depths. Overall, the diversified portfolio structure defended us well in the down markets and captured much of the upside return as you will see in the next slide. Given the importance of the investment portfolio in achieving the bond covenant requirements and ensuring a healthy reserve for USP, this is an important investment outcome, and one that can be continued with strong management from staff and oversight from the Board.

SLIDE: Investment Portfolio Performance



Here we see the results of the investment portfolio over time. Again, these strong results are important to USP achieving its financial commitments under the bond agreements. The results are a manifestation of USP's independent, non-governmental financing, which allows the organization to operate freely, flexibly, and sensibly in the world without undue constraints.

SLIDE: Conclusion

Indeed, for USP's finances it was the best of times and the worst of times. But the worst of times brought out the best in USP as whole. In many ways, the challenges of the last few years tempered the organization and made it stronger. I share with each of the other members of the Board the fact that the organization remains financially healthy and has the fiscal strength today to enable growth and positive public health impact well into the future. , USP possesses this strength not through any action of mine or even of the Board but directly through the standards-setting activities of the Council of Experts, working with staff and stakeholders who make available excellent standards for the world community we have merely done our best to be good stewards of the trust.

USP's standards help assure the quality, safety and benefit of food and drugs in accordance with USP's mission. This quality is critically important now in the 'best and worst' of times in which we live. While this will be my last term as a Board member, I will remain close to and highly supportive of USP. I wish the very best to the next Board, and especially to whoever is my successor as Treasurer, and very best wishes to USP's excellent management team. After five years as Treasurer and a decade of the honor of serving as a member of the Board of Trustees, I am still humbled by the opportunity that you gave me and I thank you all most sincerely for providing this opportunity for me to serve as a USP volunteer.






2005 – 2010 Financial Report

Larry L. Braden, R.Ph., D.Sc. Treasurer


ADVANCING HEALTH THROUGH PUBLIC STANDARDS



The best of times, the worst of times.....

- ▶ USP demonstrates strong financial health and stability through a sustainable business model.
- ▶ USP worked through its most significant financial challenge in history in 2009.
 - Bond refinancing consumed \$15 million in reserve funds.
 - Investment losses consumed \$12 million in reserve funds.
- ▶ USP weathered the storm better than many companies.
 - 38 position eliminations reducing staff from 616 to 578.
 - Austerity measures included reduced travel expenses, reduced energy usage, and other non-compensation reductions further lowered costs.
 - Satisfied bond covenants despite reduced portfolio values and sales.
 - Preserved investment grade bond rating.


3



USP's bond financing was challenged by financial crisis

- ▶ USP issued bonds in 2004 to fund the construction of the new Rockville headquarters.
 - Variable rate demand bonds (VRDBs).
 - Interest rate swap with AMBAC fixed interest rate at 3.78%.
 - Bond insurance from AMBAC allowed USP to issue as a AAA borrower.
- ▶ Financial collapse beginning in May, 2008 and failure of AMBAC forced USP to refinance.
 - Forced to terminate interest rate swap at a cost of \$15.0 million to USP.
 - Issued new VRDBs.
 - Replaced AMBAC with Bank of America as guarantor.
 - Obtained interest rate cap to limit how high interest costs can rise.

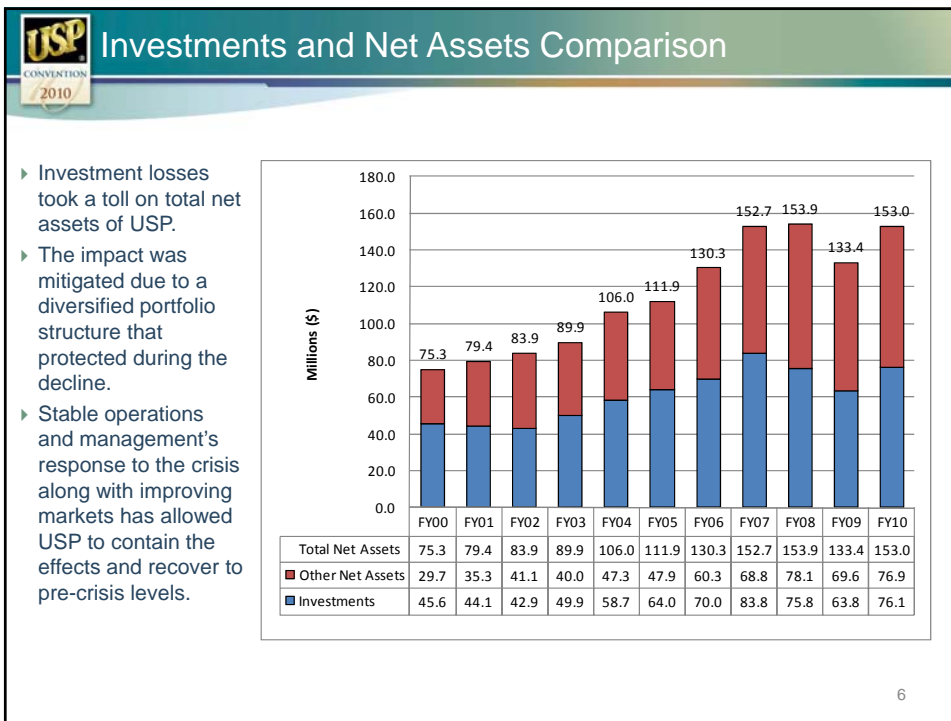
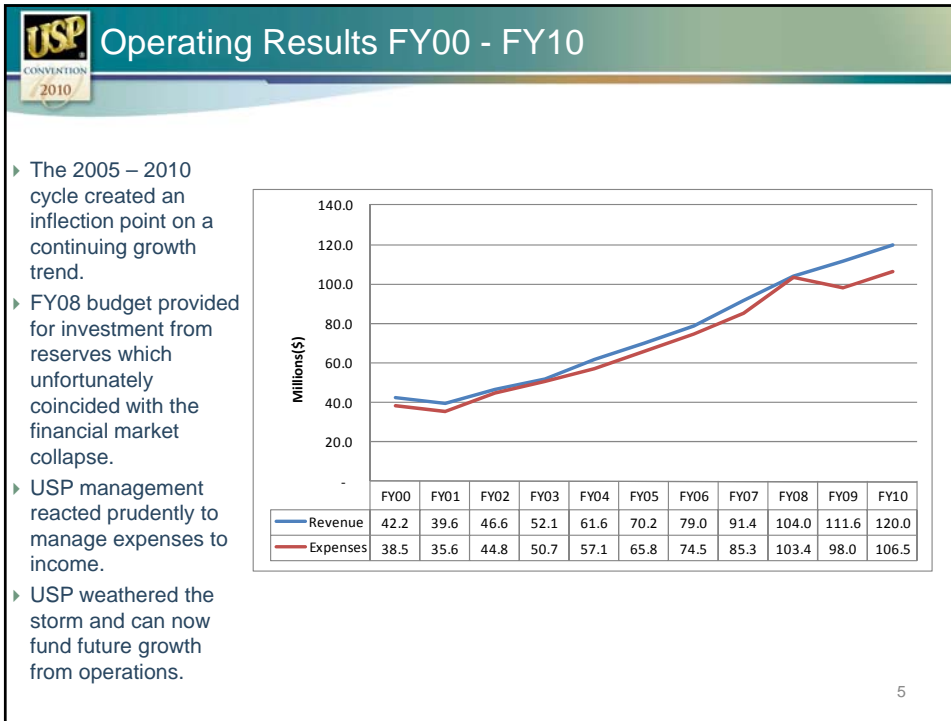
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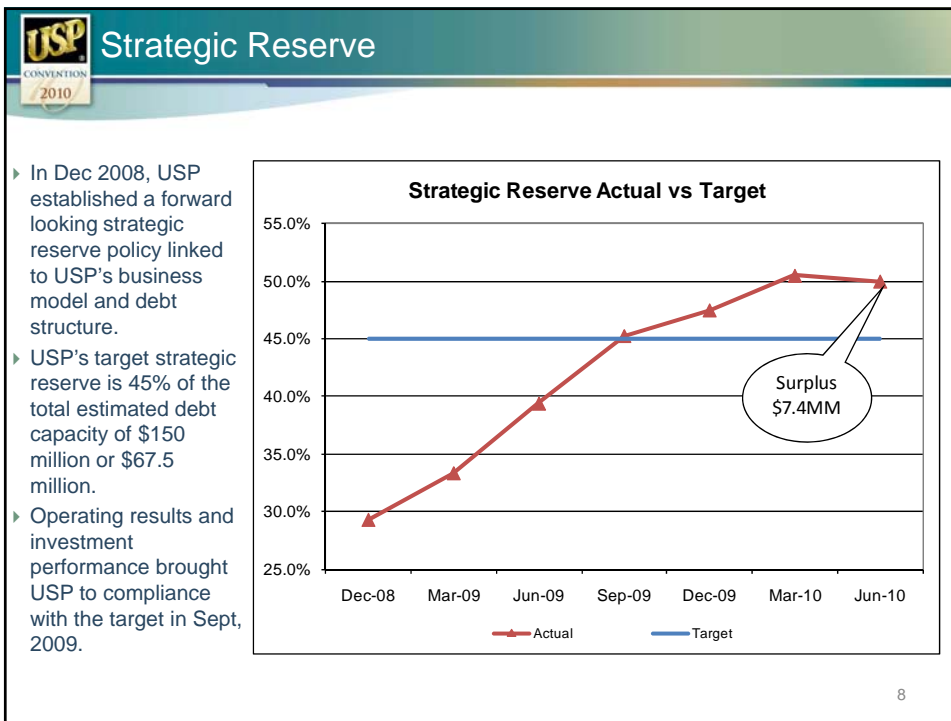
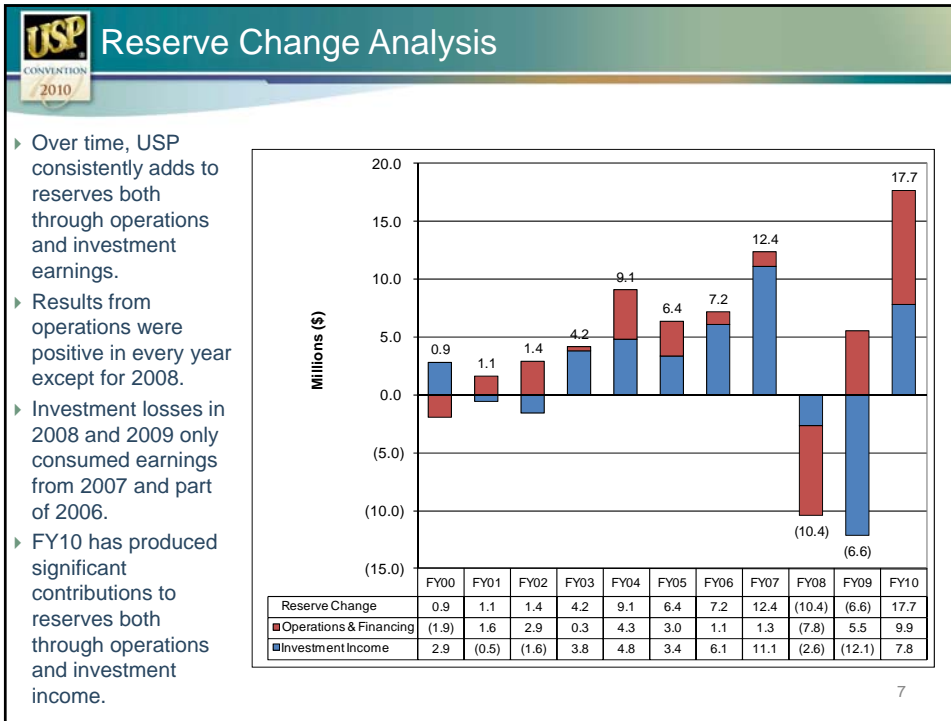


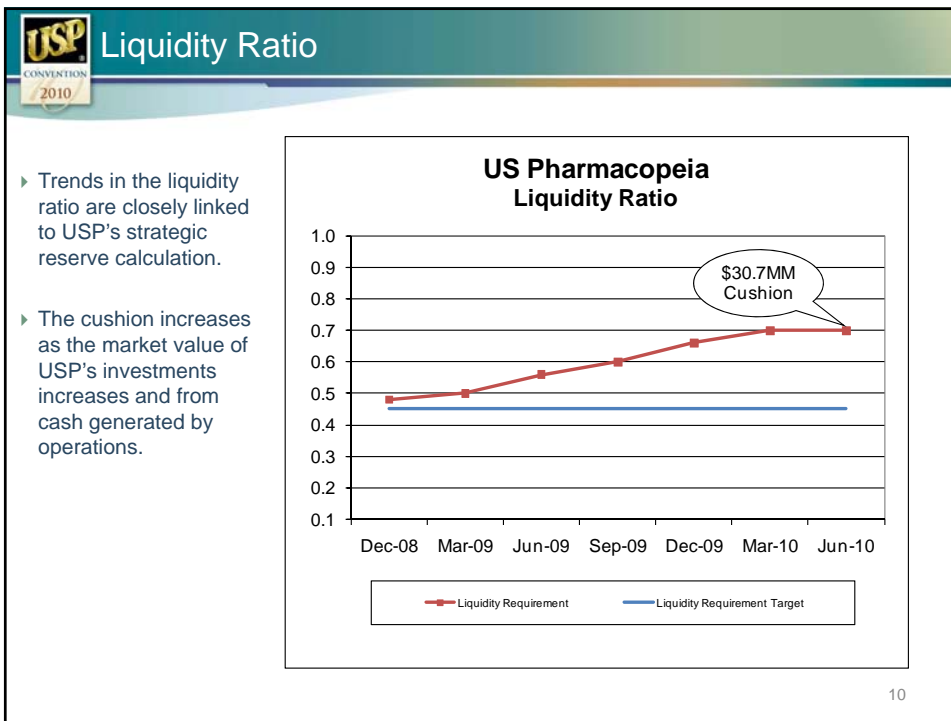
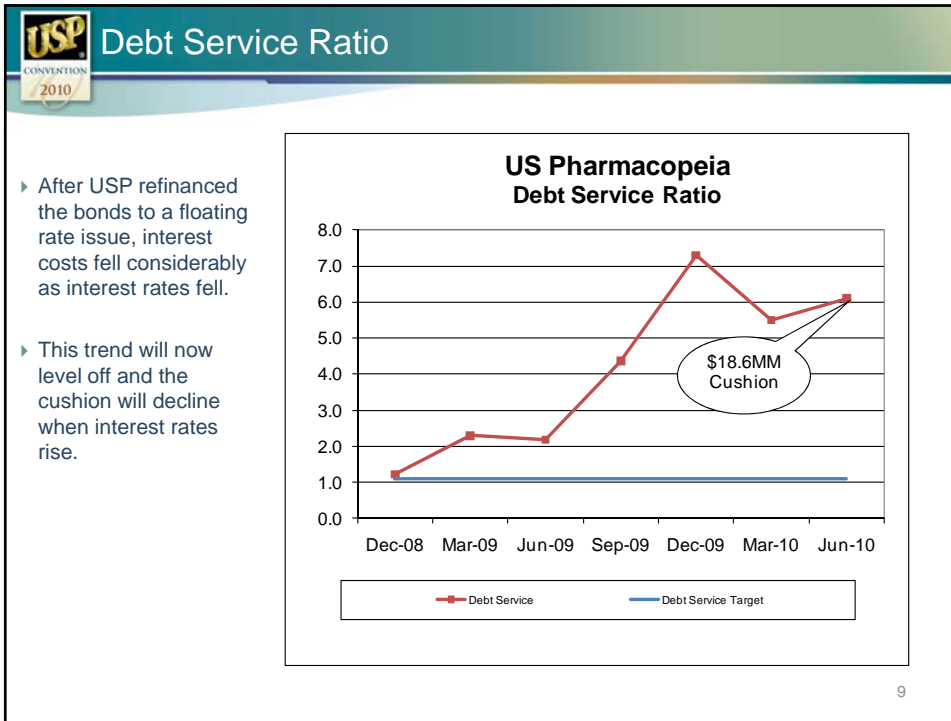
Global financial and capital structure developed to support growth


- ▶ In 1990, USP had \$9.0 million in debt.
- ▶ Today, USP has \$122.4 million in debt in four different structures:
 - Public Tax Exempt Bonds (\$98.7 million).
 - Bank Qualified Tax Exempt Bonds (\$10.6 million).
 - Taxable Loan (\$13.2 million).
 - Short Term Revolving Line of Credit (\$0 balance, draw as needed).
- ▶ USP's public debt is rated A2 by Moody's – an investment grade bond rating.
- ▶ USP maintains a productive working relationship with Bank of America
 - Facilitates very low borrowing rates – 2.5% or less on revolving credit line and taxable loan.
 - Provided access to efficient and low cost expansion funding for India expansion.

4










Audit Committee Activities

- ▶ External auditor engagement awarded to Grant Thornton (GT) in 2006.
 - Firm was selected for extensive experience in not-for-profit auditing and a global platform and presence that matches USP's.
 - All audits for global subsidiaries are performed by GT to ensure consistency and transparency for the Audit Committee.
 - GT has broad consulting and risk management capabilities beyond audit services which USP utilized over the years.
- ▶ Whistleblower Complaint Process
 - In 2005, USP implemented a Whistleblower Complaint Process to reflect best practices under the Sarbanes Oxley Act.
 - The Audit Committee reviewed several anonymous letters during the cycle and completed an independent review of the circumstances that led to the *USP33-NF28* recall.

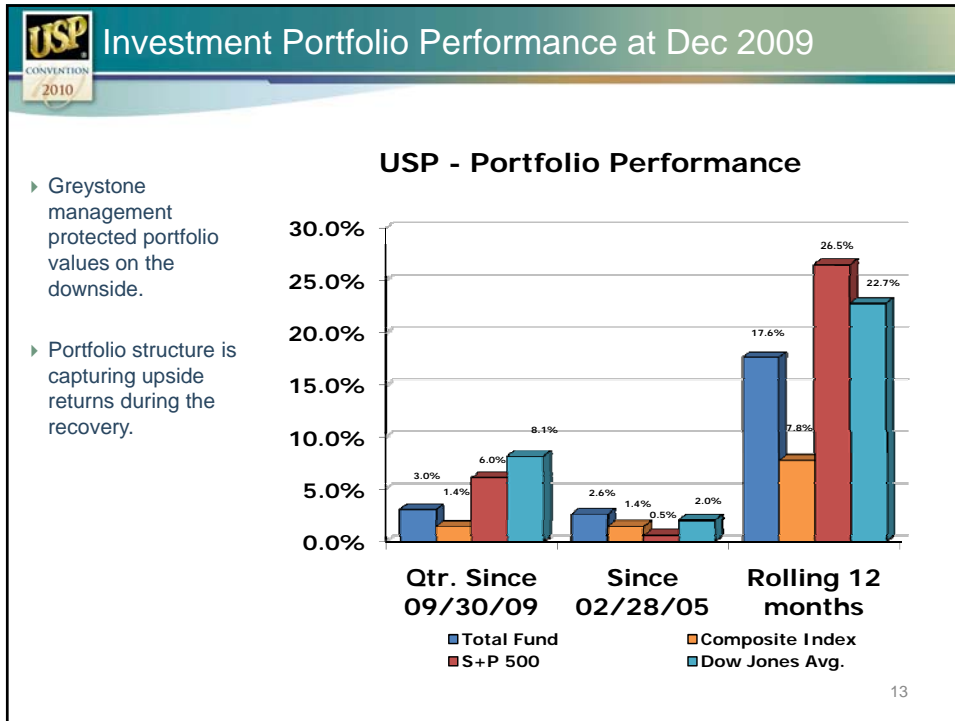
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Investment Committee Activities

- ▶ Greystone Consulting (formerly Smith Barney, now a part of Morgan Stanley) began managing USP's portfolio in February, 2005.
 - USP takes a long view of the portfolio since it is part of the strategic reserve.
 - A diversified portfolio structure was created which defends in down markets to preserve capital.
- ▶ Professional management added value and improved earnings.
 - The portfolio return of 2.55% exceeded the composite index of 1.41% since inception.
 - Greystone's fees are 0.22% or approximately \$150,000 annually.
 - Active management added 0.92% or about \$650,000 over the convention cycle while protecting the portfolio from downside risks.

12



Conclusion

- ▶ Crises bring out the best in people and organizations.
- ▶ USP's resilience in science, operations, and management leave it well positioned for upcoming Convention cycles.
- ▶ Strong science and strong management will combine for a bright economic future for USP.

14