Executive summary

With tough economic conditions continuing in Europe and the US, more companies from developed economies are looking for growth opportunities in emerging markets. And as companies operate in these markets, audit committees have specific roles to play in ensuring that strong risk and control processes are in place.

Together with the full board, audit committees should require senior management to conduct extensive scenario and business continuity planning; implement enhanced market due diligence; foster relationships with key market stakeholders; and ensure that local management supports the risk and control environment.

These are the key findings of new research commissioned by Ernst & Young. The research, undertaken by Tapestry Networks, explores how leading audit committees are changing their approach to risks in emerging markets. Findings are based on the views of audit committee chairs, board directors, CEOs, CFOs, corporate heads of developed and emerging markets and advisors in Europe and North America.

Other key findings include:

**Emerging markets bring opportunity – and risk.** With economic uncertainty and low growth characterizing many Western markets, emerging markets are becoming more attractive to companies in developed economies. However, many respondents believe that these markets have become, in some ways, riskier in recent years. Executives said that natural disasters have shown the perils of extended supply chains, while political upheaval in North African and Middle Eastern markets showed that fast growth can be accompanied by instability. Even healthy markets, such as Brazil, India and China, are showing signs of slower growth or inflation. Audit chairs believe boards and audit committees must ensure that their companies stay agile and prepare for the unknown.

**Local market intelligence should drive analysis and decision-making.** Directors, executives and experts note that companies need to ensure that analyses in business plans, partner selection and acquisition due diligence must be informed by local insight. The attitudes of government officials, competitors and customers must be taken into account. Boards should probe management plans more critically, and audit committees can ensure that due diligence is sufficiently robust.

**Connectivity with local markets is essential.** Directors stress the need for audit committees to assure that head office is working closely with local management to ensure conformity with company practices and ethics. They view relationships with local governments and companies as essential. Audit committees can insist upon having local talent trained properly and embedded firmly in the firm’s internal audit, risk management and compliance teams.
Emerging markets bring opportunity – and risk

European companies still face considerable uncertainty as the Eurozone crisis continues. Ernst & Young’s Eurozone Forecast reports that 2012 will be a very challenging year for the Eurozone and risks to stability have become more serious. Recent actions by leading credit rating agencies highlight the continued challenges. For example, in February, Moody’s cut the ratings of six European nations, including Italy, Spain and Portugal. It said that France, Britain and Austria could be stripped of their top-level AAA rating, and warned that it may cut the credit ratings of 17 global and 114 European financial institutions. Political brinkmanship moves to resolve the crisis exacerbates the uncertainty.

Not surprisingly, given the current financial situation in mainland Europe, companies are more interested in growth in emerging markets. However, after relatively stable growth in such markets in the early part of the last decade, conditions have changed and new challenges are emerging:

Emerging markets may be overheating.
A recent Ernst & Young report predicted that: “70% of world growth over the next few years will come from emerging markets, with China and India accounting for 40% of that growth.” While this trend is expected to continue, there are growing concerns about overheating and inflation. David Lubin, Global Head of Emerging Markets Research at Citi, noted: “There are a number of serious inflation threats lurking in emerging markets ... emerging markets’ policy-makers are not really willing to sacrifice growth in order to achieve an inflation target.” Mr Lubin added: “Where China leads, in many respects, other emerging markets will follow.” While growth in China remains robust, many analysts point to the Chinese Government’s concern about inflation, the number of bad loans on Chinese banks’ books and overinvestment in unnecessary projects, as warning signs that the Chinese economy is due for a correction.

Ever-growing concerns related to intellectual property rights.
One audit committee chair said: “There are fewer rules and regulations in [emerging] markets, and you have to expect you’re going to run into more compliance issues or an absence of regulation in these markets.” For example, a director of intellectual property analysis observed: “Intellectual property is a big problem, especially in China. The [counterfeiters] are so blatant about it. The authorities look the other way.” Participants noted that intellectual property thieves have become increasingly emboldened to steal more than just software. Indeed, the Associated Press reported in July that counterfeiters in China are “replicating entire Apple stores.” A risk advisor who participated in this report said: “Successful brands and products are being counterfeited and sold on an unprecedented scale ... The lack of knowledge among customers and, most importantly, a large proportion of the retail industry being unorganized and unregulated, accounts for the majority of counterfeit sales in the country.”

Democratic reforms in the Middle East and North Africa bring new geopolitical risks.
Participants pointed to political upheaval throughout the Middle East and North Africa as signs that those markets remain fragile and subject to economic and supply chain uncertainty. Some believe such instability enhances the risk of malfeasance and fraud. Deutsche Bank commodities analyst Soozhana Choi recently told the New York Times: “As anti-government protests have spread from Tunisia and Egypt to the streets of Bahrain, Yemen and OPEC member countries Algeria, Libya and Iran, concerns about geopolitical risks and the potential for supply disruptions have returned aggressively.” Matthew Lynn, a financial journalist, wrote: “There is no point in getting a 20% annual return if you then lose the lot when the government gets overturned in a revolution. The Arab Spring was a reminder that emerging markets can collapse amid political turmoil.”

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2 Ian Chua and Soyoung Kim, “Moody’s may downgrade UBS and Morgan Stanley,” Reuters, 16 February 2012.
3 “Tracking global trends: how six key developments are shaping the business world,” Ernst & Young Global Limited, 2011.
5 Ibid.
**Strong oversight is required when pushing into emerging markets**

Given management’s desire to push for increased growth in emerging markets — and signs that such markets could be somewhat more risky than in the past — participants confirmed that companies are rethinking their approach to these markets. In conversation, many audit chairs express a desire to discover leading practices for companies expanding and operating in emerging markets.

Participants highlighted four key areas where the directors can enhance their company’s international market strategy. Some roles fall to the full board, particularly those relating to strategy and senior talent, while others present opportunities for the audit committee to add more value. More robust board or audit committee review should necessitate that senior management:

1. Conducts extensive scenario and business continuity planning
2. Implements enhanced market due diligence
3. Fosters relationships with key stakeholders in each market
4. Ensures local management supports risk and control environment

**1. Conducts extensive scenario and business continuity planning**

Using the Eurozone crisis as an example, several said boards and audit committees are increasing the use of scenarios that address certain financial market or economic events. This can take place during full board strategic discussions, or in audit committee examinations of emerging markets. They stress that creative, disciplined scenario planning allows companies to assess the potential impact of external factors and their likely responses to a given set of events. One director said: “We do our own heat map of risks, but the real issue is our nimbleness and ability to respond.” Participants are increasing activity in scenario planning, road-testing continuity plans, ensuring proper access to funding and crisis communications.

**Pushing scenarios further**

Some said that it is important to “consider the worst-case scenario,” and push management to consider more factors. Business plans take into account a base case as well as harsher downside conditions. Among other factors, scenarios may be characterized by different rates of economic growth, differing fiscal and monetary policy responses and assumptions on different levels of liquidity in the capital markets. Their impact on key activities is analyzed in terms of risk and opportunity, and critical assumptions and estimates have to be tested and re-tested. The aim is not to predict the future, but to ensure that the board and management are fully aware of how a given scenario might affect their firm, so everyone is comfortable with the level of risk that the situation represents and understands how the firm would likely respond.

Directors and executives are pushing their thinking further than previously on second-order effects, i.e., from the Eurozone crisis. Companies are worried about the impact of such departures on contracts. TUI, a German travel company, recently requested that its contracts with Greek hotel owners be amended to allow the company to pay these owners in whatever new currency might replace the euro. A key consideration for a firm’s finance function is the organization’s ability to incorporate new currency effects. Currency risks arise in dealing with partners located in different countries across the Eurozone, particularly those that are more likely to exit the euro and revert to their own currencies. Banks are pushing their thinking even further, onto what some call third-order effects; not just their direct exposure (first order), or the effects on their bank counterparts (second order), but on what happens to companies relying on European banks that would face significant stresses if a crisis ensues (third order).

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10 See Ernst & Young, *Eurozone Forecast*, December 2011.

11 Tony Barber, “Business and the Eurozone: Looking for the Exit.”
Emerging markets bring opportunity – and risk  

Plan ahead for business continuity
Business continuity takes on greater importance in emerging markets that lack the infrastructure to handle severe natural disasters. One audit chair said: “[Natural disasters] can happen anywhere, but the concern we have in these countries is their ability to spring back.” Another audit committee chair said that the audit committee can work to ensure management is “fully prepared to react in the crucial 24 to 48-hour period after something happens.” They also need to consider longer-term effects. As one finance executive said: “While it’s been a while since the Japanese tsunami, the effects on the supply chain are still being felt.”

Having an understanding of supply chain effects is critical. One board director noted that “the extended supply chain has really expanded some of the [operational] risks.” Audit committees should ensure that management considers how the supply chain would be affected in a variety of scenarios. One audit committee chair said directors should: “Have management walk the audit committee or board through each of the scenarios. Ask management, ‘What are the five worst scenarios? What is the response for each of them? Who is responsible for each action? How will we protect our reputation?’” Another director suggested asking: “Where will we shift capacity? How will this affect production in numbers?” Contingency suppliers may need to be identified. One audit chair remarked: “We have an item on our [audit committee] agenda every quarter – it’s called critical suppliers. Sometimes we have to intervene.” Intervention may include extending credit to suppliers because, as another committee chair noted, companies “are sometimes the funder of last resort” for their suppliers.

One professional advisor to companies emphasized the importance of communicating with the managers responsible for action: “The audit committee should be talking to the people in the plant who these scenarios are designed for – not the business continuity team. Do the people at the plant know what they are supposed to do, and can they answer your questions about the scenarios?” Another audit committee chair said, to build the scenario of limited connectivity into a plan, “Listen to how they are implementing actions with limited connectivity – when a disaster hits, you might not be able to rely on phones or normal communication.” This advisor said that companies are incorporating practice runs for certain business continuity plans, while another explained, “If you don’t have these surprise practice runs, you are not going to be ready.”

Consider funding implications
Audit committees should ensure management understands fully how market conditions of the past four years have affected access to funding. One audit committee chair explained: “Audit committees are paying more attention to funding, access to liquidity, credit lines and bond issues for the company.” Audit committee chairs stressed the importance of asking management about questionable banks: “CFOs and audit committees need to ensure management is closing down those exposures.”

One consequence of ongoing market uncertainty has been that corporate boards have become even more risk averse, and companies are choosing to sit on large cash balances. Ernst & Young’s December 2011 Eurozone Forecast predicts “business investment to be on hold in 2012, [with] many boards … buying back shares or holding cash reserves rather than investing in growth – either through investing locally in Europe or in rapid-growth markets.”12 An audit committee chair echoed this trend, saying: “On the funding side, most companies hold more cash than they need.”

Another consequence has been the effect on actual funding. Firms are increasingly looking outside of Europe. European companies have stepped up the degree to which they are accessing funding in the US, even though this elevates exchange-rate risks.13 Some firms have looked further afield. In mid-January, India’s Reliance Communications Ltd secured funding from Chinese lenders for the second time within a year.14

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12 Ernst & Young, “A Test of Nerve and Confidence,” Eurozone Forecast, December 2011.
“[We have to ensure management is] fully prepared to react in the crucial 24-48 hour period after something happens.”

Press for robust crisis communications planning
Successful communication during and after a crisis can help protect a company’s reputation. Participants said that, as global footprints expand, it is important for companies to learn how best to communicate in each market. One audit committee chair said: “There is a greater possibility of mishandling communication when you don’t know the nuances of how it might be received [in other markets].” Several suggested that the audit committee should ensure management has prepared for the types of issues that could be important for each audience, and how each group might react. They should get management to determine who within management, or in some scenarios the board, should lead communications. Sometimes the CEO should be the spokesperson, while in other cases the head of the relevant business unit or geographic area would be more appropriate. One audit committee chair said: “Sometimes the CEO is not going to be the best one to deliver a certain message. You have to think about how it could be perceived.” Determining the spokesperson in the heat of the moment is not optimal. Some participants believed that preparing generic press releases in advance is best practice. Scenario planning can extend to how the company will communicate with news outlets worldwide. One audit committee chair encouraged others to answer the question: “What are the sound bites for each scenario?”

Questions for audit committees
- In light of volatile conditions globally, how has your company changed its scenario planning process? How engaged is the audit committee in that process?
- How robust is the dialogue on second and third-order effects of specific scenarios?
- How have recent events caused your company to update its crisis management plans? Is an effective crisis communication plan in place?
Emerging markets bring opportunity—and risk continued

2. Implements enhanced market due diligence
Audit committee chairs agree that, when companies are considering entry or material growth in a foreign market, “considerably more time needs to be spent on market due diligence.” Many believe that the heightened uncertainty in these markets over the past few years—whether it be major natural disasters, greater political instability or the effects of the global economy on the local economies—has elevated the need for more thorough due diligence. This relates to suppliers, commercial parties or potential acquisitions. Given that audit committees are often more deeply involved in the detail of their company’s due diligence approach than the full board, participants suggested that audit committees ensure that management:

- **Leverage internal audit’s involvement in international activities.** Members said an internal audit presence in these markets is crucial. These teams are often deployed to new markets “to perform due diligence on vendors, suppliers and contractors well before the company decides to go there.”

- **Evaluate local competitors’ behavior.** Local companies may have an advantage because of their insight into possible changes in the business environment, such as the likelihood that certain regulations will be put into practice. One executive said: “There is a reason [your local competitors] do things in a certain way ... understand why.” The analysis may point to issues that deserve greater analysis in the due diligence process.
“Look at the regulatory environment and how local laws and guidelines are executed. Look at the availability of skills. Does management have the capacity to adapt to the needs of the market? Look at the way local competition is changing the way the game is played.”

- **Research the tax environment.** According to a recent Ernst & Young survey, tax enforcement is becoming more aggressive, and companies are reporting that “the pace, volume and complexity of tax policy, tax legislation and tax administration change is a source of more risk and more uncertainty than ever before.” Indeed, the survey found that “73% of respondents feel that entering into or operating in emerging markets significantly increases their levels of tax and tax controversy risk.” The tax function increasingly wants the board and audit committee to understand that the “tax risk environment has shifted.” One advisor suggested that “the audit committee should talk directly to the tax director … ask [the tax director] how the tax environment in a new market will impact upon the company’s overall tax strategy.”

- **Provide oversight of complex accounting.** Entering a new market introduces accounting and reporting complexities for the company and more responsibility for the audit committee. One audit committee chair said: “[The audit committee] has to oversee the [International Financial Reporting Standards, IFRS] implications and reporting changes.” Audit committee chairs agree that frequent communication with the audit engagement partner and entire audit team helps to ensure that accounting issues are addressed in a timely and effective manner. This is particularly important as the world continues its moves toward adopting IFRS globally. While many countries have adopted these standards, some audit chairs remain concerned that the standards are being implemented in different ways on the ground, and note that the standards themselves are being changed, in some places significantly, such as lease accounting and the increased use of fair-value accounting. Moreover, some key markets have still not adopted IFRS. This is very challenging for companies operating across multiple markets, particularly those operating in emerging markets where the state of IFRS adoption is mixed.

- **Test the risk-return analyses.** One risk advisor noted: “Companies … need to identify all of the risk drivers holistically in calculating the potential return and risk in emerging markets. Look at the regulatory environment and how local laws and guidelines are executed. Look at the availability of skills. Does management have the capacity to adapt to the needs of the market? Look at the way local competition is changing the way the game is played.” The risks and rewards can change significantly and rapidly in emerging markets.

**Questions for audit committees**

- How can the board and the audit committee familiarize themselves with the competitive landscape in emerging markets?
- How do you oversee risk and controls in emerging markets? What improvements could be made to these practices, particularly in your firm’s approach to due diligence?

16 Ibid., 24.
17 Ibid., 44.
3. Fosters relationships with key stakeholders in each market
Directors believe that, even with good management in place, it is important that firms develop strong local connections in new or growing markets. This can reduce the risks associated with relying on third parties that prove to be less reliable or trustworthy than expected. They noted that, although the audit committee itself does not forge these relationships, it has a role in encouraging management teams to do so. Here are four key actions:

- **Build a relationship with the local government.** In countries where the government holds significant power over private businesses, relations with the government are particularly important. One audit chair said: “Management has to get to know governmental bodies ... and be immersed in the country dynamics to make sure they are prepared for shifts or regulatory changes.” Another executive said: “One way to enter the market is through joint ventures with [local] governments, so that there’s an alignment in terms of objectives. You have to have good relationships and a strong reputation among the countries that you operate in.” It is also important to be sensitive to how local governments might react to actions that are commonplace in other markets.

- **Partner with local companies.** Participants said that partnering with local companies can help Western companies adapt better to a new environment, but stressed that the partnership relationship varies according to country. One audit chair pointed out a new role for the audit committee, saying: “The audit committee has become involved in [probing management’s approach to] sourcing from markets where business gets done. We validated that the manufacturer we were dealing with in these countries had good practices, so that we wouldn’t find later on that we had a supplier that could drag down the company’s reputation.” Given the pace with which countries are adopting their own compliance rules, particularly relating to bribery and corruption, an advisor added: “Global corporations and their internal audit teams need to be more vigilant in managing their vendor and customer compliance relations. An effective program for vetting the partners should be a critical priority as part of anti-corruption compliance, due to vicarious liability provisions of the relevant statutes under laws like the Foreign Corrupt Practices Act and UK Bribery Act.”

- **Ensure local advisors are complementing in-house market knowledge.** Several participants suggested internal audit could be more effective when paired with local expertise: “You outsource some activity to organizations that are on the ground, and you keep them really close to your internal staff. I don’t think you can rely on your own internal staff over there unless you’ve been there for a while. It is a long process to instill the knowledge; you need to be over there.” The same applies to the legal team.

- **Leverage board member relationships.** Several audit committee chairs said that their companies will look to board members for introductions to key market participants. Research participants suggest that European boards tend to be comprised of directors with diverse backgrounds and business experience, more so than American boards.

### Questions for audit committees

- How does your company’s management build relationships with foreign governments?
- In what ways does your company leverage local companies, strategies and advisors?
- How can the board or audit committee help your company increase its immersion in local markets?
“You need to think about developing successors from all over the world. To do that, you need to build leadership consistently so that a global leader [can] emerge.”

4. Ensures local management supports risk and control environment
With risk management being a key audit committee responsibility, participants said it is essential that the audit committee ensures consistency in risk management and controls approaches in emerging markets. One audit chair observed: “The audit committee has been much more involved in emerging markets risk. The audit committee gets into the nitty-gritty. We are looking at the coverage internationally, on audit activities both internal and external ... we had the CFO of international in to talk to us about the risks he’s facing. He had the head of risk with him.”

In order to achieve better controls, participants said it is important to train local talent in the firm’s ethics and values. This encourages mobility and global connectivity throughout the company, so that institutional knowledge gets transferred from headquarters to all operations.

Participants identified several areas where audit committees can probe management on how they are using talent strategies to maintain a consistent risk and control environment:

➤ Developing an international mind-set in management.
One audit chair said: “The board needs to be picking global people, people who work in global businesses, people from all over the world. [One executive] joined the board and is very familiar with Colombian and Korean trade agreements.

You must be making sure you have people who fit the footprint of the company .... We want someone on the ground who has traveled extensively.” Another added: “You need to think about developing successors from all over the world. To do that, you need to build leadership consistently, so that a global leader [can] emerge.”

➤ Design partnership roles for senior management. One audit committee chair said: “I’ve seen the most success when there is a partnership between [the foreign] national and a [home-country] executive to run the business. One might be the CEO and the other the COO. This [partnership] is essential in Latin America and Asia, where business mores and ethics are so different to the way we think in the US.” This design seems aligned with the desire that many companies have to create more global senior management.

➤ Source locally. “You have to build capability with local talent,” one participant said. “[Local talent has] an important role to play with your brand in the region.” Strong local relationships create roots in a region and offer protection from local or international shocks. An audit committee chair said: “Our internal audit team recently recruited a manager who is Asian. She has a lot of business experience there and speaks the language.”

➤ Invest time in the market. Several participants said boards should ensure that senior executives are tasked with getting the company established in the emerging markets that the company is entering. A risk leader in Europe, Middle East, India and Africa remarked: “CEOs and group CFOs need to realize that, in order to make their investment in emerging economies work, they need to spend significant executive time in these countries. My advice to the board and audit committee would be to include the time that the CEO or group manager needs to spend in these locations when considering the risk-return of these investments. ... Why should those locals be loyal to you? They may build their own side businesses. To prevent this, you must invest significant time and resources.”

➤ Reiterate company values. One executive noted: “Operating in emerging markets has to come from your value base: what are the values of your company? Are you willing to participate in a lot of the activities that have become custom in emerging markets, but may not be up to your standards? Our legal counsel will visit our various operations around the world and communicate this point. They will discuss anticompetitive behavior and our marketing practices, just to remind our employees of our standards.” It is hard to walk the line between home country values and sensitivity toward the local culture. Another executive remarked: “With foreign locations, you have to establish boundaries for the leaders to align ethically with the company, but you also have to give them enough room to do the work that will make your company successful in those markets.”

Questions for audit committees

➤ How does your company encourage senior management mobility? How well does senior management work and interact with local management?

➤ How does it ensure that local talent is fully conversant with, and supportive of, the firm’s overall ethical approach? How is local management incentivized to embed the firm’s values and ethics in their business?

➤ What metrics do you use to determine if the firm’s ethics and values are being adhered to in emerging markets? How do the risk, compliance and audit professionals evaluate the degree to which firm-wide ethical standards are applied in these markets?
Conclusion

In a business environment conditioned by fears over the future of the Eurozone, concerns that some emerging markets are overheating and extreme geopolitical risk, participants advise audit committee chairs to provide greater oversight. Participants recommend that audit committees ensure that management plans ahead for extreme scenarios; forges relationships with governments and companies in emerging markets; enables global connectivity and mobility across management ranks; and increases due diligence. They also stress the importance of strong fundamentals, such as good people, a keen awareness of the culture in the target market and a robust risk management and control environment.

The most important thing an audit committee can do to oversee risk in emerging markets, is continually exercise skepticism regarding the company’s plans. Growth prospects in emerging markets are so attractive that many management teams formulate plans too hastily, without paying sufficient attention to new customers, competitors and regulators. The audit committee and board should challenge management to consider all of these relevant stakeholders as it formulates the company’s expansion plan, and it should ensure that the overarching strategy for entering an emerging market is disciplined and based on principle.
Appendix: Research participants

Tapestry Networks interviewed a broad range of board directors and international business and economics subject matter experts. All discussions were held under a modified version of the Chatham House Rule whereby views expressed during the discussions are not attributed to individuals or their organizations. In addition to seeking the views of audit chairs on the various networks run by Tapestry, the following directors and subject matter experts were interviewed specifically for this issue of InSights:

- Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics
- Michael Bratt, Chief Financial Officer, Volvo
- Ian Cameron, Senior Vice President, Corporate Development, and Chief Financial Officer, Methanex Corporation
- Jeremy Grist, Head, Climate Change and Sustainability Services, Ernst & Young, Africa
- Phil Hodkinson, Audit Committee Chair, British Telecom
- Abbas Hussain, President, Emerging Markets & Asia Pacific, GlaxoSmithKline
- Richard A. Johnson, President and CEO, Foot Locker, Footaction, Kids Foot Locker and Lady Foot Locker
- Alexis Karklins-Marchay, Head, Emerging Markets Center, Ernst & Young
- Roger Lawrence, Corporate Vice President, Quality Assurance and Regulatory, McCormick & Company
- Daniel Lebègue, Audit Committee Chair, SCOR
- Sugan Palanee, Markets Leader, Ernst & Young
- Wolfgang Schäfer, Chief Financial Officer, Continental AG
- Risto Siilasmaa, Audit Committee Chair, Nokia
- Kees Storm, Audit Committee Chair, Anheuser-Busch InBev and Unilever
- Joe Tesoriero, Executive Vice President and Chief Financial Officer, Dole Food Company
- Lars Westerberg, Audit Committee Chair, Volvo
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The views expressed in this document represent those of the individuals who participated in the research. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks.

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