Cyber security

Why every company needs to face up to the threat of cybercrime
Welcome to Issue 6 of Reporting, EY’s international magazine that aims to provide you with insights on the challenges business executives face in building and maintaining the confidence of their stakeholders in complex and dynamic capital markets.

As the economic landscape continues to remain challenging, boardrooms around the world are grappling with where and how they should pursue growth opportunities and assess new risks. We see the continued intertwining of two themes.

First: corporates are increasingly recognizing that planning for the long term, and creating a sustainable business model, provides a means of looking beyond the short-term economic uncertainty. Currency fluctuations, shifting capital flow between developed and high-growth markets, the continued fragility of the banking sector worldwide, and the range of national initiatives to stimulate market activity or increase fiscal control, have created a choppy sea. Taking time to review the horizon long-term, and the organization’s long-term strengths and strategies, gives some balance. Increasingly, investors and other stakeholders ask for this to be evidenced.

Second: agility is needed — to respond rapidly to new opportunities and operationalize business strategy ahead of the competition. This may mean entering new markets or regions, where more rapid economic, political and social change is taking place. In our article “Bridging the gap” (page 26), the investment opportunities in Turkey are explored as an alternative to the BRICS countries, with its unique position bridging Europe, Asia and the Middle East.

In May, the Global Reporting Initiative (GRI) conference held the launch of the GRI’s fourth-generation sustainability reporting guidelines – the G4 Guidelines. All speakers emphasized the need for reporting to supply relevant and reliable information on the creation of sustainable businesses and markets. There is consensus that increased transparency will fuel public debate and political will, and change market demand in many industries to transform the global economy in the long term. (See globalreporting.org for more information.)

Felice Persico
Felice Persico is the Global Vice Chair, Assurance

Christian Mouillon
Christian Mouillon is the Global Managing Partner, Risk Management

Felice Persico leads EY’s global Assurance practice, which includes external audit and assurance, financial accounting advisory, sustainability and fraud investigatory services.

Christian Mouillon has recently assumed the leadership role of Global Managing Partner, Risk Management, with responsibility for enterprise risk management within the EY network.
For multinational businesses, new risks are emerging, and perhaps a different corporate mindset is needed. Our article on cyber security (page 5) points out that risk prevention may no longer be a viable strategy — a risk response is where business leaders should focus.

Risks are not always external; on page 12, a summary of EY’s recent Fraud Survey highlights that there is a perception in the business community that the pressure for growth stimulates unethical conduct in some quarters.

Boards, and in particular the directors who provide independent oversight, need to be constantly asking the most difficult questions of the executive, and of themselves. Our article on the dangers of groupthink (page 22) advises against unconscious conformity and discusses options to minimize the possibility of its occurrence. Achieving consensus on how to reach the firm’s broader goals remains important. But, alongside their shared aspirations, the article states that the board must also afford the space for different views to be taken into account. And those who are responsible for oversight need to continue to challenge.

On 1 July, we announced a new Global Chairman – Mark Weinberger – and the new EY name, which is on the front cover of Reporting. We also unveiled our purpose: “building a better working world.” We see this as a reflection of our role as a professional services organization undertaking audits of some of the most complex global organizations to attest their performance to capital markets, and as advisors to help companies improve their risk management and resistance to fraud, and manage their impact on the environment and society for the long term, while providing a fair return to all financial stakeholders – investors, lenders and nation states. It is both an aspiration and a statement of deep intent held by us, the EY leadership, and our 170,000 colleagues worldwide, to create positive change with our clients, governments and other stakeholders.

We hope you agree that the topics we cover in Reporting will help business leaders, faced with the challenges of extremely dynamic and sometimes unpredictable international markets, to improve their immediate working world continuously. We welcome your feedback.
Cyber security: the challenge
Every business faces the threat of cybercrime, but where to invest in security, and how much, remains a lively debate.

5 things I’ve learned
Fabienne Lecorvaisier of Air Liquide describes the importance of clarity and preparation when reporting to the board.

The poll
EY’s latest fraud survey reveals that an alarming number of businesses appear to be turning to unethical conduct.

Rethinking global risks
Our report looks at four issues that should be on the agenda for international companies on the lookout for systemic risks.

Tax and reputational risk
Companies are facing increased scrutiny over how they handle their tax affairs, and getting it wrong can put a brand at risk.

The dangers of groupthink
Unconscious conformity within groups presents a dangerous and stealthy risk to businesses.

Bridging the gap
Turkey presents a tempting investment alternative to the BRICS, according to a recent report.

The buy side
The four managing directors of Wall Street stalwart Tweedy, Browne describe the firm’s tried and tested investment approach.

My wish list
International non-executive director Jackson Tai shares his perspective on how to improve governance and corporate decision-making.

The gender debate
If women are indeed more risk-averse than men, does a CFO’s gender make a material difference to the performance of a business?

IFRS changes for 2013 year-end
A summary of the new standards that ongoing IFRS preparers need to be aware of.

... and more
Recent publications from EY, plus books that may be of interest.
Cyber security: the challenge

As the threat posed by cybercrime grows, companies face a challenge in protecting the data they hold. David Stevenson assesses the seriousness of the problem and what boards can do to address it.

Shawn Henry, President of US-based IT consulting firm CrowdStrike Services, is a former Executive Assistant Director of the FBI, where he oversaw computer crime investigations spanning the globe. So, when he says that there’s a corporate cyber war raging, it’s worth taking notice.

Henry says every board needs to assume their company’s data is under assault, and the damage incurred is likely to be both financial and reputational.

How serious is the problem? Is the number of cyber criminals increasing, or is it just that more victims are willing to report data breaches? Many corporate victims of cybercrime are understandably still reluctant to report any costly lapses in security, but

Henry says that “increased awareness has, at the very least, enabled increased analysis of the problem.”

The Privacy Rights Clearinghouse (PRC), a California-based, non-profit consumer education and advocacy project, is one of the few relatively objective organizations to track crime trends. It estimates that there have been 3,740 data breaches since 2005, with a grand total of 567,788,137 records compromised as of October 2012. And the problem shows no sign of going away; in that month alone, the PRC reported 40 data breach incidents, many involving hundreds of thousands of files.

Perhaps the most worrying cybercrime victim to date has been US data specialist Heartland, a major
player in the electronic handling of customer payments. In 2009, in what may be the largest-ever corporate security breach, it disclosed that criminals had gained illegal access to 130 million credit and debit cards. The impact was immediate and devastating; Heartland’s share price fell by 80% when the breach was disclosed, and it ended up paying out more than US$100m in settlements.

There is a particularly distinctive regional challenge in Asia, where transnational legal initiatives to combat cybercrime have achieved only limited traction. According to “Cybercrime in Asia: Trends and Challenges,” published in 2012 in the Handbook of Asian Criminology, of all the countries in the Asia Pacific region, only Japan has signed the Council of Europe Convention on Cybercrime, a key legal structure designed to combat cybercriminals. A 2010 report by Symantec highlighted China in particular, which faces ongoing struggles with a huge amount of malicious activity, both at the individual and company level. With Asia boasting the fastest growth in internet penetration rates in the world, achieving data security is of paramount importance to businesses operating in the region.

Board-level questions

In the aftermath of the cybercrime that hit US data firm Heartland (see above), Chairman and CEO Robert Carr was forthright in his views about the lessons to be learned. His advice to boards was succinct and to the point:

1. Do not underestimate the insider threat
2. Ensure the appropriate audit scope
3. Maintain in-house security expertise at senior executive level

The consensus among both victims of cybercrime and cyber security professionals echoes these views. The bottom line is that boards need to show an interest in cyber security, no matter what sector they are in. According to Mark Hughes of BT Group, that means “you need to start with the CEO and move down to COO, CTO or CIO, and the audit and risk committees.”

That view is echoed by Shawn Henry of CrowdStrike Services, who says that “boards need to understand the threat and demonstrate leadership. Every executive has a responsibility because they all own the company data. This has to be a ‘whole company’ response.”

Whichever specific committee or director is charged with coordinating cyber security, there are a few key questions boards may also want to consider.

- How quickly would you, as a board, be able to respond publicly to an attack? Many businesses have taken a few days to announce an attack, but this delay can be damaging. Transparency very early on is crucial to maintaining a corporate reputation.
- Do you have any specific insurance for cybercrime? Many new policies include cyber-liability insurance.
- What is your business disaster and recovery plan in the event of a cybercrime attack releasing sensitive customer data?
- Do you have a chief information security officer? If not, why not?
- Is there someone with IT expertise who sits on a dedicated risk committee looking at the risk from cybercrime?
- Have you considered contract clauses for your suppliers relating to cybercrime? For instance, through its procurement system, the US Air Force has forced its vendors to provide systems that have been configured specifically to protect against cyberattacks.
A LACK OF URGENCY

It’s not surprising that many companies worldwide are now taking cybercrime extremely seriously. Reports suggest that awareness of the problem among corporate IT professionals is soaring; in one survey carried out in 2011, 80% of the 200 IT executives surveyed reported that they had detected at least one attack.²

But that sense of urgency hasn’t necessarily filtered up to board level. Carnegie Mellon University’s research institute, CyLab, conducts a biennial survey of board members and senior executives. The 2012 report, which surveyed Forbes Global 2000 companies, revealed that, although 91% of respondents indicated that risk management was being actively addressed by their board, the areas receiving the least attention were IT operations (29%), computer and information security (33%), and vendor management (13%).³

If these survey results are indicative, businesses are leaving themselves wide open to exploitation, with potentially costly consequences. A study published by Ponemon Institute in March 2012 found that the average cost of a data breach in the US was $US194 per record.⁴ With a typical data breach involving thousands of records, the scale of the damage can be sizeable.

Henry certainly believes that boards need to take cyber security extremely seriously. “Virtually every company I know is at risk,” he says. “And to those who say they don’t have anything of value to steal via cybercrime, I say, tell your shareholders you don’t have anything of value in your company, then.”

Experts suggest that organizations should take particular care to understand the cyber security implications of major structural or product changes. According to Badar Ali Al-Salehi, Director of the Oman National Computer Emergency Readiness Team, companies are at their most vulnerable when planning:

- The introduction of new software — e.g., a new database or email, customer relationship or accounts systems
- The commissioning of new hardware or a major upgrade of an existing hardware system
- A move to new premises or a major refurbishment of existing premises
- Changes in staffing — e.g., involving the loss of key personnel

Some sectors that handle particularly sensitive data, such as banking and the defense industry, have done a huge amount of work to boost their cyber-defenses. But Paul Walker, who leads the Forensic Technology and Discovery Services group at EY in the UK, insists that other sectors also need to be aware of the challenge. He argues that it is a major issue for any organization with sensitive client data, such as a law or accountancy firm, as well as those whose business is centered around intellectual property. For Walker, too many companies are relatively immature and highly reactive when it comes to damage limitation.

“Cybercrime is an ever-changing landscape, and no organization should consider that it has won the war”

Paul Walker, EY

INFORMATION: CYBER SECURITY
Al-Salehi agrees. “The bottom line is that companies are dependent on their information and communications technology infrastructure to support their business objectives, so it is paramount to protect themselves against cyber threats,” he says. “It is important to conduct a cyber security assessment in order to better evaluate threats and their impacts, and then put controls in place to mitigate those threats.”

SENSIBLE LIMITS
Yet, there are sensible limits as to what an organization can actually do to secure its digital assets. Mark Hughes, CEO of BT Security, reminds boards that they need to have “a sense of proportionality about online business, as we all transact business online, and cybercrime comes with that.”

Professor Thomas Rid, a security analyst based at King’s College, London, agrees that not all cybercrime defenses are business-critical. He told the BBC’s Today program in March 2013 that “cyber attacks are not created equal. Smaller attacks are easily defended against, but the big attacks that steal intellectual property and create multi-million-pound damage are quite rare.”

Not everyone agrees with this academic caution. According to Al-Salehi, “having too much security” is an unhealthy concept. “There is never ‘too much security','” he says. “Security is digital capital.”

Cyber threats – the terms you need to know
Like most technical fields, cybercrime has an ever-growing lexicon of terminology that can be hard for outsiders to follow. Below is a quick guide to the most common threats that businesses need to be aware of:

**Virus:** a computer program that can replicate itself and spread from one computer to another.

**Trojan horse:** a program that tricks the user into giving access to a computer network.

**Worm:** a self-contained program that will replicate itself across a network.

**DDoS:** distributed denial of service. A DDoS attack involves hackers using thousands of computers via botnets (see below) to send bogus traffic to a particular service in the hope of overloading it.

**Botnet:** a collection of internet-connected programs communicating with other similar programs in order to perform tasks. There are legal botnets, but illegal ones can be used for a variety of purposes, such as sending spam or carrying out DDoS attacks.

**IP spoofing:** a technique that involves an external hacker gaining access to, or forging, the address of a trusted system to fool another system into granting it access.

**Phishing:** apparently innocuous emails or requests designed to steal personal information through malicious software, or by luring unwitting recipients into sharing information.

**Spear phishing:** a relatively new phenomenon accounting for a significant percentage of all attacks on enterprise networks. It is used by scammers targeting specific individuals within an organization to access sensitive information.

But there are practical impediments to a more active anti-cybercrime policy. Cost is undoubtedly an issue, although experts are quick to point out that quarterly security audits need not be prohibitively expensive.

Many businesses also worry about the capability of internal audit staff to run a proper security and data analysis – and, even if these staff are capable, some business leaders worry about who at the senior level has the practical experience to make sense of
the resulting assessment. More acutely, many cyber security experts are also struggling with a lack of expertise. Walker worries that the shortage of skilled IT security staff is “really hitting home now.”

LEGAL REQUIREMENTS
The brutal reality is that boards have no choice but to take the issue of cybercrime seriously. If nothing else, regulators will increasingly demand full disclosure as early as possible.

In the US, for instance, the Securities and Exchange Commission (SEC) has already said that it believes risk oversight – in all its many guises, but including cyber security – is “a key component of a board.” SEC rules that came into effect on 28 February 2010 require disclosure about the board’s role in a company’s risk oversight process and its leadership structure.

If all that regulatory pressure wasn’t a big enough incentive to take action, boards also need to think about the possibility of litigation. One recent study suggested that the odds of a firm being sued after improperly disposing of data (for example, by putting financial records out with the trash, or discarding computers containing personal information) are three times greater than after breaches caused by lost or stolen data, and they are six times greater when the data breach involved the loss of financial information.  

Perhaps it’s time that all boards really do assume that their valuable data has been breached – and start planning what to do about it (see panel, page 6). As Walker concludes: “Cybercrime is an ever-changing landscape, and no organization should consider that it has won the war.”

1 privacyrights.org/data-breach.
6 Amended Item 407 of Regulation S-K.
Fabienne Lecorvaisier knows only too well the challenges of managing shareholders and board members without taking your eye from the daily finances. Clarity and thoroughness, she says, cut through the fog.

**Fabienne Lecorvaisier** started her career at Société Générale before progressing through various positions at Barclays Bank and the Banque du Louvre. She joined the Essilor Group in September 1993 as Development Director and, in three years, was appointed Director of Finance and Information Systems of Essilor America. By 2007, she had risen to Director of Strategy and Acquisitions for the whole group. She joined Air Liquide in 2008; alongside her current role as Group Vice President, Finance and Operations Control, she sits on the Executive Committee and on the boards of several Air Liquide subsidiaries.

1. **Always be flexible**
   Because Air Liquide’s business model is extremely capital intensive, the core words for what we do are flexibility and adaptability. To provide timely and adequate financing in 80 countries at the lowest possible costs, we have diversified our financing sources around the world. We use local bond markets as much as possible, and we became the first French corporate firm in Hong Kong to issue offshore bonds in RMB to finance our development in China, and the first non-public company to issue a Socially Responsible Investment-qualified bond to finance our acquisitions in home health care.
2. Have a clear view ahead
   Transparency and anticipation are the most important things when we are dealing with the board and audit committee. Our shareholders are demanding people who don’t like uncertainty and surprises, even good ones. It’s best to anticipate any and all possible changes that may happen, so we provide the board with detailed and very structured pre-reading documents. As we then only have to recap the key points and decisions, there is time for debate in the meeting itself.

3. Say what you do and do what you say
   Shareholders invest their money and expect a return. They will be understanding and more likely to accept temporary difficulties if they trust your medium-term strategy, so you must always be sure to explain the differences between the short, medium – and long-term approach you are taking. Always admit that forecasting is difficult, but if you communicate and stay within broader ranges, it will reassure investors, as will putting your focus not just on the difficulties themselves, if any, but also on the action plans you have to overcome them.

4. Be the first mover
   At Air Liquide, we establish long-term relationships with customers, on 15- to 20-year-long contracts. It is therefore critical for us to be the first to invest in new territories. This is the specific challenge of the industry we work in. We have recently invested in Ukraine, but, as always, we made sure that we conducted in-depth analysis of the country and the potential customers, assessed the risks and trained the managers, and we run extensive compliance and ethics control programs. We cover ourselves through the European Bank for Reconstruction and Development and public and private insurances.

5. Use new technology and social media
   New technology hasn’t really changed finance. Conference calls, WebEx and internal social networks are useful tools that have made communication, management and reporting easier and more efficient. However, social media and instantaneous broadcasting have increased the risk of rumor-spreading, so we need to keep a watch on social networks and reach our investors before they hear of a rumor that is usually erroneous. This has led us to strengthen our relationships with opinion leaders and analysts, to make sure they get information that is exact, and that they get it from us first.
The results of EY’s latest fraud survey suggest that pressure to demonstrate growth in challenging conditions has resulted in an alarming number of organizations appearing to turn to unethical conduct.

EY’s 2013 EMEIA (Europe, Middle East, India and Africa) Fraud Survey conducted interviews with more than 3,000 board members, managers and their teams across 36 countries to gain a detailed understanding of how fraud and corruption are perceived in both developed and rapid-growth economies. With instability across many markets, sluggish or minimal growth and an aggressive enforcement environment around the world, businesses are operating under testing conditions. The researchers aimed to understand how these conditions affected business conduct.

Complete and accurate picture?
The results show that unethical conduct — including fraud, bribery and corruption — is not just a hypothetical risk. One in five of our respondents has seen financial manipulation of some kind occurring in their own companies in the last 12 months. This is more pronounced in rapid-growth markets, where nearly a quarter of respondents are witnessing this behavior. Of particular concern was the response from those working in finance departments, where the results showed:

- 11% of respondents had seen revenues recorded before they should have been
- 8% knew of customers being sold unnecessary products to meet short-term sales targets
- 10% were aware of under-reporting of costs
Is management aware and taking necessary action?

While the results relating to ethical misconduct are concerning, the survey also shows that management is aware of this issue.

Forty percent of directors and senior managers are aware of some type of irregular financial reporting in their company. Within the finance area, nearly a quarter of respondents are aware.

Thirty-eight percent of all respondents — and 45% of those in rapid-growth markets — believe companies in their countries have often reported financial performance as better than it was. Sixty-one percent of respondents in Spain believed companies often exaggerated their results — showing that the practice is not limited to rapid-growth markets.

The results also serve as a warning for multinational companies with subsidiaries in, for example, India (where 54% think financial performance is often exaggerated), Russia (61%) or Nigeria (68%). These businesses have good reason to look critically at what is being reported back to the center from other jurisdictions.

Too good to be true? Asking difficult questions

Accurate financial reporting is essential in order for businesses to understand performance. However, if management does not conduct a sufficiently rigorous review or fully understand local operations, there is a risk that poor performance can be hidden and management intervention delayed.

From our observations during fraud investigations, inflating revenue through fictitious or early recognition or hiding costs can be the result of a variety of practices. These include raising invoices early and using provisions to manage the release of profit. Yet these strategies can be identified if management looks closely and asks the right questions:

- Are reported results consistent with the cash requirement and cash performance of the business?
- Are balance sheet metrics, such as inventory and accounts receivable, keeping pace with changes in sales?
- How does performance compare with other business units? Are relative changes in line with your expectations? Is one business performing exceptionally?
- Is the business unit responsive to more detailed questions about reported results?
- What visibility do you have over aspects of performance that can be verified independently, such as cash and inventory?
- How do reported results compare with other information such as recruitment patterns or recent new customer wins?
- Does the business regularly report results in line with budget?
Q: Can you indicate whether you think the following applies, or does not apply, to your country or industry? Companies in this country often report their financial performance as better than it is.

Base: all respondents 2013 (3,459); developed (1,500); rapid-growth (1,103); Austria (100); Greece (100); India (100); Kenya (100); Nigeria (103); Russia(100); Saudi Arabia (100); Spain (100). The “don’t know” percentages have been omitted to allow better comparison between the responses given.

David Stulb, Global Leader of EY’s Fraud Investigation and Dispute Services practice, comments:

“Given the current challenging market conditions, companies face sustained pressure to meet growth and profit expectations. In this environment, we have seen that some inevitably succumb to unethical behavior. Shareholders expect management to take responsibility for protecting the business by implementing anti-bribery and anti-fraud programs at all levels of their organization.

“The mere existence of a program is not enough to mitigate the risk, however. Companies must ensure the program is communicated effectively, employees are trained adequately, and it is continuously monitored and updated.

“Our experience shows that leaders of organizations that successfully manage the risk of fraud, bribery and corruption ask the difficult questions and demand answers, particularly about the financial reports they receive.”

For full details of Clear navigation to avoid business risks: EY’s Europe, Middle East, India and Africa Fraud Survey 2013, visit ey.com/fids.
Rethinking global risks

EY’s Business Pulse report explores the top 10 risks and opportunities for global companies as they begin to look ahead to 2015. Our extract considers four possible adverse developments that companies should be watching for over the next three years.

A world of risk

In our series of articles on systemic risks, we have focused on some of the most challenging long-term risks global businesses face, from volatile energy supplies to water shortages. In this issue, we examine four of the more immediate and significant global political and economic risks to businesses that were identified in EY’s extensive Business Pulse report. The report identifies specific scenarios that could unfold in the next three years and looks at their implications for businesses.

In years gone by, unexpected risks in another region or economy didn’t necessarily have serious consequences elsewhere. But in an increasingly globalized and interconnected world, this is less often the case. Instead, factors outside a firm’s control can pose a pressing challenge to its strategy, operations and profitability. In turn, this demands a wider view of the potential risks and opportunities that are rarely on the corporate radar.

The report considers four of the emerging challenges. And, as each carries consequences for a wide range of markets and sectors, it considers plausible scenarios for how each may evolve over the next three years. To maximize the benefit to businesses, rather than considering these challenges as general concepts, the report identifies specific scenarios that may occur.

The challenge of QE unwinding

A chief concern globally is a disorderly unwinding of the quantitative easing (QE) program undertaken by leading economies, as this could see bond yields and interest rates rising sharply.

Because so many investors have moved into treasury bonds and invested in equities, changes in policy parameters that affect their value will inevitably drive significant economic and investment restructuring. Such substantial intervention and unpacking has never occurred before in monetary...
policy and it would be unrealistic to assume that the process will go smoothly, however capably it is managed. The unwinding process will be of global significance and has already had major effects in emerging markets.

More positively, several developed-world economies are unquestionably in much better shape than even one year ago: housing is recovering; bank capital levels are better leveraged; bank lending is more expansive; parts of manufacturing are regaining global competitiveness; consumer confidence and spending are improving; and prospects for energy independence in the US have boosted confidence. Estimates for the federal deficit have been revised downward and the negative effects of sequestration-triggered spending cuts have not yet occurred to the extent predicted. The strength of the dollar as the global reserve currency has been maintained.

However, the rising number of long-term permanent unemployed who are now detached from the economy is an increasingly salient challenge for the leading developed economies, and one that poses a new set of policy challenges so far unaddressed by lawmakers.

DEEP RECESSION IN THE EUROZONE: TESTING THE LIMITS OF AUSTERITY
Since the onset of the Eurozone crisis, European governments have worked through the decision-making mechanisms of the EU to agree on a series of largely reactive reforms. For businesses, the key risk associated with the crisis is the possibility that the resulting path of austerity will perpetuate a vicious cycle of low (or no) growth, and thus a worsening of debt-to-GDP ratios. While austerity has restored a degree of calm to volatile markets, it is at the cost of public protest and political upheaval.

As public spending represents a sizeable part of many EU economies, austerity packages often lead to increased unemployment, which, in turn, threatens to drive these countries into a deeper recession. At present, it appears that the postponement of fiscal targets in some European economies may make it possible for Eurozone countries to move toward abandoning austerity. New measures to support easier access to finance, not least from the European Central Bank, will support recovery long term, and the EY Eurozone Forecast September 2013 concludes that the Eurozone is now emerging from its longest recession in decades, but the recovery will be slow. In this situation, severe austerity packages already being implemented by indebted states could cause unemployment – already at a record high of 12.2% across the Eurozone in April 2013 – to rise even further. This would reduce aggregate demand and further erode public finances, hurting business activity and increasing both borrowing costs and the risk of further bailouts.

"EU institutions are likely to play an increasingly influential role in the future of the Eurozone"

Continuing disagreements over policy objectives have caused further divisions between politicians. EU institutions are likely to play an increasingly influential role in the future of the Eurozone as national political figures face domestic political pressures that pull them in different directions. In some cases, these pressures include demands that countries exert their national sovereignty at the cost of a united approach to tackling the challenges facing the Eurozone. If key EU institutions prove unable to engineer a coordinated response as leading politicians come under parochial pressure at home, the prospects for political paralysis at a time of deep economic recession are significant.
CRUMBLING BRICS? THE GROWTH PARTY’S HANGOVER

The outlook for the BRICS, once hailed as the engines of growth, now looks more modest. Policy-makers in BRICS countries may remain trapped between slowing growth and higher inflation, with, in some cases, increased debt burdens casting doubts over domestic demand-led growth even as inadequate investment in infrastructure threatens to constrain longer-term growth prospects.

Major developing economies are of key concern, precisely because their scale and growth rate are so important to the global economy. They have to consider, for example, the effects of quantitative easing efforts elsewhere in the global economy, as well as persistent economic weakness in the EU. If the world economy implodes for a second time in a decade, fiscal resources may become strained, even to the extent of an outright recession.

Even if this extreme scenario is avoided, the volatility of such economies may then increase as it starts to generate internal boom-bust cycles. Such cycles would have far-reaching implications for markets that depend heavily on demand from major emerging markets. The effects on consumer-oriented sectors may have particularly serious repercussions, as the expansion of middle-class spending patterns in the BRICS had been a key source of buoyancy amid slackening developed-market demand.

THE MIDDLE EAST: BOILING OVER?

Since early 2011, risings and unrest across the region have overturned old and once stable political orders, ushering in a new period of shifting relationships within and between the countries of this dynamic and resource-rich region.

There are some good reasons for optimism about economies in the region, given their need for international loans and their new-found tendency toward market-oriented reforms. This is particularly true in post-uprising economies, but whether this will be translated into real changes in their legal systems remains to be seen. However, progress on crucial subsidy reforms and state dominance of the economy is likely to be slow, given the high level of political instability and lack of consensus on fundamental issues. Such challenges to the political economy are likely to destabilize already delicate political balances across the region, making it harder for those conducting business with the region to calculate the risks of doing so.

ANTICIPATE, OBSERVE AND, IF NECESSARY, ADJUST

By highlighting these emerging challenges, the report aims to invite readers to reconsider their assumptions about the wider geopolitical and economic context, as part of their efforts to stress test their company’s strategy. Each of these issues has direct business implications.

Anticipating and adjusting to these possible emerging challenges fosters a culture of flexibility and nimbleness – putting companies in a better position to respond to inevitable global uncertainties, even if some of these challenges do not play out in the way described above.

To download the report Business Pulse: exploring dual perspectives on the top 10 risks and opportunities in 2013 and beyond, produced by EY, go to ey.com/businesspulse
Tax and growing reputational risks

Companies are facing increased scrutiny of how they handle their tax affairs — and getting it wrong can put a brand at risk with all types of stakeholders.

Whether it's companies being accused by politicians of acting immorally, television programs accusing large multinationals of unacceptable practices, or prominent, critical articles in international financial media, multinational companies have been subject lately to a growing barrage of criticism.

But the issue at hand is not child labor, unacceptable working conditions or poor environmental practices – the typical concerns that usually give rise to corporate reputational risk. Rather, they were based on questions regarding the tax affairs of these companies. Businesses face unprecedented disclosure requirements by tax authorities, while tax audits are becoming more frequent and aggressive, and typically result in larger reassessments than before, not to mention significant penalties and interest.

With the G8 and G20 now fully engaged in the discussion, all this is creating the most challenging environment for tax controversy in years. More detailed disclosures and transparency requirements for corporate taxpayers are on the rise too, and there is increasing public debate about corporate tax avoidance and the boundaries of acceptable tax behavior.
As these pressures continue to rise, so too the issue of tax reputational risk rises on the corporate agenda. The intense scrutiny, even when unwarranted or inaccurate, can hurt brand reputation and — potentially — shareholder value.

TAX ACTIVISM

Even after an initial push for tax-related transparency represented by the United States’ 2002 Sarbanes-Oxley Act, the general public expressed relatively little interest in tax disclosures until quite recently. However, the now-austere economic environment and sweeping spending cuts in many countries have generated new interest in corporate taxation and a thirst by some for more knowledge and transparency around large companies’ tax affairs.

This has been led by journalists and activist groups, both of whom are calling for companies to “pay their fair share”. As public interest grows, so does political focus on the issue. These parties are scrutinizing corporate reports and other information sources for news of tax controversies, and spotlighting low effective tax rates or factors that they believe indicate overly aggressive tax planning activities.

Media claims often reach inaccurate or misleading conclusions that ignore permissible, straightforward activities, such as deliberately enacted tax incentives or government-approved transactions. “The facts cited in these stories are often incorrect,” explains Monique van Herksen, an EY professional who specializes in tax controversy. “International taxation is an incredibly complex area. Journalistic sound bites that are based upon a lack of understanding or evidence can be very misleading.

“The problem with handling the issue is often that the charge that challenges your reputation is merely an out-of-context one-liner, while the explanation or correction takes far longer to express,” she adds. “It doesn’t meet the media’s ‘elevator test’. Having another set of one-liners to recite back to whomever made the charge in order to survive the issue can be difficult to do. Good compliance, timely payment of taxes that are in fact due, and removing unnecessary or dormant companies, goes a long way to establish commitment to being a good corporate citizen, which is usually the underlying challenge.”

In fact, a recent EY survey of senior tax executives reported that 100% of respondents said that they have shifted their risk parameters in response to recent developments of this kind. Eighty-eight percent, meanwhile, said that they were somewhat or extremely concerned about media coverage on the amount of taxes some companies are paying or their seemingly low effective tax rates.

But, at the same time, almost half of businesses surveyed felt that engaging directly with the media was a “no win” situation. “Effective preparation and robust risk mitigation is key in this new environment,” says Rob Hanson, Leader of Tax Controversy at EY. “By the time a story has been pushed around the world via social media, it’s probably too late to respond, whether or not that response would have had any effect anyway.”

HOW MUCH TAX IS “ENOUGH”?

“Much of the media attention focuses on claims that companies are avoiding paying their fair share of taxes by means of aggressive tax planning that reduces effective tax rates,” says Chris Kealy, an EY professional who works closely with multinational companies to help them meet their global compliance and reporting obligations. This is despite the fact that tax planning has long been held to be a legitimate activity. As early as 1929, Lord Clyde, then the UK’s Lord Justice General, stated that “no man in
this country is under the least obligation, moral or otherwise, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his store.”

Regardless, public interest groups and the media are increasingly applying a moral compass to tax planning, irrespective of whether the taxpayer fully complies with all their legal obligations. “They take the position that a company with operations in a particular country should pay ‘adequate’ tax revenues in return for using its resources and infrastructure,” explains EY’s Asia Pacific Tax Performance Advisory Leader, Albert Lee. “The trouble is, who is the arbiter of exactly what that ‘fair’ level of tax is? Companies rightly use the laws of a country to decide their taxes, and revenue bodies enforce whether that payment is right or not. But companies are increasingly finding themselves charged in the court of public opinion today, and that can really damage brand and reputation.”

A further risk of tax reputational damage can arise from a lack of visibility over a company’s local subsidiaries, says Aidan O’Carroll, Global Director for Global Compliance and Reporting Services at EY. “As companies globalize and regionalize their operations, they are moving to shared service centers and business process outsourcers,” says O’Carroll. “As a result, there can actually be little local tax competency left in individual countries. This comes at a time when local expertise and relationships with tax authorities have never been more important for managing tax risk.”

CALLS FOR TRANSPARENCY
One specific area in which developments have been seen is in increased calls for transparency by some commentators. Greater transparency between taxpayer and tax authority is viewed as a good thing by many in the business world; it can lead to fewer disputes, greater mutual understanding, and a relationship based upon cooperative compliance. “At the same time, it is important that confidentiality is maintained, as this transparency has to be built on greater mutual trust,” says Chris Sanger, EY’s Global Tax Policy Leader. “Fear that commercially sensitive information could potentially be released could undermine such trust,” he continues. “The need for greater transparency and more information is about constructive and productive dialogue between taxpayer and tax authority, not necessarily something that should play out on the public stage.”

Perhaps heading the list of recent developments in this area are new proposals from the European Commission relating to country-by-country tax payment reporting. This kind of reporting was first considered by the OECD in 2010, and has since been applied to companies in the extractive industry. European proposals for higher levels of tax transparency also affect financial institutions as part of the Basel III requirements. The proposals provide that, from 1 January 2014, European banks and other institutions regulated under CRD IV should disclose a spectrum of information to the Commission, including pre-tax profit or loss, taxes paid and subsidies received. During 2014, the Commission will review these additional three disclosures provided by the banks and assess whether they should be made public from 2015.

Recent developments have included calls by some for these proposals to be extended to all companies. Following its 22 May meeting, the European Council issued a set of conclusions on taxation that included a call for “rapid progress” on a number of issues, including a statement that “the proposal amending the directives on disclosure of non-financial and diversity information by large companies and groups will be examined, notably with a view to ensuring country-by-country reporting by large companies and groups.” To decipher the language of the Commission, this basically refers to extending the current transparency proposals. It is clear that not all EU Member States support this stance, however, and developments are being watched closely.

Tax authorities around the world have also increased requirements for tax reporting, at the same time as increasing overall enforcement levels. Some measures require disclosure of uncertain
or aggressive positions on tax returns, but certain countries are going far beyond mere reporting requirements. “In Australia, Canada and the UK, for example, the heads of the revenue authorities are asking the leaders of large multinationals, one on one, to explain how they are proactively managing tax risks,” says van Herksen. “Based on these conversations, the tax authorities are applying risk ratings that directly affect the audit approaches used with these companies.”

MANAGING COMPLIANCE
So how can companies respond to all this? Hanson argues that effective compliance management is the first place to gain ground over reputational risk. “In this new environment, companies just need to comply. They need to manage that compliance in such a way that they have effective processes and controls and an effective dashboard of information on where their potential exposures lie," he says. “And then, in those places, it is important to work on your relationship with the revenue body, as well as to know what potential dispute resolution mechanisms may exist.”

Tax audit resolution should also take reputational risk into account. “Audit settlement discussions and resolutions used to be relatively private matters between the tax authorities and the taxpayer,” says Kealy. “Today, it is quite different. It’s essential to consider the possible reputational impact if audit settlement details were to end up in the news media, and to keep in mind that there is interest in financial statement disclosures about years under audit and material issues.”

Such considerations now go beyond the tax director; managing tax reputational risk is a growing C-suite, audit committee and board level concern, since it is here that the business’s policies for tax risk and tax controversies should be established and monitored. Tax planning should be aligned with those policies and with the corporate message to the community at large, all of which should be assessed in light of how the public and the revenue authorities may perceive it.

At Sandvik AB, a global technology and engineering group headquartered in Sweden, high-level tax strategy is decided by the board. The company also undertakes tax planning in a very structured way. As an example, it has a process for evaluating whether specific tax planning activities align with the company’s established strategy.

“Reputation is an important area to evaluate, as well as commerciality, so that we can be sure that tax planning has a business purpose,” says Pierre Jansson, Vice President of Taxes at Sandvik. “Planning activities also require advice from general counsel and our financial controller. Decision approval levels are very clear, and specific sign-offs are needed.”

REPUTATION MANAGEMENT
Overall, the tax director needs a clear grasp of the firm’s risk appetite, has to ensure transparent reporting on this internally, and must help establish clear processes and protocols for flagging and managing risks. “Whatever decisions a company makes should take into account the fact that somebody will have full knowledge of them, that you’ll be second-guessed on them, and that commentary – whether in the correct context or not – can be shared quickly,” says Kealy.

Tax reputation risk is yet another pressure, and managing it involves more robust, regular interaction between tax executives, their boards and audit committees. But the upside is that this also helps to create a more resilient company.
The dangers of groupthink

While infighting and dissent can ruin a team, unconscious compliance can cause different kinds of problems. Groupthink is a dangerous and stealthy risk to businesses that is challenged best by attention to bias. James Gavin investigates

The term “groupthink” was coined by Dr. Irving Janis, a professor of psychology at the University of California-Berkeley, after researching a series of leadership failures, from the Bay of Pigs invasion to the Vietnam War. It is defined as a mode of thinking where pressure for unanimity overwhelms members’ motivation to appraise the alternative courses of action realistically.

Groupthink tends to manifest itself in organizations through the manufacture of a form of consent that stifles evaluation and challenge. With the campaign for boardroom diversity enjoying a headwind across the globe, awareness of the danger of groupthink has grown exponentially.

“Groupthink is most likely to occur in workplace cultures where challenge to the status quo or dominant leadership majority is rare”

Dr. Katie Spearritt, Diversity Partners
COLLECTIVE RESPONSIBILITY
Despite this increasing awareness, groupthink still has the power to afflict boards and audit committees. One reason for this is that it is a largely unconscious dynamic. As Dr. Katie Spearritt, CEO of Australia-based consultancy Diversity Partners, argues, it is often a comfortable experience for participants because there is little or no conflict around ideas – a solution is readily agreed upon, with minimal dissent. All sides feel validated on that basis, which has the effect of inuring them to the impending danger.

“Groupthink can happen around just about any type of decision-making – such as discussions related to safety, finance or people – and is most likely to occur in workplace cultures where challenge to the status quo or dominant leadership majority is rare,” says Spearritt.

Of course, achieving consensus on how to reach the firm’s broader goals remains important. But, alongside their shared aspirations, the board must also afford the space for different views to be taken into account.

“We’ve seen that leadership teams that are aware of the potential for groupthink regularly encourage employees to speak up, and emphasize the importance of seeking out different perspectives,” Spearritt adds.

SPEAKING UP
Boards and committees do have a number of options to minimize the possibility of groupthink taking root. The role of the chair is critical in boosting interaction between board members and in setting the tone of board deliberations. As Josh K. Jones, an assurance services professional at EY in the US, puts it: “There are ways that he or she can foster an environment where people feel more comfortable expressing contrary views. In the most effective audit committees, we have observed a variety of methods to encourage the mutual sharing of views.

“That includes, for example, the leader of the group taking the time to create that environment, being proactive and asking for different perspectives from people who might not always get their views heard.”

Executive search firm Tyzack Partners regularly advises on boardroom effectiveness reviews, which can be a useful tool to understand the board’s approach and style. “It can help to establish baseline guidance – for example, in the recruitment of non-executive directors,” says Robin Murray Brown, a partner in the firm.

The review needs to take place at least every two years, he adds, and there must be scope for people to raise issues confidentially. “For that reason, I would always recommend some kind of external expertise. The review’s results should be shared with the entire board, so that it doesn’t end up with the chairman setting his ‘secret police’ on directors.”

Diversity on the board can also help to avert groupthink, according to Peter Matthews, Chair of Global Learning at EY. “The idea of having a board that has people of the same educational background, the same career experiences, the same sex, the same ethnic background, means that you won’t get the variety of experiences that enable the best decision to be made,” he says. “Diversity on a board is a powerful way to avoid groupthink, as people’s minds won’t be programmed to think in the same way.” (For more on the potential benefits of appointing women to senior positions, see the feature on page 34.)

“Diversity on a board is a powerful way to avoid groupthink, as people’s minds won’t be programmed to think in the same way”

Peter Matthews, EY

This is a particularly pertinent issue in the Asia Pacific region, where research suggests a growing recognition that boards need to incorporate diversity considerations – especially with regard to gender – when appointing directors. “A lot of Asian companies are very homogenous, not only in gender but in terms of nationality,” says Alicia Yi, the Singapore-based Managing Director of Strategic Client Services for executive search firm Korn/Ferry International.
“Even the globally active ones often don’t have foreign board members.”

“As economic conditions become more complex and interdependent, these businesses need to think about how they appoint board members. Asian companies really need to look at composition in a structured manner.”

Non-executive directors are an increasingly valuable source of diverse talent on a board. But here again, there is a tendency to negate the potential advantages by hiring experienced, familiar non-executive directors.

“Unquestionably, there are some very strong people who move from board to board, and shareholders like that,” says Matthews. “But, rather than having six 60-year-old Western males, I believe my interests as a shareholder would be better reflected if I had people from a wider variety of backgrounds, even if that means that they don’t have 15 years’ experience on a board.”

CHAMPIONING INDEPENDENCE
On the plus side, non-executive directors can provide senior expertise to review and challenge decisions – a role that is only improved by their informed detachment.

However, ensuring that a non-executive is truly independent can be a challenge in some parts of the world. Yi says that in Malaysia, there are guidelines on how many non-executive directors firms must have, but this is unusual in Asia Pacific. She explains that where family businesses dominate, the family consensus can overrule nominations and limit the checks and balances non-executives ought to provide.

In the UK, the Corporate Governance Code has been reviewed in recent years to reflect the expectations placed on the company’s chairman to populate a balanced board.

“The concept behind the balanced board is that you don’t have people who think the same way on every topic,” explains Graham Durgan, Chairman of the Non-Executive Directors Association, and a non-executive on the boards of CRF Capital Partners and Thomas Murray (Network Management) Ltd. “Non-executive directors should be selected, at least in part, on their ability to challenge existing views.”

When it comes to recruiting these individuals, firms may need to advertise openly, to overcome assumptions about where talent can or should be found. In current practice, non-executives are often chosen through recommendations from well-placed individuals or using executive search firms. Says Spearritt: “We see any increase in the transparency of the hiring process as a positive development, because it supports better oversight, which, in turn, lessens the risk of biased hiring decisions.”

In fact, sheer capacity constraints are pushing firms to look beyond the immediate talent pool. “One of the conversations we have with clients is that not enough names are being yielded, because the really good candidates are people who are already touching the limits of what they can commit to,” says Murray Brown.
ARE SMALL BOARDS BETTER?

Board size and structure can also play a critical role in promoting a culture of openness and discussion. The UK Government’s Walker Report on corporate governance in the banking sector, published in 2009, found that larger boards tend to suffer from the phenomena of passive free-riding, dislocation and groupthink, reducing their ability to monitor senior management effectively and govern the business. When boards are composed of more than 12 people, it argued, a number of psychological phenomena are compromised, including span of attention, the ability to deal with complexity, the ability to maintain effective interpersonal relationships, and motivation.

However, groupthink can afflict any board. “In my experience, it’s not related to size alone,” says Ruth Picker, Leader of EY’s Asia-Pacific Risk Management practice. “Diversity and having a good chair are critical, as is having the courage to simply come out and say, ‘I don’t agree with what Joe Bloggs said.’”

Not only that, but groupthink can take root at any point in the organization. “It’s not just boards and audit committees,” Picker says. “If you think about what happened during the financial crisis, that was groupthink on a huge scale – so many people all somehow believing that the property market was never going to fall. Irrational market behavior is groupthink writ large.”

Beth Brooke, Global Vice Chair of Public Policy for EY, agrees: “On the heels of the financial crisis, the need for diversity of thought at the board level has never been so clear,” she says. “We have an opportunity – and a responsibility – to learn from those mistakes and to guard against the groupthink that can occur at the board level.

“We can only achieve this if board and company leaders believe and embrace something fundamental: that difference matters. Building a diverse and inclusive board requires focusing on a range of competencies, not consistency, in recruiting members, while remaining transparent about, and accountable to, your diversity targets,” Brooke concludes.
Turkey offers a tempting alternative to foreign investors keen to pursue interests outside the BRICS, according to a recent report.

Turkey has overcome a series of political and economic challenges to generate stable economic growth that is projected to continue over the medium term, despite the recent unrest.

Turkey’s world-class features include its strategic location at the crossroads of Europe, Asia and the Middle East, and the size of its domestic market. These strengths are attracting a number of investors, who remain confident about Turkey’s future. We can expect its new investment incentive scheme and continued reform program to boost investors’ confidence in the country, and quicken its development into a regional and global hub.

In the past, Turkey’s economy has been vulnerable to volatile foreign institutional investment that is quick to arrive and quick to withdraw, prompting the Government to focus instead on foreign direct investment (FDI). Several FDI incentive schemes have been created, most notably in April 2012, when the Prime Minister announced a range of measures designed to attract foreign investors.

**RISING FDI**

FDI is certainly on the rise. Turkey attracted 8.5 times more FDI over the last decade than in the previous 80 years. It recovered quickly from the global downturn and its GDP has grown nearly three-fold (in US$ terms) in 10 years.

There are a host of drivers for investment, including a young, skilled workforce and the low-cost labor that is available. Within 25 years, there will still be five workers for every person of pensionable age in Turkey, compared with fewer than two in Japan and Germany.

Moves have been made to encourage a more flexible labor market, while the New Turkish Commercial Code should improve auditing standards and transparency (see “Viewpoint”, page 28). Turkey’s move toward EU integration has also encouraged more predictable taxation regimes and trade laws, which should allow investors to plan with confidence. An ambitious tax reform program...
The shift, the growth and the promise: EY's 2013 Turkey attractiveness survey, the country lags behind other emerging economies in its complicated corporate taxation. Investors also call for greater investment into the nation's limited innovation and R&D capabilities, as well as changes to a stringent employment protection regime that restricts employers.

Bureaucracy, bribery and influence-peddling have also created a difficult environment for businesses, leaving many struggling to comply with complex administrative requirements. Moreover, while Turkey's location is a positive for international businesses, its proximity to regional instability, and the recent demonstrations in Istanbul itself, are negatives.

Nevertheless, the country is slowly but surely attracting investors' attention. As the Government makes concerted efforts to improve the country's business environment and innovation culture, businesses can benefit from greater efficiency of operations, better competitiveness and enhanced value gained from reduced costs.

To read The shift, the growth and the promise: EY's 2013 Turkey attractiveness survey, go to emergingmarkets.ey.com

Turkey fact file
Population: 74.6 million (the 18th largest in the world)
Land area: 783,562 square km
Real GDP growth: 2.6% (2012)
CPI inflation: 6.5% (2012)
Public debt: 37.7% of GDP (2011)
Currency: Turkish Lira (TRY)
Bordering countries: Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Iran, Iraq and Syria
The Turkish Government has been proactive about adapting financial regulations in line with global trends, so the regulatory environment is investor-friendly. But the speed of some of the amendments is very quick, and market participants have a hard time adapting to new regulations. What’s more, the case law that supports the regulations takes time to appear, and that leads to gray areas.

One particular area where new regulations have been introduced is anti-bribery and corruption, but more needs to be done to enforce them. We perform an annual fraud survey that shows that corporate governance in Turkey is improving. We see increases in regular internal audits, whistle-blowing hotlines, and written policies and procedures – but we don’t see the amount of bribery and corruption falling.

The bigger, publicly quoted companies in Turkey do generally follow global corporate governance best practice. Mid-sized companies still have some way to go, though.

The same applies when it comes to the accounting framework and auditing. Publicly quoted companies, and those in key sectors such as financial services, are regulated and must prepare their financial statements, and should be audited, using standards that are close to international standards. Non-regulated companies are not required to follow international standards for financial reporting and independent audit.

With the introduction of the New Turkish Commercial Code in July 2012, the number of companies that have to be audited has increased. Under the Code, companies also need to have an early risk committee and prepare annual activity reports and affiliate reports, among other things.

Another area that is positive for investors is tax. In 2006, the corporate tax rate decreased from 30% to 20% – one of the lowest among the OECD countries. In addition, new tax incentives came into force in 2012 to encourage more investment in underdeveloped regions, especially the southern and eastern parts of Turkey. This should be good for FDI as well.

Overall, there are still some challenges in Turkey that potential investors need to think about. But FDI has been increasing over the past couple of years and looks as if it will continue to do so. The outlook is positive.
Our long-term success is largely due to the stability of our investment team and the efficacy of our value-based investment approach. Some of our team have been here almost 40 years, and even among our analysts and administrative staff we have very low turnover – possibly because we compensate them well, but, importantly, because we respect their input.

We have a long and colorful history spanning 92 years, where our partners have always bought in to the methods and approaches that have worked, relatively reliably, over the long term. We have also been unusually balanced in our management teams – after all, if it’s all about that approach, and not about you, that allows egos to remain in check.

CHOOSING CAREFULLY
There is both a quantitative side and a qualitative side to our investment approach. First, we look for companies that appear to be statistically mispriced. They could be trading at substantial discounts from even conservative estimates of their underlying intrinsic value – which we class as what a knowledgeable buyer would pay outright for the whole business in an arm’s-length transaction.

One of the few reliable sources of information about how a company has performed over the year is reputable audited financial information. This is where our research process begins. Without the financials, it is hard to know where to start, much less where to end. We spend a lot of time on the
footnotes to gauge how conservative or aggressive the accounting treatments are, and we also focus a lot of our attention on the income statement, cash flow statement and balance sheet in an effort to determine the company’s financial strength.

We then spend a lot of time studying what has been paid for businesses, in terms of a multiple of pre-tax and after-tax income, or their book value. Then we wait for the market to give us a buying opportunity, such as a cheap price or discount to that multiple.

Once we find that opportunity, the qualitative side of our analysis comes into play, and we study the stability and sustainability of the earnings power of the business. When you wake up in the morning, you never want to read in the paper that a company in which you have invested has been taken over by the creditors or has been leapfrogged in terms of its products.

We also tend to shy away from highly leveraged businesses and businesses where rates of change are rapid. If the business is right, you can make very good returns over long periods.

THE VALUE OF INTELLIGENCE
In addition, we like to see our companies allocate capital intelligently. Empire building through ill-advised acquisitions, or a focus on maximizing near-term earnings momentum, is not what we want to see. We prefer to see companies pay dividends, pay down debt and buy back stock when it is trading below its intrinsic value. We appreciate long-term strategic thinking.

While we like to see a record of intelligent capital allocation, we tend to agree with Warren Buffett: “With few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.” Our focus is on the business and not media-trained managements.

Our approach to research and investment has changed very little since the financial crisis. That said, while we have always been averse to investing in highly leveraged businesses, we pay more attention these days to the near-term financing needs of our portfolio companies. A liquidity crisis like we experienced in 2008 can pose significant challenges to businesses that need to continually roll over debt.

Also, since the early part of the 1990s, we have shopped globally for stocks and, for the most part, we have found more bargains outside than within. For the first time in many years, the financial crisis of 2008 produced a number of new investment opportunities for us in the US as well as abroad, but with the run-up in stock prices over the last year, it is now very difficult to find substantial mispricings in equity markets either here or abroad.
LOOKING AHEAD

We are extraordinarily humble when it comes to making forecasts regarding the macro- or micro-environment. While we do not make decisions in a vacuum, our focus has always been on the business. We have always believed that the performance of the stock is inextricably linked over time to the performance of the business, and so the company’s historical earnings power – and its competitive advantages to sustain that – are of critical importance to us.

We don’t just look at the company’s performance in isolation, of course. We examine industry pricing behavior and the potential impact of new technologies on the business model, look at the company’s acquisition plans and capital structure and review its capital allocation policy historically, and examine recent insider activity in the company’s shares.

Intense outside competition can cause earnings power to mean revert if the company does not have a durable competitive advantage, so we spend a lot of time studying the dynamics of a company and its industry, and look for advantages that can help create a moat around the business.

PROFILE

In its entire history, Tweedy, Browne has had only 11 principals, 4 of whom are currently active and oversee its operations as a management committee.

William H. Browne (top left) has been with the firm since 1978, Thomas H. Shrager (top right) since 1989, John D. Spears (bottom left) since 1974 and Robert Q. Wyckoff, Jr. (bottom right) since 1991. No managing director or general partner has ever left the firm to join another investment firm.
Without the application of universal accounting standards, managers, board members and audit committee members are really operating in the dark. Everyone realizes the interdependence of markets, and companies frequently connect with counterparties across the globe in high-value, long-term contracts. Businesses routinely prepay for services and place large deposits with banks halfway across the world. But, if we are measuring with different standards, the question is: “Do we really understand the strength and integrity of these counterparties?”

Profile
Jackson (Jack) Tai serves on numerous high-profile boards around the globe, including those of NYSE Euronext, Singapore Airlines, The Bank of China Ltd., MasterCard Inc. and Royal Philips Electronics NV. He is also the Non-Executive Chairman of the privately held retailer Brookstone, Inc. From 2002 to 2007, Tai served as CEO and Vice Chairman of Singapore-based DBS Group Holdings and DBS Bank Ltd., one of Southeast Asia’s largest financial institutions. Previously, he spent 25 years in the investment banking division of J.P. Morgan & Co., holding senior management positions in New York, Tokyo and San Francisco.

Harmonize Global Accounting Standards
Without the application of universal accounting standards, managers, board members and audit committee members are really operating in the dark. Everyone realizes the interdependence of markets, and companies frequently connect with counterparties across the globe in high-value, long-term contracts. Businesses routinely prepay for services and place large deposits with banks halfway across the world. But, if we are measuring with different standards, the question is: “Do we really understand the strength and integrity of these counterparties?”
Many countries are converging on IFRS, but even in some of these, local accounting standards still apply. So we have a situation where, even in a particular country, you don’t have comparability. In the US, the Securities and Exchange Commission published a statement supporting a single set of high-quality, globally accepted accounting standards. But, in the US, the actual progress toward a single set of globally accepted accounting standards isn’t there.

CREATE ONE RULE FOR BANK CAPITAL

Regulators have been debating Basel bank capital standards for years. Some progress was made in the G20 Summit in Seoul in 2010, but we don’t have standardized, let alone harmonized, bank capital standards today. And even bank stress tests – like the ones administered by the supervnational banks – are different, because we have different national interests.

The Asian banks have benefited from their more resilient economies and from enormous scale in places like China. That has enabled China, Singapore and Hong Kong to call for more stringent capital standards – and sooner than the Basel III guidelines recommend.

But while this is happening, the US, which never adopted Basel II, is still ambivalent about Basel III standards and is uncommitted. Meanwhile, economic regulators in the EU are being judicious about pushing forward the actual timelines for implementing Basel III.

FRAME REPORTING TO FIT TODAY’S MEDIA

We must recognize that the public wants its financial information differently today, and wants it quickly. I don’t see shareholders poring over stale, dry and lifeless annual reports that are distributed by mail. And I don’t see them rushing to company websites, because many contain bloated documents with lots of peripheral information that can actually obfuscate the message.

Whether we like it or not, the way we communicate, including in business, is changing rapidly. Shareholders around the world, even those in emerging markets, increasingly rely on journalists, cable broadcasts and the mass media to understand the progress of a company. Indeed, US regulators have recently opened the door for companies to communicate their progress through social media channels. Management teams must be mindful of the disclosure regulations they operate under, but we may have to spend more time in front of analysts and journalists, and in understanding how shareholders get their news.
FRAME DISCLOSURES TO ADDRESS THE ENGAME AS WELL
Transparency and timely reporting are a must. But many investors – particularly institutional investors and sophisticated traders – dissect quarterly disclosures to feed their short-term trading habits. That’s not entirely what quarterly reporting is about, and it creates another conflict where what the company wants to do – convey progress in its longer-term strategy at regular intervals – is being used differently by an investment community that’s become more focused on the very short term – perhaps even on nanoseconds in high-speed trading.

So, it’s important that managers, boards and audit committees be mindful of the necessity to frame their quarterly reports to remind shareholders about their medium- and longer-term business strategy and its progress toward the company’s endgame.

EXAMINE CORPORATE CULTURE AS WELL AS SIGNS OF CORPORATE GOVERNANCE
In the West, we pontificate on governance issues. We tend to look down on organizations if they don’t, for instance, separate the chair from the CEO, have directors who are independent, disclose on a timely basis and so on. But I believe a one-size-fits-all approach to corporate governance may be a little bit overrated.

In any market, being able to evaluate and understand an institution’s organizational culture is probably as important as grading them based on cosmetic indicators of corporate governance. Many organizations may score well in a checklist for corporate governance, but at the same time, there may be gaps in the way they encourage better organizational behavior, principles and values. Sometimes, it takes generations of CEOs and other leaders to firmly embed corporate values, so we have to be careful that cosmetic indicators of corporate governance don’t become the “emperor’s new clothes.”

MY WISH LIST: JACKSON TAI
October 2013
Companies have wrestled with the challenge of achieving gender diversity among senior management and board positions for many years, the theory being that top-team diversity enhances organizational performance. (See Issue 3 of Reporting for an in-depth article on this.)

A McKinsey & Company study suggests that it can also enhance financial performance. The study, which analyzed 180 publicly traded French, German, UK and US companies between 2008 and 2010, found that the returns on equity were, on average, 53% higher for companies in the top quartile for executive-board cultural and gender diversity than for those in the bottom quartile. Margins on earnings before interest and taxes also averaged 14% higher for those in the top quartile.

The gender debate

Research suggests that women have a tendency to be more risk-averse than men, and that this can have significant benefits when they occupy senior financial positions. However, whether a CFO’s gender makes a material difference to the organization’s performance remains an open question. Alison Coleman weighs up the evidence

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“The idea that women are risk-averse is a myth, but they are risk-aware and favor a long-term strategy”

Dr. Ruth Sealy, Cranfield School of Management
Looking at gender specifically, a Credit Suisse Research Institute report published in July 2012 found that shares of companies with a market capitalization in excess of US$10b and women in board positions outperformed comparable businesses with all-male boards by 26% over a period of six years.

If these results were replicated at CFO level, it would be highly significant, given their role in providing key financial information to the board; the CFO not only helps to shape strategy and improve performance, but also to maintain financial and organizational integrity.

Indeed, some studies do hint at gender differences in attitudes to risk at this level. An unpublished 2009 study by Professor Darren Kisgen from Boston College looked at 73 large US companies that replaced their male CFOs with women for at least four years. It found that average growth in assets over a three-year period was 17% lower than the average of 500 similar companies with male CFOs. Kisgen concluded that having a female CFO leads to fewer acquisitions.

However, when deals did take place, shares of the companies with women in senior finance roles performed better by about 2% in terms of stock price reaction. According to Kisgen, this suggests that female CFOs, on average, do make decisions that are better for overall shareholder value.

### Opportunities in India

While women in the established nations of the West sometimes struggle to break into traditionally male-dominated board and senior management positions, it’s a different story in emerging economies. That’s partly the result of cultural differences; women tend to be more economically important, as they are involved in driving economic growth through small business and collective enterprise.

Urmil Khurana, Regional Director of Finance, South Asia at Starwood Asia Pacific Hotels & Resorts, says there are still not enough female CFOs in India, “but the ones who are there are making a huge difference to their organizations by changing the workplace culture to ensure that opportunities for career progression are fair for both men and women.”

Khurana believes they work differently from their male counterparts. “Female CFOs balance growth and risk mitigation,” she says. “They are far less mercurial in their reactions, and able to take calculated risks, foreseeing the long-term impact, which ensures the creation of long-term shareholder value.”

So, can female CFOs effectively change the role and leave lasting changes in companies that will persist, regardless of the sex of future CFOs? It is already happening in India, says Khurana. “We are seeing women being treated as assets, rather than part of a diversity program. With access to good role models and mentoring, support from within their organization, external support from their families and the right mindset, there is reason to be optimistic for the future.”

### GOING BY THE NUMBERS

The research findings suggest there is a case for a greater female representation at CFO level, but how does it play out in the real world of finance?

Julie Teigland, EMEIA Accounts, Industries and Business Development Leader at EY, says: “In the current economic climate, all CFOs are having to make tough decisions that involve a certain amount of risk, while exercising some caution; for example, in...”
making financial decisions or accessing new markets. With such small numbers of female CFOs, it is difficult to say for sure whether risk awareness is related to gender or individual personality, or simply to the risk of failure.”

Eeva Sipilä, CFO of cargo handling solutions provider Cargotec, headquartered in Helsinki, Finland, says there are other factors that affect attitudes to risk and, in turn, organizational performance.

“Regardless of gender, the behavior of the CFO will be prone to being more risk-averse if the overall risk appetite of the company itself is not huge,” she argues. “You have to look at the economic climate as well. In recent times, the global economy has experienced great volatility, which in itself has encouraged risk-averse behaviors.”

Dagmar Rehm, CFO at Bilfinger Industrial Technologies in Germany, agrees that the disproportionately small number of female CFOs makes the study findings difficult to correlate with a real-life situation.

She says: “In my 24 years, only two female CFOs have ever crossed my path, so I cannot comment from personal experience on differences in the way that men and women approach the role.

“However, along with many other female colleagues in finance, I believe that there is a tendency for women to be more diligent, and more concerned with gaining an understanding of finance and being sure of making the right decisions, than with rapid career progression.”

THE TALENT PIPELINE
The fact that there are so few female CFOs makes it difficult to test the hypothesis of whether the gender of a CFO has an impact on an organization’s risk-taking profile and financial performance. This situation arises from a talent pipeline issue, says Dr. Ines Wichert, a senior psychologist at the Kenexa High Performance Institute, the research and development arm of global human capital management firm Kenexa.

“The CFO is the second in command to the CEO and the public face to investors and analysts, so the demands on them are very high,” she explains. “To be able to perform effectively at that level, you need an array of different experiences beyond purely financial experience. This can take several years to acquire.” Taking time out to have a family can take several more years.

Nevertheless, the CFO role is considered a main route to the boardroom for women, according to the Cranfield School of Management report Milestone or Millstone. Published in March 2012, the study found that a higher proportion of female executive directors came from a financial background than their male counterparts.

However, there are likely to be more women in finance working in areas that require long-term decision-making (such as wealth management and pensions fund management) than on the trading floor, where quick decisions have to be made, says Dr. Ruth Sealy, who co-authored the report.

“The idea that women are risk-averse is a myth, but they are risk-aware and favor a long-term strategy,” she says. “What is also interesting to look at is when women are promoted to the top finance roles; for example, in The Glass Cliff research carried out by Exeter University in the UK in 2004.

“Generally speaking, across the world there is a higher likelihood of a man being appointed to a senior role than a woman,” she continues. “But this report highlighted the fact that women are more likely to find themselves in senior positions when the organization is going through a crisis, or at risk of failure.”

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**THE INVESTOR’S VIEW**

It’s a point that should resonate with investors. If we accept that women’s attitude to risk could – at least potentially – have a steadying influence when they are in senior executive and management positions, the question for companies and their shareholders is whether women’s more cautious strategies will pay greater dividends in the long term. In the current economic climate, investors ought to value a longer-term approach. But is there any evidence that this is happening?

Valerie Kendall, a Partner at private equity house WestBridge Capital, thinks so. “Investors are increasingly realizing that what company boards need is a wider balance of skills and experiences to cope with this changing backdrop,” she says. “This may mean involving more women, but also more skilled operators from broader backgrounds. This should encourage a greater challenge to the received wisdom of how companies operate.

Valerie Kendall, WestBridge Capital

“Shareholders look at results and who is delivering them. The gender of the driver is not the determining factor.”

“Shareholders look at results and who is delivering them,” she adds. “The gender of the driver is not the determining factor.”

So, if gender is a key part of the diversity required for a well-balanced senior executive team, is there a case for positive discrimination when it comes to appointing women to the CFO role?

Kate Grussing, Managing Director of executive search consultancy Sapphire Partners, says: “It is true that companies recruiting diverse senior teams will be more effective, but using positive discrimination to achieve that balance is not the way to do it, as you rarely find two candidates who are identical. You are looking at their individual experience, whether they’ve encountered real challenges in their career – a difficult merger or some other bump in the road – and how well they dealt with it.”

Academic studies may point to gender playing a part in the way that CFOs operate and influence the long-term success of their organization, but for now, it seems that there are too few women occupying the role to say for certain that they represent a safer pair of hands at the financial wheel than men. And, significantly, the argument that it is individual skills, experience and career dedication that influence performance, rather than gender, comes from female CFOs themselves.

“I see the CFO role as being particularly suited to neither men nor women,” says Rehm. “It is a role that involves intense discussions and encounters with technically-minded people, which may be something quite different to anything you’ve experienced before. It requires a willingness to understand the technicalities, and extreme dedication to your career.”

Sipilä adds: “The role of the CFO, like everything else, is changing. It is becoming much more forward-looking, and the demands of the role and attitudes to risk will change accordingly, just as they have over the past decade. The CFO role is a job where gender has no significant influence, and hopefully in 20 or 30 years, when more companies have women in the CFO role, we will see that.”

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**INSIGHT: FEMALE CFOs**

“Shareholders look at results and who is delivering them. The gender of the driver is not the determining factor.”

Valerie Kendall, WestBridge Capital

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IFRS changes for 2013 year-end

As the 2013 financial year-end approaches for many companies, we provide a snapshot of the key changes to International Financial Reporting Standards (IFRS) that companies will need to take into account when preparing annual financial statements.

Financial reporting plays a key role in providing transparency on the long-term impact of business decisions and accountability for those decisions. The IFRS changes for 2013 could affect current accounting and reporting, business processes and tax decisions. Management will need to assess the changes and communicate the impact to investors and other stakeholders. Audit committee members and those charged with governance should be monitoring key decisions and the implementation of relevant changes.

**Area of IFRS change and key elements**

- **Consolidation (IFRS 10)**
  - Group structure, including interest in structured entities
  - Broader definition of ‘control’ may result in changes to a consolidated group on transition to IFRS 10

- **Key potential financial statement impact**
  - Comprehensive understanding of the investors’ rights and exposure; and the investee purpose and design
  - Procedures and internal controls to identify and assess controlled entities
  - Input from business units, legal and other departments
**Area of IFRS change and key elements**

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INFORMATION: IFRS CHANGES

- For defined benefit plans, revised accounting for actuarial movements and extensive disclosures
- Potential changes in short-term/long-term classification
- Changes in timing of recognition of employee termination benefits

- Assessment of communication with stakeholders
- Actuaries’ knowledge of the new requirements
- Additional procedures and controls over the actuarial information in the revised disclosures

- Additional disclosures on the effect of netting arrangements that apply not only to items that are presented net on the balance sheet, but also those that are subject to netting arrangements even when the offsetting criteria are not met

- Potential modification of management information systems, including the linkage of credit systems to accounting systems
- Additional procedures to gather information

Employee benefits (IAS 19)

Revised accounting and disclosures for employee benefits

Disclosures of financial instrument offsetting (IFRS 7 amendment)

Disclosure of netting arrangements for financial assets and liabilities

Other changes

In addition to the changes summarized above, other IFRS changes that became effective for annual periods beginning on 1 January 2013 include:

- Amendments to first-time adoption of IFRS (IFRS 1)
- An interpretation dealing with stripping costs in the production phase of surface mining (IFRIC 20)
- Annual improvements containing amendments to a variety of standards, which are intended to be non-urgent but necessary (Annual Improvements – 2009-2011 Cycle)

These pages summarize some of the general implications of the changes affecting calendar year-end companies in 2013. Preparers should refer to relevant literature to make a complete assessment of the impact. Our latest IFRS publications and tools can be found online at ey.com/ifrs
... and more

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Foreign direct investment into Europe held up in 2012 despite the ongoing problems in the Eurozone, according to EY’s annual European attractiveness survey. This report, now in its 11th year, combines an analysis of international investment into Europe over the last year with a survey of more than 800 global executives on their views about how and where global investment will take place in the next decade.

UNLOCKING VALUE: EY’S 2013 KAZAKHSTAN ATTRACTIVENESS SURVEY
Set to become one of the top three fastest-growing economies in the world by 2015, Kazakhstan is seen by investors as a safer place to grow amid the global economy’s instability. Find out more in EY’s Kazakhstan attractiveness survey.

For the latest updates on IFRS, visit ey.com/IFRS
On the shelf
New and recently published books

The Fearless Front Line: The Key to Liberating Leaders to Improve and Grow Their Business by Ray Attiyah (Bibliomotion, April 2013)
Leaders all too often find themselves mired in operational details and daily issues. This book argues that, by setting a standard for frontline workers to take pride in and ownership of their roles, the leadership can be freed to focus on the big picture.

The New Digital Age: Reshaping the Future of People, Nations and Business by Eric Schmidt and Jared Cohen (John Murray, April 2013)
Schmidt and Cohen know technology. The former is Google’s Executive Chairman; the latter was an advisor to US Secretaries of State Condoleezza Rice and Hillary Clinton. Together, they write about the remarkable impacts of recent technologies and the social and political changes that will follow them.

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This event has been running for over a decade and attracts more than 500 finance leaders. Our 2013 program offers the opportunity to hear from, and interact with, senior international regulators and standard setters. Confirmed speakers include Steven Maijoor, Chair of ESMA; Ian Mackintosh, Vice Chairman of the IASB; Nick Land and Jim Sutcliffe from the FRC; and the BBC’s Business Editor, Robert Peston.
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