Why investors are placing increasing importance on non-financial indicators

Beyond financials

As mature economies have dealt with turbulence, new opportunities have arisen in rapid-growth markets. But because each emerging economy is different, grasping them requires a thorough understanding of the local market. EY’s Emerging Markets Center offers a window seat from which you can explore the latest insight, identify trends and spot opportunities. So if you’re looking to expand in the world’s fastest-growing economies, it’s time to get on board.

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Big data
How data analytics can improve business performance

Focus on risk
Why good risk management looks beyond the obvious
Dear readers,

I hope the first quarter of 2014 saw you and your businesses embracing some emerging optimism from economic forecasts and surveys of business sentiment worldwide. For many of us, now the annual reporting cycle has drawn to a close, our time is spent reflecting on the financial measurements of last year.

What we hope to do in Issue 7 of Reporting is to provide insights on the challenges of reporting corporate performance, covering topics that senior executives and boards should consider as they continue to adapt their organizations to survive and thrive - not just for 2014 and 2015, but for the years beyond.

In this context, the requirement for all of us is to consider an ever-widening range of challenges and risks. Christian Moulion’s article on risk on page 13 suggests that we should all look around corners for that which is not visible. My observation, from the leading companies and boards I meet with, is that balancing time between an effective response to short-term crisis and proper consideration of long-term change requires continued evaluation. For all of us in global business, there are at least two resources that will make a big difference: the effective use of technology and the strategic focus on talent, not only for resources that will make a big difference: the effective use of technology and the strategic focus on talent, not only for short-term crisis and proper consideration of long-term change requires continued evaluation. For all of us in global businesses, there are at least two resources that will make a big difference: the effective use of technology and the strategic focus on talent, not only for resources that will make a big difference: the effective use of technology and the strategic focus on talent, not only for...
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Recent publications from EY
As Jonas Prising, President of multinational human resource consulting firm ManpowerGroup, puts it: “Increasingly, companies are taking a supply chain view of their workforces.” Instead of relying on a pool stocked by others – schools, universities, competitors – those employers that have embraced the new thinking see the pipeline as their responsibility. Hence the rapid rise of human capital up the chain of business priorities.

How seriously an issue is taken in the business world can be gauged by its position on the boardroom agenda. Using that measure, the management of, and investment in, top talent has experienced a phenomenal increase in importance during the past decade.

“Talent management has moved to the top of the agenda,” says Bin Wolfe, EY’s Managing Partner – Talent in the Asia-Pacific region. Recognition is growing that effective talent management can be a major – perhaps decisive – factor in business success.

Key to this is a fundamental shift in thinking, from seeing the available talent as inhabiting a “pool” from which organizations can fish at will, to viewing human capital in terms of a pipeline.

As Jonas Prising, President of multinational human resource consulting firm ManpowerGroup, puts it: “Increasingly, companies are taking a supply chain view of their workforces.” Instead of relying on a pool stocked by others – schools, universities, competitors – those employers that have embraced the new thinking see the pipeline as their responsibility. Hence the rapid rise of human capital up the chain of business priorities.

**STRUCTURAL CHANGES**
That may seem to be something of a paradox. The recession has left huge numbers of graduates out of work across the developed world. The proportion of graduates in member countries of the OECD who were unemployed increased by an
average 1.5 percentage points between 2008 and 2011, to 4.8%. It suggests that a large amount of talent is looking for work.

So can business afford to wait for top-quality personnel to come knocking at its door? The short answer is no, not least because the OECD countries are no longer “the world,” and not even the fastest-growing part of it.

“You have to look at the reasons for the underlying changes,” says Prising. “Are they cyclical? We would say not. There has been a pretty big recession, but underneath the cyclical changes we see structural change. These structural changes are not coming at the rate of one every 20 years. They include globalization, technology and an aging population.

Clayton Gammill, EY’s Principal for Human Capital in Dallas, Texas, says: “Businesses are starting to get a grip on human resources. They have to, because of the way the growth of services is changing the economy. When you need a knowledge worker, it is not straightforward to fill that position.”

A PROACTIVE APPROACH
One example of a proactive approach to this issue is Microsoft’s IT Academy in India, which seeks, in its own words, to “plug the skills shortfalls in India” and to begin to rectify the situation where “not many people in the country have undergone IT training that equips them with international accreditations and certifications, shaping them into global talent.”

The academy provides IT courses on Microsoft technologies in participating Indian schools and colleges. These include courses both for those students wishing to become competent in everyday business applications and for those who are pursuing a career in IT.

A similarly forward-thinking company is industrial and financial giant GE, which spends about US$1b globally every year on education and training programs such as its “entry level” scheme, which combines job assignments with classroom work.

All this, of course, could be seen as a diversion that could hit the bottom line, and thus upset shareholders. Indeed, getting the message over to investors is not easy, according to Gammill. “The markets deliver a quarter-by-quarter ordeal for companies, insisting on earnings growth,” he says. “It makes it extremely difficult for many publicly owned companies to invest in human capital. Most organizations say they want to do that, but the markets obstruct them.”

That said, those that stay the course have a good story to tell their shareholders. “Companies with the courage to insist on investing during the downturn…”

“Increasingly, companies are taking a supply chain view of their workforces”
Jonas Prising, ManpowerGroup
are beginning to see that pay," he says. “They gobbled up talent when it was on the market. Those that did not are now having to cast round for talent and will be paying more for it.”

Prising is confident that shareholders are starting to take a longer-term view, recognizing that the old, low-cost recruitment method can actually be bad for business. He says: “The spot-market approach worked quite well some decades ago, when you could pass on to customers the inevitable wage inflation of buying talent as and when you needed it. That is much more difficult now.”

GAP ANALYSIS
“Companies take a very high-end view and do not tend to have a good feel for what talent they have in their workforce,” says Dina Pyron, the UK-based Global Director of Human Capital at EY. “There is too much of the attitude that hiring is simply to ‘fill a void,’ rather than asking: ‘Is this person right?’

“When you meet an American CFO or a British CEO, they know what’s outside their door,” she continues. “In other words, firms often know the top talent that is close by, but are less aware of talent that is further afield. That is not enough if you want to be competitive in the future. We often ask clients: ‘Are you open to considering a new CFO from non-western cultures?’ They pause and say that could be a good thing to think. Then they ask: ‘Is that talent there?’

“Five years ago, the majority of our top Human Capital clients globally were coming out of the United States,” she says. “This year, more than 50% had a European headquarters. We are also seeing more Asian businesses. There is great speed of change, and it is accelerating. You don’t have 15 years between big changes anymore.”

She adds that companies need to understand the competencies of staff three or four layers below management level. “With technology, you are able to do that. Competency system software allows firms to carry out gap analysis, to find out what they need and what they have.”

A talent audit, she adds, can flag up looming skills shortages as people leave or retire and “allow organizations to go down to a much younger level and develop new talent.”

These systems can also prompt companies to re-examine matters such as the length and content of training courses, to try to get people functioning more quickly in their new roles.

The challenges vary around the world, with Wolfe pointing out that “in emerging markets, people tend to move jobs a lot more.”

EXCEPTIONAL TALENT
So, does all this effort yield tangible business results? Pyron says yes, citing Managing today’s global workforce: elevating talent management to improve business, a 2010 study carried out by EY. That study showed that when these strategies are aligned, investment returns as a return on common equity improve by more than 20% compared with those of companies whose strategies are not aligned. When they are both aligned and integrated, the average out-performance is 38%.

Ultimately, says Wolfe, the issue is simple. “We are looking out for exceptional talent. If we want such people, our competitors want them too.” In this environment, the only alternative to a costly scramble for a limited number of people is to invest in making that number bigger.

This simple equation lies at the heart of the new approach whereby human capital is treated not as an expense, but as an asset. But this, in turn, raises the question of whether, as with any other asset, a financial value can be put on an organization’s human capital.

“This question has been asked a lot,” says Pyron. “Ultimately, the answer is likely to be that technology development and more sophisticated metrics will enable companies to understand better the true talent value of their workforce in a more traditional way.”

But Gammill advises caution. “In theory, you could put a balance-sheet value on human capital,” he acknowledges. “You know the compensation that you are paying someone, so in a sense you know their net worth.”

But even in today’s open labor markets, there remains, he says, the simple fact that one person’s skills may be valued very differently from one employer to another: “The trouble with human capital is that you can be worth US$50,000 to one company and US$100,000 to another.”

However, Wolfe remains upbeat. “Can accounting techniques find a way of valuing the asset - an organization’s human capital and its ability to optimize that human capital? Yes. It’s a great opportunity for whoever manages to establish such a system. It is an exciting challenge for the profession.”
The increasing importance of non-financial performance

A recent EY report reveals that investors are placing increasing value on non-financial indicators in their assessments of company performance.

Over the past decade, many companies have been increasing their reporting of non-financial information, including data on their environmental, social and governance (ESG) performance. In some jurisdictions this is driven by regulatory requirements. In some industries, natural resource shortage, climate change and societal pressure are having a fundamental impact on business models.

Non-financial reporting is evolving, but, unlike financial statements, no globally consistent framework or guidelines have yet been universally adopted. EY’s view is that this is an increasingly important area of focus – especially given that the majority of global investors in our recent survey told us they’re using this information for decision-making – whether or not companies themselves choose to disclose it. This is partly because non-financial performance is a good benchmark for how well companies manage risk.

Financial stakeholders continue to scrutinize cash flow, investments and reserves, but are constantly seeking surety that the companies they invest in have sustainable futures and are managing risk and growth for the long term. They look to a range of information to make this assessment – beyond the financial statements.

In September 2013, EY conducted a global survey of 163 institutional investors, to examine their views...
on non-financial reporting and explore how they used the current information available, and the value they place on it, when making investment decisions.

**A ROLE IN INVESTMENT DECISIONS**

The majority of investors told us that, in the last 12 months, assessing non-financial performance had played a pivotal role in their investment decision-making process.

Of the 11% who said that non-financial performance had not played a key role in the past 12 months, the principal reasons they gave were that it was unclear if the non-financial disclosures were material or had a financial impact.

But their method of evaluation is varied. Fewer than 20% use a structured evaluation of social and environmental impact statements and disclosures, while 32% evaluate these statements informally. (See Figure 1.)

Investors are increasingly using the non-financial information from these company reports to assess risk. Respondents told us that the two most important non-financial issues were the business impact of regulation and the ability to minimize risk.

They are most likely to take ESG information into account when examining industry dynamics and regulation, risk and time frames, and when adjusting valuations to account for risk. (See Figure 2.)

A mutual fund investment manager explained that his firm takes a dual approach to assessing ESG data. “From the top down, we’re thinking about long-term ESG themes that impact economic growth over the next three to five years,” he explained. “On a bottom-up basis, we are looking specifically at credit analysis - corporate credit, but also emerging market sovereign credit; for example, integrating ESG risk factors into the individual companies and countries in which we are investing.”

A portfolio manager from a South African third-party fund said that they needed a set of material issues to weigh up different companies. “We have a tick box, a list of questions we apply ... it gives you a good feel straight away. For example, on environmental: are they measuring environmental impact? Have they set targets? Is the environmental framework in place?”

**DIRECT FROM THE COMPANY**

The most relevant source of information on the non-financial performance of a company was taken from the company itself – through annual or integrated reports - rather than from a third party. Information sourced from third parties, such as Bloomberg, index ratings and press or media coverage, is judged as being less valuable.

Investors had different preferences on the amount of information they wanted and how detailed it should be. Some investors said they wanted less – but more consistent – information that highlights the most material aspects. Others were more interested in being able to evaluate data themselves. This suggests that companies should provide a variety of information through different channels to meet the needs of different financial stakeholders as non-financial reporting develops.

We asked participants who should provide oversight of sustainability reporting, and the overwhelming view was that it is a board responsibility. Many align it to financial reporting; 67% of respondents believed it should be an audit committee’s responsibility, with some form of independent verification.

Investors want information that is specific to the organization. Almost two-thirds of investors think that it would be beneficial to have both sector-specific key

**Figure 1:** Which of the following statements best describes how you and your investment team evaluate non-financial disclosures that relate to the environmental and social aspects of a company's performance?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>19.5%</td>
<td>Conduct structured evaluation</td>
</tr>
<tr>
<td>32.0%</td>
<td>Evaluate ESG impacts informally</td>
</tr>
<tr>
<td>13.0%</td>
<td>Rely on guidelines from third parties</td>
</tr>
<tr>
<td>35.5%</td>
<td>Little or no review</td>
</tr>
</tbody>
</table>

*Source: Tomorrow’s investment rules: Global survey of institutional investors on non-financial performance*
INFORMATION: INVESTOR SURVEY

will be critical in determining what to measure, manage and report.

3) Keep abreast of international developments. With both the Global Reporting Initiative’s G4 Guidelines and the International Integrated Reporting Council’s Integrated Reporting Framework now released, and with further developments such as the Sustainability Accounting Standards Board’s non-financial accounting standards, this area of reporting is evolving rapidly. Understanding these areas can be key to gaining a competitive advantage and staying abreast of potential new developments.

4) Act now to control the information about your performance. Investors are finding ways to get data— and they are assessing you on it.

5) Ensure board-level oversight and governance. The majority of investors said that they think a company’s non-financial performance should have audit committee oversight and should be verified.

For a full copy of the study – Tomorrow’s investment rules: Global survey of institutional investors on non-financial performance – visit ey.com/ccass.

RECOMMENDATIONS
From the findings of our investor survey, we recommend that companies consider the following actions:

1) Invest in reporting. Companies can ensure financial stakeholders have greater confidence by providing more information on ESG performance. There is value to be gained from greater transparency.

2) Report on – and highlight – what’s truly material to your business. Investors just can’t tell whether most of the information currently available is important to longer-term value creation. Learning what key stakeholders believe is fundamental to your company’s sustainable business development will be critical in determining what to measure, manage and report.

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1 The GRI Sustainability Reporting Guidelines (the Guidelines) offer Reporting Principles, Standard Disclosures and an Implementation Manual for the preparation of sustainability reports by organizations, regardless of their size, sector or location.

**Figure 2: How frequently do you take non-financial information into account in the following stages of your investment decision-making?**

<table>
<thead>
<tr>
<th>Stage</th>
<th>Frequently</th>
<th>Occasionally</th>
<th>Seldom</th>
<th>Never</th>
</tr>
</thead>
<tbody>
<tr>
<td>When examining industry dynamics and regulation</td>
<td>52.8%</td>
<td>35.2%</td>
<td>8.5%</td>
<td>3.5%</td>
</tr>
<tr>
<td>When examining risk and time frame</td>
<td>49.0%</td>
<td>37.8%</td>
<td>11.2%</td>
<td>2.1%</td>
</tr>
<tr>
<td>When adjusting time frame to account for risk</td>
<td>45.1%</td>
<td>32.4%</td>
<td>15.5%</td>
<td>7.0%</td>
</tr>
<tr>
<td>When making asset allocation and diversification decisions</td>
<td>30.2%</td>
<td>32.4%</td>
<td>24.5%</td>
<td>12.9%</td>
</tr>
<tr>
<td>When reviewing investment results</td>
<td>29.8%</td>
<td>41.8%</td>
<td>19.1%</td>
<td>9.2%</td>
</tr>
</tbody>
</table>

Source: Tomorrow’s investment rules: Global survey of institutional investors on non-financial performance

Values may not total 100% due to rounding.
The International Organization of Securities Commissions (IOSCO) brings together the world’s securities regulators and develops, implements and promotes adherence to internationally recognized standards for securities regulation. David Wright, IOSCO's Secretary General, explains why it is focusing on promoting the global convergence of securities regulation.
“There is a view that we’re going to need more discipline at a global level to ensure convergence happens”

Do we understand all the interconnectivity between these complex markets? I’m not sure we do.

Take India, for example: regulators there understand really well how capital flows between the different parts of the economy. As a result, many emerging economies have come to the table at the G20 and elsewhere in great shape, trailing none of the baggage of regulatory and supervisory failures that we’ve witnessed in Western capital markets.

Of course, at IOSCO we remain committed to convergence of market standards, but that isn’t straightforward. On the one hand, if we’re converting toward a market-based model, that will help convergence. But on the other hand, none of these global standards are mandatory or required by international law. As I often say, we only have peer pressure and monitoring and transparency.

But if, instead of just 3 or 4 major capital markets, you have 20 – which we will have in 20 years – it will matter very much how the standards are applied. Certainly, there is a view that we’re going to need more discipline at a global level to ensure convergence happens and dangerous regulatory arbitrage does not. Because if it’s everybody for themselves, and some countries apply parts of a standard but ignore others, then you risk fragmentation into a 20 x 20 matrix of interpretations.

So we are now focusing on strengthening the global convergence toolbox, and in 2013 IOSCO set up a new committee – the Task Force on Cross-Border Regulation – to look at the tools that we need to develop on the convergence agenda.

We all have to recognize that there is a big global good out there that can only be served if everyone is prepared to cooperate and trust each other. They’re more likely to do that if there’s a corpus of law they can sign up to. In the end, we’ll be driven there when people realize that cooperation has huge benefits, whereas going it alone will only lead to fragmentation.

Good securities regulation is vital if securities markets are to promote growth and development. In the broadest sense, such securities regulation encompasses accounting standards and disclosure requirements for issuers; listing requirements for exchanges; takeover rules; capital, liquidity and client money regulations for intermediaries; fiduciary standards for investment managers and custodians; and conduct rules for all market participants.

If these rules work well, the securities market will attract both issuers and investors. The market will price instruments fairly and accurately and provide liquidity to investors so that they can readily sell their holdings without depressing the price.

Ideally, each securities market would come up to these norms and, ideally, there would be a single set of rules that was valid across all markets so that issuers, investors and intermediaries could concentrate on the merits of the investment rather than on the fine print of the rules.

We are far from this ideal state. Many securities markets require improvement. But what model should jurisdictions implement? Developed markets diverge from one another. Waiting for developed markets to converge can be a long process – as the case of international accounting standards amply demonstrates. Emerging markets should therefore focus on ensuring that their securities markets converge to good practice. They should not let perfection – a uniform global standard based on best practice – become the enemy of the good, namely a good domestic securities market.

That lesson applies in developed markets as well. If each jurisdiction takes the view that its system is the best system, and that the rest of the world should accordingly converge to its system, little, if any, convergence will actually occur.

Indeed, markets may fragment, or even contract, if a major jurisdiction attempts to force others to adopt its version of perfection by applying its standards extraterritorially. Perhaps authorities need to remember that convergence is not the primary objective of securities regulation. Good markets are, and they can come in more than one variety.

Viewpoint

Convergence: is perfection the enemy of the good?
Dr. Thomas Huertas, Financial Services Risk, EY

“Convergence is not the primary objective of securities regulation. Good markets are”

Good securities regulation is vital if securities markets are to promote growth and development. In the broadest sense, such securities regulation encompasses accounting standards and disclosure requirements for issuers; listing requirements for exchanges; takeover rules; capital, liquidity and client money regulations for intermediaries; fiduciary standards for investment managers and custodians; and conduct rules for all market participants.

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A recent EY survey suggests that internal audit teams are lacking critical skills, particularly those relating to IT risks and data analytics.

In 2013, EY commissioned Forbes Insights to conduct a global survey focused on Internal Audit’s shifting mandate within the organization. One thing that became clear is that, far from its traditional compliance roots, Internal Audit is increasingly being asked not only to provide operational business insights to the organization, but also to serve as strategic advisors - helping the organization to address today’s key business risks and prepare for critical emerging risks.

The poll

What are the top emerging risks that your organization is tracking or monitoring?

- Economic stability: 53.80%
- Cyber security: 51.66%
- Major shift in technology: 48.15%
- Strategic transactions in global locations (e.g., M&A, divestitures): 43.66%
- Regulations around data privacy: 38.79%
- Risks in third-world countries or emerging markets: 36.26%
- Customer preferences: 35.09%
- Competitor innovation: 31.97%
- Social media: 22.42%
- Climate change and sustainability: 16.18%
- Sovereign risk: 14.81%

Technology risks

Although respondents ranked cyber security, major shifts in technology and regulations around data privacy among their top five emerging risks, only 26% say they are heavily involved in addressing information technology (IT) risks.

The rapid evolution of technology is creating a number of risks as it raises the potential to change the business landscape completely across entire industries. These changes are creating both internal and external challenges: organizations must be prepared to leverage new technology aggressively to remain competitive, while at the same time effectively managing the related risks.

One way to provide broader coverage of risks is through the use of data analytics. But the survey found that:

- 12% of Internal Audit functions use data analytics throughout the entire audit cycle.
- 47% use analytics mainly for testing.
- 66% of those who do use analytics use them for fewer than 30% of their audits.

When respondents to the survey were asked to identify the skills and competencies their internal auditors should have, data analytics ranked sixth; but it topped the list of skills or knowledge internal auditors were lacking. So it's no surprise that specialized IT skill is the most common area where respondents use third-party service providers for internal audit purposes, with almost 43% doing so.

The report concludes that competency in data analytics is critical to Internal Audit's success as strategic advisors to the business. To provide the value the business demands, Internal Audit functions need to work quickly to close this and other competency gaps.

For a copy of the full report, please go to ey.com/iasurvey2013.
Risk: looking beyond the obvious

EY’s Christian Mouillon examines the progress of risk management practices over the last decade, and suggests that executives and boards should broaden their consideration of seemingly unlikely events.

In hindsight, a systemic failure on the scale of the financial crisis of 2008 points to a collective failure to expect the unexpected. As a result, allowing for the improbable is now much more strongly embedded in the practices of risk management and corporate planning.

The interesting question is: why did it take a financial crisis to widen our perspective with regard to risk? We had already witnessed the accounting scandals of Enron and WorldCom. The consequent focus on greater regulation, internal controls and increased reporting through the 2002 Sarbanes-Oxley Act and the global variations on it were enacted a full five years before the crisis hit.

The paradox is that increasing transparency and controls will not deter a crisis when the source of risk is unrecognized.

Nevertheless, the corporate world was taken by surprise, perhaps because its attention was focused on the 80% of events with the highest probability of occurrence. The outlying possibilities – the events in the peripheral area of vision, the tail of distribution – failed to register.

The notion that liquidity would dry up was in that peripheral area. In particular, the assumption on credit turned out to be wrong: the credit risk in fact...
lay with the banks, not with the asset management portfolios. It was an external risk that capital market participants collectively failed to consider. In the case of sub-prime lending, widely regarded as the trigger for financial collapse, few people understood it properly, or understood that the securitization of debt actually amplified and returned risk to the financial institutions involved: they thought the financial risk was spread. Commentators have long contributed to diagnosing the cause of this myopia. With hindsight, we can see a systemic failure of effective controls.

Some legislators ask how regulators, boards and related governance systems, rating agencies, and auditors in their oversight role, all failed to see the possibility of such disaster. The answer is largely that the scenario was outside everybody’s field of vision.

Today, markets are more volatile – and corporate reputation is significantly more fragile. Companies now recognize that, almost overnight, a single incident or action can destroy years of hard work and of investment in building performance.

**COMPLEX ISSUES, COMPLEX RISKS**

So how has the corporate world reacted? How have the lessons from the financial crisis been incorporated into a broader field of vision and better risk management?

We are operating in an increasingly complicated business environment, not least because of the globalization of competition and supply chains, and, of course, rapid technological developments. This complexity requires independent directors, stakeholders and auditors to apply greater scrutiny and exercise professional skepticism. The more complex the business, the more important it is for those charged with oversight to challenge management in order to understand risk.

As auditors, the most complex issue we are facing is valuation of assets, and we need to visualize what might happen if parameters change. Yet, in an environment of extreme economic volatility, predicting the macroeconomic conditions that will prevail in 10 years’ time is almost impossible.

Consider the issue of nuclear decommissioning. The activity itself may be assumed to be many years in the future, hence assumptions as to how the work will be done, or what the regulatory requirements at the time of decommissioning will be, mean that today’s estimate of costs will be uncertain. Equally, recent Japanese and German experience shows that other events may bring forward the decommissioning work, and the basis on which the valuation was made may be found wanting. In practice, a great deal of sensitivity analysis is needed for multiple scenarios in order to assess reasonably the potential cost.

Good management accepts challenging questions and audit as a constructive contribution to its business, and investors want auditors to ask searching questions. They are realists – while they know that it is impossible to hedge against each and every eventuality, they expect a greater awareness of a wider range of risks, and clarity on the provisions and actions that management is taking. Technology provides part of the means to achieve this. Investment in powerful analytics tools enables unprecedented levels of audit sampling, and increased sampling reveals patterns and trends, as well as facilitating better assessment of future failures through predictive analysis. A whole range of parameters can be fed into the programs and the outcomes of a wider variety of scenarios can be considered.

There is another valuable benefit for businesses that adopt the practices and tools needed to create strong enterprise risk management. It’s important to ensure that enterprise risk management is embedded in the business, not seen purely as the domain of a technical and compliance function. Business managers have to understand risk probabilities and impacts. They must own risk, because they own performance: the two elements are interdependent. A risk management function needs to oversee that the processes and judgments are effective.
THE CHALLENGE OF GLOBAL COMPLIANCE
In addition to a reassessment of the centrality of risk, the proportion of management time spent on compliance has multiplied during the last decade. The great paradox is that we have a globalized business world and yet increased national regulation. This means that compliance poses a considerable challenge for organizations that are, for the most part, globally interconnected. The cost to companies of complying with each set of national regulations is extremely high, especially if those regulations contradict each other. For example, when management and auditors report on internal controls, the assurance levels may also not be comparable, whether you are incorporated in the US or somewhere else in the world.

Many observe that significantly more demands are placed on the private sector than are imposed on the public sector in the areas of governance, reporting and transparency. I would argue that the greatest long-term risk sits with sovereign states, rather than within corporations; firstly with regard to their financial viability, and secondly with the level of long-term uncertainty over their political actions. We have only to look at the US Government’s attempts to deal with the debt ceiling: the announcement that there will be tapering of quantitative easing caused immediate volatility in emerging markets, and now in the more mature economies.

Would it be possible to overcome some of these risks if sovereign governments were required to report in the same way as corporations? EY has long argued for improved public accounting. I do not envy the politicians when they have to make decisions on barely reliable data, or investors when they have to invest in sovereign bonds and assess the credit risk. However, I do sometimes ask myself whether, if we applied a corporate approach to the management of sovereign states, all participants in global markets would be better served in the long term.

Will companies and governments face another shock on the scale of the financial crisis in our lifetimes? We cannot be sure, but the likelihood is that volatility will increase. As auditors, we must continually challenge assumptions and uncover what lies beyond our current field of vision.

It is natural to permit the probable to dominate our outlook and strategy. Risk management today, however, must seriously consider the less obvious scenarios. The financial crisis has taught us that the least probable eventualities might be the most damaging. We should use our expertise, as well as the technology available to us, to look for what is out of focus and then give it definition.

“Would it be possible to overcome some of these risks if sovereign governments were required to report in the same way as corporations?”

Profile: Christian Mouillon
Global Managing Partner – Risk Management
Christian Mouillon oversees the strategy and execution for all of EY’s risk management activities, including independence, ethics and compliance. He joined EY in 1978 and has held a number of leadership roles. He has led EY’s Global Financial Services and Global Assurance and Advisory Business Services in France. In 2003, he became the first Quality & Risk Management Leader of the former Continental Western Europe Area. In 2004, he was named Global Vice-Chair of Assurance and Advisory services and in 2007 he was appointed Deputy Managing Partner and Markets leader for EMEIA. From 2009 to 2013, he was Global Vice Chair, Assurance, and was then appointed to his present role.
GREATER TRANSPARENCY

Companies need to focus on genuine communication rather than simply meeting the demands of regulatory disclosure. They need to help shareholders to understand the business better, whether that means the key decisions taken during the year or the performance of the company in specific strategic areas.

Too often, when there’s a topic that boards aren’t comfortable communicating, they revert to “filing language” mode, using stock phrases rather than company-specific language. This makes shareholders suspicious that something is being hidden. It would be more productive, and create more trust on behalf of shareholders, if boards were seen as forthcoming.

THE ROLE OF THE CORPORATE SECRETARY

I’d like to see better-resourced corporate secretarial departments that are structured to provide independent counsel and insights to the board members, and to be the communication channel between long-term shareholders and the board. The investor relations function tends to put more focus on communicating to financial analysts and the investment banking community. These are important constituents from a company’s perspective. But there needs to be a
mechanism for regular, inward communication of the views of the long-term shareholders.

The corporate secretary or governance professional in a company can play a central role in building those relationships with the stable shareholder base, soliciting feedback and ensuring the board and senior management are alert to shareholder concerns and emerging governance trends at an early stage.

**PUT PAY INTO CONTEXT**

I wish there was less focus on pay in the governance conversation and that it was discussed in more sophisticated terms. Shareholders should ask: “Is pay linked to strategy and performance? Is there a thoughtful and consistent approach over time?”

It’s seldom the case that poor pay practices destroy shareholder value. Rather, such practices are usually a symptom of a weak board, or one that’s not paying attention, and in these cases pay is one of many governance lapses that might result in behaviors that destroy shareholder value. Shareholders and others need to look at executive pay in the context of long-term performance, and the relevant measures of that. Otherwise, the discussion becomes very subjective.

**MODERNIZE THE VOTING PROCESS**

I’d like there to be a more informed and less noisy discussion about proxy advisory firms. Practitioners have to accept that they’re part of the governance landscape. Yes, sometimes they come out with recommendations that a company doesn’t agree with, but ultimately it’s for the clients of the proxy advisors to determine how to vote.

If companies really want to focus on an issue in the proxy voting chain, they should be looking at how complicated, and in parts antiquated, it is. Companies and shareholders should work with their agents and regulators to encourage investment in processes that would simplify and modernize the system. As share registers become more international, it is important that all of the investors eligible to vote are able to get their instructions submitted accurately and relatively easily. The more readily thoughtful investors can participate in shareholder meetings, the lesser the influence of the proxy advisors followed by unthinking investors.

**CONTROL YOUR MESSAGE**

We hear a lot of criticism that the market is too short-term. But companies are in a position to counter short-term pressures by communicating their strategy and being explicit about the time frame over which it will be delivered. They can do a much better job of making sure that shareholders understand the metrics against which management should be measured.

If they don’t, it’s only natural that investors will choose their own metrics, which might result in management not getting credit for achieving the milestones they were targeting. Often, I hear a CEO or CFO say: “But no analyst asks about long-term drivers of our business on our quarterly calls.” Our response would be: “Why don’t you just say it?” Put the message out in front of the analyst community and make sure that when you’re answering the questions that analysts do ask, you tie it back to the company’s long-term goals.

**EMPHASIS ON ENGAGEMENT**

Historically, corporate governance in the US has been synonymous with proxy voting. Voting is important, but it’s one point on the spectrum of governance activities. Investors should have clearly articulated policies on engagement and be prepared to have more robust discussions on key governance matters outside proxy season. I think investors also need to engage in the policy debate, with regulators and others, to ensure the governance framework protects the long-term interests of investors. This is happening in some quarters but is not yet market practice.

**HARNESS THE INTERNET**

Filing requirements are pretty onerous. Fortunately, a number of companies are using websites to provide a more complete picture of their governance practices and how they support the business. For instance, it’s helpful to publish the charters of the various subcommittees of the board for shareholders wanting to understand their respective responsibilities. Similarly, information about some of a company’s environmental or social programs might not warrant inclusion in filing documents, but can still be of interest to investors and can be published on the website.

The best companies are thoughtful about what they’re putting in the public domain and how it helps the end user understand the company, its business and the quality of the management. But there’s a huge gap between what the best companies are doing and the companies that are not yet as sophisticated in their communications with shareholders and others with an interest in the company.
Technology research company

Gartner’s definition of “big data” in terms of the three Vs – volume, velocity and variety – has become well known. But this is a highly technical summary of the properties of big data.

One of the most important misperceptions about big data is that deploying such technologies is a challenge for organizations. In fact, storing large amounts of data is no longer a huge technical issue. The more relevant question should be: which data should we store? And why? At a high level, the answer to this is simple: actionable insights have business value, as they help you to run your business in a better way. These insights can be derived from analytics, which in turn means using data. Storing that data helps to gain the actionable insights, according to the context of your business process.

Therefore, business value should be the fourth V, as that is what big data needs to deliver. And, as with the other three Vs, this business value needs to be quantified before you embark on a project.

**ACTIONABLE INSIGHTS**

To generate business value, analytics has to align with key business functions. It needs to deliver actionable insights that address management objectives and enable better decision-making. In this context, “actionable” means that analytics outcomes directly support decision-making and lead to actions that are integrated into the organization’s business processes and culture.

As well as creating better predictive outcomes with relevant and traceable data, information analytics provides value in the form of actionable insights in three distinct areas:

**Growth:** analytics supports business growth strategy, research and development with relevant insights for innovation and sales.
**Improvement:** analytics increases financial and operational efficiency by providing insights that help in identifying the correct cost-reduction indicators.

**Protection:** analytics helps to protect your business by keeping your data under control and monitoring potential threats.

The type of analysis that can be carried out depends on the kind of data you have access to. Big data is not a single, enterprise-wide solution. For example, the analytics based on streaming data from environmental sensors is a totally different class to text analytics of survey responses. Both scenarios require different analytical approaches, different IT environments and tools, different skill sets, and even different attitudes to data privacy. And, of course, the value and quality of mass sensor data and human-generated data differ considerably.

It’s important to be aware that there is a big difference between data and information. (See graphic, below.) Data does not, in itself, have any value associated with it, apart from the cost of storing and maintaining it. However, once the data has been put in context and associated with additional attributes relevant to that context, the value of the enriched data grows. Data in different contexts will lead to different actionable insights, and therefore will have different values.

Here are some examples of the value of analytics in each of the three areas listed previously.

**GROWING YOUR BUSINESS BY BETTER UNDERSTANDING YOUR CUSTOMERS**

Over the past decade, the use of technology to track customer behaviors during the buying process in order to increase revenue and margin has grown significantly. Data modeling using information from a range of sources – loyalty cards, social media, online usage, transactions and even in-store cameras – has allowed companies to use complex analytical techniques to model customer behavior, and ultimately to influence the frequency, value and speed of purchase through improved targeting and pricing and adjustments to the client experience.

This is not a new phenomenon. Customer relationship management and direct marketing have been in existence for several decades,
with many of the techniques simply adapted for the online marketplace. The problem with this approach is that, for maximum efficiency, it relies on perfectly accurate information. However, the concept of a “perfect” data set is flawed, particularly where customer behavior is dynamic. It is possible to invest hugely in data cleansing in an effort to address this, but the rewards don’t justify this investment.

What has changed is the exploitation of big data. It is now possible to combine data from multiple sources to create data sets that are so large, complex and dynamic that traditional data processing has been superseded by analytics that rely on mathematical models that take data points to extrapolate, find patterns and model future outcomes. This overcomes the lack of a perfect data set.

In consumer markets, there are several well-known examples of industries using large amounts of data to good effect. For example:
- Just-in-time (JIT) pricing and schedule design, as used by airlines
- Customer loyalty cards
- Understanding consumers in rapid-growth markets
- Online advertising - selling access to individuals by their characteristics

IMPROVING YOUR BUSINESS BY REALIZING EFFICIENCY GAINS IN BUSINESS PROCESSES

Smart energy is one of the “megatrends” facing each of us every day. We all consume energy, and our consumption is measured and used to create bills at regular intervals.

The problem is that utility companies need to produce energy in sufficient quantities for all consumers, be it private individuals or businesses. To estimate the required capacity, utilities need to know as exactly as possible who is using what amount of energy, and when. This information allows them to make detailed plans for output. Currently, the need to optimize energy production is focused on peaks in energy consumption, usually mornings and evenings. During the rest of the day, the capacity needed is significantly lower.

Creating the capacity to produce enough energy for the peaks is one of the key factors that are driving energy costs ever higher, but this process can be significantly improved. Utilities around the world are planning, or indeed already rolling out, smart meters that are capable of capturing accurately the energy consumption of each consumer in terms of time and amount.

Typically, smart meters will collect data every 15 minutes. This creates huge data sets which, when analyzed properly, will provide exact energy consumption profiles for each consumer and region. This information fits Gartner’s definition of big data, due to the volume, variety and velocity of data creation.

So where is the business value of the information that is gathered? Once the utility has exact usage profiles of its consumers, it can either optimize the provided capacity or, by using different tariff models, motivate consumers to start using energy at different times of the day. This should result in a more balanced use of energy throughout the day and reduce the need to increase capacity during peak times.
INSIGHT: DATA ANALYTICS

PROTECTING YOUR BUSINESS BY ENABLING INTERNAL AUDIT

As global business processes become more and more complex, internal audit departments are starting to use more advanced analytics to deliver deeper and faster insights.

For example, a global automotive company was interested in improving the efficiency of its dealership audits through targeted risk identification. The internal audit team wanted to focus on-site dealership audits on those dealerships with the highest aggregated risk and cost-benefit of audit. So it defined behavioral indicators that would identify transaction abnormalities based on numerous dimensions, including local demographics, peer-group comparisons and product comparisons. It developed a predictive model based on hundreds of different variables using multiple dozens of terabytes of data. Information from historical audit results (pass or fail) was taken into consideration to enable the transactions to be scored.

This approach enabled the business to assess risk for 100% of all claims, as compared with a random sampling approach that would typically only cover 1% of the population. By doing this, the exception identification rates improved globally by a factor of three. As a side effect, new opportunities to deliver value to the business, by increasing the marketing effectiveness of incentive programs and by warranty cost reduction, were identified.

Such side effects are frequently observed, and can take two forms. Sometimes, a department gains value based on analytics carried out on data provided by another department; and sometimes, the actionable insights provided by the analytics have to be performed by others within an organization.

For example, in an automotive company, the after-sales department stores information about customer complaints regarding failing parts and problems they have experienced in their interactions with the garage. The cost of storing this data is allocated to the after-sales department.

The data is then taken by the market research team and combined with other data to determine what needs to be changed in specific car models in order to sell them to customers. Therefore, it is the market research team that generates the actionable insights from the data gathered by the after-sales team. Finally, the changes that have been identified then have to be incorporated by the engineering and manufacturing department in order to gain the value from the analytics.

QUANTIFYING THE VALUE

In virtually every organization, there is a long list of analytical problems and potential projects, most of them backed up by logical reasoning. Unfortunately, with limited resources, businesses have to prioritize analytics projects based on the value they create, and therefore that value has to be quantified. Quantifying the value is not necessarily a complex process but, as a minimum, it should include the identification of the correct KPIs and a clear view of the tangible and intangible returns expected.

This is crucial, because the information war has already started. From now on, business performance will depend to a great extent on an organization’s ability to gain access to the right information, and to exploit it to the maximum.

At a high level, analytics will help companies to:
- Move from a retroactive and intuitive decision-making process to one that is proactive and data-driven
- Build models that more closely predict future real-world scenarios and their related problems and opportunities
- Uncover hidden patterns and relationships in the firm’s data, more and more frequently in combination with external data

Once you understand the concept of business value in the context of big data, you can proceed in a series of steps:

1. Understand your business problem and address it in such a way that it becomes clear which insights need to be discovered through analytics.
2. Gain access to the information needed to tackle the problem. This demands an analysis of which data is most needed, what is already available and where any key gaps lie, along with an assessment of data quality and a sense of where missing data might be sourced.
3. Perform the analytics, using mathematical algorithms to help uncover patterns within the data. These findings need to be translated back to the business problem to help interpret the outcomes in the most useful context.
4. Act on the insights – even if they imply a major shift – by adapting processes and behaviors in order to capitalize fully on the transformative potential of analytics.

Finally, while doing this, don’t forget to balance the risks and opportunities of the analytics to be performed, as data privacy and data security are fast-rising concerns.

“From now on, business performance will depend on an organization’s ability to gain access to the right information, and to exploit it to the maximum”
Lucinda Bell has 23 years’ experience in communicating with stakeholders, most recently as Finance Director of real estate investment company British Land. Here she describes what she believes are the key lessons she has learned in the course of her career.
Keep it simple
Delivering a straightforward message to stakeholders can be a challenge, but later on you reap the benefits. Firms have a great deal of information that they have to distill internally. Having clarity over that information makes it so much easier to be consistent with your various stakeholders, and to understand fully the context within which they receive the information. In this, the reporting context is very important. When we talk about our business to investors, we make sure they are seeing the big picture.

Lucinda Bell is Group Finance Director of British Land, a post she has held for the past three years. Since joining the UK FTSE 100 real estate firm in 1991, she has held a series of roles, including Director of Tax & Financial Planning. She has worked with three chairmen and three chief executives in that time. Since 2011, Bell has overseen £4b of equity and debt financing activity at British Land.

Listen to your stakeholders
We have many stakeholders, and we need to find out what is on their minds and what they are responding to. There are a variety of ways to undertake this engagement. At British Land, we hold a series of workshops with a range of interested parties - lenders, investors, occupiers - and seek out their views about what we should be doing in corporate social responsibility (CSR), for example. One key investor said it was not only important that British Land led on CSR, but that it was using its own influence to share best practice to influence the market as a whole to improve CSR and corporate governance. We ask stakeholders what areas we should be talking about next, and that informs what we decide to do. Another useful mechanism is to undertake an investor audit, which gives feedback on what the shareholders want us to do.

Be consistent
Companies shouldn’t be afraid of repeating themselves in communicating a message. At British Land, we have a lot of overseas investors and we are conscious that for many of them, real estate is quite a specialist sector and they may only have thoughts about British Land every so often. One key aspect of consistency, therefore, is repetition: you are reminding people of what you said last time. Above all, you need to ensure that your message is getting across, and a degree of repetition within that is very useful.

Do what is right – not what is easy
I do think you have to do the right thing; that is why our values include integrity - and that is absolutely true in the reporting space as well. At British Land, we’ve ended the practice of quarterly reporting because it was the right thing to do, not because it was convenient. We are a real estate company with long time horizons, but we were producing full numbers every quarter. By moving to semi-annual reporting we have improved the quality of our communications to shareholders. We communicate when we have things to say, of course, but are not producing numbers every quarter. That’s been well received and has given us more time to run the business. All those good things are the right things to be doing.

Use the full range of communication techniques
We are increasingly extending our range of communication modes and have started putting a number of short videos up on the website, covering aspects from half- and end-of-year results to how we manage our debt - which is particularly important for a capital-intensive business such as ours. These videos are available for anyone to look at and help to keep our communication simple and consistent. I now receive a lot of videos - it’s a two-way street. We have already put up video statements from the head of retail and the head of office space, which is really encouraging.

However, one has to be very conscious that modern communications methods are different from traditional ones. Take Twitter: because things get retweeted and people express opinions, the heavily compliance-based communications mechanisms have had to adapt. A lot of communication now is outside of firms’ control.
India remains one of the top global destinations for foreign direct investment (FDI) because of its local labor costs, domestic market and availability of educated workers.

FDI projects across the globe declined by 16.4% in 2012, but India was the fourth-largest recipient of such investment in terms of projects started that year. There was a notable spike in investments from the Middle East (with a 123.3% year-on-year increase in project numbers from 2011 to 2012) and Southeast Asia – ramping up efforts to tap into an underlying potential that the US, Europe and Japan have long seen. Although in 2013 the number of jobs declined slightly on the previous year (due to a drop in industrial projects), India still accounts for 9.4% of jobs created by FDI worldwide.

According to Enabling the prospects: EY’s 2014 India attractiveness survey, technology, media and telecommunications (TMT) is the most attractive sector to investors, followed by industrial and business services. While TMT will remain the leading sector, investors expect retail, automotive, life sciences and consumer products to become more attractive in the next two years. The industrial sector is also likely to grow in importance over the same period. This is in line with the sentiment from survey respondents, which suggests that India will be among the three leading destinations for manufacturing by 2020.

PLANS FOR THE FUTURE
India features prominently in many of the respondents’ plans for the future. In the short term, we see investors consolidating their presence in India. This year will be decisive for new players as the election results come in and expectations are formed in terms of sustaining the pace of reform and regulation. More than half of international business leaders surveyed plan to enter or expand their existing operations in India over the next year, while the vast majority of those not planning to enter have no short-term or overseas expansion plans overall.

India also has a strong foothold in investors’ emerging market strategies, despite the recent slowdown in economic activity, according to the survey. Of the respondents who have an emerging markets strategy, nearly a fifth said that India accounts for more than 20% of their total capital allocated for the developing world.

As well as the country’s strong fundamentals, foreign investors applaud its strong management and business education system and an improving telecommunications infrastructure.

However, the country does have some notable weaknesses. The supply of transportation, energy and logistics infrastructure is insufficient to support the 7%-8% growth expected in the future; corruption, delays in approval, and complex fiscal and legal obligations discourage foreign investors from establishing a base in India; and the country’s taxation policies remain complex, despite Government efforts to improve tax design and administration.

In order to realize its potential as an investment destination, India needs to improve in these areas, while other priorities that emerged from the survey included boosting production, easing FDI regulations and increasing awareness about emerging cities.

One significant step has been the introduction of the Companies Act 2013, which is expected to make it easier and more efficient to do business in India.
by instilling self-compliance, accountability and greater transparency. (See Viewpoint, right.)

**NEW OPPORTUNITIES**

Nevertheless, as already mentioned, India’s fundamentals continue to be strong. By 2015, the Indian economy is expected to be worth US$2.4t (INR129t) and the country’s population is set to reach 1.3 billion. This will lead to huge growth opportunities for foreign investors, who will be able to tap into the domestic market and position India as their regional export hub. Moreover, the EY research shows that global investors are starting to recognize the Government’s efforts in manufacturing, with the vast majority expecting India to be a leading manufacturing hub by 2020.

New opportunities are emerging across the country at all income levels. Recent years have seen increasing consumer spending in rural areas, a rising number of Indian millionaires, the empowerment of female employees and the emergence of new tier-II and tier-III cities (the next level down from the main metropolitan centers) such as Ahmedabad, Jaipur and Chandigarh.

EY’s survey indicates that business leaders not already established in India have developed a “wait-and-watch” attitude toward investment there. However, taking into account the country’s changing dynamics, opportunities are emerging for investors to adopt a targeted, tailored strategy for successful entry into the Indian market—and, indeed, to ensure a sustainable future in the country.

To read *Enabling the prospects: EY’s 2014 India attractiveness survey*, go to emergingmarkets.ey.com.

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**Viewpoint**

Transparency and simplification

Sudhir Soni, Assurance Leader, EY India

The Companies Act 2013 represents a comprehensive change to the regulatory regime in India. There are five key areas where it will have a significant impact:

1. **Corporate governance.** An important change is the requirement to appoint independent directors; previously, they were only mandatory in listed companies. The act includes a stricter definition of independence and a code of conduct for independent directors that is quite onerous, and could potentially expose them to class action suits. As a result, I would expect board processes to become much more strict. In particular, there is a significant emphasis on the evaluation and approval of related party transactions.

2. **Financial reporting.** Among other things, the act requires that companies prepare consolidated financial statements. It also proposes the creation of a new regulator, the National Financial Reporting Authority, which will increase oversight of the accounting and auditing profession, and makes provisions for the introduction of IFRS. This was originally planned for 1 April 2011, but the launch was delayed. We now expect that IND AS, the IFRS-equivalent standards, will be rolled out in India in the next two to three years.

3. **CSR.** One provision that is receiving wide attention is the need for companies to spend 2% of their net profits on CSR. This is not mandatory, however. The law proposes that companies shall spend 2% on such activities; if a company is not able to do so, it must make a disclosure as to why not.

4. **Fraud.** The Government has set up a Serious Fraud Investigation Office with numerous powers, and the penalties for fraud have been significantly enhanced. The act also requires listed companies to implement a vigil mechanism to enable employees and directors to raise concerns.

5. **Mergers, amalgamations and reorganizations.** The act makes it simpler to merge wholly owned subsidiaries into their parents, which has previously been a complex process, and allows for cross-border mergers, which were not previously provided for.

Overall, I believe the new Companies Act is a good thing. Many of the concerns foreign investors have about India relate to transparency and the complexities of procedures. So the simplification that the act introduces, the stricter penalties for fraud and the improvements to corporate governance should be positive signs for investors looking at India.
CFOs now have to ensure greater transparency and provide more robust information to both internal and external stakeholders. Closely aligning management information with financial statements is central to this. *Sarah Ryle* explains the benefits of this approach.
**Today’s CFOs find** themselves needing to ensure greater transparency than in the past, and to give stakeholders more robust information. In doing so, they need to consider increasing compliance trends, and this in turn increases the need to think more intensively about reporting structures and the company’s IT and controls environment. Transaction-based controls (checks made for each transaction or activity which are embedded in the IT structure and requested automatically by the system) will become more relevant than entity-level controls, and effective shared service centers will increasingly dominate fully decentralized management structures.

Furthermore, new reporting elements (such as integrated reporting and disclosure of non-financial KPIs) and industry-specific reporting requirements are becoming of increasing relevance. Against this backdrop, the benefits of aligning management information with financial statements are significant, despite the challenges and risks involved.

Historically, the annual financial statements are the most important communication that companies have with their shareholders and other third parties, and consume significant management time and attention. The statutory accounts in financial reports are heavily scrutinized, and unexpected elements can have a rough and immediate impact on share price. Banks and shareholders are increasingly demanding more regular updates from boards, and are specifically interested in the information that forms the basis of monthly internal management reports.

Consequently, the cross-validation of management reports and company accounts is accelerating in all sectors. This can throw up problems for the finance function, though, when the management information report and audited financial statements are produced using different systems and processes, and are often created by different teams.

**NO SURPRISES**

Pierrick Vaudour, a senior manager in EY’s Reporting Solutions cluster in Paris, says: “Banks want this information monthly. Management reports are typically used not only to record performance, but also as the basis for decisions concerning the future of the business. Accounts are statements of what has actually happened. Yet there must be no discrepancies.”

Harmonization is generally achieved by aligning the format of management reports with that of financial statements. The processes involved in collating the data in statutory reports are set by reporting and accounting standards.

Management reports, with their broader range of information to support decision-making, may not have the same absolute accuracy. For example, many industries rely heavily on predictive forecast data.

Bert Steens, a professor at the VU University Amsterdam in the Netherlands and a member of EY’s financial accounting advisory services team, suggests that “in management information, it is better to be approximately right than precisely wrong. I am always trying to balance the time you need to produce accurate information and the speed you need to make sure all stakeholders really feel they are involved and receive the right information on time. There is a trade-off, and this will always exist, because some information needs processing.”

Vaudour agrees. He also suggests that, while recognizing that the process of collecting statutory reporting data is more robust, harmonization can mean aligning the financial statement more closely with the management report, rather than the other way around, when GAAP allows it.

He gives an example: “I observed that a scrap metal company was presenting its financial statements in an industrial way and [running the firm] as a trading business. They did not match. We had to align the accounting view with the real management view. IFRS allows you to present the financial statements one way or another, according to the culture and processes of the firm.”

As a result, a better understanding of the performance of the business and its real value is possible. Vaudour adds: “A trading business is analyzed through the balance between the level of risk taken and the realized or not unrealized profitability, or the capacity to finance its position. An industrial business's performance is analyzed through realized sales, working capital management efficiency and value added to the product.”

**THE IMPORTANCE OF CONNECTION**

However the financial statements are structured, the key is to connect. Vaudour explains: “Management reports always include profit and loss figures for the period; a typical issue is that these do not match the final [year-end] figure. Closely linking the management report to the accounting process can address this.

“When you share information, it is a way to decentralize decision-making and encourage an entrepreneurial culture based on the whole picture”

Pierrick Vaudour, EY
Vaudour continues: “Consider a company that is focused on selling, as the bonuses of the management are essentially based on sales. The management report, calculated with a standard margin, will not look at the costs in a focused way. At the end of the year, the financial statements show the margin has reduced because the market has been more difficult than the company predicted. The bottom line is a disaster, while the sales are going up. This de-correlation has to be identified more quickly. The best way to address this issue is to run an optimized accounting process on margin to feed the management reporting.

“Another issue is that working capital is linked to the balance sheet,” he adds. “With the availability of cash increasingly important, working capital has become very significant to banks and stakeholders. Cash flow generation is even more important than the sales and margin to some stakeholders. In a crisis environment, identifying whether clients are paying their bills and are not at risk of bankruptcy can be essential. Up until recently, firms were focused on P&L in their management reports and have not provided [secured data] on working capital.”

Linking the management information and financial statements can help a company when it needs shareholders to understand financial performance in the context of market conditions. Steens observes that companies are now questioning the value of detailed annual budgets, which can be overtaken by external events, in favor of regularly reviewed and updated – or rolling – forecasts, which can be adapted to take variables into consideration.

“Rolling forecasts have the ability to include the most recent insights,” he says. “Maybe your business performed better than it was forecasted to because there was a macroeconomic factor that made life easy. You could not say the management had performed very well if they had surfed on the waves of the economy.

“The opposite could also be true,” he adds. “Managers could be working very well in a challenging time frame, but didn’t make the target.”

THE RISKS
Aligning the two types of reporting is an expensive process and carries operational risk. Transforming financial systems is complex, and requires significant resources to ensure process redesign, effective data migration, continuous system accessibility, and consistency of reporting with past financial statements.

Providing internal management information to stakeholders without the same level of rigorous checking that accompanies statutory accounts can introduce new reputational risk if forecasts and performance indicators need to be adjusted after they have been published.

There are also commercial risks in providing competitors with business insight if sensitive management information is in the public domain. Steens observes: “Information can reflect strategies meant to differentiate yourself from the competition and, if that is shared, your competitive advantage could easily be jeopardized.”

Patrick Zurstrassen, Chairman of the European Confederation of Directors’ Associations and an independent director sitting on nine boards, feels there is also a principle to be safeguarded. “Privacy is indispensable to a normal, sound debate and to decision-making. Nevertheless, it is important to improve information for shareholders, and to go beyond statutory reporting.”

In the current financial and economic environment, lenders and investors are demanding more information from corporates who need cash. The reality is that many corporates will need to share more management information with third parties – although it may be possible to negotiate with banks, for example, on the KPIs to include.

Steens makes the case for being overprepared. “The information-gathering process should be a daily routine,” he suggests. “It is difficult to predict when decisions will be required, so you must make sure the standard set of information is available all the time. That includes information about
competitors’ market share, strategic initiatives in that market, developments regarding customers, and new technologies. We are talking, to a certain extent, about non-standardized information for which a standardized process should be in place to make it available.”

Vaudour agrees. “It is a long process to harmonize and it takes time. But you don’t have time when you need a loan: you usually need the money in a hurry. So there is a real advantage to doing this work now.”

Despite the cost of harmonizing reporting systems and the work involved in preparing 12 external statements each year, there are additional arguments for alignment. “Companies should see this as an opportunity to revamp their culture as well as their processes,” Vaudour continues. “When you share information, it is a way to decentralize decision-making and encourage an entrepreneurial culture based on the whole picture.”

There may be another welcome outcome: companies could find that the annual burst of activity and pressure around year-end changes as a result of harmonizing management reports with financial statements. The very rhythm of reporting could be altered forever.

Case study: Compagnie du Ponant

French luxury cruise operator Compagnie du Ponant carried 20,000 passengers on five-star cruises and expeditions to destinations across six continents in 2013, with a turnover of €85m.

Compagnie du Ponant’s CFO, Alexis Blavette, outlines the impact of aligning management information with financial statements:

“We have embarked upon a significant program to align management reporting and monthly financials. We have done this in order to put the whole P&L under better control and to enable monthly drill-down of financials.

“The main benefit is that we avoid year-end surprises. Management analysis is now in line with financials month after month: management financials and KPIs, consolidated for the whole year, make up the financial statements at year-end with only minor adjustments.

“We are able to define the owner of each P&L line, which is a guarantee of a fully controlled business. There is coherence between monthly management KPIs and financials, enabling in-depth analysis of deviations from the budget of a specific P&L line by a single manager. The alignment also improves our budget planning, as earlier management KPIs can be used as drivers in a business plan model that correctly fits financials.

“We have done this by producing management information at least monthly, in the form of KPIs that combine financials and business data. Manual reconciliations with company financial statements are still possible on an annual basis; however, monthly reconciliation is no longer practicable. This means connecting the business software with the financial software, redefining KPIs so they are coherent with group accounting rules and shared metrics, and modifying business processes to provide the most correct information, such as cutoff.

“As well as the technical transformation, we need to manage change with senior management and their teams. We face many challenges in assigning all P&L lines to owners: we have to avoid one manager having an impact on his colleagues’ lines. This means a slight redesign of the P&L or the secondary reports.

“Our alignment program has required software upgrades, new IT interfaces, a complete process redesign and the redefinition of KPIs. We have invested in IT and consultants - as well as investing a great deal of our own time - in order to manage change within our departments. I am sure, however, that it is worth it.”
The buy side

Online opportunities

THE ASIAN TECHNOLOGY SECTOR IS BOOMING, BUT INVESTORS STILL NEED TO LOOK BEFORE THEY LEAP. MICHAEL OH OF MATTHEWS ASIA AND BEN ROGOFF OF POLAR CAPITAL, WHO BOTH SPECIALIZE IN INVESTMENTS IN THIS SECTOR, DISCUSS WHAT THEY LOOK FOR IN ASIAN TECH COMPANIES

Michael Oh (MO): What really gets me excited regarding Asia’s technology sector are the services industries – especially internet-related companies. With the rising adoption of smartphones and tablets, more and more consumers in Asia are going online, expanding the market for internet services. China already has the largest number of internet users in the world, and recently also became the largest market for smartphones.

We are quite positive on Chinese internet companies overall. The sector tends to be very volatile, but I believe the long-term growth opportunities are still great. Unlike in developed cities in China, the offline infrastructure is not yet very developed in the country’s second- and third-tier cities, and this provides great growth opportunities for Chinese online companies. For example, if you want to buy electronics, it’s very hard to find a good physical store with a selection of products in these smaller cities. But now, with online e-commerce companies, consumers living in such cities are getting unprecedented access to a vast selection of electronic goods.

Ben Rogoff (BR): At Polar Capital, most of our Asian internet investments – which are among our most profitable and highest-growth holdings – appeal primarily to a domestic audience, given language barriers. But, like Michael, we focus away from the “box makers” – those companies that manufacture low-margin product, either for themselves or for other brands.

We also tend to avoid actively investing in early-stage or “blue sky” companies and technologies, as we believe the timeline to mainstream adoption is often greater than investors expect. This, together with a much higher than expected failure rate, often results in equity markets mispricing early-stage companies. That said, we are excited about 3D printing and mobile payments.

We’re quite selective about which companies we invest in in China, given the apparent disconnect between economic growth and financial return to shareholders there. We also remain a little apprehensive about the variable interest entity (VIE) structure1 that overseas investors need to embrace in order to invest in a number of the leading Chinese internet companies.

MAKING A DECISION

MO: When deciding whether to invest in a company, in Asia or anywhere else, you need to visit a business’s headquarters and factories and meet with their clients and suppliers.

Having said that, reviewing audited financial information closely can also lead you to detect some red flags. We have seen some cases where, by carefully dissecting audited financials,
specifically in areas such as related-party transactions and financials related to M&A transactions, potential losses have been avoided.

**BR:** I agree. Audited financial information is obviously critical in helping us make investment decisions, but it remains only one of many inputs that we use. Naturally, we tend to focus on cash flow (particularly for recurring revenue businesses), margins (as a proxy for quality, and for how management perceive shareholders in the “pecking order”) and balance sheet integrity (providing us with a backstop should our investment decision prove incorrect).

**MO:** What I try to focus on is a company’s long-term potential. How will it evolve in three to five years? When you think in those terms, then looking at next quarter’s financial forecast becomes less relevant and you can focus more on the company’s fundamentals, such as the business model and other industry dynamics. We also try to evaluate the quality of the management. We examine their past corporate actions and assess how well they have treated minority shareholders. In general, corporate governance in Asia has improved a lot in recent years, but we would still like to see more improvements.

**BR:** One thing that we have found in this sector is that sell-side research has typically proved to be too conservative when attempting to assess the impact of new technologies as and when they reach the “inflection point.”

As such, we tend to favor our own assumptions at that point. We look at the addressable market, penetration rates and likely growth trajectory. Likewise, at the company level we will typically use annual reports and other regulatory filings, broker and third-party research in order to build up a quantitative picture of a potential investment quickly.

**MO:** Understanding the history of a company’s founders and senior management certainly helps a lot – how the company got to where it is now, as well as what its management has accomplished.

When you meet senior management in Asia, you can often tell a lot by observing how they behave during the meeting. Speaking local languages helps a lot, especially in Korea, Japan and China, since they tend to feel more at ease in their native language. Matthews Asia has an investment team with a diverse background, and many of us have lived and worked in Asia. That helps in uncovering new opportunities in the region.

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1 The VIE is a structure in which a non-Chinese company, through contractual or services arrangements, has control over a Chinese operating company that holds the necessary licenses to operate in a “restricted sector,” such as media or telecommunications.
The digital difference

The growth of digital communications is changing the way in which companies communicate their financial and business performance to stakeholders. Rose Jacobs investigates.

When Legal & General (L&G) first started experimenting with online reporting in 2007, it was with the idea of reader choice in mind. The first step was a small one: the UK-based financial services group asked investors whether they wanted the traditional printed annual report sent by post, or whether they were happy to view an electronic version. “There were a limited number of requests for the paper version,” explains John Godfrey, L&G’s Director of Corporate Communications. “Economically, giving investors the option of an online report was a sensible thing to do.”

Since then, the choices have become more varied. L&G investors now decide whether they want to read the report on their desktop computer, their tablet or even their smartphone, and they choose whether to download the whole publication or “curate” the experience - selecting, say, the headline numbers and remuneration report, but leaving aside the divisional reporting and accounting notes.

The company has also experimented with other tools - such as charts the user can manipulate and video interviews with executives - in an attempt to meet a range of needs, without confusing investors. “Some tools were user-friendly, and we embraced those,” Godfrey says. “Others were gimmicky and we weren’t sure how much value they added.”

Recent years have seen corporate reporting embracing a range of information technologies across geographies and sectors. This is driven in part by investors increasingly accustomed to getting their information from online tools and apps that are intuitive, modern and crafted with the end user in mind. “No one starts their search for corporate information in a library any more,” says James McCobb, Head of Digital at the consultancy Fishburn. “More and more, they start on the iPad in the morning, maybe read more on their phone while waiting for the train, then move on to the tools at the office. And people expect to move seamlessly across technologies during the day.”

Moreover, the financial services industry - including analysts and institutional investors - appears to be adopting mobile devices for the workplace more quickly than any other. It is even ahead of the high-tech sector, according to a 2012 report from Good Technology.

Communications Strategy

A growing number of companies see the new channels as a way to rethink their corporate communications strategy more fundamentally. The advantage of stakeholders accessing reports and other information online is that their interest - or lack of it - is measurable. Clicks provide affirmation that a piece of information is sought after; the route by which they arrive gives a sense of how reports are navigated; and time spent looking at a chart or piece of text demonstrates its usefulness.

This is changing the way in which annual reports are generated. This year, Godfrey explains, L&G is preparing the print and online versions of the report side by side rather than consecutively. “It’s partly about reporting, but it’s partly about your entire approach to corporate communications.”

This approach is, to some extent, being enabled by regulators open to change. In early 2013, the U.S. Securities and Exchange Commission ruled that companies could use social media, so long as investors were made aware that it would be using these channels to provide corporate information.
It said: “The Commission supports companies seeking new ways to communicate and engage with shareholders and the market.”

Meanwhile, in the UK, the Financial Reporting Council (FRC) is launching a project to investigate “the future of e-enabled reporting.”

“We still think of the annual report as a document that is printed – a one-off every year,” says Sue Harding, Director of the FRC’s Financial Reporting Lab, before asking: “Is there a better way?”

Some experts predict that a gulf will develop between, on the one hand, the static figures produced once a year and signed off by accountants and the board of directors, and, on the other, real-time figures updated regularly and available online or through an app. “We look forward to a full and frank exchange of views between companies and investors on all aspects of e-enabled reporting,” says Harding.

Social media is also popular with investors. A study for the US National Investor Relations Institute found that, even in 2011, more than half the buy-side institutional investors surveyed already used social media when researching companies, and nearly as many planned to use it more in the future.

Stephen Diamond, a law professor at Santa Clara University in California, points to incidents such as a sharp fall in US markets in April 2013, following a hoax tweet about an attack on the White House, as evidence that some traders and trading algorithms take social media very seriously indeed.

Should companies therefore be taking a more proactive approach to the medium? McCobb warns against being too hasty. “It’s easy to underestimate the hidden cost of running these channels,” he says, referring to the 24-7 nature of the internet.

Adlai Goldberg, who leads EY’s global social media analytics hub, agrees. “It’s a very different skillset, and people are now working on how to build the right levels of control,” he says. He points out that, up to now, companies have often taken a scattershot approach to managing these channels, with multiple systems and processes, often developed from scratch by individual departments.
“But people (outside a company) don’t distinguish whether a Twitter account is run by the consumer relations team or the investor relations team. They just see it as a line into the company,” he cautions. Managing reputational risk, not to mention regulatory risk, means unifying corporate social media policy.

DIGITAL TRENDS
Some early trends in online reporting – let alone social media – are already in retreat. Thomas Rosenmayr, Head of Sales & Marketing at Austrian company nexxar, which helps companies prepare online reports, says video, in the form of pre-recorded interviews and webinars, is much less popular now than four or five years ago, partly because of the cost involved. His advice to investor relations (IR) departments is to focus their resources on perfecting tools that have proved far more popular among users, such as search.

Indeed, says Goldberg, “each investor looks at their investment opportunities through lenses that are important to them – and that individual approach is only going to increase.” Companies’ responsibilities, then, lie in publishing information broadly, but also making it easy for investors to pull out what they see as essential.

In Asia, Jeannie Ong, Director of the Investor Relations Professionals Association (Singapore) – IRPAS for short – and Chief Marketing Officer of telecoms group StarHub, says that, while most companies provide online access to annual reports, “we are probably not as advanced in our use of [technologies such as interactive tools] as companies in Europe and the US.” A recent IRPAS survey found that 87% of IR officers at listed companies in Singapore either rarely or never used social media to engage investors, compared with 4% who said they did so frequently.

There are often good reasons for this approach. StarHub, for example, found that the hit rate on its interactive annual report was so poor that it removed the feature. Ong attributes this to the company’s investor register being dominated by institutional investors rather than retail investors.

She also points out that, in Asia, “social media is still regarded more as a personal and social communications platform,” whereas business communication tends to take place on more traditional platforms, such as email. Companies may well use Twitter and Facebook for consumer communications, but their IR teams are moving more slowly.

Regardless of geography, Godfrey argues that understanding users’ needs is essential – and something that online reporting enables. “We did track use of the documents quite closely,” he says of past online reports, “so we got to know what people were interested in and what they came back to.”

He adds that sustainability reports can also be used as a laboratory to test the direction that statutory reports might eventually take. “Without the regulatory pressure, you can be more innovative and take on a bit more risk,” he says.

CSR Europe, a network for corporate social reporting, includes in its assessment of online sustainability reporting best practices such as multichannel access, personalization and interactive dialogue through the creation of blogs and online communities. The group argues that “the future of CSR and sustainability reporting arguably lies in a shift from informing to communicating, engaging and learning” – and it is this pathway that financial reporting may eventually tread as well.

Ultimately, there is a sense that the audience is changing, from shareholders alone to a larger group of stakeholders. Many corporate sustainability reports already recognize this; the statutory reports will follow. The big question is how quickly and thoroughly corporate communications will be transformed, as companies seek to deliver their key messages using the latest technologies.
Dear readers,

I hope the first quarter of 2014 saw you and your businesses embracing some emerging optimism from economic forecasts and surveys of business sentiment worldwide. For many of us, now the annual reporting cycle has drawn to a close, our time is spent reflecting on the financial measurements of last year.

What we hope to do in Issue 7 of Reporting is to provide insights on the challenges of reporting corporate performance, covering topics that senior executives and boards should consider as they consider what changes their organizations will need to survive and thrive – not just for 2014 and 2015, but for the years beyond.

In this context, the requirement on all of us is to consider an ever-widening range of challenges and risks. Christian Mouillon’s article on risk on page 13 suggests that we should all look around corners for that which is not visible. My observation, from the leading companies and boards I meet with, is that balancing time between an effective response to short-term crisis and proper consideration of long-term change requires continued evaluation.

For all of us in global business, there are at least two resources that will make a big difference: the effective use of technology and the strategic focus on talent, not only for today, but for the next decade. Technology is a theme that runs through many of the articles in this edition, and throughout our business life.

We talk about the business value of data analytics on page 18. We can help with the navigation. If any of the issues in Reporting spark your interest, please get in touch with your EY contact and we will continue the discussion.

FELICE PERSICO
Felice Persico is the Global Vice Chair, Assurance

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