



KPMG
International
Annual Review
2006

Thinking business

KPMG INTERNATIONAL

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After three years of exceptional growth, business is used to a level of stability not seen for many years. The economic outlook is less certain as we approach 2007 and growth is likely to slow. But the pace of change in the global economy will not.

Businesses and their advisers need, more than ever, to stay one step ahead of that change and anticipate the diverse issues that will affect their prosperity. Those who think laterally and stay agile will be most likely to succeed.

Business has enjoyed more or less ideal conditions in recent years with strong growth, low interest rates and buoyant financial markets. That is about to change as the global economy enters a period of turbulence.

Europe, Japan and the so-called BRIC economies—Brazil, Russia, India and China—still look robust. But the U.S., the world's largest economy, has already slowed markedly. As a result, short-term interest rates have been rising amid fears about inflation and the dollar has dipped abruptly.

Most bets are on a slowdown in the months ahead, but the consensus remains—at this stage—that the advanced economies will return to more usual and more sustainable trend rates and that China and India, while expanding less quickly, will still see growth in high single digits.

Some are more pessimistic, however, and for three main reasons:

- The end of the U.S. housing boom is depressing both residential investment and consumer spending and is likely to dampen activity for a while yet. The U.K. and Australia have achieved a “soft landing;” can the U.S.?
- Inflation pressures may tempt central banks to raise interest rates more aggressively, or keep them higher

for longer to control inflation, at just the time economies are slowing.

- Investors, some central bankers argue, are assuming that the extraordinarily favorable business environment of recent years will last forever. If the outlook deteriorates rapidly, investors could have a sharp rethink and send financial markets into a spin.

Businesses have to make sensible judgments about these short-term economic concerns. But more profound, longer-term change is continuing apace and demanding their attention too. In the pages that follow, we look at some of these issues. Businesses face some tricky choices. Those slow to adapt will be hard-pressed to compete. The most successful will be the most agile.

The potent mix of globalization and technological and demographic change is reshaping the world. Producers and consumers can increasingly view the world as a single marketplace. Industry needs to restructure to produce in the most efficient way and in the most efficient place.

The current boom in mergers and acquisitions is driven, at least in part, by the need for big companies to reap economies of scale. Supply chains are being constantly tweaked and reconfigured to take advantage

of changing market conditions.

Outsourcing and off-shoring activities are moving higher up the value chain. The search for opportunities in exciting new markets is accelerating. Capital is being exported to areas where labor is relatively inexpensive, while labor migrates, where possible, to higher-wage economies.

Regulation is globalizing at a similar pace and so are the institutions and markets on which businesses depend. This is a world where new dangers to companies—requiring ingenious solutions—are emerging all the time, such as the increasingly sophisticated threat to intellectual property from piracy and counterfeiting. And it's a world where society's expectations of companies are higher than ever, requiring greater accountability and approaches to doing business that can be seen to be sustainable.

All this would not, of course, be possible without free trade. Will it continue to be the dominant economic idea of the coming decades?

Not all the signs are good. Some fear the failure of the Doha Development Trade Round marks the start of a dangerous retreat to protectionism. Should it prove so, we could see a temporary slowdown in growth turn into something much worse—for the world's poorest and most affluent, alike.



WHAT'S THE DEAL?

The mergers and acquisitions (M&A) market is busy again and there's no shortage of companies and private equity (PE) houses looking for attractive deals. However, recent KPMG research suggests corporations must work much harder to create value from transactions, while hedge funds and the PE industry are facing increasing scrutiny.

In 2005 the value of acquisitions worldwide grew to more than USD2.98 trillion according to Dealogic; in 2006 the figure is expected to hit a record high of more than USD3.33 trillion.

This extraordinary growth reflects a favorable change in climate. Low interest rates mean debt is cheap. It's also available from a wider range of sources, with hedge funds and insurers now dominating the banks as providers of leverage. There's plenty of capital to be had from traditional sources, but abundant global investment capital is also emanating from new sources such as Dubai and Qatar. Markets such as India, China, Russia and Brazil present exciting opportunities for inward investment and the pace of outward investment from these markets is accelerating. But a number of important changes in the M&A market are presenting fresh challenges.

- A decade ago PE was a cottage industry. Its success in raising

new funds and the use of leverage in deals mean that PE houses and partnerships now have access to the sort of funds that make even the world's biggest companies potential targets. This year, for instance, the PE house KKR held talks with Vivendi about a solo USD51 billion take-over of the media and entertainment giant. Big PE houses, working together, now have the firepower to take on deals two or three times bigger.

- The rising power, influence and activism of hedge funds—now estimated by Hedge Fund Intelligence to control assets of more than USD1.5 trillion—are putting companies and PE houses under growing pressure to deliver returns from transactions.
- Hedge funds and PE houses are not finding it all plain sailing though. They are coming under far greater scrutiny. There are worries that hedge funds lack accountability and are free of regulation. Where PE is

concerned, some would like greater assurance that they are complying with regulations and are being taxed equitably. This year the UN Committee on Trade and Development has warned about the effects of PE cross-border deals on host economies. The U.K.'s Financial Services Authority and the Forum on Tax Administration are two others that have raised concerns.

- Leverage is now available from diverse sources (banks are estimated by Standard & Poor's, the rating agency, to control just 40 percent of the market) and on a wide variety of terms. The greater availability of interest-only debt means companies can do bigger deals with minimal cash-flow problems as the capital does not need to be repaid until the end of the borrowing term. This is pushing up prices and fuelling M&A activity. All well and good in a strong market, but in tougher times, some may well be left shouldering uncomfortable levels of debt. It will be those that work with advisers to come up with innovative debt-financing models and secure synergies valued in the deal that will prosper.
- Availability of increasingly sophisticated transaction advice—on both the buy and sell sides—

More companies have the means, the appetite and the shareholder support to do deals.

means the market is much more professional and competitive, with premiums rising rapidly. The threshold by which a successful deal is measured has been raised.

Strategic guidance

The pressure is on for deal makers to get the better of their rivals and prove to their own shareholders that they can create value and manage a wide range of pre- and post-deal risks.

Experience working with corporations, PE houses and other clients in 148 countries tells us that responding to these complex issues and making the most of opportunities is tricky. Even the largest organizations require help devising the right strategy.

The planning war—buyers versus sellers

The key for successful deals is making sure that value can be extracted from the transaction as quickly as possible. Pre-deal planning and post-deal execution both need to be faster and better. Increasingly, buyers face much more professional teams on the sell side, increasing the need to plan and execute effectively.

Precise planning and efficient execution might sound like an obvious prerequisite to any successful deal. Yet global research carried out by

KPMG in 2006 among 101 companies and 20 PE houses that had undertaken deals worth more than USD100 million underlined the importance of getting this right.

Our report “The Morning After,” found that more deals enhanced value than reduced it, but the largest proportion achieved only neutral value. It also found that:

- Companies were now paying an average of 43 percent of the expected synergy benefits in the purchase price.
- Forty eight percent believed pressure to deliver the value identified ahead of the deal is greater.
- Two thirds of acquirers said they failed to reach their value target.
- Too few do enough post-deal planning and it can take up to two years to gain real control.
- PE houses are often better prepared.

Undoubtedly these pressures will intensify. And, as more capital is released to fund bigger deals, the need for strong, professional advice will only intensify.

TEN STEPS TO A BETTER DEAL

Getting to the point of purchase is hard enough, but the really hard work begins with integration. Yet it's clear that acquirers can prepare better for both the buying phase and the reality of merging. We have developed a 10-point check list for organizations entering the deal arena.

- 1 Perform robust pre-deal analysis—and be confident of synergies before including them in the price.
- 2 Identify and analyze post-deal issues in advance—they could be deal-breakers.
- 3 Use any period of regulatory scrutiny to plan and begin post-deal management planning before completion.
- 4 Put a dedicated team in place to manage the post-deal work.
- 5 Get control of finance and reporting systems as soon after completion as possible.
- 6 Identify any cultural differences between the two organizations and work out in advance how to deal with them.
- 7 Anticipate management and leadership issues early and keep a close eye on how they are dealt with.
- 8 Achieving incremental value and day-to-day management issues deserve equal attention.
- 9 Plan aggressively to exceed original synergy and performance targets.
- 10 Keep a careful track of the value being delivered by the deal and make honest assessments of the effectiveness of post-deal work.



LISTING—STOCK MARKETS FACE CHANGE

There was a time when stock exchanges were the stages on which dramatic corporate takeovers were played out. Now they are just as likely to find themselves in the bid spotlight, as the London Stock Exchange and Euronext have learned in the last two years.

The equity trading centers of the world are under pressure to adapt to an ever more sophisticated M&A market, a massive increase in takeover activity, the capital needs of huge multinational corporations and the growing power and influence of global hedge funds and private equity houses.

At the same time they are wrestling with changes in regulation—both national and international—to ensure they offer a competitive deal environment that is both liberal and compliant. Consolidation is increasingly the order of the day as the world's biggest exchanges look for advantage and try to see off new competitors such as the group of investment banks planning a new European share-trading platform. Smaller exchanges face a fight for survival.

So where should a company list? Is it inevitable that one financial center will eventually dominate?

This seems unlikely at this stage. It is more probable that activity will gravitate toward the world's largest

markets with London, New York and Hong Kong, the latter buoyed by China's expanding and increasingly global corporate sector, dominating. Competition between them is fierce and likely to grow fiercer.

London, perceived as offering a favorable regulatory environment, is currently drawing work away from New York, for example. In the first half of this year, for the first time, more money was raised from Initial Public Offerings (IPO's) in London than in New York. New issues—now truly global—have this year included companies from Peru, Pakistan, Russia and Dubai. Twenty years after the Big Bang, share trading remains the strongest area of growth for London and new technology will, beginning next year, mean even faster dealing times while consolidation and competition will force dealing costs down.

The next 10 to 20 years will see this competition continue. We can expect these three big exchanges and a few other near rivals, such as Tokyo and Frankfurt, to thrive, although not

necessarily in their current form. Our firms' work with clients looking for the best place to list suggests geography or differing regulatory regimes will remain deciding factors for companies looking for the best place to list. Above all they are seeking out the largest and most liquid markets and will continue to do so.

Smaller national bourses and exchanges will need to find new ways to compete in this world, which has major implications for middle-sized companies looking to raise capital.

The signs of change are already evident here too. The major second-tier markets such as London's Alternative Investment Market (AIM) and the NASDAQ are increasingly global. The year to the end of September 2006 saw 102 international IPO's launched on the AIM market, compared with 71 the year before. Growth companies—at the earliest stages of development—appear just as able to be mobile when looking for the best place to list. And these exchanges are increasingly assertive, as the NASDAQ's bid for the London Stock Exchange shows.

We recognize we must use our talent, knowledge and intellectual property responsibly to serve our clients and the communities in which we operate.

TAX, TRUST AND THE PUBLIC INTEREST

Lack of trust between governments and taxpayers damages both sides, but there is a way forward.

Tax authorities are expected to provide reliable revenue streams to government while maximizing the tax yield. Businesses are expected to minimize their effective tax rates in the interests of shareholders.

This may seem an adversarial position, but taxpayers and authorities share a common goal—a robust and dynamic economy. A thriving business can make a substantial overall economic contribution through job creation and local investment as well as provide tax revenue. Equally the use of tax revenue to help fund investments in the business environment helps business to prosper. On both sides tax is best approached as a balanced ecosystem based on mutuality.

Indeed, there is increasing recognition that the management of tax can be viewed as a signal of wider policy intent and strategic priorities. Corporate policy on tax planning and control may signal attitudes in relation to competitiveness, transparency, regulatory and investor relations and enterprise risk management, for example. Similarly, government tax policy and collection can indicate attitudes toward wider economic

policy and its degree of acceptance of globalization in relation to investment and tax-base flows.

Unfortunately, lack of understanding between tax authorities and taxpayers about their roles and the pressures they face restricts opportunities to develop mutually beneficial approaches to tax policy. The existence of this tax “trust gap” was confirmed by an OECD Center for Tax Policy Administration forum in 2006 in Seoul, South Korea, where authorities from 35 countries exchanged ideas and set policy on international tax administration. The forum acknowledged the heavy demands on already hard-pressed administrators, which are increased by conflict with taxpayers.

This is an omission as we see signs that some tax administrations recognize that they have an important role to play in attracting and retaining corporate investment. As KPMG’s “Corporate Income Tax Rate: A Trend Analysis” survey in 2006 reveals, there has been a consistent and dramatic reduction in corporate tax rates over a 14-year period. The survey notes that if governments are to avoid a “race

to the bottom” in terms of headline rates they must consider other tactics, such as taking a “business-friendly” collaborative stance.

Tax advisers such as KPMG firms can address these issues by using our relationships with taxpayers and tax authorities to help eradicate suspicion. But we must continue to earn trust from all sides by helping taxpayers to remain both competitive and compliant in an ever more complex legislative world.

Bridging the tax trust gap

Five suggestions for improvement from KPMG:

- Greater clarity on policy purpose and tax law design from legislators.
- Joint training for public and private sector tax practitioners.
- Introduction of a voluntary code of conduct for taxpayers, tax authorities and tax advisers as both a framework for common standards of behavior and a platform for collaborative discussion.
- Better understanding of business among tax authorities, leading to informed responses to taxpayers’ concerns on the uncertainty of regulation and the burden of administration.
- Recognition among leading professional services firms that they have tremendous intellectual firepower and resources, and with that power comes responsibility.



RISK TO REWARD: TURNING REGULATION TO YOUR ADVANTAGE

New regulations are changing the framework for controlling risk and capital and creating incentives for banks and insurers to better manage their risks. Some have been slow to respond. Others are beginning to see that the new rules—though onerous—may offer the chance to improve controls, efficiency and returns.

For banks and insurance companies the key lies in risk and capital management. The aim is to make sure the business is neither undercapitalized—where it might go bankrupt because it cannot meet unexpected commitments arising from its risk portfolio—or overcapitalized—pushing down the returns to shareholders.

For banks, the new Basel II regulations increase the range of risks that they are required to consider when setting their capital requirements. But the new rules also offer incentives for banks that can show they have drawn up an accurate risk profile, matched by the right levels of capital and controlled as part of a system of proactive risk management.

Insurers are now under similar pressures. The European Commission has made it clear that its proposed Solvency II framework, expected to come into effect in 2008/09, will require insurance companies to implement economic capital management measures similar to those of Basel II.

The regulatory changes have been well flagged. Yet there is evidence that some institutions are continuing to underestimate the work they face in meeting the new regulations. For most it will involve a significant change in culture and the introduction of new risk policies and procedures. Tightening the current practice or bolting on a few compliance functions will not be enough.

The experience of those banks that are ahead of the field is that it can take a number of years to make the transition and demands strong leadership from the board, a thorough overhaul of risk management procedures and an effective program of reeducation at all levels of the organization.

But there are real strategic and operational benefits to be had.

By being able to allocate total economic capital back to individual departments, products and lines of business, a bank should have a much more accurate means of assessing its overall

performance. This in turn should allow more effective decision-making on products and marketing, expansion and configuring its portfolio. Informing important stakeholders—such as shareholders, regulators and rating agencies—should also be easier.

Companies across all sectors are facing increased regulation. The challenge is to go beyond merely meeting the new rules to a point where compliance is used to improve performance and create value.

Insurers should be able to get a detailed view of the risks they are taking and match the capital to those risks more accurately rather than continuing to rely on actuarial statistics to develop a rule-of-thumb approach to setting capital levels. As competition intensifies in the sector, many are realizing they need more sophisticated measures.

But the key is to adopt early and implement rigorously. Those just starting out face a challenging agenda. Effort, resources and expert guidance will be needed. It is essential they start the work soon.

“I can’t do business unless my advisers understand my company’s culture and industry control.”

Client, KPMG Brand Survey 2006

CONTROLS: IMPROVING PERFORMANCE

More copious and accurate internal reporting requirements, which cost some companies many millions of dollars, may generate business benefits as well as enhanced compliance.

In a large, complex international business inefficiency and errors at a local level can lead to increased risk and substantial unnecessary cost. Without access to sophisticated and standardized data from across the business it can take time for senior management to identify, analyze and address significant performance issues. And producing consistent and meaningful financial reports from a wide range of locations and activities may require onerous consolidation of data.

There may be a solution in the form of the enhanced controls many companies were required to adopt in response to Sarbanes-Oxley (S-O), International Financial Reporting Standards (IFRS) and other new standards. These brought greater consistency and rigor to reporting, and forward-looking companies are now finding many more ways to derive value creation and value preservation benefits from their new controls processes, along with more robust compliance.

While not the glamorous area within global business, controls are critical to sustainable success, they are people-

driven and they should pervade every aspect of a company’s activities. From fraud prevention to privacy, from tax issues to growth management, from supply chain efficiency to remuneration, wider use of sophisticated, standardized controls processes can give management and board committees much improved oversight of both how the company is operating at a local level and who is responsible for what is happening.

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Many early adopters of controls transformation are now seeking a consolidated view of the company’s controls, with a single integrated team taking responsibility for assessing all compliance and performance monitoring. This is particularly valuable for companies with significant overseas operations subject to regular legal,

regulatory, commercial and internal variation and change.

KPMG teams are supporting a wide range of businesses as they evolve their approach to controls. For example, at U.S. transport-to-construction conglomerate Trinity Industries a KPMG co-sourced internal audit team is working with management to enable 400 employees to define and deliver performance improvements across areas as diverse as plant operations, inventory management, asset management and information technology. Annual S-O section 404 costs have already dropped 40 percent as a result.

In essence, controls transformation is about improving the quality and availability of information about a company’s actions, and that can only help to improve compliance, risk management and performance. It seems the pain and anxiety created by new standards may be giving way to opportunity.

For the full version of “The Compliance Journey: Balancing Risk and Controls with Business Improvement” by KPMG, please go to www.kpmg.com/review2006



SOURCING: NEW MODELS EMERGE

Rapid technological change and the rise of China and India have created startling changes in the way businesses are organized and run. The Internet, broadband and cheap telephony have put a new supply of highly educated, skilled labor at the disposal of companies in every corner of the globe. Economic reforms in emerging economies mean the barriers to trade are being rapidly dismantled.

Customers are becoming more global too and adept at using browse, search and buy technology to purchase goods and services.

In the face of such dizzying change, all companies need to be asking tough questions about how they are structured and reviewing a range of sourcing options including outsourcing, partnering and shared services—both domestic and off-shore.

Sourcing is by no means a new thing. But the parameters have changed greatly since the first structures of 20 years ago. Now far more sophisticated services and functions are being transferred—R&D, legal, customer services, code development, and medical diagnosis, for instance. As the value of sourcing arrangements grows, so does the strategic significance. With reputation, reliability and returns at stake, it's a boardroom issue, not just a matter of procurement.

Placing key functions off-shore through outsourcing arrangements or captive shared services can offer huge benefits, including lower labor costs, access to more skilled workers, greater capacity and flexibility to meet customer needs. But such relationships require careful control, seamless coordination and a proper transfer of knowledge. Although many organizations have seen significant benefits, there are others that have come to rue the day they moved off-shore in the face of customer complaints, worries over intellectual property and service standards.

It is critical that companies carefully consider the options available to them from the beginning and understand how these options fit into the business strategy. Too often, KPMG Advisory teams are called in to help sort out situations that are not working because the relationship was wrong from the start.

Companies need first to determine the answer to some basic questions, like:

- What competitive advantage are we looking for? Cheaper development, better skills, faster response and/or improved service?
- What is the range of alternatives available to us, and how do these alternatives meet our business requirements?
- How will we continue to adapt to market changes?
- What risks are acceptable to the organization and how do we manage those risks?

Such questions not only make decisions more rational but also help set targets by which performance can be measured. Companies failing to ask the questions risk being left behind.



CREATING COMPETITIVE SUPPLY CHAINS

From Shanghai to Sydney, from Singapore to South Carolina and from London to Mumbai, executives are rethinking the way they structure their supply chains. We are moving from a copy cat best practice approach to personalization, where supply chains are designed and run to offer maximum competitive advantage.

Companies are moving away from the traditional linear chain. Instead, they are turning their supply organizations into interdependent ecosystems in a bid to create greater value for their customers.

We wanted to discover which new approaches to supply chain management are being employed by executives in some of the world's most prestigious companies. So KPMG's global Consumer and Industrial Products practice worked with Cardiff Business School and Stanford University during 2006 on a series of studies to understand how global complexity in the supply chain affected the financial performance of companies. We looked at the business models of 86 business-to-business and business-to-consumer enterprises in Europe, America, India and Asia Pacific regions such as China, Singapore and Australia.

Our study found that the new approach to supply chains recognizes that the forces of market complexity offer a growth opportunity if companies can tailor products and services to meet

a much wider range of customer needs. To do so they need to get closer to a wider range of customers with different needs, requiring them to team up supply and distribution partners who have the right skills and knowledge.

Companies that can come up with progressive approaches, engage their suppliers and encourage them to move from knowing to doing are more likely to tap new revenue streams.

The new supply chain designs spread innovation processes more widely among suppliers, unlike the old approach of restricting innovation to the higher tiers of the chain. Now the emphasis is on making the right product in the right way from the consumer's rather than the producer's point of view.

Our survey also found that executives in China and India were not content to remain trapped in the low cost/back office design. They are using the supply chain for competitive advantage and pushing for direct technology transfer to help them change their supply models.

Lean manufacturing and high-quality standards are being applied in emerging economies, the survey found, but generally attention to detail in supply chains has been lacking in recent times. This provides a window of opportunity for the mature economies to develop the capabilities to build new supply chain models.



COUNTERFEIT: THE LOWEST FORM OF FLATTERY

Forget the traditional image of rogue street traders thrusting briefcases full of fake Rolex watches at you. Counterfeiting has evolved into a global industry estimated to be worth more than USD500 billion a year, a key source of funds for organized crime and a major problem for companies across many sectors.

Interpol estimates that counterfeiting has grown eight times faster than legitimate trade since the early 1990s. Seizures of counterfeit goods by E.U. customs authorities increased 900 percent between 1998 and 2001.

The counterfeiters are getting better and more ambitious and have moved quickly. Besides luxury goods and the well-publicized problems with music piracy, counterfeiting is now a significant issue in pharmaceuticals, tobacco, automotive and aircraft parts, alcoholic beverages, petroleum products and software.

The World Health Organization has estimated that 10 percent of all medicines sold globally are fake, with the figure even higher in developing countries (a Nigerian survey found that 80 percent of medicines sold in Lagos pharmacies were counterfeit). The Federal Aviation Authority estimates that more than 500,000 fake airline parts are installed each year. Entire counterfeit BP petrol stations have been found in Bulgaria, Azerbaijan and Romania.

Counterfeiting causes real economic harm. Reduced profits restrict investment in research and innovation; lower sales harm employment (counterfeiting is estimated to have caused the loss of more than 200,000 jobs in the U.S. and Europe); and reduced revenue from VAT, income tax and duties have a direct effect on government welfare programs.

And counterfeit products cost lives. Some 60 people were killed in Estonia in 2001 by illicit vodka containing methyl alcohol. The *Shenzhen Evening News* estimated that 192,000 people died as a result of counterfeit medicines in China during 2001. Recent counterfeit seizures in the E.U. have included fake Gillette razors with dangerously uneven blades and cardiovascular pills made of brick dust, dyed yellow using road paint and given a lacquered finish with furniture polish.

The tobacco industry is facing a major counterfeiting issue. Cigarettes represent almost the ideal product for the counterfeiter. They are small

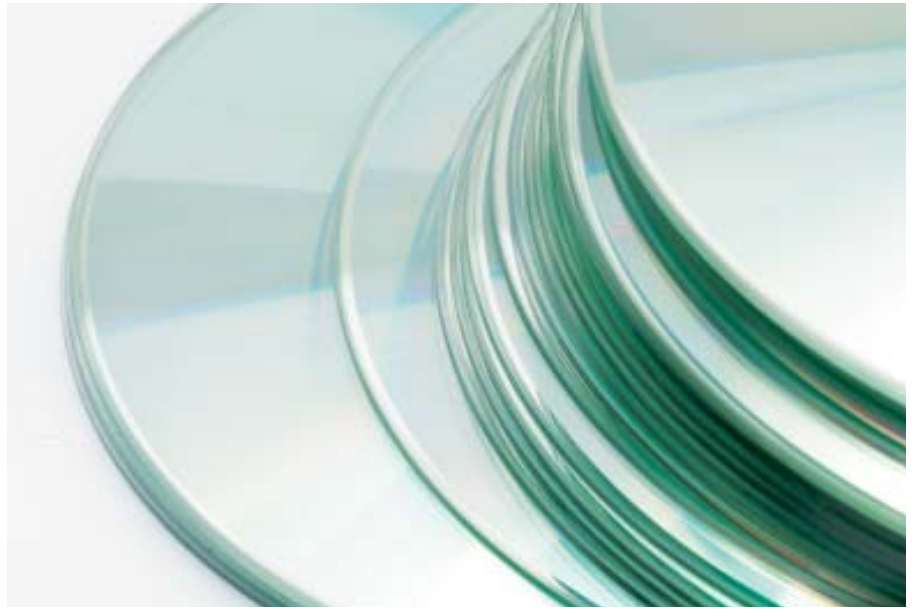
and easily transportable. Taxes typically make up a large proportion of the retail price, meaning counterfeit profit margins are very high. Distribution channels are highly fragmented in many markets and hard to monitor, with street sales and independent outlets common at a unit level.

In Germany alone, more than 400 million counterfeit cigarettes were seized last year and one estimate puts annual counterfeit production in China at 190 billion cigarettes.

If the counterfeit industry were a country, it would rank among the top 20 largest nations and be rising up the list at an alarming rate.

As part of its wider work in this area, KPMG's Strategic & Commercial Intelligence unit is working closely with Philip Morris International Management S.A. to measure and help combat cigarette counterfeiting.

In the first phase we are trying to get an accurate picture of the scale of the problem across each of the 25 E.U. markets. One of the biggest problems is knowing where to look and where



to direct resources to stem the tide of fake goods. The participants in this illicit industry are doing their utmost to keep their operations invisible and existing research tends to be neither detailed nor accurate enough.

KPMG therefore developed its own methodology to assess each market, including cigarette and other tobacco product consumption, legal cross-border shopping within and outside the E.U., counterfeit sales and contraband tobacco flows.

This approach combines primary market research, econometric modeling, market analysis, expert interview programs and existing industry research surveys. Following a pilot phase to test and refine this methodology in three markets, including 27,000 interviews to help in understanding consumers' tobacco shopping behavior, this approach is now being rolled out across the remaining 22 E.U. countries. Philip Morris International believes the KPMG project will "be key to an informed dialogue with the European Community and Member State governments, not only on the scope of the problem but on potential ways to address it."

This is all part of our wider work on counterfeiting. KPMG firms are also helping clients deploy supply chain checking systems, such as track and

trace, as well as running counterfeit and grey market audit checks to police the protection of intellectual property. For example, KPMG is working with brand protection teams at a number of companies, including network equipment manufacturers and electronics and mobile communications companies, to reduce counterfeit activity through contract compliance checks on their distribution channels. In addition, KPMG firms are helping track unlicensed distribution of music content.



ENERGY SUPPLIERS TO THE WORLD

Russia and Saudi Arabia sit on abundant natural resources including the globe's richest reserves of hydrocarbons. They are relatively lightly populated and positioned between the key markets of Europe, China, India and North America. Poised to become energy suppliers to the world, they are building their economies around that competitive advantage. But they face unique challenges.

KPMG has established itself as a leading adviser to many of the world's most important energy companies, combining our skills in financial reporting and internal audit, financial risk management, tax, accounting and governance. Our member firm clients are undertaking advanced exploration, seeking to acquire prospects, identifying, negotiating, planning, commissioning or operating significant resources projects.

Energy and natural resources projects are intrinsically high risk. In the West, increased regulation and stakeholder activity is challenging organizations to listen and respond to a wider range of stakeholder concerns. Globalization means internal audit departments must embed appropriate risk controls across increasingly complex and diverse communities. Process failure can make or break companies and the reputations of those charged with their design and execution. Equally, informed decision-

making and meticulous execution can significantly increase the likelihood of success.

For some time we have been making our knowledge and skills available to companies in Russia and Saudi Arabia, where some of the challenges differ from those in the West.

The stakes are high and all of this has led to a realignment of organizational reporting, governance, risk management and assurance and resulted in a war for talent.

Privatization of the Russian oil industry is well advanced and many companies now have international listings. But 80 percent of the world's oil industry remains in state control. In Saudi Arabia the oil giant Saudi Aramco continues to be state owned, although it operates with the characteristics of an international oil company. However, Saudi Aramco has already opened up its downstream operations to joint-venture partners with more projects on the way. Take the huge multibillion-dollar PetroRabigh petrochemical refining

By working with leading companies in the sector we are playing a part in the development of the capital markets in these countries.

project—a joint venture between Saudi Aramco and Sumitomo Chemicals on Saudi Arabia's Red Sea coast and a new KPMG audit client.

Traditionally, governance structures within Russian and Saudi Arabian businesses are different from those in the West. These days, however, we are beginning to see greater convergence with companies often selecting the best parts of the western model and blending it with their own approach. So in our advisory work our job is to help clients explore, tailor and adopt governance and management processes that meet their needs, whether it be the implementation of an enterprise risk management system or carrying out planning, budgeting and process design feasibility studies.

To help ensure the success of these projects we have had to mobilize KPMG's international experience and enhance our local teams to make sure our member firm clients have a current perspective on global industry trends. By working closely with our member firm clients we are transferring knowledge in areas such as risk management and corporate governance and have examined the workings of internal audit in both national and international operations.

The role of these industries in their national economies and internationally is pivotal. They have the power to create great wealth and stimulate domestic GDP growth, bringing wider economic benefits at relatively low cost. By working with leading companies in the sector we are playing a part in the development of the capital markets in these countries.

The consequences of this growth are important drivers for the governments of both Russia and Saudi Arabia, which are seeking more influence in world affairs. Ultimately the development of these industries will have a significant impact outside their national borders. With the growth of both China and India and the growing importance of Russia and the Middle East as energy suppliers to the world, many believe we are beginning to see a fundamental realignment of global economic power.



REDIAL—MOBILE OPERATORS LOOK FOR NEW REVENUE

Consumers around the world want to use their mobile phones to surf the net, read e-mails, listen to music, watch film clips and play games. They want more multi-media services but it would seem they are unwilling to pay a premium for them, according to KPMG research carried out in 2006 among 3,576 phone users in Europe, North America and Asia.

KPMG firms are therefore helping telecommunications companies to look at new ways to monetize these services.

Convergence is happening at a rapid rate and nowhere is this more evident than in the mobile phone sector. Up to now telcos have relied on selling more and more services to their customers to keep revenue growing. But the scope for increasing charges may be narrowing for a generation of users who see freely available Internet content as their model.

Our survey of consumers across the world detected a real appetite for services such as movie previews, video dramas and sports clips. There were different content preferences in different regions. Asian consumers preferred entertainment, while Europeans and North Americans favored information-related services. But overall, few saw limits to the sort of content they thought could be put on mobile phones.

This is good news for service and content providers that are investing heavily in the new services. The dilemma is how to make money



with them. Consumers in the survey were clearly reluctant to pay more. In fact, nearly 40 percent said they would not be prepared to pay a premium over their current bill to receive new services.

If consumers continue to favor single service providers, the likelihood is that a few telcos will emerge as dominant players. Implementing innovative business plans quickly may become a prerequisite for survival.

Another important trend picked up in our survey was consumers' preference for a single service provider. This implies that the market will ultimately be dominated by relatively few providers.

The question is: what will mobile operators need to do to make sure they can fully exploit this opportunity? The answer: swiftly rethink their business models.

Service providers must try to persuade consumers to pay more for new services and recognize that people in different markets have different content preferences. They will need to focus on building up a strong base of loyal

subscribers and use this to develop a "wallet sharing" approach to building revenue, where they offer third parties—such as mobile-commerce companies and advertisers—a gateway to their customers.

Content producers need to recognize that short, effective content will be most in demand. In Asia our survey showed the preference is for music and gaming, while in the West demand for information services is highest. However, some types of content have universal appeal—news, movie previews and sports clips. These are good markets for advertisers.

Developing high-quality, location-based advertising opportunities will be the key for marketing and m-commerce companies. They start from a strong base. The click-through rate on mobile services of this sort is already four times higher than on the Internet.

Investors need to be acutely aware of changing business models in the mobile industry. Above all they need to understand the likely return on investment they will see if the industry embraces wallet sharing as the principal operating model.

KPMG firms offer media, entertainment and communications clients a range of services to help them manage their digital operations covering key issues

such as content security, licensing and rights management, contract compliance, royalty reviews and content revenue assurance.

Our Digital Services Framework (DSF) provides clients with a pragmatic approach to finding digital content solutions for content creators, owners and aggregators, wireless and broadband carriers, third-party content platforms and off-portal operators. In a world where consumers can access any type of content immediately and relatively cheaply, the DSF is designed to identify the challenges providers will face and offer strategies based on real experiences.



LATIN AMERICA'S VIBRANT MARKETS ARE NOT TO BE MISSED

Not so long ago Latin America was widely regarded as a virtual “no go” area for investment by many international companies. But that has changed. More and more businesses, their confidence buoyed by a strong record of recent growth on the back of soaring commodity prices and economic reform, now see this exciting and youthful market of 528 million people as one that companies can not afford to ignore.

The region—which accounts for 50 percent of the world's arable farmland, 14 percent of the world's daily oil output and is the leading producer of copper, gold, silver and other metals—is already attracting some USD61 billion of foreign direct investment (FDI). It also has the advantage of a young population with 30-35 percent of the people of Brazil and Mexico under the age of 15, compared with 25 percent in China.

Recent economic growth has inspired confidence. Regional GDP growth reached a 25-year high of 5.5 percent in 2004, before slowing slightly to 4.3 percent in 2005. Growth is unlikely to match rates expected in Asia in the next few years, but the consensus is that it will remain strong.

2006 marked one of the most important political years in Latin America, with no fewer than 13 presidential elections. It was an opportune time to assess how business attitudes toward the region were changing. We worked

with the Economist Intelligence Unit to survey attitudes to investment among 100 senior executives from a cross-section of industries, mostly large organizations with operations in the region.

Brazil and Mexico now sit as second and third in the league of emerging countries attracting FDI, and some executives believe they offer better returns than China or India. Brazil is rated as second to China as a consumer market in which to invest.

While few executives believed Latin America could match Asian growth rates, most saw attractive opportunities in the region and many said they plan to invest in the larger, more stable markets in Mexico, Brazil, Argentina and Chile.

Three quarters expected the rewards to outweigh the risks.

Of course risks remain and four fifths of executives wanted to see new, more populist administrations push through further economic reforms to consolidate earlier liberalizations and action to bolster local currencies and reduce inflation. At a micro level many cited attracting the right people at all levels as a challenge, and lack of intellectual property protection, inconsistent regulation and legal regimes as obstacles. Executives want rules and regulations to be applied consistently in key local markets. A clear preference for mergers and acquisitions (38 percent) versus joint ventures (23 percent) was picked up as the preferred investment route—perhaps indicating a desire to maintain greater control over their operations.

KPMG sees Latin America as a key region for growth and investment, particularly the increasingly strong business axis between the Iberian peninsular and the region. We have now created an Iberoamerica Oversight Board, chaired by our CEO, Mike Wareing. It is charged with developing our strategy for the region and overseeing key accounts.

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Publication Name: KPMG International Annual Review 2006

Publication Number: 304980

Publication Date: January 2007