It’s more than the numbers

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Reporting

Turbulent times
How can CFOs use hedging to counter the effects of currency volatility?

Tax demands
Why the audit committee should focus on tax risks

Reinventing India
How India became one of the world’s most attractive investment destinations

Building blocks
Blockchain is transforming financial services – and the future of corporate reporting
Dear readers,

Technological innovation has revolutionized our lives. Both personally and professionally, we are experiencing a pace of change that has not been matched since the Industrial Revolution.

This can be exhilarating, but it can also be disconcerting. New technology has the power to disrupt businesses and threaten current working practices. The march of disruptive innovation will be relentless – it will affect the organizations we audit, and the auditor too.

Greater use of automation and data analytics have already begun to change the way auditors operate and their required skillset. In this issue of Reporting, however, we examine the new kid on the block – a technology that some claim will have as big an impact as the internet.

Blockchain, the distributed ledger that underpins the Bitcoin currency, is set to transform financial transactions. In doing so, it could certainly have considerable implications for audit and the world of corporate reporting.

Will this new technology that allows transactions to be recorded in real time help to create greater transparency and trust in a company’s financial accounts? Could blockchain allow “annual” results to be published on an almost daily basis? Our cover feature (see page 4) suggests that, consequently, the role of the auditor will change, shifting emphasis from random sampling to the analysis of a large population of data.

Uncertainty and change are also discussed in other features in this issue of the magazine. “In search of the perfect hedge” (page 24) examines how CFOs are responding to increased turbulence on the currency markets following the UK’s decision to leave the European Union.

“The buy side” (page 28) looks at gold investments – another area that has been affected by Brexit – while, in “My wish list,” Hanne de Mora advises audit committee members to be prepared for regulatory change (page 22).

In an ever-changing world, we all need to adapt and modernize the way we work and communicate. This is equally true, of course, of Reporting magazine, which has been covering corporate reporting since 2011.

We now have ambitious plans to expand our editorial coverage and create a new and improved website for Reporting: ey.com/reporting. Our content will include video interviews, animated infographics and picture galleries, as well as our more traditional offerings of interviews and features.

The new site will become a hub for thought leadership around corporate reporting. It will build on the success of the magazine, and will encourage more interaction with and feedback from our readers.

We will keep you updated as our plans develop. In the meantime, please feel free to let us know your views through your EY contact or by emailing us at reportingmagazine@uk.ey.com.

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EY Global Assurance Vice Chair
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Blockchain is set to transform financial transactions, and thus the world of corporate reporting as well. Sally Percy examines the implications for the financial services industry, for the finance function and for audit.

**Imagine a world** where transactions are executed automatically and verified in real time, and where a computer settles derivative contracts on your behalf. Could the world you’re imagining soon exist, thanks to blockchain?

Blockchain may be best known as the distributed ledger technology that underpins the digital currency Bitcoin, but it could also be used for a host of other purposes that involve transmitting data securely. These include payment processing, online voting, executing contracts, signing documents digitally, creating verifiable audit trails and registering digital assets such as stocks, bonds and land titles. Its potential for application within the transaction-based financial services industry is particularly vast, but it is relevant to organizations in every sector.

Going a stage further, blockchain could even overturn entire business models in certain sectors by empowering the growth of “virtual organizations,” also known as decentralized autonomous organizations (DAOs). DAOs operate through computer programs known as “smart contracts” that carry out the wishes of human shareholders by automatically executing the terms of a contract – for example, transferring money or assets.

By the first quarter of 2016, US$1.1b of venture capital had been invested in Bitcoin and blockchain start-ups, according to the Q1 2016 State of Blockchain report by CoinDesk, a news website specializing in digital currencies. “Blockchain technology represents nothing less than the second generation of the internet,” claims Alex Tapscott, CEO of consultancy Northwest Passage Ventures and co-author of the book Blockchain Revolution. “It is going to have a profound impact not just on financial services, but on the world of business and society as a whole. For the first time in history, two or more parties need not know or trust each other to transact or do business online.”

**AUTOMATED PROCESSES**

In the future, finance teams could make use of distributed ledgers – together with artificial intelligence – to automate a range of processes, from...
Blockchain is a type of database known as a distributed ledger that operates on a consensus basis. Whenever a user submits a new data block to the blockchain, the majority of other users must confirm that it is valid. The database does not have a central administrator. Every data block in the ledger is linked to the previous block by a cryptographic algorithm called a hash, with the linked blocks forming a chain – hence the name “blockchain.” Each user holds a copy of the distributed ledger on their own computer and the data is replicated and synchronized across all copies of the ledger in real time. If one of the computers holding a copy of the distributed ledger fails or comes under attack, the other computers continue to maintain the database.

**What is blockchain?**

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**IMPLICATIONS FOR AUDIT**

Blockchain could have considerable implications for audit as well. Tapscott says: “If, each time a company entered into a transaction, an unchangeable record was automatically reported to a distributed ledger, … you could actually have a real-time audit, because all transaction data is recorded to the distributed ledger.”

“I can see the world moving to real-time auditing,” concurs futurist Rohit Talwar, Editor of *The Future of Business*. “Audit firms will provide plug-ins for blockchain, do the audit in real time, spot anomalies and then send in humans to dig deeper if necessary – unless software can do it for them, of course.”

Blockchain could also spell the end of random sampling by auditors, since code could perform a check on every single transaction in future. Talwar also suggests that blockchain, together with artificial intelligence, could transform the way in which fraud investigations and forensic accounting are undertaken. “The real-time systems would highlight and investigate anomalies and unusual transaction patterns as they emerge,” he explains.

Nevertheless, many commentators suggest that auditors will always be needed to design the appropriate audit strategies in complex systems – making decisions about what level of audit is required, how data should be captured, and the type of audit analytics that should be applied. An even more crucial role will be to provide assurance in an increasingly complex control environment and, for instance, to ensure the party or entity that is entering the records on the distributed ledger does actually exist and the transaction has economic substance.

“Auditors do far more than just add up the numbers and make sure they come to the right

Bank of Ireland is focusing its innovation efforts in two core areas, says Garvan Callan, Customer, Digital and Innovation Director for the bank's retail business. The first of these is incubating tech start-ups, which entails providing them with facilities in flagship branches and helping them to take their products to market. The second is monitoring important strategic trends, including blockchain.

“We see blockchain as a technology that can potentially reshape how we work as an organization and how we interact with our customers,” Callan explains.

Blockchain could have an impact on three areas of the bank’s business, according to Callan. There are potential opportunities in providing more efficient payment processing and settlement processes for customers; improving the customer interaction process by making it faster and offering a single, time-stamped view of transactions; and creating a new layer of data and process transmission that sits on top of the bank’s existing legacy IT structure.

“Blockchain could be a way to enhance the traditional exchange, payment and settlement infrastructures, which find it hard to keep up with the exponential growth in customer expectations around digital,” Callan explains.

While blockchain offers huge opportunities for financial services institutions, it also challenges them, he adds, since they will have to “scale up what is effectively an open-source technology in a closed environment.”
In *Blockchain and T2S: A potential disruptor*, a report published by Standard Chartered, Alan Naughton, the bank's Head of Product, Securities Services, says that blockchain has “the potential to impact markets globally.” However, he warns that “change will not happen overnight” and that distributed ledger technology will take years to come to fruition. “It will require harmonized standards and regulation agreed by the industry, regulators and governments. The scale of the challenge should not be underestimated,” Naughton argues.

He also suggests that the current, relatively small level of transactional volumes is an issue. “If blockchain is to truly evolve, it must prove itself beyond niche or small segments of the market. It needs to show that it can handle huge volumes of time-critical transactions in a highly regulated environment.”

Swiss bank UBS launched its Crypto 2.0 Pathfinder program in 2015 as part of its strategy to improve customer experience. Senior Innovation Manager Alex Batlin heads the program, which is researching blockchain and its likely impact on business models. “We’re looking at anything to do with value transfer,” he says. “It could be payments, derivatives or securities. But we’re not looking at virtual currency, because that has attracted a lot of legal controversy.”

UBS was one of the first nine members of the R3 consortium of banks that is exploring blockchain technology. “There’s no point being the only ones looking into something if it’s a network effect you’re seeking,” Batlin explains. “You won’t make a business out of it.”

Blockchain is not just about technology, he continues. “It’s about integration with existing legal and regulatory frameworks. We’ve worked with regulators and central banks to see how we can co-design the systems in a way that’s good for us and good for them.”

Annika Schröder, Innovation Manager at UBS, adds that blockchain is just one aspect of a broader technology revolution that is taking place. She says: “Robotic automation processes can be applied to anything from low-level, manual repetitive work to work that requires advanced knowledge.”
value,” Smart adds. “They also audit control mechanisms, disaster recovery mechanisms, processes, resilience and systems. So the auditors will also need to audit whether the distributed ledger systems are working correctly.”

TOO GOOD TO BE TRUE?
In principle, blockchain is extremely secure. That’s because every transaction on blockchain is digitally signed, providing assurance that only a certain party could have recorded it. In addition, the data is validated by a majority of other users on the system. Having said that, if the majority of the users on the distributed ledger become corrupt, it is possible to break the chain. Blockchain can also be vulnerable to programming mistakes, as a Swiss-based DAO – actually called The DAO – discovered when it lost US$50m in virtual currency in June 2016 after someone exploited a programming mistake. The reality is that no system is flawless – not even blockchain.

Blockchain has other shortcomings that need addressing. These include its comparative slowness, heavy consumption of power (which makes it expensive to run and environmentally unfriendly), privacy issues (other users on the ledger need to be able to see data if they are to validate it), a lack of standards governing the industry and its limited scalability to date.

Given the opportunities and risks associated with blockchain, it is not surprising that the technology

“In future, every single company is going to need a blockchain strategy.”

Alex Tapscott, author

has attracted the attention of governments, central banks and regulators. In June 2016, the European Securities and Markets Authority announced that it was consulting on whether distributed ledger technologies should be used in the securities markets.

Paul Brody, Global Innovation – Blockchain Leader at EY, says: “Regulatory approval is going to be required for any major implementation of blockchain in company accounts and reporting, which means that we won’t see a rapid adoption of the technology.

“Blockchain is spreading quickly in non-regulated areas,” he continues, “both as a general-purpose information technology and as a tool for integrating financial services with operating technologies. Companies will use these unregulated use cases to build confidence as they gradually implement blockchain in their core financial operations.”

We are still in the early days of understanding what blockchain can do, but the long-term potential of the technology is undoubtedly huge. “In future, every single company is going to need a blockchain strategy,” Tapscott predicts. “It will need to rethink its whole organization and what it does.”
A new era of corporate disclosure

Eric Hespenheide, interim Chief Executive of GRI, explains why widely accessible digital data on sustainability performance will transform corporate disclosure by providing powerful new tools for decision-making.

We are on the cusp of a new era: the way we capture, analyze and use sustainability data is about to be transformed. We are moving from an era where sustainability information is collected and reported, to one in which stakeholders — including companies themselves — use this information to learn more about their organizations, their risks and opportunities, and to make better decisions.

Over the past decade, we have seen a dramatic increase in the number of companies measuring their sustainability performance; there are now several thousand organizations monitoring these impacts and reporting on them every year. While the increasing number of disclosures is certainly a welcome trend, we must ensure that both the quality and utility of that information remains a key focus of reporting. Well-designed, quality data should be at the heart of the strategic decision-making process, and this can lead us toward a more sustainable economy and world.

In response to a wide range of global social and environmental challenges, the international community has increased its efforts toward creating a more sustainable world. In 2015, it took two major steps forward: the launch of the United Nations Sustainable Development Goals and the Paris Climate Change agreement. These are important principles with international support but, as with any principles-based approach, they are simply “pledges” until they come into action and are measured with actual data and information to demonstrate real progress toward these goals. That is the value of reporting, and with these global goals, sustainability data has become more important than ever before.

This is reflected in GRI’s Sustainability and Reporting 2025 trends analysis, which estimates that digital data on sustainability will be the main tool guiding our efforts to tackle the immense issues of the social and environmental agenda such as climate change, human rights, ecosystems protection and waste management. Society expects companies and governments to produce and share almost real-time data across open platforms, which includes information on their supply chain partners and also offers an overview of total impacts by region. This data will be easy to access and analyze.

The main findings of our analysis indicate a number of expected changes for sustainability disclosures over the next 10 years:

• New format and multiple information sources: There will be a formal shift from annual reporting to the frequent exchange of sustainability data.
• New content, new focus: This will move toward the macro challenges faced by society and will put the supply chain in the spotlight.
• New role for stakeholders empowered by information: There will be almost real-time interactions through various channels.

Organizations such as GRI are beginning to take this leadership approach and turn it into action. One of the highlights at this year’s fifth GRI Global Conference in Amsterdam was the focus on data and technology, and how this is a critical part of the future of reporting. In 2015, GRI embarked on a new technology strategy that includes three main components:
1) Convening leaders to discuss the future of sustainability, technology and data
The GRI Technology Consortium brings together more than 30 technology leaders who share the common goal of creating innovations from data and bringing the sustainability movement into the digital age. The consortium highlights current and future solutions that use sustainability data to enhance decision-making for both business and government, and provides recommendations for the public regarding sustainability, technology and data.

2) Turning ideas into action
We are creating a sustainability data platform to both liberate the data from reports and digitize the reporting process. The GRI Digital Reporting Alliance brings together a group of companies working on two projects: creating the technical infrastructure and platform for digital reporting, and accelerating the demand for it.

3) Planning for the future
Our focus is on innovation and collaboration among private and public sector organizations toward new uses of sustainability data and information. We have worked for nearly 20 years to help businesses and other organizations to identify, measure and communicate their impacts on a wide range of sustainability issues. Today, we also work to help businesses and their stakeholders use this data to empower sustainable decisions.

But it all relies on open, public standards as the foundation for business and policy decisions.

Standards have been the architecture of every data revolution in history, and it is no different for the information revolution facing the reporting world today. This is why GRI (through the Global Sustainability Standards Board) is so focused on ensuring the development of our sustainability standards, and ensuring that they continue to be offered for free, as a public good, so they can be integrated into other frameworks, standards and approaches. These are all necessary approaches to ensure that sustainability information is more than just reported, but also becomes a key factor in all business and policy decisions. And isn’t that what reporting is all about?

PROFILE
Eric Hespenheide is interim Chief Executive of GRI (the Global Reporting Initiative) and serves on the GRI Board of Directors. He previously chaired the Global Sustainability Standards Board. Prior to retiring in 2013, he led Deloitte’s global sustainability reporting and assurance practice for a number of years. In addition to GRI-related activities, he is the Chair of the American Institute of Certified Public Accountants Sustainability Assurance and Advisory Task Force, a member of the Institute of Internal Auditors Global Advocacy Committee and serves on the Dean’s Advisory Committee at Louisiana State University and the University of Detroit Mercy. He previously served on the Working Group of the International Integrated Reporting Council during the development of the <IR> Framework.
Unlike Hong Kong commuters, who make short, fast rides on the city’s subway network, Stephen Law embarked on a long and intriguing journey to becoming Finance Director (FD) of MTR Corporation (a role he was preparing to leave when he spoke to Reporting). His career path wound across continents and business sectors before arriving at MTR headquarters at Kowloon Bay. On the way, he managed private equity funds across Asia, was CFO of China’s second largest outdoor advertising operator, founded an interactive marketing agency and structured IPOs.

Being stationed back home after 13 years working in Asia’s burgeoning private equity sphere offered two key enticements. “As an investor, I helped companies to develop new strategies and expansion plans,” Law explains. “I always say that, as an investor, you probably understand the company 60%, and as an auditor you understand it 40%. But if you are a management team, you understand the business 100%, and I wanted to be a part of that. Also, I am Hong Kong-born, it is my home, and this role gave me an opportunity to serve the Hong Kong people.”

It’s almost three years ago that Law took up the challenge of being FD for a company that is not just a titan of the Hong Kong business world, but an intrinsic part of everyday life. The Hong Kong subway has patronage (i.e., total number of customer journeys) of more than 5.4 million each day, and MTR’s under-construction new lines and property developments are visible across the landscape. In addition to the four new lines being constructed, the Government has announced plans to build seven more rail lines to reach areas beyond the current network coverage.

A BROAD PORTFOLIO
As FD of a global leader in railway operations, which employs more than 16,000 people in Hong Kong alone, Law has had a broad portfolio of six departments. In addition to financial control and management, treasury, investor relations, information technology, and materials and stores, he was tasked with creating a new function.

“I started the investment control and financial management department, which looks after MTR’s investments beyond Hong Kong,” he explains. “We review the feasibility study, evaluate the risk assessment and perform financial analysis for potential investments. Then, with input from other divisions, we can decide whether we should make the investment. If we decide to do so, my team will continue to monitor the financial aspects of the project. It’s a bit like managing a portfolio of companies, which is what I used to do in private equity.”

This aspect of Law’s role reflects how MTR’s core competencies in its home market – railway operations and property development – are being adapted beyond Hong Kong. The company was established in 1975 as the Mass Transit Railway Corporation to construct and operate Hong Kong’s urban metro system. Twenty-five years later, in June 2000, 23% of its share capital was issued to private investors in an IPO, and it was listed on the Hong Kong Stock Exchange in October 2000.
Today, MTR’s diverse operations include railways, residential and commercial real estate development, leasing and management, advertising, telecommunications and international consultancy services. Globally, MTR operates and manages London Overground, as well as TfL Rail (the first phase of the new Crossrail service), in the UK; Stockholm Metro and MTR Express (an intercity railway between Stockholm and Gothenburg) in Sweden; and Melbourne Metro in Australia, where it is also a shareholder in the Sydney Metro Northwest project.

Hong Kong remains central to MTR’s operations, however. “Here, almost 90% of people use public transport, and 48% of those use the MTR. This huge volume of passenger traffic makes us one of the most used subways in the world,” says Law. “Each year, we need to invest around HKD7b (approximately US$0.9b) just to maintain our existing level of service.”

As a public transport company listed in Hong Kong, MTR’s main stakeholders fall into two groups: investors and the general public. “Investors will focus on MTR’s financial performance, financial position, dividend policy and any changes in key performance factors, such as the performance of business segments, the market share, the patronage, and so on,” Law explains. “However, the general public will view MTR through the lens of our service quality and focus on how we deploy resources to maintain it, and how we develop the railway network in Hong Kong. To satisfy the needs of both groups, the reporting needs to be comprehensive and to cover financial performance as well as our contribution to society.”

CHINESE CONNECTIONS

The emerging superpower to the north of Hong Kong is considered a key growth market, and MTR constructed and operates three metro lines in Beijing, one in Shenzhen and one in Hangzhou. It also has property interests in Shenzhen and Tianjin.

“Mainland China is becoming more and more commercial, and for many industries it is now the number one market in terms of business opportunities,” says Law. “The railway sector is expanding very fast across China, and for MTR, as an experienced railway operator in Hong Kong, there are a lot of opportunities because we are seen as a reliable partner.”

There are challenges, though. “Probably our biggest challenge in mainland China is human resources. Unlike in Western countries, we cannot employ sufficient trained people, because the modern railway sector is evolving fast — it’s almost like a new industry. So, as we expand in China, we will have to train a lot of people and set up all the HR functions and processes at the same time.”

These comments are made with the authority of Law’s proven business credentials in China. While holding senior positions with TPG, Morningside Group and Wheelock Group, Law spent considerable time working in mainland China as the wheels of commerce began to spin faster in an economy that is now the world’s second largest.

“Those were exciting days,” says Law. “I started in private equity in 2000, at the beginning of the internet fever in this part of the world. My firm was investing in many Chinese companies that are now household names, like internet services provider Sohu and travel company Ctrip. Back then, internet-based companies in China needed help to develop their financial structures and business models, because, although they were gaining high IPO valuations, they had very low revenues. So we had to create a plan to rapidly increase earnings.”

During China’s dazzling growth in the first decade of the new millennium, Law undertook a range of roles, serving as a director of one of China’s top three online gaming operators and as CFO of the second largest outdoor advertising operator in China, before leading its sale to global giant JCDecaux. He founded and consolidated the Communication Central Group, the largest independent interactive marketing agency in China (it was later sold to Publicis), and developed a brewery joint venture in Tianjin in partnership with Foster’s of Australia. In 2014, his expertise was recognized by China’s Ministry of Finance, which appointed him as an expert consultant to provide advice on finance and management accounting.

Fast forward to 2016, and a major China project — the Express Rail Link between Hong Kong, Shenzhen and Guangzhou, China’s third most populous city — has been a significant focus during Law’s tenure at MTR. Once it is completed in 2018, the express railway will connect Hong Kong with China’s rapidly expanding high-speed intercity network and enhance Hong Kong’s positioning as the southern gateway to mainland China.

The Hong Kong Government is the owner of the Express Rail Link and MTR is the project manager. The railway ran into complications, however, when the projected budget of HKD65b (approximately US$8.4b) escalated to HKD84b (approximately US$10.8b) as a result of a number of external factors.

“For me, there is a real sense of achievement from getting the finance for the special deal.”
This triggered a review by the Hong Kong Legislative Council (LegCo) to approve the additional funding. “It was a very complex process, because we had to talk to all the stakeholders, including investors and LegCo members, to seek their approval,” says Law. “There were numerous financial, engineering and political issues to consider.”

The long-term economic benefits for Hong Kong remained the driving force, but finding the right funding package was critical. Eventually, 99.8% of the shareholders who voted agreed that a special dividend of approximately HKD26b (approximately US$3.35b) would be payable to the shareholders, including the Government. The carefully structured financial resolution was a viable and pragmatic deal and was approved by both the shareholders and the LegCo.

The experience was, says Law, both instructive and rewarding. “For me, there is a real sense of achievement from helping the company to get through the shareholder meeting and getting the finance for the special deal. I spent a lot of time structuring the right deal to secure approval from LegCo and the shareholders. Now that we have the funding in place, we can provide a valuable service for the Hong Kong people.”

BACK TO THE FUTURE
Law credits his accounting background, which began at Arthur Andersen in the UK, for enabling him to succeed in his various roles. “Looking back, it was important to start my career with a Big Eight accounting firm. The experiences I gained there broadened my understanding of the business world and served as a platform for my future career path,” he says.

As the finance role continues to evolve, so too does his personal appreciation of its strategic status in the corporate world. “In the real world, everything has to be supported by finance. Accounting used to be driven by auditing, but today it is about how to use the company’s financial figures to find its critical strengths and weaknesses. This knowledge forms the basis for the overall business strategy,” he says.

Being FD of a company whose business transcends continents, the opportunities and challenges of new technology have also been top of mind. “MTR is a listed company, so every investment we make has to be justified by both financial and non-financial considerations,” says Law. “But, as the company expands, we also need to use newer and better management systems. Every company is now looking at big data to serve its customers better, or to gain a competitive advantage.”

While technology and accounting find new ways to coalesce, Law credits working in the private equity world with honing his appetite for adding value. “The private equity world is exciting, but it is hard work,” he says. “You have to source deals, enter discussions with new partners, monitor company and sector performance, complete rigorous due diligence and create a post-deal business plan before you even enter the critical negotiation phase.”

As he prepares for the next stage in his career journey, he concludes: “What I learned mostly is that, at every stage, the important thing is to add value to the company – and that has been very relevant to my role at MTR.”
STEPHEN LAW: CV IN BRIEF

- Earns BSc (Civil Engineering) degree from the University of Birmingham, UK, in 1984. Joins Arthur Andersen as a chartered accountant trainee in Birmingham.
- Returns to Hong Kong in 1989 as an audit manager for KPMG.
- Appointed as Regional Financial Controller of Acer Consultants, a civil engineering consultancy, in 1991.
- In 1995, joins Wheelock Group as an investment control manager, and obtains an MBA from the University of Hull in the UK.
- In 1999, leads i-Cable (a Wheelock group company) from a single revenue to a triple revenue model, and completes its IPO in Hong Kong and the US.
- Takes on the role of Director of Morningside Group in 2000 to manage a portfolio of private equity investments.
- In 2006, joins TPG Growth Capital (Asia) Limited as Executive Director, and manages a fund targeting growth companies in China and Vietnam. Promoted to Managing Director in 2009.
- Becomes a council member of the Hong Kong Institute of CPAs in 2010.
- In 2013, becomes Finance Director of MTR Corporation and a member of its executive directorate.
- Appointed by China’s Ministry of Finance as an expert consultant to provide advice on finance and management accounting in 2014.
- In 2016, working with other executives, successfully persuades shareholders and Hong Kong LegCo to approve new funding for the Express Rail Link.
- Also in 2016, becomes an adjunct professor of the Hong Kong Polytechnic University.
The poll: role of the CFO

EY’s latest The DNA of the CFO survey identifies four forces that are increasing the pressure on finance leaders and changing the way they shape their roles.

EY’s first The DNA of the CFO study, conducted in 2010, painted a picture of a role that had broadened to encompass not only traditional financial skills, but also more strategic and market-facing responsibilities.

Six years on, the latest research reveals that change has accelerated rapidly. The study, which surveyed more than 750 finance leaders from around the world, identifies four new forces that are transforming the expectations placed on CFOs. And it suggests that CFOs who don’t proactively define their role in response to these forces could compromise their ability to shape strategy with the CEO and drive the innovation necessary for sustainable growth.

Caught in the eye of a perfect digital storm

58% say they need to build their understanding of digital, smart technologies and sophisticated data analytics.

For CFOs, digital disruption can feel like being caught between the promise of rain and the threat of drought. On the one hand, digitization offers the opportunity for new business models and revenue streams. On the other, it makes the organization vulnerable to competition from new players and agile incumbents, and creates exposure to new risk.

Focus on growth places premium on CFO’s digital know-how

Percentage of respondents who believe that they will need to build their understanding of digital, smart technologies and sophisticated data analytics

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<th>Category</th>
<th>Percentage</th>
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<tr>
<td>Driving growth is my number one objective over the next five years.</td>
<td>34%</td>
</tr>
<tr>
<td>Orchestrating organizational transformation is my number one objective over the next five years.</td>
<td>25%</td>
</tr>
<tr>
<td>Driving cost efficiency is my number one objective over the next five years.</td>
<td>23%</td>
</tr>
<tr>
<td>Managing strategic risk is my number one objective over the next five years.</td>
<td>19%</td>
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</tbody>
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To fulfill their agenda of growing and protecting the organization, finance leaders need to understand and embrace a digital business model. They also must play a key role in building the organization’s readiness and confidence to act and react with urgency.

Data: the disruption that will transform finance

57% of group CFOs believe that the delivery of data and advanced analytics will be a critical capability for tomorrow’s finance function.

Data and analytics are changing the way CFOs think about business problems, opening their eyes to new opportunities, and challenging accepted and entrenched organizational beliefs. However, many organizations are struggling to turn the promise of data analytics into the reality of improved performance. This presents an important opportunity for CFOs to step in and transform their organizations by turning the promise of data analytics into measurable performance gains.
CFOs are managing an increasingly complex stakeholder universe. Stakeholders’ demands are often in conflict, and CFOs have to juggle the requirements of regulators with the demands of investors and other stakeholders. The high expectations of stakeholders and the increasing scrutiny of regulators are not likely to fade in the future. CFOs will need to practice ways to respond to conflicting demands more effectively.

The report concludes that the impact of these disruptions is seen in the increasingly diverse backgrounds, profiles and job descriptions of finance leaders worldwide.

CFOs, like all leaders, must proactively shape the role they play in response to these major disruptions, and manage the impact on traditional finance tasks in the way they build and develop their team. To assist with this, the study provides a personal development plan. It provides a framework to help CFOs evaluate their own competencies, strategic considerations and major external forces impacting their organization and their role. By proactively managing these factors, CFOs will be able to secure their influence into the future.

For a copy of the full report, Do you define your CFO role? Or does it define you? The disruption of the CFO’s DNA, please go to ey.com/dnaofthecfo.
Reimagining India

With a stable, business-friendly government at the helm, India is flourishing. Radical liberalization and imaginative development programs have made it one of the most attractive destinations in the world for investors, as Swati Prasad reports.

“Almost literally the one bright spot in the world is India. India is probably going to grow around 7.5% this year. We think even higher next year.”

So said Jim Yong Kim, President of the World Bank, on a visit to India in late June 2016. At a time when economists around the world were preoccupied with the result of the UK referendum on membership of the European Union and its potential effect on the global economy, Kim preferred to highlight India in his media interviews.

He said that Brexit had had a very temporary impact on the Indian stock market. “That resilience tells you something. Had Brexit happened five or six years ago, my guess is that the impact would have been greater,” Kim told The Hindu newspaper.

It’s not hard to understand why Kim is upbeat about India. According to India’s Central Statistics Office, the country’s economy grew by 7.6% in the fiscal year 2015-16, maintaining its status as the fastest-growing major economy in the world. And in 2015, India replaced China as the top global destination for foreign direct investment (FDI), attracting US$63b of FDI projects.

While much has been written about India’s young demographics, its services sector and cost arbitrage, probably the biggest differentiator today is its Government. After 30 years of coalitions, India has a stable government that is perceived as being friendly to businesses. “If you look at the investment climate in the last 20 years, India has never been more hospitable to FDI,” says Pulapre Balakrishnan, Professor of Economics at Ashoka University.

“Multinationals have flourished here since the reforms, and I think there is no better time to invest in India from the point of view of the policy regime.”

Radical liberalization

Under the previous regime, foreign companies had shunned India due to challenges such as policy paralysis, retrospective taxation, slowing economic growth and rising corruption. But immediately after coming to power in May 2014, Prime Minister Narendra Modi began working on changing that perception by traveling overseas and meeting business communities. In the following 25 months, Modi visited 42 countries.

Modi’s brand-building exercise has been supplemented by liberalization. In November 2015, the Government opened up several key sectors such as defense, construction, civil aviation and media to FDI and eased norms for businesses such
as single-brand retail and private banking. And in June 2016, it again liberalized its FDI regime by easing norms further for a host of important sectors. In defense, civil aviation and pharmaceuticals, for example, 100% FDI is now permitted through the government approval route.

The new norms ensure that multinational corporations will manufacture in India, rather than source goods from overseas. Modi’s foreign trips, reforms and programs like Make in India (which seeks to make the country a global manufacturing hub) have begun to pay off. Make in India was launched in September 2014, and FDI inflows jumped 48% between October 2014 and April 2015 compared to the previous 12-month period, according to the EY 2015 India Attractiveness Survey.

“There is definitely an improvement in India’s business environment,” says Saumen Chakraborty, President and CFO of Hyderabad-based pharmaceutical company Dr. Reddy’s Laboratories. Besides, opportunities for India to emerge stronger are tremendous, he adds. And Balakrishnan points out that sectors such as finance and insurance offer considerable scope for foreign investment.

Building Brand India
Several factors are working together to improve India’s attractiveness. Programs like Make in India and Smart Cities Mission (which seeks to create 100 smart cities across India by 2020) offer foreign investors the opportunity to build India.

Employment generation is a big challenge, considering that over 65% of India’s 1.25 billion population is below the age of 35 and nearly 12 million join the workforce each year. Through initiatives like Make in India, Skill India and Startup India, the Government hopes to address this challenge. Says Amitabh Kant, CEO of NITI (National Institution for Transforming India) Aayog: “I believe that India will see a huge number of start-ups in both digital and manufacturing in the years ahead and that India will become a nation of job creators rather than job seekers.”

The Government is also working on improving the country’s inadequate infrastructure. In April 2016, Road Transport and Highways Minister Nitin Gadkari announced that road construction is at an all-time high of 20km per day, and the Government has set an ambitious target of constructing 41km of national highways every day in 2016-17, up from more than 16km in 2015-16. There are also schemes that seek to revive loss-making power distribution companies and revamp public sector banks.

Overall, there is a perception that the Government is working hard. “In the last two years, we haven’t heard of any major scandal,” says Chakraborty. Under the previous regime, a number of scandals had rocked the nation and badly damaged the country’s image.

With a better business environment, India has inched up in the World Bank’s Ease of Doing Business survey, from 142nd out of 183 economies in 2015 to 130th in 2016. Modi hopes to dramatically improve India’s ranking and reach the top 50 within three years. The Government also aims to reduce the time taken to register a business from 27 days to just one.

Improving corporate governance
Back in 2009, the Satyam Computer Services scandal (when the company chairman falsified the accounts by US$1.47b) rocked India’s corporate world. But that proved to be a turning point for corporate governance in India.

The Companies Act 2013 is bringing about considerable change. It mandates that companies must have at least one woman on the board, a third of which must consist of independent directors, and includes rules pertaining to executive salaries, corporate social responsibility and audit rotation.

“Though it is too early to gauge the real impact of the Companies Act, in my view it’s an excellent regulation that has improved corporate governance in India,” says Chakraborty. “It has made directors cognizant of the fact that they need to add value.”

Moreover, beginning this financial year, India is transitioning from Indian GAAP to Ind AS (Indian Accounting Standards) in a phased manner. The change to Ind AS will bring accounting in India substantially closer to the norms followed by global companies under International Financial Reporting Standards (IFRS).

“The international audience will be much more comfortable with Ind AS. Evaluation will be a lot easier,” Chakraborty comments.

The Government has also reduced bureaucracy by making policies consistent and transparent, particularly in the area of taxation. “Today, the Government of India has enunciated a clear stand on retrospective taxation, which is that it will not be resorted to,” says Balakrishnan. Under the previous Government, some major companies had taken the retrospective tax issue to international arbitration. It was one of the main factors deterring companies from setting up shop in India.

India’s Finance Minister, Arun Jaitley, proposed four different schemes to “clean up” past tax issues in the 2016 Union Budget and also proposed a one-time scheme to resolve disputes.

Overcoming hurdles
Given India’s complex problems and its huge and diverse population base, there are several challenges that are bound to come in the way of development. Dispute resolution, for instance, can often take decades. “We need to see improvement in the
judicial of the manufacturing sector, while agriculture remains a concern. Even today, 50% of India’s workforce rely on agriculture and allied sectors for their livelihood. But the economic contribution of agriculture to India’s GDP has been steadily declining since 1950–51, from 53% then to around 13.7% today. Instances of farmer suicides have increased as a result of factors such as a high debt burden and poor monsoons that don’t provide the rain that arable land depends on. Fragmented land holdings, lack of mechanization and poor access to cheap capital have led to low yield. Indeed, the Modi Government has received criticism for not doing much for agriculture.

Another issue is the tendency of opposition parties to block regulations. There are more than two dozen bills pending in the Upper House of Parliament, where the ruling BJP does not have a majority. Take the case of the Goods and Services Tax (GST), which was intended to be introduced at national level by 1 April 2010 and was finally passed on 3 August 2016. The GST reform — among the biggest reforms of the Modi Government — will have an enormous impact on companies in India across indirect taxes, supply chain, technology compliance, accounting and reporting, and change management.

Moreover, infrastructure development and job creation need to gather momentum. India will be the youngest country in the world by 2020, with a median age of 29, according to research by the IRIS Knowledge Foundation. Creating jobs for its youth is a gargantuan task.

Finally, demand continues to be a big bottleneck. But with good monsoons this year and the adoption of the Seventh Pay Commission by the Government – which will cost the exchequer US$16.88b in 2016-17 – there should be more money in the hands of farmers and more than 10 million government employees and pensioners. This is bound to increase demand, triggering more positive spinoffs for the economy. Although there are some hurdles still to be overcome, it looks as if India will continue to grow for the foreseeable future.

To read Ready, set, grow: EY’s 2015 India attractiveness survey, go to ey.com/attractiveness.

India is going through significant changes insofar as corporate governance is concerned. First, the Companies Act 2013 has brought about substantial changes in the way companies need to be governed.

Second, financial reporting in India is transitioning toward IFRS-converged standards, known as Ind AS. Beginning 1 April 2016, Indian companies with a net worth of INR5b (US$76m) or more have to follow Ind AS.

The regulator – the Institute of Chartered Accountants of India – is working toward making all other accounting standards more aligned to IFRS. With time, small companies would also come in line with IFRS. The new regulations governing companies and the phased approach to transitioning to Ind AS will ensure that the global community has greater comfort in doing business in India.

In my view, the Companies Act 2013 has been a turning point for corporate governance in India. Since the Satyam fraud, which was a huge blow to corporate governance, there is a lot more awareness among companies and their directors. The act, which has seen some amendments, takes corporate governance to another level. The new regulation addresses issues such as related party transactions, independent company directors and their appointments, auditor rotation, corporate social responsibility and several other aspects that didn’t previously exist in corporate law in India.

Today, companies consider noncompliance among their most significant risks. Companies are giving far greater attention to corporate governance. They understand that good governance is also good business.

In fact, I feel the pendulum may have swung to the other extreme, which may inhibit risk-taking. For instance, whereas the Sarbanes-Oxley Act in the US applies only to listed companies, the Companies Act 2013 applies to all companies – listed and unlisted.

In the meantime, several amendments to the act are pending approval by Parliament. In my view, once these amendments come into force, they will facilitate ease of doing business and promote growth.
Tax has become a highly sensitive political issue recently, with multinational companies (MNCs) accused of not paying appropriate amounts in some of the countries in which they operate. Governments, tax authorities and campaign groups are seeking greater transparency — and this has significant consequences for company boards and their audit committees.

News stories from around the world frequently highlight what is described as “aggressive tax planning.” These stories are fueled by the disclosure of private legal and financial information — such as the so-called “Panama Papers” — and have led to public criticism of large MNCs. In response, governments and institutions such as the European Union (EU) have started to act with a level of coordinated action that is rarely seen.

The best example is the Base Erosion and Profit Shifting (BEPS) project from the Organisation for Economic Co-operation and Development (OECD) and Group of 20 (G20) countries. Under BEPS, a 15-point action plan, described by the OECD and G20 as the “most significant rewrite of the international tax rules in a century,” was approved in November 2015.

It seems inevitable that collective action on corporate taxation will grow, creating a dilemma for global companies as they weigh up the risks and the possible impact of any controversy and bad publicity. Audit committee members need to be aware of the risks associated with tax policies. Changes to tax policy require companies to gather more information, provide it in different forms and report it in different ways.

### TAX TRANSPARENCY

Greater transparency on corporate taxation is being encouraged on at least three fronts, each having an impact on the audit committee:

1. **Increasing requirements for country-by-country (CbC) reporting**
   Under BEPS Action 13, companies with group revenues of at least €750m will have to report...
revenues, profit before income tax, income tax paid and accrued, total employment, capital, retained earnings and tangible assets in each jurisdiction in which they do business. The objective of the CbC report is to provide tax authorities with an overview of global operations, showing where income is earned, staff are located and taxes are paid. The OECD proposal recommends that this applies for fiscal years beginning on or after 1 January 2016, but the commencement date in each jurisdiction will depend on the speed of national implementation. Financial information will be exchanged automatically on an annual basis with the tax authorities where the MNC operates. However, BEPS does not require the information to be reported to the public.

Audit committees will need to be aware of the new tax-related disclosures that are required, make sure that the appropriate data are available and understand the consequences of the information being shared among tax authorities. Sharing of data brings a number of concerns, including issues with translation and context. It should also be remembered that tax-related problems are a major element in financial restatements and where material weaknesses are identified in internal controls.

2) Greater disclosure of information to the public
BEPS may not require public disclosure under Action 13, but this is still a likely outcome in many countries. For instance, on 12 April 2016, the EU proposed legislation that would force companies in Europe with revenues above €750m to disclose publicly their tax and profit information for individual countries. They would also be required to disclose how much tax they pay on the business they conduct outside the EU, as well as other information concerning employees and the nature of the activities performed in each jurisdiction. This is not just an EU issue – it will affect MNCs with European subsidiaries, and what starts in Europe often tends to spread further. Public disclosure of selected information is a phenomenon that already affects banks in the EU (which have been required to make such disclosures since 2014 under Capital Requirements Directive IV), as well as extractive industries.

Audit committee members should assume that financial information will be made public and determine whether there are likely to be any issues to deal with when this happens. They need to help establish the right approach – balancing the desire for reducing tax with reputational concerns – which will involve integrating tax strategy with risk management.

3) State aid investigations
The European Commission’s competition directorate is increasingly questioning perceived deals. The directorate has highlighted preferential tax agreements that, it argues, constitute illegal state subsidies. This issue is of particular relevance to US-based MNCs, a number of which have faced probes. This has led the US Treasury Secretary Jack Lew to write to the commission claiming that US companies have been unfairly targeted.

This situation creates uncertainty for audit committee members, who will want to know whether the particular tax treatment of their EU companies could be construed as state aid. The consequences could be significant, with companies potentially having to repay any aid received. It has implications for past and future tax liabilities and could also affect decisions on mergers and acquisitions.

REPUTATIONAL RISKS
Audit committees need to consider the impact of all three issues as part of their risk assessment. Members have to understand the reputational dangers and be aware of the – sometimes contradictory – forces affecting the company. They should be checking that the company is prepared for this and can answer detailed questions.

Audit committees should also consider whether the company has a robust and transparent relationship with the relevant tax authorities. This can create more certainty about tax treatment and, when problems do arise, allow for a faster dispute resolution, given greater understanding of the background.

Questions for audit committees to consider

- Do you know what tax strategy your company is adopting or the parameters by which it is deciding that strategy?
- Does management know what the CbC report will look like and what questions it will give rise to if and when it goes public?
- What is the company’s exposure to state aid risk?
- Does the tax department have enough resources to operate effectively?
- Is the audit committee confident that the tax function is able to clearly identify and manage ongoing risks, disputes and litigation?
- Is adequate investment being made into the tax function to allow the company to meet current and future tax compliance and reporting obligations, and to take advantage of tax planning opportunities?
The ongoing focus on taxation, in the press and at both the governmental and intergovernmental level, is resulting in demands for even greater transparency. Businesses are under increasing pressure to publicize financial information, aimed at demonstrating that where companies generate profits aligns with where they pay tax.

While such information has historically been kept confidential within the tax administration, in the new environment it is prudent for companies to assume that much of their financial information will become public, and to make sure that they are ready with appropriate answers to any challenging questions.

In addition, given that the information often lacks context, questions are likely to abound. For example, the information might show large numbers of people working in one country, but little or no taxable profit. But how this arises will vary, and could derive from the offset of losses incurred in previous years. Without context, this information will merely prompt further questions.

Even without public reporting, there are dangers that data can be misinterpreted. In the new, globalized environment, what is filed with one tax authority is readily shared with all tax authorities. Sometimes this can create confusion, especially if this involves the translation from one language to another.

In some circumstances, it may therefore be better voluntarily to disclose financial information beyond the tax authority, rather than be responding to questions at a later stage. The experience so far of companies that have shared information early is that, although they attract attention at first, if they can respond effectively, it can avoid challenges later.

The direction of travel is clear, and this is now a case of “when,” not “if” businesses will be called upon to produce that sort of financial information. Audit committees will want to make sure that the company’s tax department is managing this process properly. Committee members should be aware of the potential for controversy and have a strategy in place to manage it, should the need arise.

Risk associated with controversy, reputation and bad publicity has to be managed. The audit committee will want to keep this issue near the top of its agenda.

Viewpoint

"Audit committee members should assume that financial information will be made public."

It is particularly important to have a good relationship with the tax authority in the home country as, in the new environment, that tax authority may be required to argue its position in disputes with other jurisdictions.

Resources are certainly a factor. With companies expected to gather increasing amounts of data and to implement more nuanced tax policies, there could be a requirement for additional skilled staff in the tax department, more sophisticated systems and the creation of cross-functional teams (including representatives from the public relations department). These issues have to be discussed when determining budgets – and it is critical that the audit committee is aware of these decisions.

Corporate taxes are, of course, only one element of the discussion. For most companies, payroll taxes and VAT payments will be more significant, and the penalties for getting these wrong can be severe. So audit committees should make certain that they focus on all aspects of taxation.

Demands for greater transparency aren’t going away. Audit committees should assume that tax will continue to be a reputational, as well as a financial, issue. Additional public disclosure is inevitable, with greater demands placed on the tax department. It will require significant oversight from the audit committee.

This is an edited version of an article first published by the EY Center for Board Matters. To read more, go to ey.com/boardmatters
BE AHEAD OF THE CURVE
A core competency of any audit committee is the regulatory framework. It’s changing quickly but, more often than not, you can see these changes far ahead.

For example, it’s expected that, in 2018, the European Union will establish new data privacy rules, with punitive fines for companies that breach them. We don’t know the exact details of this policy yet, but we know it will come. The audit committee can make sure that the company is prepared and starting to implement necessary changes, and has the right processes in place for when the law is introduced.

TAKE PART IN STRATEGIC DECISIONS
Regulatory and compliance assessments play a key role when boards are revisiting their strategy. I know of construction companies that decided against entering certain geographies because they feared widespread corruption there might damage their values. Or what about a country in which you have to work with distributors and agents: will the company have enough influence on those people to ensure full compliance?

The same goes for regulatory risk when expanding into new businesses. Perhaps the regulatory framework is so difficult that a company decides against it because margins...
are too thin and risks too high. Considering regulatory issues helps in assessing the true risk-adjusted return. In this way, an audit committee can protect shareholder value.

**INSOURCE KNOWLEDGE**

In recent years, many European companies have set up sizable internal audit teams, which report directly to the audit committee. They are an important element of the formal control network, and they can make sure that the values and the culture of a company are respected.

But I would also like to make a case for having a smaller internal audit team and supplementing it with outsourced expertise when necessary. Similarly to production peaks, there are also knowledge peaks, when special skills and expertise are required. For example, if a company has recently expanded into Indonesia, the internal audit team might not have the required understanding of the Indonesian business environment to adequately perform an audit. That is where outsourcing comes into its own. External consultants can help a company to cover those knowledge peaks.

**PROMOTE DIVERSITY**

In 2002, four years before Norway passed a law that required at least 40% of company board members to be women, I was voted onto the board of Norwegian telecoms company Telenor and then asked to join the audit committee. I hope that the work I’ve done and the impact I’ve had has shown that I was a good choice, and I’ve been on other boards since.

The debate about quotas helped open people’s minds. Diversity isn’t just about women, but also about mixing different career or cultural backgrounds. Similarly, global companies need boards with exposure to different geographies, functional expertise and industry verticals. Diversity helps to create a culture that stimulates debate and, ultimately, delivers better outcomes.

**CULTURE AND VALUES MATTER**

In an increasingly international business world, where news of breaches spreads around the globe within seconds, a company can’t just rely on a formal control framework. The informal control environment built on culture and values is equally important, and this has been a focus of my work on audit committees. Executives need to trust each other to do the right thing. Ideally, they feel comfortable challenging each other.

If a serious breach occurs, the company needs to be ready to take punitive action and the responsible person has to go. Creating that culture starts with setting the right tone at the top. Executives are role models whose behavior and words have a major influence on employees. They should also encourage people to take part in culture days and training courses for these control systems by setting an example and participating themselves.

**LISTEN TO YOUR AUDITORS**

Working with your auditors over a long stretch of time builds trust, and this trust makes it possible for audit firms to provide valuable insights, aside from delivering a “true and fair view” of the company’s finances. They can raise concerns about risk areas the company should be aware of early on.

If auditors work well with an audit committee, they might point to the fact that a team in a foreign country is not functioning well, or that there is a lack of documentation at a subsidiary – not bad enough to jeopardize the audit firm’s work, but maybe worth looking into. External auditors can be a valuable resource for these kinds of observations. Again, it’s all about creating a culture of trust.

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**Profile**

Hanne de Mora is the Chairman and one of the owners of a-connect, a global consulting and talent pool firm that she cofounded in 2002. Prior to that, she worked in various capacities at McKinsey, Procter & Gamble and Den Norske Creditbank. She has 14 years’ experience on boards and audit committees, starting as a director at Telenor in Norway, and chaired the audit committees at Norwegian firm Tomra, Swedish company Sandvik and Swiss group Valora. She is currently a member of the audit committee at AB Volvo and sits on the IMD Foundation Board, the governing body of a Swiss business school.
A period of global currency volatility has been prolonged by the UK’s decision to leave the European Union. The response of CFOs to this market turbulence has centered on a range of hedging strategies, as Andy Davis discovers.

**After several years** of relative calm in global foreign exchange markets, conditions have turned much more turbulent. The UK’s decision to leave the European Union produced the biggest one-day movement ever seen in sterling’s rate against the US dollar, sending it to a 30-year low.

The fallout from the UK referendum is expected to cause volatility in the value of sterling against other currencies for some time. But, well before this latest shock, other major shifts had taken companies by surprise. In the closing months of 2014, the US dollar in particular strengthened dramatically relative to most other currencies. For US-based multinationals, this had an immediate and unwelcome impact on the financial performance they would report to the investment community — an impact now likely to be reinforced among those exposed to sterling, and to the euro itself.

Various reasons have been offered for the turbulence that began in late 2014. Slowing economic growth in China and the resulting decline in demand for basic commodities had an effect. Growing signs of divergence between the world’s major central banks were also a big factor — the US signaling a move to gradually raise interest rates, while the Eurozone and Japan remained committed to monetary easing. Political instability, caused by events such as Western sanctions on Russia and the corruption scandal surrounding Brazil’s Government, has played a part.

Whatever the precise cause, the effects were inescapable. According to the FiREapps Currency Impact Report for Q4 2015, the number of US companies in its survey that reported foreign exchange setbacks reached a record level, 66% higher than in Q4 2014. For the first time, the proportion of the FiREapps survey sample experiencing “currency headwinds” was above 40% for two quarters in a row.

In particular, US companies that generate most of their sales overseas suffered a major impact to their revenues and earnings because of the sharp appreciation in the dollar. In some cases, companies that managed to increase their international sales volumes by close to 10% nevertheless saw the value of those sales in dollar terms decline significantly year-on-year as the effect of a stronger dollar fed through.

The story was similar in Japan, according to the Nikkei Asian Review, with the country’s exporters hit by depreciation in the euro and emerging market currencies. The publication reported that,
for the nine months to December 2015, about a third of the major nonfinancial corporations with March year-ends reported foreign exchange losses totaling US$3.5b—three times their level a year earlier. More recently, a sudden jump in the value of the yen during June 2016, after the Bank of Japan’s meeting produced no further monetary easing, will have hurt Japanese companies’ foreign earnings further.

RAPID MOVEMENTS
The nature of exchange rate shifts, says Robert Royall, Derivatives and Financial Instruments Solution Leader in EY’s Financial Accounting Advisory Services team in New York, is that they are rarely smooth—as the instant reaction to the UK referendum result demonstrated. “It’s a jolting journey along a general trend,” he says. “From December 2014 to March 2015, the movements were astonishingly rapid and the dollar strengthened much faster than anyone thought it would.” An issue that had previously been the preserve of corporate treasurers was now a central issue for CEOs and CFOs in their conversations with the financial community.

Royall explains that US companies whose reported earnings in dollars had benefited from a gradual weakening of the US currency since about 2002 now began to ask whether they should hedge their foreign currency exposures—and, if so, how. There are various approaches to the problem, although none gets around the basic issue in hedge accounting that a simple translation of revenues or profits from one currency into another for the purposes of consolidated reporting cannot be hedged. But where companies transact across borders from one currency to another, hedging can help.

The most obvious approach is to take advantage of any “natural hedges” within the business; for example, where a subsidiary generates revenues in a foreign currency that it can also use to pay for costs incurred in the same currency. Natural offsets of this sort provide a measure of protection. Crucially, though, in a large and complex international corporation with scores of subsidiaries and a global supply chain, harnessing them can be highly complex and depends on having timely information about where and when the company is generating and spending cash.

“Prior to the past two years, companies generally had that information on a monthly or quarterly basis,” says Royall, “but in 2015, exchange rates moved so dramatically within a month that this wasn’t good enough for some companies. They wished they had daily—or at least more frequent—information.”

A ROLLING HEDGING PROGRAM
Natural hedges are an important part of the approach taken by Abbott, the US-based health care company with extensive emerging markets operations. Since its demerger from the pharmaceutical company AbbVie at the end of 2012, Abbott has had much greater exposure to emerging market currencies, according to its CFO, Brian Yoor. This is a necessary condition of its long-term strategy to benefit from growing demand for health care across the developing world.

Where possible, says Yoor, Abbott’s strategy of serving markets better by increasing its local presence—expanding sales and marketing teams, manufacturing, and even opening R&D and administrative centers—not only matches costs more closely to the spending power of local customers, but also has the beneficial side effect of creating bigger natural hedges within the business. “It serves the need to find as good a natural offset as you can,” says Yoor, “but at the same time, it’s tied to your long-term strategy, and for us, strategy comes before all.”

The demerger created a business with 70% of its revenues outside the US and 50% in emerging markets. Although natural currency offsets were important, Abbott’s management realized they would also need to manage the company differently, Yoor explains. Having previously taken a “more opportunistic” approach to hedging, Abbott now put in place a rolling hedge program that looked 18 months ahead. “We went through to see where hedges were available in certain countries and whether they were affordable. Can we get the hedge accounting treatment that we want? Is it a liquid market?”

The hedging program cannot provide the same perfect match as a natural hedge, but it served

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**Is currency volatility here to stay?**

Vodafone’s Group Treasurer Neil Garrod observes that adjustments in exchange rates are one of the key means by which economic rebalancing between nations takes place, but argues: “What we’re doing—with quantitative easing, with the Bank of Japan, with currency pegs in China—is that we’re actually stopping that natural balancing effect from occurring.”

He believes that major exporters such as China and Germany should have much stronger currencies, based on their economic fundamentals, and that the barriers preventing these “structural imbalances” from correcting themselves create the potential for violent exchange rate adjustments in future.

Abbott’s Brian Yoor points to multi-year cycles of strengthening and weakening in the US dollar: “We’re on the longer end of what will have been a strengthening cycle for the US dollar—I think some of the longest periods were seven years and we’re in year five,” he says. “I’d like to think that the bulk of the decline in some of these non-US currencies is behind us. Some of them weakened by close to 50% in a two-year period.”
Abbott well during the turbulence of 2014–15, says Yoor: “We were able to use a blend of certain instruments that generated income for us in a very volatile environment and enabled us to continue to invest in the business.” He adds that Abbott investors understand that the benefits of a rolling hedge program will change over time; for example, as hedges taken on 18 months earlier start to expire and are replaced by new positions that may be more expensive. “You’re still realizing a benefit, but it’s not as much year-on-year,” says Yoor.

ECONOMIC HEDGES
Like Abbott, Vodafone Group has recently undergone a transformation that changed its currency profile, with the sale of its stake in Verizon Wireless in the US. The mobile telecom company that emerged reported its results in sterling but had half its revenues in euros, 15% in sterling, 10% in rupees and another 10% in rand.

CFO Nick Read says that, in the last full year, currency movements reduced reported revenues by about £2bn and earnings before interest, taxes, depreciation and amortization by about £700m. However, with its longstanding exposure to emerging market currencies, which are prone to volatility, the company has developed an approach to managing its currency risk that has several strands.

Part of this involves “economic hedges,” says Read, in which Vodafone matches the currency mix of its debt to the discounted cash flows of its various foreign subsidiaries. “What that means is that a negative impact on the P&L provides us with a reduced or positive impact on our net debt, which reduced by £2bn [last year]. So there’s an economic hedge.”

The company manages its global procurement centrally, reducing the exchange rate risk of purchases priced in emerging market currencies by converting the contracts into local currency payables. In this way, it avoids negotiating in euros and risking a translation hit through the rest of the year.

Read says that Vodafone’s policy is to report on its “organic performance” and then to isolate the impact of currency fluctuations to make them clear. Investors have a good grasp of the effects of currency volatility on Vodafone, he argues, pointing to the close relationship between movements in the company’s sterling-denominated share price and changes in the sterling to euro exchange rate. However, given that half the company’s revenues are now generated in euros, in April 2016 it switched its functional currency to euros instead of sterling and announced that, in future, it would also declare dividends in euros rather than sterling. This should result in less volatility in Vodafone’s reporting and also means that it will no longer be generating cash flows largely in euros but paying dividends in sterling. The change effectively passes inherent exchange rate risk from the company to its shareholders.

“I polled institutional investors on their support for moving to euros and they were overwhelmingly in favor, given that they can manage the currency risk from their end,” says Read.

WHAT’S YOUR APPROACH?
Royall says that the foreign exchange (FX) volatility leading up to the UK’s EU referendum and the repercussions afterward illustrate that the issue of managing FX risk is still a live one. “There’s an uneasy calm at the moment,” he says. “A year ago, everyone’s consciousness was raised about how bad the movements can be and a lot of companies started to

How Vodafone factors currency risk into its investment decisions
A central element of Vodafone’s approach to managing currency risk in its investment decisions is its use of a specific weighted average cost of capital (WACC) for each market it analyzes.

Group Treasurer Neil Garrod explains: “The evidence suggests that real interest rates are not globally consistent and that the real interest rate in Nigeria, Ghana or India will be higher than the real interest rate in dollars and euros.” These differences reflect the risks – including currency volatility – of investing in those countries. So, by basing its assumed WACC for each market on the real interest rate in that market, Vodafone aims to capture the risks of investing there and so set a realistic hurdle for the returns it needs to generate.

“Lots of corporates apply the group’s WACC, which is completely wrong,” says Garrod. “You need to be rewarded for the territory you’re in, and those territories have higher real rates. There are a couple of reasons, but a big one is currency risk.”
ask themselves, ‘What’s our philosophy about foreign currency?’”

That is the question they must all ultimately answer, he believes. “The issue is volatility, not what the long-term trend is. Hedging doesn’t reverse the long-term trend; it helps to smooth the jolts along the way. You have to decide if hedging is something you believe in or not.”

Some companies will feel they need as much protection as possible; others will take the view that currency swings are part of being a long-term international enterprise and that currency volatility tends to even itself out in the long run. But whatever their view, CFOs of multinational companies will need to continue focusing on the twin challenges of managing currency risk and ensuring that they are communicating their approach to this complex, multifaceted problem as clearly as possible.

Companies have a variety of tools available to help them manage currency risk, but they can never escape the effects of volatile exchange rates entirely. The key is to keep reassessing whether they have the best mix of measures to address their particular exposure, and to redouble their efforts to help investors understand the hedging philosophy they are acting upon and the reasons underpinning that philosophy.

Abbott’s supply chain challenge

One particular challenge for Abbott in helping its investors understand the effects of currency volatilility on its reported earnings is the global nature of its supply chain. Although investors might expect a change to feed through immediately to reported revenues, a great deal depends on where and in what currency the inputs for products manufactured were incurred and the quantity that is held as stock within the supply chain, says CFO Brian Yoor. As a result, it may be that Abbott can only fully appreciate the impact of changes in various exchange rates on the margins it ultimately generates from its sales some months later.

“When we talked to investors this year, they saw, for example, improving exchange rates in some of the emerging markets and their immediate tendency is to say, ‘You should be increasing your earnings,’” says Yoor. “That's a fair point, but you can’t just use a straight translation model, because there’s the lag effect of the inventory that’s already in your supply chain, which has been sourced in various locations and currencies. Therefore, if things were to stay as they are from the point at which we have that discussion, you’d likely see more favorable profit from translation anywhere between two to three quarters out.

“We had those conversations with investors and it took a while. It probably took a year for them to get comfortable.”
In 1997, Canadian company Bre-X Minerals was at the center of the biggest mining scandal in history. Two years earlier, it had fraudulently reported large gold deposits in one of its mines in Indonesia, as a result of which its stock price had soared. When the fraud was exposed, the company collapsed and its shares became worthless. Among the victims, three large Canadian pension funds each lost millions of dollars.

Since the Bre-X scandal, standard setters have worked to improve disclosure in the sector. Today, local standards such as NI 43-101 in Canada and the JORC Code in Australia require companies to provide far greater financial and technical information for each project, with independent verification.

Florian Siegfried, Manager of the Precious Capital Global Mining and Metals Fund, agrees that corporate reporting in the sector has greatly improved, pointing to criticism from investors as well as increased regulation as the drivers for this trend. But, though mining companies now provide a lot of useful information, more is still needed.

OPERATIONAL METRICS
When reading reports, Siegfried starts by looking at operational metrics, such as whether the company has higher- or lower-grade deposits in its mines, as these will drive the financial figures.
“Investors have to watch carefully to make sure that miners avoid the mistakes of the past.”

He compares these metrics with prior quarters to see if there is a trend and, if so, how steady that trend is. Then he compares them with the assumed metrics, for example in the project’s feasibility studies. “This is to see if predictions are bearing out in the real world,” he explains. “There is often a big difference, and feasibility studies can be wrong by plus or minus 20%.”

Even if a project is financed and built on time and budget, the reality check still only comes in production. If a company bases its project on incorrect fundamentals – for example, if its recovery rates are too optimistic – it will not make any cash, and that can kill a project. If it has bank financing, this could even send it into receivership if the technical and financial covenants are breached. Siegfried says this scenario has been all too common, especially during the recent mining downturn.

INDEPENDENT VERIFICATION

Siegfried welcomes the new levels of independent verification, for example, in calculating metal resources and reserves, mined grades or operating costs in each mine. But, he says, “by using different assumptions, companies can still play with how they calculate that,” leading to significant variation in reporting.

He would like to see additional metrics relating to individual projects being reported, so that investors can understand such assumptions. “We don’t necessarily just want to see what the company

### Counting the cost

Despite the improvements in reporting from gold mining companies, criticisms about lack of transparency continue, including in the area of cost reporting.

Siegfried says investors are still not able to understand completely whether the costs that companies report are accurate. “The metrics are not robust enough and many projects still do not make it in reality,” he says. “This has caused a lot of frustration among investors, particularly when they suffered big losses in the mining downturn.

“Some companies are doing a fantastic job now in the details they provide in their reports,” he continues, “but the market is pushing for more from others, and financial transparency as a whole has to increase overall.”

In the past, companies disclosed what it cost to generate one ounce of gold on a cash basis. But that number excluded many items, including corporate general and administrative costs and reclamation costs, as well as capital expenditure to sustain the business. “This means the market could get the inaccurate impression that they had a healthy cash position,” Siegfried explains.

The World Gold Council introduced more accurate reporting guidance in 2013 and the industry started reporting the all-in sustaining costs (AISC) calculation in an attempt to give more accurate information on total production costs per ounce. But, Siegfried says, “AISC still doesn’t include the whole bottom line of what it costs to produce an ounce of gold – and companies can play around with that number. For example, non-sustaining capital expenditure and exploration costs are excluded.

“I think that AISC will disappear and that we will move to a fully-fledged, all-in costs basis for accounting and reporting,” he concludes. “I don’t mind whether this is as a result of regulation or whether the industry does this itself, but I would like to see more transparency in that area.”

PROFILE

Florian Siegfried is Head of Precious Metals and Mining Investments at AgaNola, an asset manager based in Switzerland. He was previously the CEO of Precious Capital AG, an asset management company specializing in mining and metals investments, and he still manages the Precious Capital Global Mining and Metals Fund following its purchase by AgaNola. Prior to joining Precious Capital, Siegfried was CEO of shaPE Capital, a private equity company founded by Bank Julius Baer & Co. He holds a Master’s degree in finance and economics from the University of Zürich.
earns in its bottom line; we also want to find out whether each mine is generating cash and how it is using that cash,” he says. “For example, is it funding another project that might make no money? Not every company provides this degree of asset-by-asset transparency.”

Forward-looking statements are much more helpful, he adds, because mining is not just about cash generation. Companies are in a highly capital-intensive but depleting business and have to find ways to replace their reserves constantly.

“Finding the next mine is tough and takes years to develop,” says Siegfried. “In the corporate report, I want to see a statement about how management will continuously reinvent the business and replace what it has mined out – and be reassured that it has the financial and operational ability to do that.”

DANGEROUS ASSUMPTIONS
Assumptions that companies use to calculate net present value or internal rate of return can also be controversial, says Siegfried. Some use three-year trailing average metal prices, which is fine if the gold price keeps rising, as it did from 2009–12. But when prices fall by 30% or 40%, as they subsequently did, those numbers may become worthless.

“I would rather they were highly conservative and used a fixed price below the actual price,” says Siegfried. “Price volatility makes mining a high-risk business, and companies have to keep costs as low as possible to operate effectively,” he adds, “so the way they report costs and the ability to reduce them are fundamental.”

Now that metal prices are recovering, Siegfried wants to see that cost-cutting measures are sustainable and driven by operational experience. “It’s important to compare this quarter by quarter,” he says. “In the past, large companies have struggled with this. Today you have to be smaller and more profitable. That’s what I’m looking for.

“The risk now is that management [gets overexcited] again – for example, in overpaying for acquisitions or salaries. Investors have to watch carefully to make sure that miners avoid the mistakes of the past.”

Gold: a hedge against political uncertainty?
The surprise UK referendum vote to leave the European Union (EU) has substantially raised the price of gold. “Talking to family offices and other high-net-worth individuals lately, I’ve found that their rationale for holding gold is that the metal provides some sort of a hedge against political uncertainty,” says Florian Siegfried.

He adds that, after the vote, the sterling price of gold rose close to its all-time high. “In other words, gold has provided an effective protection against this kind of politically driven currency devaluation and political uncertainty,” he says. “As the socio-economic environment in the EU becomes more fragile, I think investors will continue to increase their allocations to gold,” he continues. “In an increasingly risky economic and political environment, the investment community is starting to reconsider gold as a hedge, not an investment.”

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