

Connected leadership

Equipping the board for the AGM

September 2011





Sales Revenue 300,000
Less: Sales Returns & Allowances 20,000
Net Sales 280,000

Cost of Goods Sold 100,000
Gross Profit 180,000

Operating Expense	Amount
Selling Expense	\$40,000
Admin Exp	100,000
Interest Exp	5,000
Income Tax	2,000
Total Selling Expenses	57,000

Operating Expenses 157,000
Profit 22,000
Income Tax Expense 2,000
Total Operating Expenses 159,000

Net Income 22,000
Less: Dividends 10,000
Retained Earnings 12,000

Equipping the board for the AGM

As we approach the 2011 Annual General Meeting (AGM) season, we continue to see significant uncertainty across the globe around sovereign debt and economic growth in Europe and the United States. Developments in global and domestic markets have raised the prospect of a second global financial crisis on top of what are already tough market conditions for many sectors.

The economic environment is changing on a day to day basis with extraordinary volatility observed in global stock markets and exchange rates, much as was the case during the first global financial crisis. Despite Australia not being as severely affected as other countries the observations from that 2008-2009 period included:

- ▶ Virtually all industries were impacted in some way.
- ▶ There was a tightening in the availability of credit for businesses and the supply chain in general.
- ▶ Where credit was available, terms were less favourable.
- ▶ Declining asset valuations were observed.
- ▶ Defaults rose in both the residential and commercial sectors.
- ▶ Unemployment figures rose as many companies at a minimum stopped hiring, while others implemented restructuring and redundancy programs.

Against this background, it is clear that shareholders will look for evidence that the company fully understands and can clearly articulate both its financial performance over the last year and current financial position.

ASIC and shareholder groups continue to stress the importance of statutory profit over the many and varied alternative profit measures used in the market.

Questions can also be expected on the drivers of future shareholder return including growth prospects, cost guidance and the future financial position of the company, with particular emphasis on debt and capital management and the link to assessments of impairment.

Lessons from the Centro Case and how Boards operate are likely topics and the ever present questions about Board and Executive Remuneration and recent developments in the Climate Change and Sustainability arena remain areas for careful preparation.

The AGM continues to experience declining attendance figures and the increasing power of institutional and proxy votes, however remains a significant opportunity to explain the company's story.

A recent article in the Financial Times entitled 'Abolition of the AGM Moves Up the Agenda' noted a trend in recent UK AGMs, common in Australia, where the number of visitors (media, advisors etc) often outweighed the number of shareholders attending. The future of these meetings in the electronic/digital age will be interesting to observe but for now, one of the comments in this article serves as useful reminder for Directors:

"The most interesting part is after the formal business when directors mingle (or don't!) with shareholders.

It can give a real feel for the attitude of the directors and whether they care".

Financial Times: Abolition of the AGM moves up the Agenda, by Alistair Gray & Rose Jacobs, published 1 April 2011.

It is still the case that a well-run AGM reflects positively on governance, builds confidence in the Board and contributes to shareholder value. Shareholder groups remain active across the focus areas discussed in this publication.

The material in this publication is a guide on potential areas of focus for shareholders at forthcoming AGMs with questions or topics that you should consider. A reminder of some of the basic rules of AGM preparation is set out on page 9.

To help you prepare or for a more in depth discussion on broader corporate governance issues, please call your Ernst & Young contact.



Tony Johnson
Oceania Managing Partner, Assurance.



Impact of market uncertainty

Against the background of the current market uncertainty, Boards preparing for upcoming AGMs should be able to discuss how their company is positioned and the flexibility of its financial and operating models.

There continues to be volatility across equity, foreign exchange and credit markets. Much of the commentary that follows would have been considered during the global financial crisis, however it is likely to be relevant again, given the benefit of that hindsight.

Liquidity

- ▶ How would you describe the current financial position of the company?
- ▶ How can the Board demonstrate that it has robustly challenged and reviewed cash flow forecasting and working capital management?
- ▶ How has recent exchange rate volatility been assessed when preparing such forecasts?
- ▶ To what extent is it possible/necessary to secure additional working capital or to consider:
 - ▶ Drawing on available commitments
 - ▶ Selling underperforming assets and operations to unlock liquidity
 - ▶ Cross-border repatriation of funds
 - ▶ Selling inventory for cash replenishment
 - ▶ Bolstering collections and credit functions?
- ▶ How has the completeness of bank guarantees been captured and disclosed?

Debt management

- ▶ How has the Board satisfied itself that its disclosures around current and non current debt are correct?
- ▶ How would you describe the relationships with your key lenders of finance?
- ▶ How has the company sought to build transparent relationships with debt providers, equity analysts and rating agencies?
- ▶ What is the current performance against banking covenants and what is the debt retirement strategy of the business?
- ▶ Have all triggers of covenant default been reviewed and assessed across all agreements, all business activities and all group entities to address the risk of contagion?
- ▶ Has it been necessary to strengthen debt management processes by renegotiating debt covenants; negotiating extended payment terms with suppliers; and/or, assessing access to short-term capital?
- ▶ Does the company have any plans to go to market for additional capital raisings?

Asset valuations

- ▶ How robust are current asset valuations given recent events?
- ▶ How have evaluations of asset impairment, including goodwill, investments, inventories, receivables and financial instruments changed since the last audit was completed?
- ▶ Where impairment charges have been recorded, how is management confident that all necessary charges have been recognised so that no further write downs will be required?
- ▶ How have Boards considered the impact on impairment in respect of debt funded acquisitions where the economic outlook has deteriorated significantly?
- ▶ What actions followed impairment triggers such as market capitalisation falling below net assets?



Ability to operate

- ▶ Has the Board formulated a takeover defence plan, where appropriate, to protect shareholder value?
- ▶ Has there been a need to identify, assess or restructure toxic and distressed assets and operations?
- ▶ Has the company reviewed its supply chain and third party relationships for vulnerability and 'fit'? What were the results of this review?
- ▶ What impacts did previous stimulus packages and/or investment allowances have on trading performance and what plans are in place going forward to the extent these are unlikely to recur?

Human capital

- ▶ Does the business plan any redundancies in response to current conditions?
- ▶ What will be the cost of any potential redundancies or other pension funding and labour regulations?
- ▶ What plans are in place to ensure key personnel do not leave the business at this time without resorting to exorbitant packages? (See "Board and Executive Remuneration".)

Financial performance and financial position

- ▶ Why are measures other than those used by the chief operating decision maker in the operating segment note necessary to understand the financial performance of the entity?
- ▶ Why are different measures required to talk about the same information?
- ▶ Has non-statutory financial information been prominent over and above statutory information; if so why?
- ▶ Consider what is meant by prominent (i.e., mentioned first? Bold or larger font? Number of times the measure is mentioned?)
- ▶ Why have recurring items such as amortisation and fair value adjustments been removed from profit measures?
- ▶ How consistent is the presentation of positive and negative impacts on the result across market releases and trading updates as well as compared with prior periods?
- ▶ Why is your approach different from the current reporting practices of the industry and other competitors?

The role of boards post Centro

Consideration of the response by your Board to matters highlighted in the Centro judgement

In the Federal Court Judgement ASIC v Healey¹ in June 2011 against the Directors of the Centro Group, Justice Middleton found that Directors and Officers of Centro Group had breached their duty of care and diligence and had failed to take all reasonable steps to ensure compliance with the law in relation to the approval of the annual financial report.

As a result of the judgement and penalties announced, some Boards have taken learnings and revised their approach and activities. It can therefore be expected that shareholders may take the AGM as an opportunity to question Directors on how they are responding to the findings.

Further to the above, it is worth noting the amendments to the Corporate Governance principles which introduce increased reporting around diversity initiatives for reporting periods beginning after 1 January 2011.

These changes may lead to questions around the selection of Director candidates as part of the nominations process.

General

- ▶ What is the view of the Directors on the findings and what it means for them?
- ▶ Has the company changed its corporate governance processes in light of this judgement, and if so how?
- ▶ Are the Directors considering additional training or education on any aspect of the company's processes?
- ▶ How has the company discussed its compliance against the ASX's Good Governance Recommendations and If Not, Why Not disclosures where appropriate?

Board composition

- ▶ How has the Board Chair satisfied himself/herself that the Board has the right number of members with the right background, skills and experience?
- ▶ To what extent are Board members' other directorships monitored to ensure that they can devote sufficient time and effort to fulfilling their role?
- ▶ How up to date is the Board's thinking around succession planning?
- ▶ How does the Board describe its efforts around diversity across religion, race, ethnicity, language, sexual orientation, disability, age as well as gender?

Presentation of key judgements and estimates

Shareholders will look for clarity in the disclosures in the annual report around significant judgement and estimates. This can lead to questions to the Board as to how these have been challenged by the Directors, how they compare against industry or peer examples and where changes have taken place during the year, why?

Shareholders will expect the Board to address confidently the accounting for judgement and estimates such as:

- ▶ Acquisitions and divestments
- ▶ Legal claims
- ▶ Relationships with third parties
- ▶ The impacts of movements in markets
- ▶ Impairments including the accounting for intangibles
- ▶ Going concern and debt classification
- ▶ Revenue recognition

¹ Australian Securities and Investments Commission v Healey [2011] FCA 717

Board and executive remuneration

All AGMs held from 1 July 2011 have the potential to count as the 'first strike' under the new executive remuneration legislation. With this increased shareholder power, your AGM and the remuneration report vote now have significant implications for your company's Directors.

This AGM season looks like it will again have a significant focus on Board and executive remuneration. To prepare for your AGM successfully you will need to consider the new 'two-strikes' rule and other legislative changes that impact the AGM. Further, you will need to understand the areas of shareholder focus, and be proactive in addressing queries both prior to, and at the AGM.

The 'two-strikes' rule

This year the Government implemented many of the Productivity Commission's recommendations on executive remuneration. The changes were implemented via the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 ("Bill") passed in late June 2011.

The headline regulatory change relevant to your AGM was the introduction of the 'two-strikes' rule. This rule moves the remuneration report vote from being non-binding to having potentially significant implications for companies.

If a company receives a no vote of 25% or greater on its remuneration report in two consecutive years, at the second AGM shareholders can vote to determine whether the directors will need to stand for re-election. If this 'spill resolution' vote is 50% or greater, a separate re-election meeting must be held within 90 days.

Other legislative changes

Other changes included in the Bill that are relevant to the forthcoming AGMs are:

- ▶ The prohibition on key management personnel (and their related parties) voting their shares (or undirected proxies) on the remuneration report resolution and the 'spill resolution'.
- ▶ The introduction of a no vacancy rule.
- ▶ A requirement to vote all directed proxies.

Companies will need to ensure that the notice of meeting and AGM protocols appropriately accommodate these changes.

Preparing for shareholder discussions and questions

Understanding the varying views of your shareholders and their advisory groups is a critical part of AGM preparation. In addition, the recent ASIC statement on remuneration report disclosure has highlighted areas that will be of particular focus. Our recent discussions with these groups and investors have highlighted the following themes:

Transparency: For most companies, shareholders believe that disclosure needs to improve. In particular, most companies are good at describing the "how" but not the "why". All discussions and disclosure should ensure that the commercial rationale is explained for your remuneration arrangements.

Remuneration governance: There is an increased focus on the remuneration governance approach. Shareholders want to understand how your Board makes remuneration decisions, the inputs you consider and how you manage conflicts of interest.

Remuneration quantum: There has been an increased focus on remuneration levels and how these are set. In particular, shareholders want to understand what peer groups are considered, why these are appropriate, how you have positioned remuneration against these groups and how performance has been taken into consideration.

Short-term incentives (STI): The level of disclosure and the link between STI quantum and performance is a key area of focus, particularly where significant STI payments have been made consistently over a number of years (unless the link to performance is very clear and obvious).

Long-term incentives (LTI): There is an expectation that, typically, LTI plans should measure performance over at least 3 years. Many shareholders prefer the use of more than one performance measure. Views on the appropriate performance measures can vary with the overarching expectation that the measure(s) are aligned with the business strategy. There is now a willingness to consider a broader range of metrics than in the past, when relative Total Shareholder Return (TSR) tended to be the measure of preference.



Termination: “Reward for failure” has received significant attention over recent years and resulted in the change to the termination payment cap. Shareholders expect to see companies moving all executives towards termination clauses that align with this new cap. Most also support the evolving trend of keeping departing executives’ existing awards in the plan after the cessation of employment (‘good’ leavers only).

Pro-actively dealing with anticipated negative voting

If a shareholder advisory group has issued a recommendation to vote against your remuneration resolutions (or you anticipate that some shareholders will vote against), pro-active engagement is needed. However, you may have limited access to the shareholder advisory groups at this time of year, and little likelihood of getting them to change their voting recommendation. Your focus should therefore be your investors.

In doing so, it is important to recognise that many shareholders have now developed in-house capability. Each therefore has different approaches to how they use the shareholder advisory group voting recommendations.

Importantly, the shareholder advisory groups and institutional shareholders expect discussions to be with the Chair of the Board or the Chair of the Remuneration Committee and not with executives. However, we are aware of circumstances where the company secretary, human resources or investor relations have attend in a note taking capacity.

In your discussions with the shareholders, your focus should be on understanding their views and concerns, and clearly explaining your companies approach and the commercial rationale. Being transparent and willing to discuss the more controversial issues will help build trust with your shareholders.

Climate change and sustainability

Climate change is back on the agenda for most companies, following the release of the Clean Energy Future Plan and draft Clean Energy Legislation Package.

With a confirmed start date of 1 July 2012, and an increasing likelihood of the legislation being passed through parliament, developing an understanding of the details and preparing is critical.

The spotlight on climate change issues will be a concern to shareholders – especially if the company is highly impacted or if the shareholders perceive there to be a lack of action or response. The reputational impact of poor decisions in this area can be extreme.

Headline considerations related to climate change and sustainability

- ▶ Will you be impacted by the carbon price?
- ▶ Are you a liable entity under the draft legislation?
- ▶ Do you report on climate change and sustainability performance and information in your annual report or sustainability/corporate responsibility report?
- ▶ If you had a workplace health and safety or environmental incident, was it due to complacency?

Climate change

The Australian Government's Climate Change Plan: Securing a Clean Energy Future, was released on 10 July 2011 and draft Clean Energy Legislation package, was released on 28 July 2011. Together these outline the details of a two stage carbon policy mechanism comprising a fixed price carbon period due to start on 1 July 2012 transitioning to an emissions trading scheme commencing 1 July 2015. The draft legislation will be submitted to parliament in September 2011, after a short consultation period.

The draft legislation gives more policy certainty for Australia's carbon pricing mechanism, providing some concrete parameters for businesses to assess the implications of future climate change legislation.

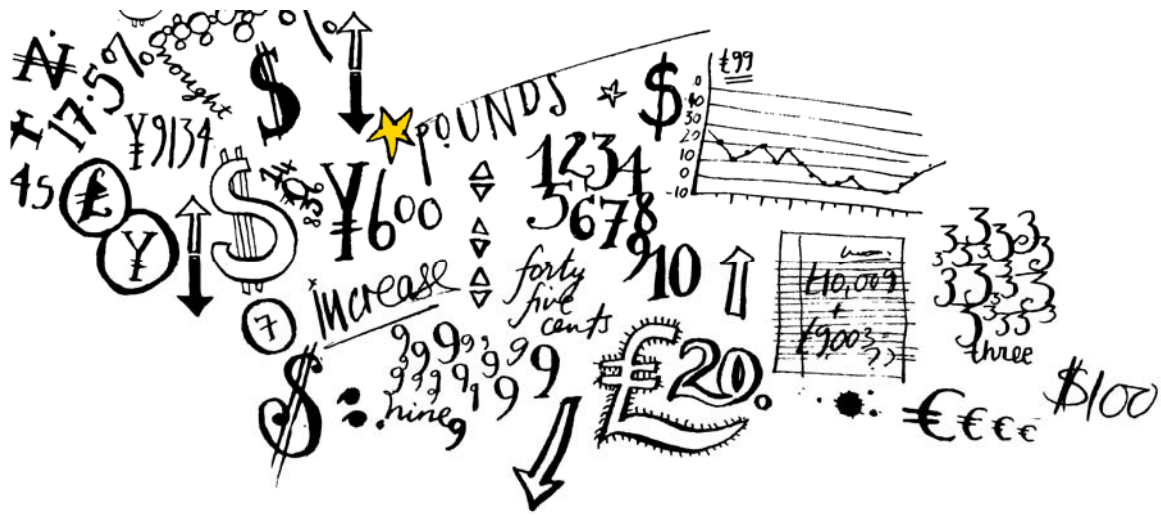
The issues affect many businesses, not just the 500 or so entities (or facilities) with direct liabilities under the carbon pricing mechanism, but also businesses that will be impacted by cost pass throughs and a changing economic environment.

There is a range of implications that businesses will need to consider. The most immediate implication is the potential impact on asset valuations, in particular whether there may be an impairment of certain assets or cash generating units. Up to 30 June 2011, uncertainty existed about the details and timing of a carbon price. However, the release of the draft legislation reduces some of this uncertainty. For a number of companies this may be an impairment indicator resulting in the need to re-evaluate the appropriateness of valuation models used. Consistency of messages here will be important between such estimates and the position companies may take when lobbying about the impact the proposed legislation may have on their business.

Other considerations include:

- ▶ Ability to adjust prices to recover costs and preparation of economic analysis to justify cost pass through strategies to the Australian Competition and Consumer Commission
- ▶ Tax implications associated with restructuring and new investments
- ▶ Assurance requirements associated with reporting obligations
- ▶ Identification of the carbon price triggers for capital expenditure
- ▶ Strategies for maximising investment in carbon credit markets (such as the Carbon Farming Initiative)

The National Greenhouse and Energy Reporting System (NGERS), which is the mandatory reporting, used by entities that exceed the thresholds defined in NGERS legislation will be used as the basis for reporting obligations under the carbon pricing mechanism. This year, the Australian Government has conducted spot audits across a number of companies reporting under NGERS. This has included a range of companies in terms of size and industry.



If you are a liable entity under the carbon pricing mechanism or are required to report under NGRS, you should consider the following questions for this year's AGM:

Cost of carbon

- ▶ What governance processes are in place to ensure that you are prepared?
- ▶ Have you conducted asset impairment tests?
- ▶ Are you prepared to respond to requests for detail of assumptions in impairment analysis?
- ▶ Have you assessed your direct liability? Do you understand the indirect impacts (e.g. increased energy costs)?
- ▶ Do you understand the options available to reduce your obligations (e.g. abatement projects, purchase of international carbon credits)?
- ▶ Are you prepared to apply for potential grant funding, tax incentives and other assistance?
- ▶ Is the potential cost of carbon impact known on areas such as profit and loss, tax and cash flow?

NGRS

- ▶ Have you checked whether you exceed the NGRS threshold for FY11?
- ▶ Are you comfortable with the quality of systems and processes used to collect the data? Are they robust enough to withstand an audit?

Occupational Health and Safety

Increasingly, companies are being asked by shareholders, how they are managing their broader sustainability risks. There is a range of sustainability risks that companies need to assess and manage. Occupational Health and Safety (OHS) is one such risk that needs to be revisited by companies, particularly given that the Model Work Health and Safety Act is to be enacted and implemented by each State and Territory by 1 January 2012.

The legislation imposes a number of key OHS legislative changes, including:

- ▶ Increased duty of care obligations - with penalties for a breach of care up to \$3 million for organisations and \$600,000 for officers, and up to 5 years' imprisonment.
- ▶ Civil suits and greater rights of entry for unions - with provisions that expose organisations to greater scrutiny by unions and provide the opportunity for employees and unions to instigate civil proceedings for breaches of the Act.
- ▶ Broadened consultation obligations - with penalties for a breach of the imposed duties to consult requirements of \$20,000 for officers and \$100,000 for organisations.

Companies and officers will have to demonstrate that they have actively exercised OHS due diligence. It is therefore important for officers to understand the OHS legislative and compliance requirements and ensure the organisation's OHS governance and risk management frameworks are reviewed and updated appropriately to prevent breaches and potential fines.

Here are some questions to consider with respect to OHS:

- ▶ Is there a process in place to acquire and keep up to date knowledge of OHS laws and regulations?
- ▶ Do you understand the nature of operations and the OHS hazards and risks generally associated with these operations?
- ▶ How do you ensure appropriate resources are allocated and processes are established to eliminate or minimise OHS risks?
- ▶ Are there appropriate processes in place for receiving and considering information regarding incidents, hazards and risks?

Basic rules for AGMs

Planning should always begin with a debrief on last year's event. Who turned up, how many, what did they ask? Then consider any major developments during the financial year which followed – a major acquisition or divestment, restructuring exercise, legal matters, media comment, product/service quality, key changes in industry/competitive environment – and prepare to answer questions to the extent they are not covered in addresses by the Chair or CEO.

To avoid embarrassing, yet avoidable pitfalls, it is important that Boards and company secretaries get the basics right.

Ensure you are not left short by:

- ▶ A shortage of seats for all of the Board to sit comfortably at the top table, or having name cards in the wrong positions
- ▶ Being unable to deal with difficult questions or complex points of law due to a lack of available advice
- ▶ Allowing the meeting to be derailed by an unexpected issue raised by a key interest group
- ▶ A technology failure (audio or visual) for explanatory slideshows or presentations, or not making adequate provision for the recording of proceedings
- ▶ Have a microphone ready and available near those not on the top table who can reasonably be expected to speak, for example CFO where he is not a Director

Strategic preparation for the AGM involves consideration of the following:

Involve the full Board in planning

A Board that has met in full before the AGM to discuss issues and plan its strategy will be far better positioned to deal with surprises on AGM day. This should include a debrief on the prior year AGM, the experiences of peer group companies, and procedural matters such as whether to have the Chair announce the results of proxy votes before a show of hands on the floor.

Decide the nature of questions to be directed to specific directors

For example, it may be inappropriate for the CEO to answer compensation related questions, especially if he/she is the highest paid Board member – the Chair of the remuneration committee or Chair of the Board might be a wiser choice. Ensure each director knows how his/her fellow directors will answer questions.

Meet with shareholder groups and corporate governance monitor groups in advance

This is good preparation, but remember that only publicly available information should be given at such briefings.

Contact institutional investors prior to the AGM

Gauge their support for your proposed resolutions. Prior warning of a lack of support in particular areas allows the Board to consider if and how it will proceed, and how it may amend resolutions.

Remember that motions defeated at an AGM effectively send a message of a lack of confidence in the Board. Advisor groups you may wish to contact include the Australian Council of Super Investors (www.acsi.org.au), the Australian Shareholders' Association (www.asa.asn.au) and Corporate Governance International (www.cgi.au.com).

Meet with your auditor to confirm the lead audit partner's attendance at the AGM

The auditor's attendance at the AGM has been compulsory for some years now. Auditors may be queried on the conduct of the audit, the content of the audit report, the company's accounting policies, and the auditor's independence in relation to the audit. The directors and the auditor should discuss the process for determining who will field which questions in advance.

Update the shareholder register

If a shareholder vote becomes necessary on AGM day, having an updated register will smooth the process. Consider requesting your auditors perform a review of the proxy position prior to the AGM date, particularly if any of the motions are controversial or require a poll, or set percentage of votes, to pass.

Have key service advisors and senior management on hand

- ▶ Attendance by the company secretary, senior managers as well as legal and other advisors can support directors' responses. Consider also asking your remuneration consultants to attend, especially if concerns about remuneration have been raised in the past.

Know what is in your corporate governance disclosures

Noting the 'Comply or Explain' nature of Australian governance, the annual report should have already reported how the company performed against the ASX's Good Governance Recommendations.

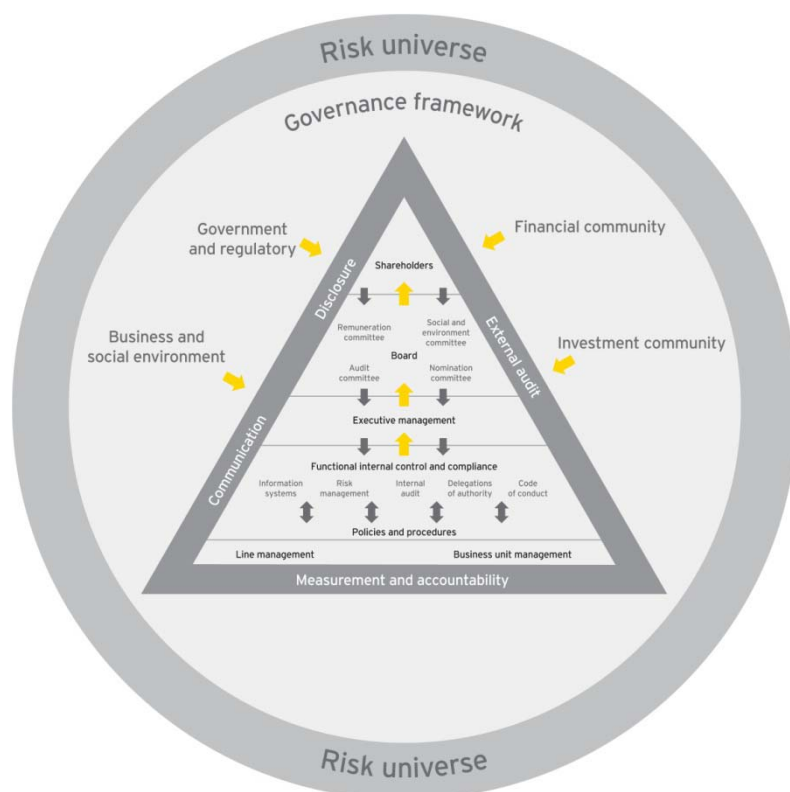
It may be worth preparing specific answers to questions which may arise on what shareholders would see as boilerplate or generic explanations to non-compliance.

Good practice governance indicators

It is important to follow a sound governance framework and be able to demonstrate this. As always, this cannot fully protect a business against uncertain times, but to operate without such a framework in the current environment is likely to reflect poorly on the company in the minds of investors and market analysts. The Ernst & Young model for effective governance below may be of assistance.

The following elements are central to the effective implementation of this model:

- ▶ A robust process to identify key risks to business objectives and a timely and appropriate risk management response
- ▶ Fit-for-purpose policies and procedures which respond to these risks
- ▶ An appropriate system of delegated authorities at each level of the organisation
- ▶ A sound system of internal control reporting through to the CEO/CFO certification
- ▶ Board committees operating effectively with meaningful remits through a set of relevant charters



Role of the corporate governance statement

Effective communication is delivered through the corporate governance statement within the annual report.

In general we believe:

- ▶ Companies need independent audit committees with deeper financial expertise
- ▶ Audit committees need to see the company through the eyes of others
- ▶ A strong and objective internal audit function must be a priority
- ▶ Audit committees must be attentive to all aspects of the external audit process
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- ▶ A process to routinely assess the performance of the Board and its committees
- ▶ An effective process of continuous disclosure and shareholder communication
- ▶ How has the Board defined director independence and is it monitored on an ongoing basis?
- ▶ How has the Board defined auditor independence and is it monitored on an ongoing basis?
- ▶ Why have the auditors provided additional services and were these pre-approved?
- ▶ How has the company identified related parties and ensured that they have been appropriately challenged and then reported?
- ▶ How has the Board responded to the risk of fraud or the circumvention of controls within the current environment?

AGM questions could arise on the following aspects of the company's governance framework and statement:

- ▶ How are the strategic objectives of the company evidenced in the Board and its structures?
- ▶ How many other directorships are held by each of the directors/senior executives to ensure they devote the right amount of time to the company?

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