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Risky business
Why the personal risks for executives have increased

Common threads
How big data and analytics can transform the audit

Integrated reporting
What issues are companies encountering?
Dear readers,

Was life really that much simpler for auditors in the past? Not so long ago, it seems to me, the main qualities a good auditor needed were financial skills, sound judgment and a healthy dose of professional skepticism. While these attributes remain the cornerstone of the audit profession, we are now seeing rapid changes in the world of business, and the competencies required for a successful career in assurance are evolving too. At the forefront of this development is the growing importance of data analytics, as well as the traditional competencies in finance – and curriculums will have to adapt to take this on board.

For this generation, an understanding of data analysis, forensics and creative thinking will be vital additions to the fundamentals of accounting, risk management and familiarity with ever-changing auditing standards. And it doesn’t stop there. Data can tell a great deal of a company’s story, but it can’t tell everything. There’s an increasing demand for auditors to be aware of non-financial information and to examine any potential impact on the external environment and internal governance.

One example of this is the link between integrated reporting (IR) and its focus on six capitals: financial, manufactured, business, and the competencies required for a successful auditor back to looking holistically at the organization rather than focusing on financial information and numbers.

The new skillset does not just apply to the next generation of auditors – it’s also relevant to all current finance professionals, including those who provide services to clients. For more information about our organization, please visit ey.com.
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Casting the net wider

As the concept of integrated reporting gradually gains traction around the world, Tim Cooper looks at the issues companies are encountering and the implications for those involved in producing integrated reports.
There is an ongoing debate in the financial reporting world on how to provide useful information beyond financial statements, which follow long-developed principles and standards, and how, or even whether, to provide assurance on this additional information.

It is against this background that the world's biggest companies are increasingly adopting integrated reports, following several major developments in the area. Most recently, the International Integrated Reporting Council (IIRC) has announced plans to produce a syllabus on integrated reporting (IR) by the end of 2015. IIRC CEO Paul Druckman says this will help trainers build courses for reporters.

This follows the IIRC's introduction of an IR framework in December 2013. While the corporate community has welcomed the framework and syllabus, the increased take-up of IR is from a narrow base and, to date, only a small percentage of companies — mainly very large ones — have produced an integrated report. There is still much work to do to promote wider adoption.

**A FLEXIBLE FRAMEWORK**

The IIRC (which was created in 2010 to help coordinate and promote consistency among all relevant parties) defines an integrated report as “a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.”

Juan Costa Climent, EY's Global Leader for Climate Change and Sustainability Services, says increasing adoption of IR “is the outcome of a process that has to do with integrated thinking and with the fact that non-financial performance is becoming increasingly important. This is because how a company performs from an environmental or social perspective has an impact in terms of future financial performance.” This, in turn, leads to the need to integrate thinking about these factors, both internally and in external reporting.

Druckman reports that the momentum behind the framework has been greater than anticipated. “Around 130 Japanese businesses are currently practising IR,” he says. “In Europe, many corporates are moving forward with their first integrated report. South Africa has also endorsed the framework.”

He says reaction has been positive because the framework is flexible, not prescriptive. For example, it shows how to report around six categories of capital. But if an organization does not want to work with those six and would prefer to use a different framework, it can, provided it explains why and references the IIRC framework as its starting point.

However, there have been challenges to the framework in the areas of directors' liability, the assurance and credibility of information, and reporting fatigue.

Druckman explains that the framework guides directors to provide transparent, forward-looking information, but some fear litigation if that information proves to be incorrect. These fears are understandable but unfounded, he says.

“An integrated report could be perceived as a positive story and perhaps not representative of the complete strategy — so we need it to be credible,” he adds. “Also, some think, ‘Here's another report we have to produce.’ They miss the point that it isn't another report — it is the report. We are trying to evolve the whole system.”

However, he agrees that there is tension between the immediate requirements of stakeholders for more, and more detailed, information and the ability of companies to measure and report on different capitals consistently and effectively.

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**Case study: EnBW**

EnBW's project to create an integrated report took more than three years. The Germany-based energy company set up the project in 2011, and in 2012-13 published a report combining finance and sustainability information.

Christoph Dolderer, Head of Group Accounting at EnBW, says: “We did not call that an integrated report, because that involves more than just optimized external reporting — you also have to do your homework within the company.”

However, that report did present, for the first time, the company's strategic goals to 2020. Dolderer says stakeholders welcomed this. “Previously, corporate reports were more compliance-oriented. But with IR, the company can be more transparent and forward-looking. It can put the information it wants into the report, rather than just that required by local laws.”

EnBW will publish its first true integrated report this year. Dolderer says the project required a fundamental change in culture and governance. “In the past, our performance management system primarily considered financial objectives. We have transformed that into a more holistic system covering non-financial issues.”

Lothar Rieth, Group Expert Sustainability at EnBW, agrees that transforming previous practice and process was a huge challenge. “In 2011, we decided to get rid of the sustainability report,” he says. “That was not easy. But it was crucial, because we tested the importance and relevance of our non-financial information and decided that all material information should become part of the financial report.”
“The ever-growing data and transparency requirements from regulators and other stakeholders will not go away,” he says. “Companies will just have to cope with it. I hope IR can ensure that information is made transparent and put in context.”

WORKING TOGETHER
Brazilian bank Itaú Unibanco took part in the IIRC Pilot Programme and produced its first integrated report in February 2014. Caio Ibrahim David, the bank’s Senior Vice President and CFO, says: “Sustainability is key to our strategy and governance, and IR was a natural consequence. The report was produced by many areas of the bank working together: finance, sustainability and management.”

The group has seen a number of benefits already. “Stakeholder feedback has been positive, particularly in gaining long-term commitment from clients,” says David. “We have used it internally and externally to share our future strategy.”

He acknowledges that one challenge in creating an integrated report is to connect performance with medium- and long-term strategy. However, Itaú Unibanco’s governance structure helps achieve this. “We have a forum in which senior members from all areas contribute to long-term strategy,” he says. “It made that connection possible.”

The Generali Group, an international insurance group based in Italy, produced its first integrated report in 2013. Massimo Romano, Head of its Group Integrated Reporting and CFO Hub, says: “After the board asked us to better understand the new trends in financial and corporate reporting, I realized that just a few people read the annual report. That was a turning point for me to improve and evolve the professional and personal life of people in the organization. Instead of working until midnight reconciling documents, people are working together and sharing practices to deliver a better product, and then they can go home to their families.” He adds that the reaction to the new format, from analysts for example, was positive.

“Integrated thinking is powerful,” he continues. “It was fantastic, for example, working with our communications and investor relations team to combine the report – breaking silos to benefit both sides. However, that is not the final step in the journey, because integrated thinking requires a long-term change of organizational mindset, which is a big challenge. You need a measurable plan, and to deliver concrete results in the short term as well.”

So how does the audience for these reports view them? Steve Waygood, Chief Responsible Investment Officer at Aviva Investors, strongly supports the IR Framework. But he says that, of the 4,000 companies Aviva invests in, only a few dozen have a report that meets its standards.

Waygood lists the main obstacles to greater take-up of IR as complexity, lack of expertise, market
short-termism and resistance to change. “We have seen some improvement in disclosures — but as long as we rely on a voluntary approach, growth will be slow,” he adds. “We need company law to change, or we need stock exchanges to coordinate and change their listing rules to encourage IR. Demand needs to come from investors as well. Otherwise, you have a voluntary standard and a plethora of different approaches by different exchanges.”

Waygood is positive about other developments that encourage sustainable reporting, such as the Global Reporting Initiative and the Global Compact. Companies should start their sustainability reporting journey by referring to those, he says, adding that IR is the most advanced, state-of-the-art approach and, at this early stage, still an aspiration for most companies.

**A NEW APPROACH FOR AUDITORS**

The consensus is that IR has wide implications for the role of corporate reporters. According to Druckman, one challenge is demonstrating connectivity between all the capitals. Another is that finance professionals are used to handling data, but IR is not data-centric. That is a challenge for auditors too. The evolution to IR could also “take the auditor back to looking holistically at the organization, rather than specifically at compliance areas,” he says.

Some companies highlight that auditors do not yet have their own framework for working with IR. “Maybe, but IR represents how the business creates value — auditors have the skills to analyze that,” says Druckman. “We may need auditors with specialized skills in strategy and value creation, but not a new profession.”

Costa Climent of EY says another challenge for reporters is identifying what is relevant to value creation. “Sustainability reports include so much information, some of which is not relevant,” he says. He adds that, in order to make IR effective, companies need to focus their strategy on how tangible and intangible assets create financial and non-financial value, both inside and outside the organization. They also need to focus on value creation for society.

“When you create value for society, part of that becomes relevant to your future finances. It changes the concept of value. To report it requires a huge mindset change,” he says. “First movers are developing this new understanding about value creation. But most of those involved in the new corporate reporting agenda are not ready, nor do they fully grasp the challenges. We have to work together to define this agenda and develop new skills and methodologies.”

“The IIRC’s new syllabus is a good initiative,” he concludes. “But we have to continue working on innovation, because some of these challenges are new and we don’t have the answers yet.”

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**Case study: Westpac**

Australia-based banking group Westpac published its first integrated report in 2009. CFO Peter King says this early adoption recognized both the role that financial services companies play in the community and society, and the way Westpac thinks about long-term value creation.

“The value of the company comes from doing the right thing for a wide group of stakeholders,” he says. To facilitate this, sustainability and financial reporting were increasingly integrated to the point where the annual review and the sustainability report became one document.

While the formal annual report is over 300 pages long, the combined annual review and sustainability report is much more concise at just 28 pages. “A smaller document that all our stakeholders can read is a better way to communicate,” says King.

He adds that IR creates benefits both internally and externally. It has improved Westpac’s standing among stakeholders, who can see that it manages for the long term. It also improves perception among potential new recruits. “But the biggest developments have been in linking strategy with the day-to-day running of the company,” he says.

Siobhan Toohill, Westpac’s Head of Sustainability and Community, says this internal integration takes time to embed: “We achieved this by building sustainability objectives into departments; creating a sustainability council comprising managers from around the business; and giving them accountability for aspects of that strategy.”

Westpac’s earlier concise report could be described as a combined report, which has become increasingly integrated in linking financial and non-financial information and value. King says: “That will always be a criticism of IR, because modeling lots of intangibles into short-term financial outcomes is difficult. Many aspects in the intangible balance sheet are medium- to long-term issues. But there is research showing the correlations over time.”

Despite being at the forefront of IR, Westpac did not join the IIRC framework pilot. King says: “We adopted the elements that make sense for us, but some are not for us. For example, we steer clear of forward-looking statements.”

He adds that IR does not necessarily require reporting staff to upgrade skills, but rather requires a spirit of collaboration, as the reporting team comprises staff from finance, investor relations, sustainability and communications.
Comment

Raising the standard

Dan Montgomery, Deputy Chair of the IAASB from 2012 to 2014, explains why recent changes to auditing standards will help to maintain the value and relevance of the financial statement audit.

Last year was a particularly busy – and groundbreaking – one for the International Auditing and Assurance Standards Board (IAASB). The board released its Framework for Audit Quality in February, unanimously approved a suite of new and revised auditor reporting standards in September, and in December approved a significant revision to its international standard dealing with the auditor’s responsibilities for other information in an annual report. These accomplishments were particularly satisfying for me personally, having served as IAASB Deputy Chair from 2012 to 2014 and as leader of its Auditor Reporting Task Force.

The common underpinning for these projects was input from IAASB stakeholders – particularly investors, regulators and other users of financial statements – that more could be done to improve the quality of the financial statement audit and communications from auditors about the audit. The calls for change became particularly strong in the wake of the global financial crisis.

The most noteworthy of the many IAASB accomplishments in 2014 was the finalization of its high-profile priority project to enhance the auditor’s report. This represents the culmination of an intensive effort over the past six years that was informed by extensive research, public consultations and global outreach to important stakeholders. The new and revised auditor reporting standards were issued in January 2015 and will be effective for calendar year 2016 audits.

As project leader, I had the opportunity to be involved in numerous discussions with many of these stakeholders – investors, regulators, policy-makers, preparers, auditors, standard-setters and others. These diverse stakeholder groups often had different views about how the auditor’s report should change or what information would be most relevant for users. But there was widespread agreement that a change in auditor reporting was needed, and this was viewed as critical to the perceived value of the financial statement audit and the continued relevance of the auditing profession.

Perhaps the biggest concern raised by many was that, aside from the auditor’s opinion, the current standard auditor’s report is not very informative. It contains too much boilerplate language and lacks transparency about the audit. What investors and others desire is a look into the “black box” by having auditors share more information about their work, including how the auditor has addressed key risks and other significant aspects of the audit.

The centerpiece of the new IAASB auditor’s report is a new Key Audit Matters (KAM) section for listed

Comment
entities that will provide information about what the auditor believes are the most significant aspects of the audit of the most recent period. KAM are drawn from matters that were communicated with those charged with governance (in many cases, the audit committee) and that required significant auditor attention during the audit.

In most cases, KAM will relate to significant or complex matters disclosed in the financial statements, including areas of higher assessed risks of material misstatement, or areas that involved significant auditor and management judgment. Examples might include impairment reserves or the valuation of financial instruments. Above all, for KAM to be considered relevant and useful for investors and other users, auditors must make sure that the information is as entity–specific as possible, and related to the facts and circumstances of the current-period audit.

Importantly, the new auditor’s report will also include enhanced communications about going concern – another topic of significant interest to investors, regulators and others, in light of the financial crisis.

Investors and other users also recognize that there is an increasing amount of other information included in an entity’s annual report which provides insight into a company, such as management commentary. So the IAASB committed to “raise the bar” regarding auditor work effort and reporting on this other information, and expects to issue the revised standard in the spring of 2015.

Of course, audit quality continues to be a high-priority topic for the IAASB and its constituents, including audit regulators. The IAASB believes its Framework for Audit Quality can stimulate helpful dialogue on this important topic among all participants in the financial reporting supply chain.

Without a doubt, the IAASB accomplished a great deal in 2014, but there is still much work to be done. For auditor reporting, the attention of the board and its staff now turns to supporting awareness and effective implementation. The IAASB will also continue its extensive outreach with stakeholders around the world to obtain input and feedback on its current and future agenda.

Speaking of which, the IAASB consulted publicly during 2014 on its future strategy and work plan, which was approved in December, and has added several important, but challenging, projects to its agenda for the next few years. These include group audits, special audit considerations relevant to financial institutions, and quality control.

One thing is certain. The auditing environment is becoming increasingly complex and challenging, and more highly regulated. As a result, the role of the IAASB and other auditing standard–setters has never been more important. Having now retired from EY, I will continue to follow the great work of the board in serving the public interest, and encourage all stakeholders to do so as well.

“The auditing environment is becoming increasingly complex and challenging.”

PROFILE
Until he retired in December 2014 after nearly 40 years with EY, Dan Montgomery was a senior partner in the Global Professional Practice department and Global Director of Auditing and Assurance Standards, Methodology and Implementation. He is a former member of the US Auditing Standards Board and a past Chair of the American Institute of Certified Public Accountants’ International Auditing Standards Task Force. He served as Deputy Chair of the IAASB from 2012 to 2014 and was the leader of its Auditor Reporting Task Force.

The views of third parties set out in this publication are not necessarily the views of the global organization or its member firms. Moreover, they should be seen in the context of the time they were made.
The massive volumes of data now available inside and outside companies, and the power of new data analytics technologies, are fundamentally changing the audit. EY’s Roshan Ramlukan explores the possibilities and explains the key issues facing auditors as they embrace big data and analytics.
Historically, data was something you owned and was generally structured and human-generated. However, technology trends over the past decade have broadened the definition, which now includes data that is unstructured and machine-generated, as well as data that resides outside of corporate boundaries.

“Big data” is the term used to describe this massive portfolio of data that is growing exponentially. The general view is that big data will have a dramatic impact on enhancing productivity, profits and risk management. But big data in itself yields limited value until it has been processed and analyzed (for more on the business value of data analytics, see the article in issue 7 of Reporting).

Analytics is the process of analyzing data with the objective of drawing meaningful conclusions. Major companies and organizations have recognized the opportunity that big data and analytics provide, and many are making significant investments to better understand the impact of these capabilities on their businesses (for an example, see panel, page 13). One area where we see significant potential is in the transformation of the audit.

TRANSFORMING THE AUDIT

As we continue to operate in one of the toughest and most uneven economic climates in modern times, the relevance of the role of auditors in the financial markets is more important than ever before. Audit firms must continue their robust audits to serve the public interest by increasing quality on a continuous basis and by delivering more insights and value to the users of the financial statements. Professional skepticism, and a continued focus on the quality of audit evidence, are required throughout an audit. Meanwhile, companies are expecting an enhanced dialogue with their auditors and more relevant insights.

While the profession has long recognized the impact of data analysis on enhancing the quality and relevance of the audit, mainstream use of this technique has been hampered due to a lack of efficient technology solutions, problems with data capture and concerns about privacy. However, recent technology advancements in big data and analytics are providing an opportunity to rethink the way in which an audit is executed.

The transformed audit will expand beyond sample-based testing to include analysis of entire populations of audit-relevant data (transaction activity and master data from key business processes), using intelligent analytics to deliver a higher quality of audit evidence and more relevant business insights. Big data and analytics are enabling auditors to better identify financial reporting, fraud and operational business risks and tailor their approach to deliver a more relevant audit.

While we are making significant progress and are beginning to see the benefits of big data and analytics in the audit, we recognize that this is a journey. A good way to describe where we are as a profession is to draw parallels with the TV and film subscription service Netflix. When the company started in 1997, it adopted a DVD-by-mail model, sending movies to its customers, who returned them after an evening or a week of entertainment. Netflix always knew that the future was in online streaming of movies, but the technology was not ready at that time, nor was high-speed consumer broadband as prevalent as it has since become.

Today, we are engaged in the audit equivalent of DVD-by-mail, moving data from our clients to EY for use by auditors. What we really want is to have intelligent audit appliances that reside within companies’ data centers and stream the results of our proprietary analytics to audit teams. But the technology to accomplish this vision is still in its infancy and, in the interim, we are delivering audit analytics by processing large client data sets within our environment, integrating analytics into our audit approach and getting companies comfortable with the future of audit.

The transition to this future won’t happen overnight. It’s a massive leap to go from traditional audit approaches to one that fully integrates big data and analytics in a seamless manner.

BARRIERS TO INTEGRATION

There are a number of barriers to the successful integration of big data and analytics into the audit, though they are not insurmountable.

The first is data capture: if auditors are unable to efficiently and cost-effectively capture company data, they will not be able to use analytics in the audit. Companies invest significantly in protecting their data, with multilayered approval processes and technology safeguards. As a result, the process of obtaining client approval for provision of data to the auditors can be time-consuming. In some cases, companies have refused or have been reluctant to provide data, citing security concerns.

Moreover, auditors encounter hundreds of different accounting systems and, in many cases, multiple systems within the same company. Data extraction has not historically been a core competency within audit, and companies don’t necessarily have this...
functions to consume the analytics produced effectively. Analytical mindset within the finance, risk and compliance technical competencies, but should extend to creating the human element. Focus should not be limited to developing investments in big data and analytics will be determined by the current framework in the standards, but that did not contemplate the ability to leverage big data. Below are four areas that require further consideration.

1) Substantive analytical procedures: these examine the reasonableness of relationships in financial statement items, to uncover variations from expected trends. However, the standard doesn’t cover using big data–based analytics to provide “substantive evidence.” One of the key differences with analytics techniques is that the procedures are used to identify unusual transactions or misstatements, based on the analysis of the data, and usually without the auditor establishing an expectation. Big data and these kind of analytics techniques did not exist when the standard was conceived, so were not considered as a source of audit evidence. The gap creates uncertainty regarding the relevance and applicability of analytics in providing anything more than indicative evidence.

2) Validating the data used for analytics: as auditors receive information from the client, they determine its clerical accuracy and completeness, and whether it is appropriate as audit evidence. This applies whether they receive printed documents (such as contracts) or electronic data. But audit analytics do not use or rely on reports generated by the system; instead, relevant master and transaction data is extracted directly from the underlying databases. Procedures are then performed to validate the accuracy and completeness of the data, and it is reconciled to system-generated reports. The auditor is then confident that their analysis is based on the same data the company uses to produce its financial information.

While the standards provide some guidance in this area, they could not have anticipated the type and volume of data that auditors are extracting. Inevitably, there are limitations in the extent to which auditors can derive evidence from the procedures that may be performed in relation to such data.

3) Defining audit evidence: the standards provide a hierarchy of evidence, with third-party evidence at the top and management inquiries at the bottom. However, the standards do not indicate what type of evidence analytics provides. It is possible to relate some of these types of tests to the current framework in the standards, but...
not all. Without a proper description of the type of evidence that analytics provides, auditors are reluctant to claim it as evidence, thus negating the benefits.

4) Precision: an audit is designed to detect a material misstatement. When companies record revenues amounting to billions of dollars and users of the financial statements expect them to be free of material misstatements, what level of precision do the auditors require of their data analytics? The standards need to provide more guidance in this area.

Ultimately, the audit of the future could look quite different from the audit of today. Auditors will be able to use larger data sets and analytics to better understand the business, identify key risk areas and deliver enhanced quality and coverage while providing more business value. But to achieve this transformation, the profession will need to work closely with key stakeholders, from the businesses they are auditing to the regulators and standard-setters.

Roshan Ramlukan is a partner in EY’s Global Assurance Team and leads the organization’s Audit Transformation Analytics initiative. He is based in Boston in the US.

“The transformed audit will expand beyond sample-based testing to include analysis of entire populations of audit-relevant data.”

How RoboCop is reducing financial reporting fraud

In 2013, the US Securities and Exchange Commission (SEC) announced new initiatives aimed at better identifying financial reporting fraud through the use of big data and analytics tools.

One of these is the Accounting Quality Model (AQM), often referred to as “RoboCop.” AQM is a fully automated system that analyzes a company’s filing within 24 hours of it being posted to EDGAR, the SEC’s online database of submissions from companies. The system is designed to identify high-risk activity by comparing the current filing with those of companies in the filer’s industry peer group.

The SEC subsequently expanded the model’s capabilities to include a scan of the management discussion and analysis sections of annual reports. SEC analysts have developed lists of words and phrasing choices that are common among past fraudulent filers. These lists have been turned into risk factors and integrated into AQM’s review process.

AQM assigns a risk score to each filing, assessing the likelihood that fraudulent activities have occurred. The AQM risk score is used by SEC inspection staff to prioritize inspections, and the nature of issues identified by AQM help influence the scope and focus of the inspection.
Rostow Ravanan of India-based technology services company Mindtree selects some of the most important lessons he has learned over his career.

1 Build credibility with the investment community
There is a need to communicate constantly with the investor community. Businesses go through ups and downs, but if you build the company’s credibility with investors, they will have faith in you, even during bad times. If you meet investors at a time when you are experiencing problems, they will probably only want to discuss the challenges. Explain clearly what went wrong and outline the measures you are taking to overcome those challenges. People like to be part of solutions, and at least some well-meaning investors might be able to give you ideas that could help solve your problems.

2 Be conservative in your valuation during an IPO
Any young company that plans to go public should start preparing 12 to 18 months prior to the IPO. During this period, choose your partners – such as lawyers, investment bankers and advisors – carefully. Go for the best in the industry, even if they cost more. Despite the best preparations, it is likely that several issues will remain unclear. That’s when you will need the guidance of your partners.

When it comes to fixing the IPO price for your company, I strongly advise CFOs to be conservative. Don’t be greedy. Keep a reasonable margin of, say, 20% – let investors make money on your IPO. The stock market goes through ups and downs; if people lose money, they will also lose faith. This margin will help you build your brand for the future.
Constitute your board smartly

Companies need to be clever when choosing board members. They should be interested in the company and capable of adding value. For example, the people on your board should have experience in your industry and in strategy formulation and implementation, financial reporting, relationships with policy-makers, understanding customer behavior and so on. Needless to say, no single person will know all these areas—so, collectively, your board needs to have all these capabilities.

It’s also important to spend time with the new members as soon as possible after they have accepted a place on the board. Brief them about the business and introduce them to a cross-section of key employees and stakeholders. In fact, there should be a properly structured induction program for board members. It’s important to engage continuously with the board.

Choose “being good” over “being successful”

Best practices start right at the top, with the promoters and the board, and filter down to the most junior employee. At Mindtree, there is a burning desire in all of us to be a good company. If we have a conflict, then we choose being good over being successful. Everyone needs to be convinced about your company’s values.

There should be a conviction that you will never sacrifice good governance, because an erosion in values percolates down a lot faster than the best practices do. So do not tolerate an erosion in values, even if that means taking action against a salesperson who is bringing in good business, for example.

Use stories to help explain technology

Don’t overwhelm your stakeholders with complex technology. The company’s shareholders and investors may not have the technical background that will enable them to understand it fully. Create stories around the technology to tell them about the work the company is doing and the positive impact it is creating.

For instance, you might tell them about how millions of passengers fly safely each year due to your flight planning system, or how the software created by your company is enabling the live telecast of a popular sports event. Then connect that story to your financial metrics. Ultimately, the members of the investing community need to decide whether they will buy, sell or hold your stock. Your job is to enable them to make the decision with adequate knowledge.
Rethinking tax for a new era

Greater demands for increased visibility on corporate tax affairs are coming. While it remains unclear what exact form these requirements will ultimately take, companies need to start preparing to adapt, says Ken Arthur.

Tax transparency, perhaps ironically, lacks a clear definition. It is a catch-all term to cover several distinct, albeit overlapping, trends. What these developments have in common is that businesses operating internationally are under pressure to reveal more about their tax financial affairs to a wider audience. What varies more widely, and what is still unclear in several of the most important initiatives, is precisely what information taxpayers will need to reveal, and to whom.

Barbara Angus, who was formerly the lead international tax official at the US Department of the Treasury before joining EY in Washington, DC, notes that in many ways, demands for transparency are nothing new. “Governments have always been interested in, and had access to, relevant information. In countries around the world, many corporations are under continual examination by tax authorities,” she explains.

Various tax authorities have long worked to expand bilateral and multilateral cooperation around the sharing of tax information. An important player in this effort has been the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes, established in 2000 to benchmark how well countries comply with their tax information exchange agreements. This tests countries’ responses to data requests relating to specific taxpayers by foreign revenue officials.

The US Foreign Account Tax Compliance Act (FATCA) and revisions to the EU Savings Directive have helped set the stage for more advanced multilateral arrangements, led by the Global Forum. The OECD’s Common Reporting Standard (CRS), issued in July 2014 and drawing extensively on the intergovernmental approach to implementing FATCA, is one example. In 2017, more than 50 jurisdictions applying the CRS — including major financial centers — will begin the automatic sharing of certain financial information between tax authorities rather than waiting for a request. This follows endorsement by representatives of these jurisdictions at the annual meeting of the OECD Global Forum in Berlin on 29 October 2014.

Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration, says that “in this area of transparency, progress has been unbelievable. All countries are changing extremely fast. Five years ago, bank secrecy was the rule; today, bank secrecy is over. Under developments such as FATCA and the CRS, governments will leverage global financial institutions to collect data on their behalf, rather than relying solely on their own resources.”

TECHNOLOGICAL ADVANCES
An important driver of enhanced information exchange is technological advances that allow authorities to gather, exchange and analyze this data in a way that would have previously been too costly and time-consuming. Just as important, however, has been the desire of governments to combat tax avoidance. The push for greater intergovernmental information-sharing was a direct response to growing concerns about the use of offshore financial centers and tax havens.

The link between perceptions of fairness and tax has driven another element of the tax
transparency picture: the push for greater public disclosure. The earliest example is the Extractive Industries Transparency Initiative (EITI), launched in 2003 in response to complaints by civil society organizations about the secrecy surrounding tax and other payments from natural resources companies to governments.

While a primary goal of the EITI was to make governments receiving these payments increasingly accountable for how they were spent, it also made businesses operating in the sector more transparent. EITI is a multistakeholder organization – including government, corporate, NGO and investor representatives – which sets standards for the publication of tax and other payments to countries related to oil, gas and mining activity. Various governments have passed rules to effect greater compulsory disclosure too, notably the Dodd-Frank Act in the US and the EU’s Accounting Directive.

Furthermore, country-based reporting requirements have spread from the extractives to the financial industry. As Philip Kermode, former Director of the European Commission’s Directorate-General for Taxation and Customs Union, argues, this has been in large part to alleviate public mistrust of that sector. For example, the EU’s Capital Requirements Directive IV stipulates that large financial institutions must provide country-by-country reports on activities, employee numbers, turnover, income, taxes paid and subsidies received.

More broadly, Denmark has joined its Scandinavian neighbors in making certain details from corporate tax filings publicly available, and Australia is doing the same for all large companies. National and multinational initiatives to date, however, have
been far from coordinated. The most talked-about current transparency initiative is the effort under the OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS) to develop a template for corporate country-by-country reporting. This will require companies to report, for every country in which they operate, figures for turnover, profit, taxes paid and accrued, employees and assets — data that will either be provided to, or automatically shared between, all relevant national tax authorities.

This focus on transparency is happening in the context of widespread public concern at what is seen as the inappropriate use of legal strategies to reduce tax payable through shifting profits to low or no tax jurisdictions. Such concerns have grown more pronounced since the early 2000s. David Dietz, Head of Compliance – North America at Rabobank, notes the striking change in the public mood: “Tax avoidance by corporations is now automatically front-page news.”

He is not alone. A 2014 EY survey, Bridging the divide, which polled more than 800 executives from leading global companies, found that 89% are concerned about media coverage of corporate tax positions and potential misrepresentations.

Under the OECD’s proposal for country-by-country reporting, the recipients of the data will be tax authorities rather than the public. This may not ultimately satisfy demands for broader transparency from a public that sometimes distrusts tax authorities almost as much as companies themselves. EY’s Barbara Angus, while expecting the OECD to remain focused on reporting to tax authorities, says that the potential for expansion remains a concern.

“There may be pressure to have what now is a report to tax authorities made more public,” says Angus. A major concern for multinationals is that even the high-level, aggregate information being contemplated for inclusion in the BEPS template would be commercially sensitive.

The OECD is aware of this issue and is continuing to consider how best to address it. Saint-Amans expects one of the challenges under the new reporting regime will be protecting the confidentiality of shared data.

Even if the data is not made public, though, past experience from the US states does not bode well for those hoping that the reporting element of the BEPS project will lead to a coherent international reporting environment.

Andrew Phillips, of EY’s Quantitative Economics and Statistics Group in Washington, DC, notes that, after state income tax receipts dropped markedly in the wake of the 2002 recession, state-by-state reporting requirements became increasingly common. The main impetus was for state governments to determine whether they were receiving an appropriate share of tax revenue from companies operating across the country. But even with a federal US coordinating body attempting to create a common reporting method, the process led to a wide range of different state requirements.

“You don’t see consistent information being requested,” says Phillips. “Nobody is sure exactly what question they are trying to ask or what the
answer is. In the US states, the question was, ‘Are companies paying their fair share?’ but nobody knew what the answer was.”

Instead, different states took different approaches, some relying on revenue realized in-state and others on various measures of operational activity, such as employee or production figures. Based on this experience, Phillips concludes that keeping the OECD reporting template unaltered and consistent may be challenging.

**WHAT COMPANIES SHOULD DO**
Transparency has already reshaped the tax world. Tobias Brauner, Head of Corporate Finance and Tax at Daiichi Sankyo Europe, says: “Hiding things doesn’t make sense. You can’t. That is not the role of a modern tax function, nor has it ever been.”

Most companies are not yet prepared for broad new reporting requirements. According to a Thomson Reuters survey published in 2014, only 35% of global firms have a tax transparency strategy. Given the global focus on greater disclosure requirements, this presents risks; but, given uncertainty about how proposals may evolve as they are implemented by countries, what should firms be doing?

Angus explains that tax transparency is something to think about on many levels. Probably the most basic level is in that of data infrastructure and software. Dietz notes that FATCA alone involved an 18-month period of significant investment in systems and redesigning processes for his organization. Looking ahead, he notes that companies will need to anticipate the needs of providing specific information to officials when putting systems in place.

Getting necessary data – which is by no means easy – is only the first step. A strategic decision is required to determine whether, and how, a broader explanatory context to data may be provided to tax authorities and, possibly, wider stakeholders.

Angus expresses concern that the data requested in the OECD country-by-country template is high-level and rough. “The data requested could be prone to misinterpretation and misunderstanding for a variety of reasons. For example, a company may be running very different businesses in different countries, so that comparison across countries would be meaningless,” she says. The risk of misinterpretation is even greater in the context of public disclosure, where information would be in the hands of persons who are not tax specialists. This is probably the biggest concern for companies.

“We are all for disclosing information to the tax authorities, but have reservations about having to disclose what is essentially ‘raw state’ information to the public,” says Dana Moscaliov, Senior Tax Advisor at DOF Subsea Australia, an engineering company in the oil and gas industry. “There are many lawful reasons why a tax payable might differ from, say, 30% of your accounting profit, but without tax specialist knowledge, the information is open to misinterpretation.”

Finally, in an atmosphere of greater transparency, firms need to be certain that if their tax affairs become public, they will pass increasingly stringent regulatory and public scrutiny. George Trollope, Vice President Tax at Sasol, a South African energy firm, explains that the shift toward tax transparency has placed the importance of tax planning developed within the business context under renewed focus. “As in the past, our focus today, and very much the driving principle of our approach to tax, is a tax policy that is aligned with the group’s business strategy,” he says.

A more transparent world is on the horizon. This will require not just the release of information, but new ways of thinking about how tax data is gathered and presented.

**Stay clear**
Four key action points for the finance function relating to tax transparency:

- Monitor and review changes in legislation to ensure that you are able to comply with them.
- Take stock of the data infrastructure and software you will need to collect the correct data, and consider what changes to your organization’s systems and processes you will need to make.
- Even correct data tells only part of the story and can be misinterpreted, so have a plan for how you will explain the meaning of your data to tax officials.
- Review your approach to tax in the light of transparency, and confirm that your tax policy is closely aligned with your business strategy.
SLOWING MOMENTUM

As the crisis spread and underlying weaknesses in a number of CEE nations came to the fore, the momentum of FDI slowed in some countries, including Poland, the Czech Republic, Hungary, Slovakia, Romania and Bulgaria.

With a 22% drop in FDI projects during the crisis years, Poland lost its leading position among Europe’s emerging investment destinations to Russia and slipped to fifth position in terms of FDI job creation in Europe between 2009 and 2013. This trend was all the more surprising given that, until 2013, Poland was the only European Union (EU) Member State to witness positive growth during the crisis. However, it is in a stronger position than most CEE economies. Unlike many others, Polish companies maintained cost discipline before the financial crisis, with the result that unit labor costs have not increased since the country joined the EU in 2004.

Moreover, no Polish financial institution needed a public bailout. Finally, with the largest internal market among the new EU Member States, Poland is less vulnerable to downturns in the Eurozone.

The Czech Republic, another key economy in the region, saw a marked decline of 37% in inward investment projects between 2009 and 2013. Despite the decline, these two countries still remain the top two Central European destinations for FDI.

Marc Lhermitte, EY’s Head of International Location Advisory Services, comments: “The crisis exposed the weaknesses in the economic fundamentals of CEE, which was heavily dependent on consumption and its banking system. Furthermore, between 2004 and 2008, approximately 75% of the FDI projects in the CEE region originated from Europe itself. As a result, when the crisis hit, FDI projects declined substantially, reaching a record low in 2009.”

Playing catch-up

The emerging economies of Central and Eastern Europe were badly affected by the financial crisis, and much still needs to be done to make them attractive destinations for investors once more.
However, Russia received 114 FDI projects in 2013 and took the leading position for FDI projects among non-Western European destinations during the crisis years. Although the FDI number was down by 11% from the previous year, it still managed to regain its leading position as the top emerging destination in the CEE region, after falling behind Poland in 2012.

“In the last few years, Russia attracted several key investment projects in the automotive and heavy industry sectors, such as chemicals and large transport equipment, and was able to keep its leading position in CEE,” explains Rajiv Memani, Chairman of EY’s Global Emerging Markets Committee. “However, it’s very likely that the geopolitical tensions arising from the situation in Ukraine will affect Russia’s attractiveness.”

CITIES LAG BEHIND
As with countries, the perceived attractiveness of many cities in the CEE region has fallen. When asked to name the three most attractive cities in Europe, only 17% of respondents to the EY survey named CEE cities. This compares with 82% who named a city in Western Europe and 19% who named one in Southern Europe.

In line with previous years’ results, investors chose London, Paris, Berlin, Frankfurt and Munich as the top five investment destinations in Europe. Moscow slipped from 8th to 10th on the list, while Prague and Warsaw dropped to 12th and 14th places respectively.

So what can be done to make CEE countries more attractive to investors? Memani says: “In 2014, global events have continued to shape the economic landscape. The changing economic situation in CEE is particularly notable. We have found that, for these countries, regulatory reforms and other government initiatives are vital for improving the business environment. Such improvement will help the CEE countries attract further FDI and so move toward a path of sustainable growth.”

To read Playing catch-up, an extract on emerging markets from EY’s 2014 European attractiveness survey, go to ey.com/attractiveness.
In light of demands from leading institutional investors for a greater insight into the workings of the audit committee, there has been increased debate over the amount of communication between the two. But, in practice, there are significant barriers to a closer relationship, as David Stevenson discovers.

A working relationship?
In May 2014, Mary Jo White, Chair of the Securities and Exchange Commission (SEC) in the US, gave a speech in which she said: “The audit committee plays a critical role in financial reporting oversight, and investors have expressed interest in increased transparency into the audit committee’s activities. The audit committee reporting requirements have not changed significantly in a number of years, and I think it is time to take a look at whether improvements can be made.”

The fact that a leading regulator has expressed a desire to increase disclosure by audit committees represents a significant step forward in the debate around the audit-related aspects of governance. However, the relationship between audit committees and investors is not straightforward. Talk off the record to audit committee members and many will echo the comments of one who admits that “investors do not have a clear view about what audit committees do. They think we subcontract out our responsibilities.”

The good news is that many investors do have a very clear idea of what they want: greater disclosure of financial and other information that can help them make informed investment decisions. The bad news is that they struggle to understand the practical challenges facing audit committees.

COMMUNICATION CHALLENGES

For many observers, the core challenge remains one of communication. Investors and audit committees need to learn to communicate more often with each other, using information both parties feel comfortable in sharing.

Angel Durandez Adeva, an audit committee member at media company Mediaset Spain, is, like many of his peers, happy to oblige. “If investors want more information related to how audit committees discharge their responsibilities, and if this is considered necessary by regulators or by the general business climate, I don’t see why audit committees wouldn’t be open to this demand,” he says.

Yet he’s also quick to observe that increased transparency, especially around price-sensitive financials, comes with its own challenges. “Legal obligations are the main barriers,” he says. “Time constraints could also be a secondary barrier, once those legal issues have been overcome.”

It may well be that audit committee reports are minimal precisely to prevent misinterpretation that might expose the company to an increased risk of litigation. Yet Durandez suggests the real challenge facing many audit committees is that investors aren’t actually that enthusiastic about communicating with them.

“If I were an investor, I’d probably be concerned with the kind of review the audit committee carries out with respect to the evaluation of general and specific risks to a company,” he says. “But it’s important to note that committees are responsible to the board, and it seems to me that it would usually be the main board that would be addressing this information to investors, not the audit committee.”

This caution is echoed by Ken Williamson, an EY Assurance partner in the UK who works across both corporate governance and audit. He says that, in all the AGMs he’s attended over the years, “I can’t remember a single question ever being directed at the audit committee by investors.”

MORE OF EVERYTHING

But talk to investors and a very different picture of engagement emerges. Indeed, some have organized public campaigns to force audit committees to work more closely with them. In the US, for instance, the United Brotherhood of Carpenters Pension Fund is running an ongoing letter-writing campaign asking S&P 500 companies to commit voluntarily to enhanced audit committee disclosures in their proxy statement.

According to Liz Cohernoun, co-founder and COO of US-based fund management group Wintergreen Advisors, “greater disclosure is absolutely possible. Audit committees are often well informed and, with proper encouragement, could add meaningful disclosure that investors would find very useful.

“Audit committees may not be aware of the information that would assist investors in recognizing areas of operations that make the company superior to others,” she continues. “Once information is disclosed, investors expect that they will get that same information year after year, so the workload is somewhat increased. But often, companies are simply not in the habit of disclosing information that is readily available.”

Institutional investors often emphasize that they need more detailed information, especially any data relating to estimates and judgments contained within financial reports. These might be the decommissioning costs of a large asset, for instance, or the state of reserves for a large, resources-based business. Another broad area of interest relates to impairment charges.

Alastair Mundy is an influential fund manager based at Investec and speaks for many when he says that “audit committees should give you the information they would want if they were looking at this business as an investor. This means more...
numbers where they matter, as well as any human rights or environmental abuses.

“An example would be a company with a large book of receivables,” he explains. “When contract accounting is utilized, how much of it is billed and agreed with customers and how much is billed in the hope that the customer will agree? This helps in assessing the extent of losses that might be hiding in a book of long-term contracts.”

Cohernor echoes this demand, saying investors want disclosure that is designed to make it clear how the different lines of business are performing and meeting their stated goals. “They also want to know how connected and beholden the directors are to the company, and they want to know what business the company is doing with its own affiliates,” she adds.

But some investors do acknowledge that they need to be realistic about the amount of information they can hope to receive. While they may want data that is relevant and practical, boards must also work within a process that doesn’t open them up to unnecessary risks. Mundy observes that “any hard and fast numerical target risks skewing incentives in an undesirable way. In this sense, a principles–based corporate governance approach is more sensible, but investors will have to live with the fact that it is also less measurable.”

GROWING TRANSPARENCY

Despite these concerns, the hard numbers suggest that audit committee transparency has been steadily improving. EY annually reviews proxy statements for Fortune 100 businesses in the US and, in its Audit committee reporting to shareholders 2014 proxy season update, it observed significant growth in transparency. According to the report: “Continuing the trend of the past several years, an increased number of Fortune 100 companies are going beyond the minimum disclosures required. These disclosures are also more robust – providing valuable perspectives on the activities of audit committees, including their oversight of external auditors.”

Andrew Hobbs, a partner at EY in the UK who specializes in corporate governance and public policy, sees this trend extending more widely. “I don’t see any substantive differences between the US and Europe,” he says. “There’s a trend toward greater transparency at the global level, although in the US, the litigation environment does mean that transparency around what the audit committee actually does is less likely.”

At the practical level, it’s clear that many audit committee chairs do have the necessary experience to manage the process of talking to investors. This experience will prove hugely useful as committees start to grapple with ever longer agendas.

In the US, there are also more, and more practical, frontline tools being made available, including the Audit Committee Collaboration framework. And new ideas are constantly emerging; most radically, the Investor Advisory Group of the Public Company Accounting Oversight Board (PCAOB) has suggested that external auditors review the effectiveness of the audit committees they work with.

But one communication channel is still rarely used, despite willingness on both sides; face-to-face meetings between individual investors and audit committees. In Spain, Durandez can think of “no situation in which face-to-face meetings are being held. Of course it would be good, provided this does not represent any breach of due confidentiality,” he says, adding: “Obviously, if these meetings were to become the norm, the committee’s members would have to become very cautious, especially about the way in which any communication was going to be expressed.”

Even without a constant stream of meetings, it’s clear that the existing relationship between the audit committee and investors will have to change, if only because of the constant demands of regulatory reform. For example, at the time of going to press, the SEC was preparing a concept release (essentially a consultation paper, published with the aim of soliciting feedback on the measures proposed) exploring ways of enhancing the relationship between auditors and audit committees. This may well include a requirement for audit committees to be more transparent about what they do.

In the UK, auditors issued their first reports under a new, principles-based standard in early 2014. Investors and other stakeholders have been generally positive about the new reports, which have varied in length and detail. Likewise, the International Auditing and Assurance Standards Board (IAASB) approved final standards to enhance the auditor’s report in September 2014, and the European Union has also adopted new auditor reporting requirements. All these measures
will doubtless have a knock-on effect on audit committee communications.

Similarly, Williamson says new UK requirements to state the long-term viability of a company will have a big impact from the end of 2015. This will force the auditor and audit committee to look beyond the existing going concern statement (which looks at the business position over the forthcoming 12 months, with a focus on liquidity) and examine what threats there may be to the long-term sustainability of a business.

Given all this impending regulatory change, surely the scene is set for an explosion of assertiveness by audit committees, helped along by a growing army of engaged investors? Mundy isn’t so sure.

“Audit committees are dependent on management for their jobs and remuneration,” he says. “It is extremely difficult to set up a corporate culture where this dependency does not give rise to conflicts of interest and a reluctance to bring bad news.”

And, despite the results of the 2014 EY proxy season update, Cohernour still believes that “as audit committees come under scrutiny — whether from investors, regulators or even the press — there can be a self-preservation attitude when it comes to disclosing more.”

Even Williamson worries that there is a real danger that a lack of engagement will prevent the relationship between audit committees and investors becoming closer. “In the next couple of years, we’ll see the audit committee process go in one of two directions,” he predicts. “It could go the way of existing boilerplate information, which no one reads, and the changes will fizzle out. “But I’m optimistic that the governance community will embrace the changes — although I’m also less confident that this interest will permeate through to actual fund managers.”
CREATING A SOLID BASE
First and foremost, we need a strong four-legged stool, the legs being financial statement preparers, independent auditors, audit committees and the regulators. That includes those regulators that oversee the preparers (the Securities and Exchange Commission, or SEC) and the auditors (the Public Company Accounting Oversight Board, or PCAOB), and standard-setters such as the Financial Accounting Standards Board (FASB).

If everyone in this process is doing their job, the stool stands and the system works. The result is useful, reliable financial information for investors and other stakeholders to make good decisions — which should result in more efficient and effectively operating capital markets. And that is good for everybody.

CLOSING THE EXPECTATION GAP
When I first entered the workforce, people were talking about the “expectation gap” between what users of audited financial statements thought they were getting and what auditors were doing. Forty-two years later, we’re still talking about it, though it seems to have expanded to include every leg of the stool. It is striking to me that, though we have made some progress, we are probably not where we need to be.

How do we go about improving the understanding among investors and regulators regarding the role and the activities of the audit committee? And how do we help investors better understand what a financial statement audit is and isn’t? Before my time on this Earth is up, I hope we can make substantive improvements through communication and engagement efforts.

OPENING UP DIALOGUE
For many years, the audit committee communicated with investors largely through the audit committee report that was in the annual proxy statement. It barely scratched the surface of what audit committees did.

In recent years, these reports have expanded significantly. It’s a wonderful opportunity for the audit committee, whose members are elected by shareholders, to communicate with the people who hired them about the work they are doing on their behalf. There needs to be a continuing evolution — and improvement — of that communication device.

Right now, you’re seeing more boards, and especially compensation committee chairs, talking directly with shareholders. Historically, the only time audit committee chairs talked to shareholders was when there had been a problem, and that’s rather late to be having your first conversation. So we have to think...
about whether it’s the audit committee’s report, or perhaps the use of technology or other types of investor outreach, that will improve that understanding between audit committees and investors.

**IMPROVED STANDARDS FOR AUDITORS’ REPORTS**

The other element is how auditors communicate with users of their product. In January, the International Auditing and Assurance Standards Board (IAASB) issued a standard that expanded the requirements for audit reports. It’s not applicable in the US, but our standards probably deserve some updating, and there is now a dialogue going on in the auditing community, with the PCAOB and others, about opportunities for improving the auditor’s report.

The challenge is: we have to be able to do that in a fashion that doesn’t undermine the audit committee and diminish its ability to provide the level of active oversight over the auditors that we need.

**AN AUDIT COMMITTEE ADVISORY GROUP**

The other thing I would like to see is a better dialogue between the PCAOB and the audit committee community. Right now, the PCAOB is limited by legislation as to what it can communicate directly to audit committees.

The PCAOB established an Investor Advisory Group in 2009 so that investors could advise it about their interests, and I would encourage the board to consider a similar group from the audit committee community, so that the customers and regulators of the auditors can actually have a robust conversation. In the last couple of years, the PCAOB has been increasingly active in reaching out to the audit committee community, but I think broadening and formalizing the dialogue would be healthy.

I would also like to see greater opportunity for the PCAOB and audit committees to talk about company-specific audit results and the quality of the independent auditor’s performance. This would allow audit committees to do an even more thorough job, but it would require some legislative change.

**COHESIVE ADVICE TO THE FASB**

Until a year ago, I was Chairman of the Financial Accounting Standards Advisory Council at the FASB. It’s a group of 30 or so people from various backgrounds who provide guidance to the FASB, and it works very well. In 2012, the Financial Accounting Foundation, which oversees the FASB, established the Private Company Council, which proposes accounting standards for private companies and is the primary advisory group to the FASB on that subject.

These are two very separate groups providing input to the FASB on similar subjects, and they are probably both interested in what the other is doing, so I’d like to see improved communication between the two advisory groups, and a similar improvement in what gets communicated to the FASB.

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**Profile**

Charles Noski retired as Vice Chairman of Bank of America in September 2012. He has been a director of Microsoft Corporation since 2003 and is currently Chair of its audit committee and a member of its governance and nominating committee. He also serves on the boards of directors of Avon Products (where he chairs the audit committee), The Priceline Group Inc. and the US National Association of Corporate Directors. He was an audit partner at Deloitte & Touche before serving in senior executive roles at several major corporations. In 2006, he was inducted into the inaugural class of the Financial Executives International Hall of Fame.
The buy side

Energy alternatives

THE ENERGY MARKET IS IN A PERIOD OF FLUX, AND POTENTIAL INVESTORS HAVE A WIDER RANGE OF OPTIONS TO CHOOSE FROM THAN EVER BEFORE. WILL SMITH OF ALTERNATIVE ASSET MANAGER CQS OUTLINES HIS APPROACH TO INVESTMENTS IN THIS SECTOR.

Energy demand will continue to grow as the world’s population expands and per capita income rises, and understanding the energy mix between coal, gas, nuclear and renewables will be crucial for investors in the coming years.

Our historical focus has been on well-managed, low-cost companies with a strong balance sheet and core oil- and gas-producing areas. But the fall in oil prices that started late last year – and that was very swift, after four years of relative stability – has led to a constant revaluation of portfolios.

However, there is good reason to believe that oil prices may well be higher than today in the medium term, and particularly in the long term. The market has temporarily forgotten the speed at which production from the US shale fields naturally declines, and the sharp reduction in global capital expenditure that we are currently witnessing should result in a better balanced market in the medium term.

The biggest risk for the oil sector would be its replacement as a fuel for transportation. It is debatable whether some form of compressed gas will usurp oil, but improvements in energy storage – predominantly batteries – could be highly disruptive.

On the subject of disruption, North American shale gas has completely revolutionized the sector – in a way, more so than oil. That’s because the benefit is mainly limited to North America, as the global gas transportation infrastructure is not yet as advanced relative to oil. North America will benefit from gas prices below US$5 per million Btu (British thermal units) for the foreseeable future, as the producers have been living with low prices since 2012 and are still profitable and growing production substantially.

STANDARDIZED MEASURES
It is essential for the investment community to have reliable facts on which to base their decisions, so audited financial information is key. Being able to build comparative models is increasingly helpful and we welcome any form of standardized reporting. Indeed, universal adoption
of a standardized measure such as all-in sustaining costs (AISC) would be a great advance for the resource industry and would be warmly greeted by investors.

Currency and commodity prices are the big variables to be considered when assessing forecasts. The detail of historical information provides the most value; for instance, how does the management group use hedging and how does it approach cost reporting?

Reserves tend to be assessed by third parties and the main variable, again, is the price applied. Understanding the operating cost structure allows you to make a judgment as to their worth; some reserves cost a great deal more to extract oil or gas from, while others can be operated relatively cheaply. As a result, robust reserve accounting is crucial. There was a good example of the market’s dislike of disappointment in January this year; one oil company released a poor well result in Peru and subsequently downgraded its oil reserves, and this was devastating for the share price, which lost 32% in a day.

Strong cash flows are vital, as relying on debt and equity markets for funding is imprudent in volatile times such as the present. Dividends are increasingly important as well – not just as a valuation guide, but investors are increasingly attracted to those companies that are paying dividends as this era of low interest rates stretches on. Companies with sustainable and growing dividends have been clear outperformers in the recent downturn.

RISK AWARENESS
As for non-financial information, a company’s risk awareness is paramount. In some cases, that can be binary – i.e., either there’s oil or gas to be extracted or there isn’t, in which case there is zero value in the business. And for the global resource investor, political or country risk is an ever-present factor, and the ability of the company to have a social license to operate in the local community is crucial. That can be achieved if the issues are handled well, as many North American operators have shown. How management groups deal with this issue is a core competency.

Understanding the management group’s strengths, experience and ability is essential, as poor management can ruin the very best asset. An appreciation of the operating environment, as well as fiscal regimes, is also critical.

Other than financial criteria, there are a range of reasons that would lead us to reject an investment opportunity: the timescale and location of the project, the management group, the partners involved and the company’s history and makeup are all important. And let’s never forget the actual rocks, i.e., the geology!

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PROFILE
Will Smith is Senior Fund Manager for City Natural Resources High Yield Trust and New City Energy at London-based alternative asset manager CQS. Prior to joining CQS in 2008, he was responsible for running Landsbanki Securities Proprietary Trading, focusing on global resources. He has more than 30 years’ investment experience, with Panmure Gordon & Co., where he was Head of FTSE 250 Market Making, and with UBS and Morgan Grenfell Securities, where he traded UK equities.
With governments around the world enforcing anti-bribery and corruption legislation more aggressively than ever before, board positions carry a significantly higher level of personal risk than they used to. Nick Martindale reports.

The days when prominent offenders would have their heads displayed on spikes outside public buildings are long gone. Yet, metaphorically at least, this is the mentality that emerged in the wake of the financial crisis, with increasingly vitriolic demands from politicians, media commentators and the public for the punishment of bank executives charged with failing to prevent risky practices that came close to bringing down the entire financial system.

This public pressure may have been partly responsible for a wave of legislation that sees individual directors held accountable for the actions of their companies. In the UK, for example, the Companies Act 2006 means individuals can face a two-year prison sentence for providing misleading, false or deceptive information or explanations to auditors, or failing to provide information or explanations when requested; this also extends to overseas subsidiaries. The Bribery Act 2010, meanwhile, carries a maximum penalty of 10 years’ imprisonment for those offering or accepting bribes.

In the US, the Foreign Corrupt Practices Act carries a maximum sentence of up to 20 years in prison, as well as fines of up to US$5m. China, too, has introduced — and vigorously implemented — a crackdown on such practices through its anti-corruption laws, while in Italy, Legislative Decree No. 231/2001 is being used to levy criminal sanctions on companies for conduct that, elsewhere, might merely generate civil proceedings or regulatory actions.

Other legislation that could pose a risk to executives revolves around health and safety and data privacy rules, while new statutes in particular industries are also likely to reflect this desire to hold individuals directly accountable.

“Whether you call it the court of public opinion or political interference, it is this atmosphere that is driving the behavior of both the prosecutors and the businesses caught up in these scandals,” suggests Elizabeth Robertson, the partner who leads the corporate crime team in the London office of K&L Gates LLP.
AWARENESS AND UNDERSTANDING
For executives, this has made life a great deal more dangerous, threatening not only their own reputation, but also their very liberty. Employees of companies around the world have already received prison sentences, including four from Rio Tinto in China, who received terms of between 7 and 14 years for bribery and stealing commercial secrets, and five executives from British pharmaceutical company GlaxoSmithKline, who received suspended sentences in September 2014.

John Smart, who leads the Fraud Investigation & Dispute Services (FIDS) practice at EY in London, says: “Compliance departments are now growing within large organizations, and even medium-sized companies, to address the key risks that the business is facing, and also to address the risk to individual executives.”

But he stresses that those executives still need to be more aware of the major risks and ask themselves just how much they understand about what really goes on in their business. The key questions they should consider include:

- What information do they need from management in order to understand the nature and potential impact of any risk?
- What level of understanding of the subject matter do they personally need in order to be able to challenge this?
- What level of confidence do they have in the public disclosures the business makes on issues that could affect its reputation?
- What more does the business need to do to identify and understand potential future risks that could affect both the organization and them personally?

Those working in particular sectors need to pay the greatest attention to this if they feel they are not entirely in control of what may be going on in their organization or its subsidiaries. Christopher Bovis, Professor of International and European Business Law at Hull University Business School in the UK, suggests those with exposure to the public sector are especially vulnerable, particularly around defence procurement and the energy sector.

“There is very little transparency or standard practice around exclusive rights for exploitation of resources,” he says. Procurement departments in particular should come under scrutiny, he adds, but even more important is the need for an effective auditing system that is vigilant against any hint of corruption.

Executives themselves also need to be more challenging when it comes to the information they are furnished with, both personally, and collectively as a board. Andrew Hobbs, Partner in the Corporate Governance & Public Policy Team at EY in London, suggests that the composition of the board and the experience of the individuals themselves is important here.

“You need a good mix of people with director-level experience who can understand what is being presented to them,” he says. “But equally, you need people who aren’t as accepting because they aren’t

Thanks, but no thanks
The increased personal risk to executives could make it harder to recruit people for jobs in particular sectors. Candidates for board-level positions are now carrying out much greater due diligence on potential employers than in the past.

“At preferred candidate status, many people will want to see the summary of the most recent board evaluation, for example,” says Kit Bingham, Partner at executive search firm Odgers Berndtson. “If you’re invited to join the board but the company won’t show you any of the key material you’ve requested, it’s a big red flag.”

Organizations working in sectors or countries where there could be issues with anti-corruption legislation are coming under particular scrutiny.

“The obvious risks are doing business in some emerging markets, or in potentially high-risk sectors such as extractives,” Bingham says. “As a result, they can be hard to recruit for.”

Before deciding whether to accept any executive position, candidates would be well advised to ensure there is an adequate structure in place to prevent individuals falling foul of legislation or other reputational issues. “Make sure you get a proper briefing about the risks you’re running, particularly if you’re likely to travel to emerging markets,” advises EY’s John Smart. “If you go to some of the high-risk jurisdictions on the Transparency International Index, you could end up with potential bribery issues. You need to understand those risks.”
as steeped in what the sector does. If your board is comprised of people who all have the same sector experience, there is a danger that they will simply accept that things are done in the way they’re always done. You need people to ask the ‘dumb’ questions.”

One emerging trend is to appoint a person on the board who has responsibility for ensuring that all systems and controls are in place, and who is responsible for receiving information around the various threats, including bribery and corruption, competition and cartels, sanctions, cyber crime, data protection and privacy issues.

INTERNATIONAL ISSUES
Directors themselves must also ensure the organization has sufficiently robust directors’ and officers’ insurance policies (including the ability to choose their own lawyer with the requisite skills and experience in dealing with such cases), and that executives understand the potential ramifications of traveling outside their home territory if there are allegations of wrongdoing.

“We’re seeing increasing enforcement action across Europe as governments appreciate the revenue that can be raised from imposing fines,” Robertson points out. “This means that executives need to think about extradition and mutual legal assistance; if an investigation begins, is it safe for them to travel? Will they get arrested on a European arrest warrant if they travel to Poland or an international warrant if they travel to China? This is an area where, in my experience, directors rely on clear guidance.”

Running a multinational or global organization can be especially challenging, with laws and requirements varying by both country and region. Sanctions are one particularly problematic area, with differences between US-led policies and those in other parts of the world, while data protection laws also vary between Europe, the US and China. “In some countries, without the benefit of legal professional privilege, it is difficult to take private or confidential legal advice, which makes it difficult for lawyers to communicate with each other,” Robertson adds.

While the environment may be both challenging and changeable, there remain cultural obstacles in some organizations that also need to be overcome, and much of this is the responsibility of executives themselves. A recent study carried out by Ashridge Business School, based on interviews with executives and managers, suggests potential for complacency.

“Anecdotally, the leader sets the tone for the board’s risk appetite,” comments Trudi West, Client Director at Ashridge, “and there are some leaders at board level who don’t take the question of risk seriously enough, or are not prepared to hear bad news. As a result, issues get repackaged in a way that is not quite as urgent as it should be.”

Yet in the current environment, with regulators, politicians, media and the wider public all pushing for greater accountability, executives can no longer afford to take any chances, or to assume that, even if they are unaware of what is happening in their organization, they will not be held liable. The mood has changed, and with it the law. It may not be a matter of heads on spikes, but there are still plenty of reputations on the line.

Chinese complications
Executives around the world could find themselves facing class actions as a result of failings in Chinese enterprises that are part of a bigger group listed overseas, warns Chris Fordham, Managing Partner in EY’s Asia-Pacific FIDS practice. “A company listed on a US exchange could have major Chinese operations that may have had origins in a state–owned enterprise,” he explains. “Over time, it will start to inject international expertise into the C-suite, but those people may not have full transparency and control.”

This can be a particular issue where third-party holding companies or distributors are injected into organizational structures with no obvious reason. “There may be viable reasons, but if an executive can’t get comfort that these mechanisms make commercial sense, they need to start asking questions,” says Fordham. “Too often, such mechanisms leave themselves open to some form of manipulation.”

A particular issue in Asia in recent years has been short-seller attacks, where researchers undertake analysis into organizations they believe may be falsifying their accounts. “There may be some reason, such as a meteoric rise, but these analysts take a short position in a company’s stock and release their report. The shares then nosedive and the short-seller then makes a profit,” Fordham says. “There have been a host of these attacks in Asia.”

The resulting investigations could see US-based executives held personally liable for fraudulent activity in Asia, and they are unlikely to be covered by directors’ and officers’ insurance.

Diana Shin, Greater China FIDS Partner at EY, says executives need to understand the nature of an organization’s various entities and how much control the parent company has over them. “They also need to ensure they have the mandate to engage the right resources and competencies to commission an internal investigation if a whistle-blower allegation comes up,” she says. “A director needs to know the answers to these questions before they consider their appointment.”
“Life is now more dangerous for executives, threatening not only their reputation but also their liberty.”
In our latest EY analytics report, we look at how companies are currently using data analytics to find, measure, create and protect value across their organizations. Strikingly, while the research shows that 81% of organizations think data should be at the heart of every business decision, most are still using analytics in an isolated way to address specific business issues, limiting the potential value to increase performance and efficiency.

The economic downturn has changed the investment appeal of Europe’s emerging markets, leading to the rise of new powerhouses in Eastern Europe. The profile of investors into Europe has also changed: investment activity from the BRIC countries (Brazil, Russia, India and China) into Europe reached an all-time high in 2013.

To discover more about the role of emerging markets in Europe’s FDI story, read Playing catch-up: an extract on emerging markets from EY’s 2014 European attractiveness survey.

The March 2015 edition of our quarterly forecast highlights some reasons to be cheerful. Two key drivers have underpinned the upturn in fortunes: externally, oil prices hit a six-year low in January this year, while the European Central Bank’s quantitative easing program – weakening the euro and bringing bond yields down further – helped to allay fears of deflation and bolstered confidence more broadly.

For the latest updates on IFRS, visit ey.com/IFRS.
Dear readers,

Was life really that much simpler for auditors in the past? Not so long ago, it seems to me, the main qualities a good auditor needed were financial skills, sound judgment and a healthy dose of professional skepticism. While these attributes remain the cornerstone of the audit profession, we are now seeing rapid changes in the world of business, and the competencies required for a successful career in assurance are evolving too. At the forefront of this development is the growing importance of data analytics, as well as the cover feature on page 10 explains. Big data will transform the audit, and with it the skills necessary to provide effective scrutiny. The next generation of auditors will need IT knowledge as well as the traditional competencies in finance – and curriculums will have to adapt to take this on board.

For this generation, an understanding of data analysis, financial modeling and creative thinking will be vital additions to the fundamentals of accounting, risk management and familiarity with ever-changing auditing standards. And it doesn’t stop there. Data can tell a great deal of a company’s story, but it can’t tell everything. There’s an increasing demand for auditors to be aware of non-financial information and to examine any potential impact on the external environment and internal governance. One example of this is the growth of integrated reporting (IR) and its focus on six capitals: financial, intellectual, social and relationship, human and natural. As Paul Druckman, CEO of the International Integrated Reporting Council, explains in this issue (page 4), IR could “take the auditor back to looking holistically at the organization” rather than focusing on financial information and numbers.

The new skillset does not just apply to the next generation of auditors – it’s also relevant to all current finance professionals, including those who fill the top corporate jobs across the globe. Chief executives, CFOs and the whole finance function will have to get to grips with a world where both big data and sustainability take center stage. Our feature on reputational risk for executives (page 30) sheds light on another area of the world which is changing rapidly. Many board-level roles come with a higher level of personal threat than ever before, as governments introduce stronger anti-terror and corruption legislation. Failure to ask the right questions and ensure compliance with national laws could threaten not only an executive’s reputation, but also their very liberty.

The next issue of Reporting also includes some very insightful analysis from Dan Montgomery, the recently retired Deputy Chair of the International Auditing and Assurance Standards Board (page 8); Charles Noski, Audit Committee Chair at Microsoft and Avon Products (page 26); and Rostow Ravanah, CFO and co-founder of Mindtree (page 14). I hope you enjoy the content in this issue, and would be delighted to receive your feedback to help us improve Reporting. A reader survey is included at the back of the magazine, which is also available online at ey.com/reportingmagazinesurvey.

FELICIA PERSICO
Global Vice Chair, Assurance

On the shelf
New and recently published books

Six Capitals, or Can Accountants Save the Planet?
by Jane Glaeser-White (W.W. Norton & Company, March 2015)
A revolution is being led by the most unlikely of rebels: accountants. It demands that they go beyond accounting for traditional financial and industrial capital and, instead, make four new categories of wealth – intellectual, human, social and relationship, and natural – part of financial statements and GDP figures. Six Capitals evaluates the promise of this coming new age in capitalism and warns of the disaster that lies ahead if it is not implemented.

Irrational Exuberance
In this new edition of his bestseller, Nobel Prize-winning economist Shiller – who predicted both the technology and housing bubbles – cautions that signs of irrational exuberance among investors have actually increased since the financial crisis. With high stock and bond prices in the US and rising housing prices in many countries, the post-subprime boom looks set to be another illustration of his argument that psychologically driven volatility is an inherent characteristic of all asset markets.

Doing Good by Doing Well: Why Creating Shared Value Is the Key to Powering Business Growth and Innovation
by Peter Baines (Wrightbooks, April 2015)
Consumers now expect big businesses with ever-increasing profits to give back to the community from which those profits arise. At the same time, shareholders want dividends. Doing Good by Doing Well shows companies how to improve the bottom line by implementing an engaging, authentic and business-enhancing corporate social responsibility program that helps staff and business thrive.

Big Data: Using Smart Big Data, Analytics and Metrics to Make Better Decisions and Improve Performance
by Bernard Marr (John Wiley & Sons, January 2015)
Big Data will give you a clear understanding, blueprint and step-by-step approach to building your own big data strategy. This is a practical introduction to actually putting the topic into practice. The book is illustrated with numerous real-world examples from a cross-section of companies and organizations.
The right guide can make all the difference.

International GAAP® 2015 provides a comprehensive guide to interpreting and implementing IFRS. The fully revised and updated 2015 edition includes guidance on the new IFRS 15 Revenue from Contracts with Customers and the new IFRS 9 Financial Instruments. Visit ey.com/internationalgaap to learn more.

Common threads
How big data and analytics can transform the audit

Integrated reporting
What issues are companies encountering?

Risky business
Why the personal risks for executives have increased