

Eastern Influx

Automotive manufacturing in Central and Eastern Europe*

Part 5: What problems should an automotive manufacturer that has moved to Central and Eastern Europe expect after the first few months, and how should it resolve them?



A growing number of automotive manufacturers are migrating to Central and Eastern Europe. In our last paper we looked at the challenges associated with managing the move to a new site, and what any components supplier acquiring a factory in one of the region's 10 new European Union (EU) member states should do in the 100 days after closing the deal. However, some problems only emerge after the first few months. Our final paper covers the issues that typically surface after a transaction has been completed but before the dust has had time to settle.

Tackling procurement fraud and other forms of economic crime

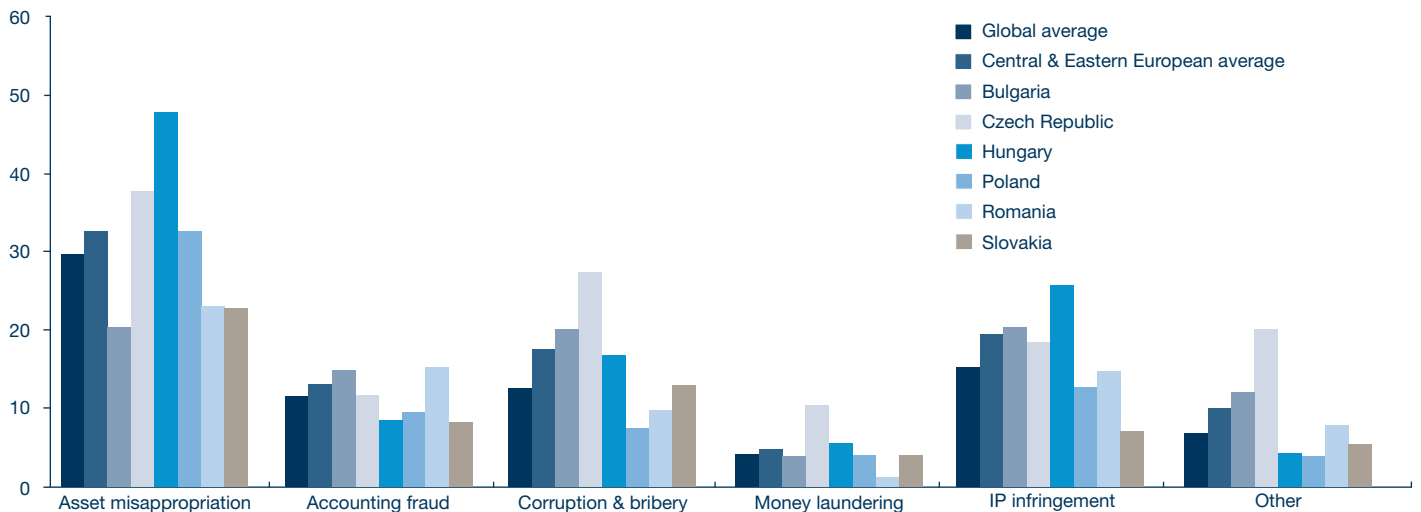
As we indicated in a previous paper, economic crime is prevalent throughout the world – and Eastern Europe is no exception. Half of the Central and

Eastern European companies participating in the PricewaterhouseCoopers Global Economic Crime Survey 2007 reported that they had been the victims of at least one economic crime within the previous two years¹.

More than half of all the offences that were perpetrated involved the misappropriation of assets or infringement of intellectual property rights (see Figure 1). More than a third of the most serious incidents were “inside jobs”, and many of them originated at the top; 38% of the most serious crimes were committed by senior managers or directors, in marked contrast with a global average of just 20%.

¹For further information, please see “Economic crime: people, culture and controls” (October 2007). Available at <http://www.pwc.com/extweb/home.nsf/docid/29CAE5B1F1D40EE38525736A007123FD>

Figure 1: The percentage of companies reporting that they were the victims of different forms of economic crime between 2005 and 2007



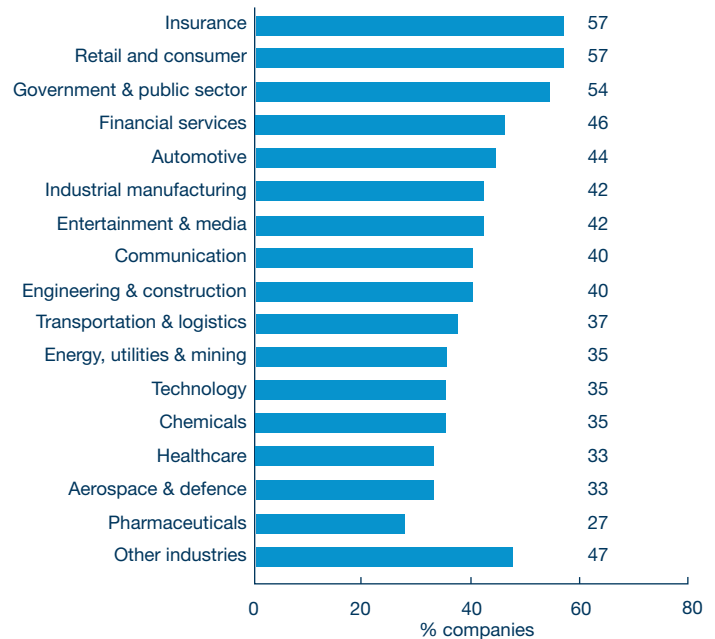
Source: PricewaterhouseCoopers Global Economic Crime Survey 2007

The automotive industry proved less vulnerable than several other sectors. Even so, 44% of the automotive manufacturers in our global survey experienced some sort of fraud (see [Figure 2](#)). And though it is difficult to determine the overall impact of economic crime, the Motor and Equipment Manufacturers' Association estimates that counterfeiting alone costs components suppliers worldwide about \$12 billion a year.

The due diligence process often exposes any instances of wrongdoing, but some frauds escape immediate detection or are simply too small to justify terminating a deal. Nevertheless, they must be stamped out as rapidly as possible.

One of the biggest problems is procurement fraud – where a member of staff conspires with an outside vendor to cheat his employer by commissioning products and services that are never delivered, manipulating contracts or signing inflated invoices (see sidebar, [Catching the crooks](#)). There have been a number of very high-profile cases affecting automotive companies in recent years.

Figure 2: Companies reporting fraud by industry sector



Source: PricewaterhouseCoopers Global Economic Crime Survey 2007

Catching the crooks

The signs of procurement fraud are often indirect, says Rafal Krasnodebski, a partner in the Central and Eastern European division of PricewaterhouseCoopers' Performance Improvement practice. It might be that a particular supplier always seems to win the largest tenders, for example, or that one of the key people in the purchasing department enjoys a more lavish lifestyle than his salary suggests he can afford.

It's not just staff in the lower ranks of the corporate hierarchy who commit fraud, Mr Krasnodebski adds. Sometimes the problem resides right at the top. We've seen cases where an acquiring company loses a number of key contracts in Central and Eastern Europe shortly after completing the transaction. When we've investigated, we've discovered that the management of the target firm has set up another business in direct competition with the buyer, and is poaching its best customers. It's essential for any purchaser to put proper operational and financial controls in place as soon as possible, and keep a sharp eye on what's happening in the months following the deal, he concludes.

However, there are several ways of mitigating such risks. The first is to create a list of approved suppliers whose legitimacy has previously been verified and refuse to pay any invoices submitted by vendors that are not on this list. A telephone number and web site are not proof that a company really exists; it is essential to perform proper supplier due diligence, including checking whether the company has been registered and does what it purports to do on the scale it claims. The list should also be reviewed on a regular basis to identify whether any suppliers are receiving an abnormal amount of business or whether there have been any changes in procurement patterns that are not in the best interests of the acquiring company.

A second measure is to ensure that different people are responsible for negotiating contracts, signing invoices and auditing the accounts. These checks and balances sometimes fall by the wayside after an acquisition because management is preoccupied with numerous other issues, but the US Association of Certified Fraud Examiners reports that the separation of job responsibilities substantially reduces the incidence of fraud. Similarly, at least two people should monitor inventory levels and verify each delivery. With weak stock control systems, it is all too easy for dishonest employees to pilfer goods or redirect them to another address.

Any company that has recently purchased a business in Central and Eastern Europe should also consider setting up a whistleblowers' hotline to let staff report any irregularities without fear of reprisals. The provision of a confidential reporting mechanism for employees is a requirement for US companies under the Sarbanes-Oxley Act but it makes sense elsewhere, too. Research conducted by the PricewaterhouseCoopers Investigations and Forensic Services practice shows that, even though Central and Eastern European companies are increasingly confident about the

quality of their risk management systems, most cases of fraud are detected through tip-offs or by chance. But companies that have introduced whistle-blowing systems are significantly less dependent on external informers than those that have not.

Lastly – and most obviously – it is imperative to vet any new staff by taking up their references with former employers and professional or educational bodies, although we would also recommend more comprehensive pre-employment screening. Of course, there will always be smart people who find ways of slipping through the net and no company can completely eliminate the risk of fraud; as with the mythical Hydra, cutting off one head merely allows two others to grow in its place. But adopting these safeguards certainly reduces the danger.

Ensuring compliance with the anti-corruption laws

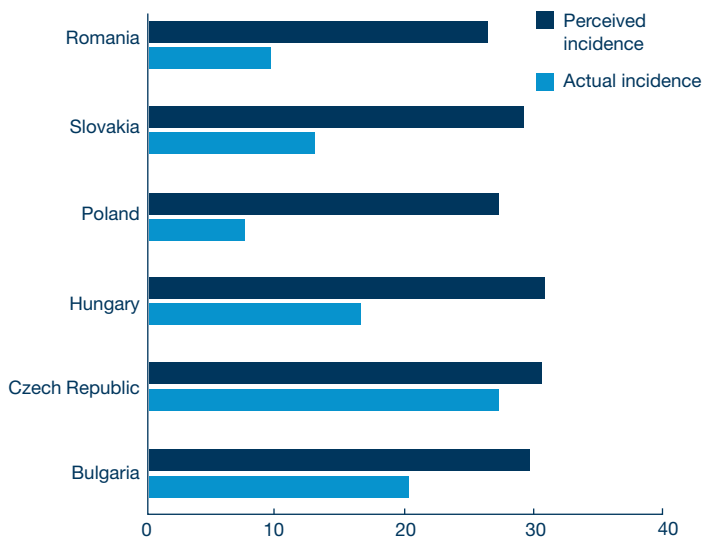
Fraud is not the only problem some acquiring companies face. Between 7.6% and 27.4% of the Central and Eastern European firms participating in our latest economic crime survey reported that they had been victims of corruption within the previous two years. A significant number of companies, it seems, still use bribery to win new business – and the laws against such conduct are now being much more rigorously enforced.

In fact, the incidence of corruption and bribery is considerably lower than perceptions of its prevalence might suggest (see [Figure 3](#)), and the increase in the percentage of companies expressing concern about such crimes is partly a reflection of the sea-change in attitudes that has taken place over the past few years. A growing number of companies in the region regard bribery as an unacceptable way of doing business. However, it is extremely difficult to avoid all such

behaviour when corruption is still common in certain parts of the public sector.

The World Bank reports that control of corruption – which it defines as the exercise of public power for private gain or “capture” of the state by elites and private interests – is strong in Estonia and Slovenia, with scores of 0.87 and 0.92, respectively. (By way of comparison, Germany has a score of 1.78, which is enough to put it in the top percentile.) But control of corruption is considerably weaker in the six other countries that joined the EU in 2004, and weaker still in Bulgaria and Romania. Indeed, the situation has actually deteriorated in some countries over the past 10 years (see Table 1).

Figure 3: Perceptions of the prevalence of corruption and bribery in Central and Eastern Europe are considerably higher than the actual incidence of such crimes



Source: PricewaterhouseCoopers Global Economic Crime Survey 2007

Moreover, government spending accounts for about 44% of Central and Eastern Europe’s gross domestic product. So, given this combination of state corruption and high public spending, it is hardly surprising that some companies have resorted to bribery – and foreign organisations have not been immune. A study completed by the World Bank shows that, at the start of the decade, multinational companies were just as likely to pay bribes for changing the law or waiving the regulations as were local firms, and even more likely to pay bribes when bidding for public contracts.

Table 1: Control of state corruption is still weak in many of the Central and Eastern European accession countries

Country	Control of corruption	
	Governance score in 2006 (-2.5 to +2.5)	Governance score in 1996 (-2.5 to +2.5)
Bulgaria	-0.05	-0.32
Czech Republic	0.36	0.43
Estonia	0.87	0.41
Hungary	0.51	0.63
Latvia	0.38	-0.65
Lithuania	0.11	-0.18
Poland	0.14	0.39
Romania	-0.18	-0.23
Slovakia	0.35	0.40
Slovenia	0.92	1.05

Source: Daniel Kaufmann, Aart Kraay & Massimo Mastruzzi, “Governance Matters VI: Governance Indicators for 1996-2006” (July 2007). World Bank Policy Research Working Paper No. 4280

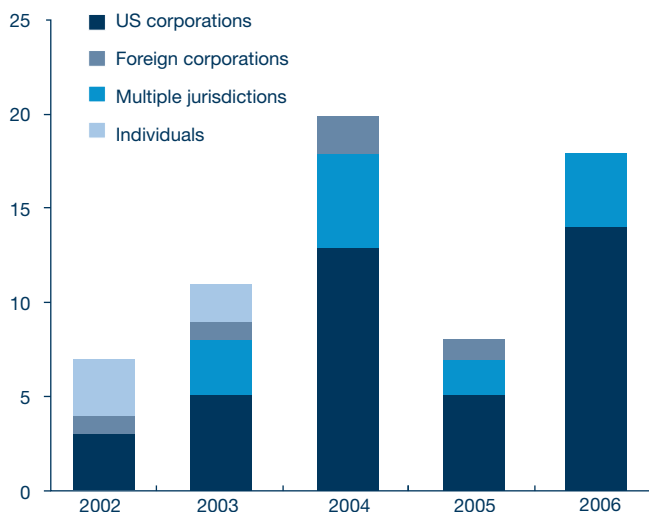
However, all companies that do business in Europe and the US are now coming under much greater pressure to root out corruption – both within their own organisations and within those of their sub-contractors. The US is leading the way, but other countries are beginning to follow suit.

The US has banned overseas bribery since the passage of the 1977 Foreign Corrupt Practices Act (FCPA), which makes it a crime for any individual or company to bribe foreign officials, either directly or indirectly, in order to obtain business. The FCPA also requires a company to maintain books, records and accounts which accurately

reflect the disposition of its assets; and to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that all its transactions are performed in accordance with the rules and regulations.

But the US Department of Justice and Securities and Exchange Commission (SEC) have now started enforcing the law much more strictly. There were 18 new investigations in 2006, up from seven in 2002 (see Figure 4). Another nine investigations were initiated in the first six months of 2007 – and three of the 22 proceedings brought by the SEC this year involved foreign companies. One case concerned three British citizens working for foreign subsidiaries of a Swiss engineering firm.

Figure 4: The number of investigations into alleged breaches of the Foreign Corrupt Practices Act has risen dramatically



Source: Shearman & Sterling, "Recent Trends and Patterns in FCPA Enforcement" (June 26, 2007).

The penalties for violating the FCPA have also become much larger. In February 2007, three subsidiaries of a British oil and gas services provider were fined \$26m, after admitting that they had paid bribes to win new contracts. Two months later, a US oilfield products and services provider was forced to pay \$44m – the largest penalty ever imposed under the Act – to settle allegations that it had engaged in improper business practices in a number of countries.

The OECD, United Nations and EU have likewise adopted various anti-corruption conventions and the number of cases is growing. Transparency International reports that 14 of the 34 signatories to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions are now actively enforcing the rules; and that there were 64 foreign bribery and corruption prosecutions outside the US in the first half of 2007, compared with a total of 49 in 2006.

Thus any Western carmaker or components supplier migrating to Central and Eastern Europe will need to

take great care (see sidebar, [Keeping the company clean](#)). Otherwise, it may find that it has unwittingly purchased a criminal conviction by acquiring a company that has previously, or is currently, violating the laws.

Managing the new supply chain

The move to a new location also has a huge bearing on any manufacturer's supply chain – and the first few months after an acquisition are the point at which any weaknesses often become most apparent. Some suppliers may be unable to meet the acquiring company's standards; others may have found new outlets for their products or services during the transition period; and yet others may be working with the acquiring company's direct competitors. For various reasons, then, the newly combined entity may well have to replace some of its suppliers.

However, most of the big Western carmakers and their Tier 1 suppliers have been operating in Central and Eastern Europe for many years, and they have already captured much of the supply base. There is some untapped capacity in Bulgaria, but very little remains in more established manufacturing locations like the Czech Republic or Poland. And the risks are obviously greater in relatively undeveloped countries.

The easiest way to find new suppliers is to piggyback off an established manufacturer, if there is sufficient capacity. Most local government offices and trade bodies also maintain a list of local suppliers, but their quality can vary hugely. So it is vital to check any potential suppliers very thoroughly before signing a contract with them. Talking to other customers will provide a much clearer picture of the quality of a company's goods or services, for example, while proper due diligence will establish whether it is

Keeping the company clean

Many Western carmakers and components suppliers are increasingly doing business in jurisdictions where a "pay to play" culture is (or is perceived to be) widespread. But should any company that fears it may lose out by acting honestly consider turning a blind eye to secure a contract?

The answer is a resounding no, says Roger Stanley, a partner in PricewaterhouseCoopers' Investigations and Forensic Services practice. Fines and imprisonment under the FCPA and other laws are not the only issue, he explains. A good character and reputation for ethical behaviour can also shield a company from the offers of corrupt outsiders.

In fact, the latest PricewaterhouseCoopers Global Economic Crime Survey shows that companies with proper anti-corruption programmes and ethical guidelines lose fewer opportunities than those with none. Compliance does not "kill" a business; on the contrary, it encourages employees to become more competitive and resourceful by focusing on the benefits of the product or service they are providing.

Carefully implemented and regularly updated controls are therefore essential for any automotive manufacturer moving into Central and Eastern Europe. If things do go wrong, it is also vital to undertake a thorough, independent investigation and subject every perpetrator, no matter what his or her position in the company, to equivalent sanctions. However, it is corporate culture that is the real foundation for an effective anti-fraud programme.

financially and operationally sound (see Figure 5). Many automotive companies are turning to external advisers to perform financial and operational due diligence – especially in countries that are further east, where information is often more difficult to obtain and there is less transparency.

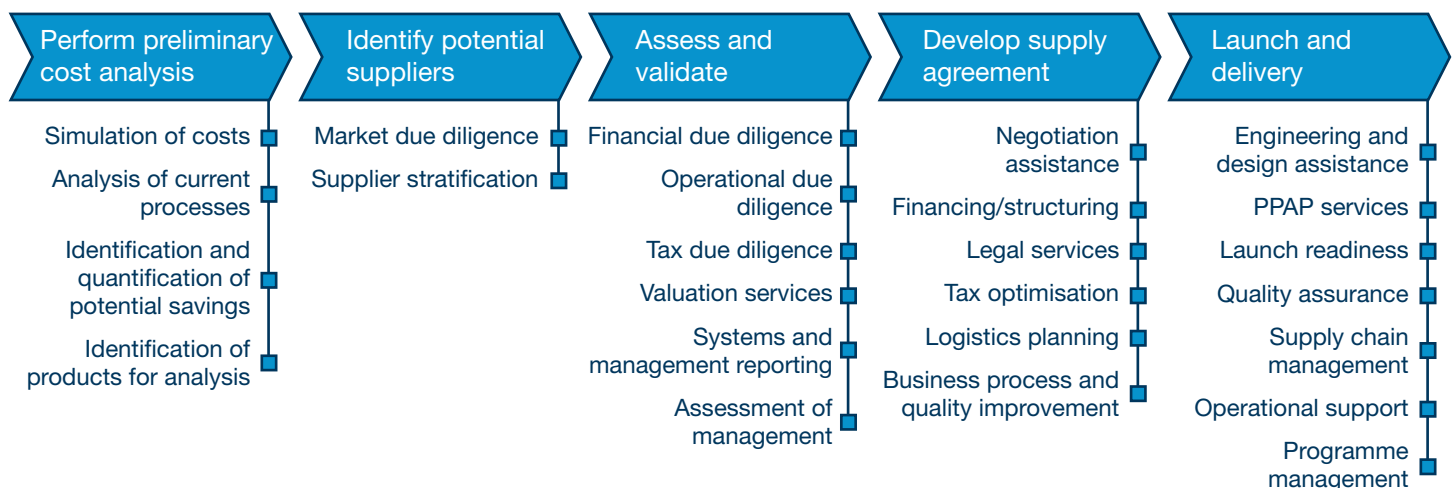
The acquiring company will then have to train any new suppliers, a process that takes considerable time and money. It generally takes much longer to train suppliers in Central and Eastern Europe than it does in North America or Western Europe because, although they have strong manufacturing skills, they lack the financial and management expertise to rationalise their own supply chains and cope with expansions in capacity. Lastly, the acquiring company will have to install a robust monitoring system to ensure that it can detect and manage supply-chain risks as promptly and effectively as possible.

Retaining the right staff

Any automotive manufacturer that has recently bought a factory in Central and Eastern Europe will also have to manage a new workforce. Moreover, if it wants to reduce its labour costs and capitalise on the opportunities for growth – the main reasons for moving east – it will need to retain most of the employees from the company it has purchased. However, this is easier said than done, especially in areas where skilled labour is scarce, as is now the case in some of the leading manufacturing centres in the region.

The Vienna Institute for International Economic Studies recently reported that acute labour shortages have hit the automotive industry in the Czech Republic and Slovakia, and that Romania is also suffering from a dearth of skilled technicians, as people flock to Western Europe in search of better pay and opportunities. Most

Figure 5: There are five main stages involved in developing a new supply chain



Source: PricewaterhouseCoopers

employers are reluctant to increase wages, fearing that this would erode their competitive advantage over Western counterparts. But rates have been climbing in the Polish construction sector, and workers at the Skoda car plant in the Czech Republic recently went on strike for more money.

It is thus more important than ever to win over the workforce of any newly acquired company. We have already talked about the need to communicate with staff as soon as the deal has been announced, but the first six to 12 months after it has been closed are arguably even more critical. It is then that employees start wondering what the deal means for them, and looking for other jobs if they are unhappy with the way events are unfolding. Some acquiring companies have seen swathes of middle and senior management walk out through the doors at the very point when they most need them.

So it is essential to communicate clearly and frequently, and treat the workforce with respect. Sorting out administrative details like the pension plan is not enough; such tasks are merely part of the HR function's normal duties. It is also necessary to think like the company's new employees, anticipate what information they will require, address their fears and manage their expectations.

The acquiring firm should, for example, announce whether there will be any cuts and when they will occur as soon as possible. It should find out what inducements – such as a change in role or title – might help to keep key employees on side (see sidebar, [Winning over the workers](#)). It should also discuss any differences in corporate culture and be prepared to learn from the target company. A management team which simply assumes its way of doing things is the right one and tries to impose it on the company that has been bought will find it very much more difficult to build

Winning over the workers

Employee management lies at the heart of any successful acquisition, says Branislav Hunčík, PricewaterhouseCoopers' Central and Eastern European adviser on human resource issues. Most people don't like changes they haven't initiated themselves and, if they think their jobs are at risk, they will vote with their feet.

It's vital to identify key employees and give them incentives to stay, although retention bonuses are not a good idea unless they are tied to performance. Otherwise, staff can simply use the time to find the perfect position in another firm. It's also important to act fast, if you need to make anybody redundant or launch a recruitment drive because some of the incumbents aren't up to the job. Leaving people in a prolonged state of uncertainty is one of the best ways of destroying morale, Mr Hunčík notes.

a shared culture. This may be an obvious point, but it is surprising how often it gets overlooked.

Conclusion

In short, there are compelling reasons for many carmakers and components suppliers based in North America and Western Europe to consider relocating to Central and Eastern Europe. The area stretching from the western border of the Czech Republic, through Slovakia and Hungary, into the southern part of Poland, is already home to some first-rate centres of automotive manufacturing. The workforce is well educated, and wages are still substantially lower than they are in the West.

However, the process is a long and complex one. Any company that wants to migrate to the region will need to start by deciding which parts of its business to move and where to move them. It will need to research national and local variations in access to skilled labour, logistics, regulations, tax regimes and the like to identify the best place in which to establish a presence.

It will also have to decide whether it wants to build a new factory or buy an existing operation and, if it chooses the latter route, it will have to find a suitable target. This is becoming more difficult, as the competition for good assets increases. Many of the most obvious targets have already been acquired and, though some of the manufacturers set up in the early 1990s will come up for sale during the next decade, they are generally smaller and harder to unearth.

Those companies that take the acquisition route will have to make numerous financial, structural and operational changes to integrate the firms they have

bought with their own businesses. They will have to manage the expectations of employees and investors, many of whom may be opposed to the deal. And they will have to overcome any cultural conflicts – both corporate and national.

Relocating to Central and Eastern Europe is not something to be lightly undertaken, then. The region is neither politically, economically nor culturally homogeneous and, although there has been some convergence as a result of the membership criteria laid down by the EU, the simple fact is that any company which fails to do its homework will struggle to realise its objectives. But a number of automotive manufacturers have successfully made the transition and, indeed, expanded. They have discovered that though the risks are higher, so – with proper management – are the returns.

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