Blind curve or ahead of the curve?

Navigating today’s complex regulatory legal and business environment in the Automotive sector.

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The new age of compliance is en route

Driven by technological innovation, complex new global supply chains, increased environmental concerns and a new generation of protectionist trade practices, globalized industries are having to fundamentally reassess and redesign their market strategies, how they manage risk, and how they comply with a plethora of changing laws, regulations and rules of the game.

The automotive sector is no exception. Indeed, the risks it faces may be even greater than those faced by many other industries because of its sheer size, the reach of its supply chains and the breadth of its clusters, its impact on the environment, and the breathtaking speed of its technological development.

As recent events have shown, the automotive industry is at the center of the political and social life of cities, regions, nations and continents. In Europe alone, for example, it is estimated that some 13.3 million Europeans, or 6.1% of the EU employed population, work in the automotive sector. Moreover, the 3.4 million high-skilled jobs in automotive
manufacturing represent 11.3% of the EU's manufacturing employment. A downturn at a single company, the closure of a plant, or a major product recall can have social and political repercussions within and well beyond the industry itself.

It is ironic that the automotive sector, traditionally so committed to sustainability and social responsibility, has seemed to struggle with these challenges, often finding itself increasingly criticized in the media for poor governance and business practices. The emissions case, which involved several companies, was a watershed for the industry. The case deeply shocked the public and earned the companies concerned large fines and legal costs, and prosecutions of individuals. It also sparked environmental concerns, raising questions of the long-term future of diesel-powered vehicles.

The emissions case also put under scrutiny the trustworthiness and values of an industry upon which the society is extremely dependent. However, some of the individual producers might buck the trend and stand out as an exception, because of the fact that the automotive sector as a whole was tarnished by the perception of irresponsible practices by a minority of players turning a blind eye on the legal protections and moral expectations of society.

If such negative views remained at that – just views, there might be less cause for concern. But, as it has been seen in other industries, when a whole sector is widely criticized for poor behavior, the major concerns can be translated into reduced revenues; increased costs; higher regulations; financial, legal and ethical constraints on R&D; and depressed share prices. Failure to meet social expectations can lead to more stringent enforcement, and for those individuals that fail to comply with these new laws, there can be prosecutions and even imprisonment. For the industry as a whole, in the longer term, it can lead to a tougher and more demanding regulatory and commercial environment.

While compliance can certainly help the company create a strong defense against prosecution and mitigate associated costs, it is not just a narrow defensive play, protecting the company and its leadership from legal action. In fact, it is, or can be a forward-looking, proactive, strategic approach to managing future risks. At the same time, where compliance failures can have a negative commercial impact, a well-designed and well-managed compliance program can potentially give the company a competitive edge.

In this paper, we discuss the key risks in the industry from a legal, compliance and ethical point of view. In particular, we look at fraud and corruption risk in a market which has had a number of large and extremely visible cases. We also look at the future ethical risk factors inherent in different parts of the production process, from sourcing to distribution, from R&D to manufacturing and suggest ways in which companies can manage these risks. We conclude with some insights and recommendations showing how an “Integrity Agenda,” combined with a robust technical and regulatory compliance strategy, can mitigate risks by creating transparency throughout the R&D and manufacturing cycles. We also help show how these insights and recommendations can turn risk into opportunity, value and ultimately into a competitive advantage.

Red flag!
When things go wrong

Despite the efforts of the automotive industry to adhere to global compliance standards, there has been no shortage of legal cases brought for fraudulent or corrupt behavior. Here are just a few:

- In 2015, one of the first cases came to light when a leading automotive manufacturer admitted that nearly 11 million of their diesel cars were fitted with “defeat devices” designed to circumvent emissions tests. The company set aside €16.2 billion to deal with the case that led to the carmaker’s first annual loss in 20 years. The costs and repercussions continue. Cases involving other manufacturers are still coming to light today.

- In early 2000s, subsidiaries of a car manufacturer devised a scheme to hide the payment of bribes through third parties involved in the supply of trucks to the Iraqi government. The company and its subsidiaries were charged with violating the terms of the books and records provisions of the Foreign Corrupt Practices Act (FCPA). The company paid total penalties of over US$ 11 million and disgorgements of over US$ 7 million plus prejudgment interest. Since then, several other companies have been prosecuted for bribery, usually in developing countries, under US legislation. In 2017, for example, another company and its subsidiaries paid US$ 94 million in criminal fines and penalties under a Deferred Prosecution Agreement (DPA).

- In 2016, a fuel economy ratings fraud by a car manufacturer claimed two top executives, cut earnings and forced the company to turn to another car company for a bailout. It used “desktop calculations” instead of running actual field tests and falsified data to prove higher than actual fuel economy. The carmaker took a charge of US$ 480 million in the fiscal year to cover costs associated with improper fuel economy testing of vehicles sold in Japan. There have been several other cases of fuel economy ratings fraud by tampering with results or conducting tests incorrectly.

- In 2017, a car manufacturer was found to be using workers who were not authorized to certify vehicles approving the final inspection at the very end of assembly lines. Further internal investigations found that employees also falsified some test data. The case led to a temporary shutdown of the company’s plants and a recall of over 1.2 million cars. Several other companies have admitted similar wrongdoing.

These and other examples point to some clear trends. First, companies of all jurisdictions are falling foul of the U.S. Department of Justice, which in recent years has bolstered its enforcement capacity and capabilities, especially around fraud and corruption. It shows that even if companies are not prosecuted under the legislation of their home jurisdiction or in the country where the crime took place, there is a strong probability that the long arm of the US law will reach them. Somehow, companies in the automotive industry may not have fully appreciated the extent to which they are open to prosecution under the US law, because of the global nature of their business and the strong likelihood that they have a strong US “footprint.”

Secondly, as the emission and fuel economy cases show, there is something of a pattern of fraudulent behavior, such as systemic compliance failures by employees and their managers. The shortcuts taken by inspection workers in one of the above cases, for example, have been partially attributed to overstretched workers under pressure to cut costs and speed output. This would suggest that the companies involved may not have sufficient internal control systems, such as audit, data analysis and managerial supervision. Nor have they instilled a truly effective ethical culture at all levels of the company. “Costs and compliance were always placed on the same level,” as one motor executive explained.2

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2 Automotive News, 7 December 2018.
Thirdly, there are several cases of foreign bribery. These frequently have involved the foreign subsidiaries of the companies and third parties, agents and distributors. These cases suggest that even if the companies had strong corporate codes of conduct and internal control at the headquarter level, they did not have a management system in place strong enough to control the behavior of employees and associated staff of third parties further afield. This was true especially in high risk markets, where the business culture may be more tolerant of financial or in-kind “gifts” or informal payments.

According to the *EY Global Fraud Survey 2018*, within the automotive sector, as many as 14% of respondents said that it is a “common practice” to pay bribes to gain contracts. Another 14% agreed that “offering cash payments can be justified if they help a business survive an economic downturn.” The automotive sector ranked in the top quartile of the list of industries on these responses, worryingly above financial services and oil and gas, both of which can be considered high-risk industries. As in other industries, 98% of automotive respondents believed demonstrating that the organization operates with integrity was “fairly” or “very important.”

Clearly between the intentions of the senior executives of a company to do business with integrity and the reality on the ground for employees or third-party suppliers who are operating in a highly competitive market, and a lax business culture, there is a gap which could be called a “corruption risks gap.” However ethical a company’s employees are, if they are measured on delivering “success,” and if that success depends on unethical decision-making because of pressures from the market, then it is a major challenge to prevent “accidents” from happening.

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3 EY Global Fraud Survey 2018, Automotive sector analysis, pp5-6, pp9-12
Caution – blind curve ahead!
Managing future challenges

So far, we have focused on the issues that the industry has faced in the recent past, especially around legal and regulatory compliance.

Here we look at two sets of emerging risks: the challenges posed at the front and tail end of the market supply process – managing supply and distribution risk, and those in the middle of the process, namely ethical challenges and technical compliance challenges posed by new technology in the R&D and manufacturing cycles.

Supply chain

All major industries are under pressure to account for the origins and the destinations of their product. The pressure comes from legislation as much as from the consumer.

On the sourcing and purchasing side: which materials are used, how they are produced, what kind of labor goes into them, how they are transported to the production facility, what other materials and natural resources are used in the process – all these are criteria for every company producing in a globalized world economy. New laws have appeared in recent years, such as the UK’s Modern Slavery Act 2015, which force companies to consider in depth where and how the supplies reach the company at the start of the production process.

On the sales and marketing side, the corruption risks gap comes in how the final product is distributed, through whom and under what conditions.

Anti-corruption laws, such as the FCPA and the UK Bribery Act, but also similar laws recently passed in a number of developed and emerging countries, have an important concept of corporate liability for the actions of third-party suppliers in countries of operations. A supplier, an agent, a joint-venture production partner and an independent company, can implicate the lead company in fraudulent or corrupt behavior.

The future of the automotive industry increasingly opens companies to several risks as mentioned above. As companies seek to reduce costs, they will inevitably be led to source from developing markets where environmental, governance, and health and safety rules are not at the same level as in the lead company’s home jurisdiction. The same applies to distribution. As companies seek new markets, they will need to hire agents and distributors in the newly emerged markets that demonstrate high growth, but also high corruption risk.

Many companies in the industry may also seek to diversify suppliers, distributors and markets as a result of changing international trade rules affecting commercial relationships in traditional markets. We are reminded of the warnings about the impact of Brexit on the UK automotive industry, now backed up by the closure of a leading manufacturer’s operations in the UK. Here again, the sheer complexity of the trade routes, the number of suppliers and their relationships with other governments, and the speed that companies need to set up these new relationships, all pose unprecedented risk.

Another consideration is the rapid transformation of the legal landscape. Because the automotive industry touches on so many spheres of life – from environment to health care and from regional development to infrastructure investment – the companies are at the center of a maelstrom of constantly changing legal directives and regulations. Negotiating a clear path requires not only knowledgeable compliance managers, but also sophisticated data management techniques. Potential challenges are cross-border regulation, waste and end-of-life disposal directives, emissions and air pollution, taxation regimes, trade barriers and exemptions, and sanctions.

The risk goes well beyond legal exposure, although companies would be well advised to ensure their compliance systems adequately defend the company in the event of a legal challenge. Recent surveys and studies confirm a significant increase in the number of people preferring to invest in sustainable and eco-friendly products. If discovered in a company’s supply chain, conflict minerals, child labor, human rights abuses, degrading or unsafe health and safety provisions, or unsustainable use of water, can all lead to major public outcry and potentially to legal action. Some of these major public outcry situations might include campaigns launched by non-governmental organizations.

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(NGOs), refusal to buy products from the customer side, and redirection of investments by shareholders.

Taking a purely legalistic, defensive approach to compliance is not enough. Companies are beginning to take measures to reduce the supply chain risk. For example, a few companies have created their own corporate conflict minerals policy, even though their home jurisdictions do not necessarily have national disclosure laws. Here again, the companies have been driven by US legislation such as the US Dodd-Frank Act.6 Other companies are introducing rigorous due diligence systems. An effective due diligence enables companies to detect many risks that would not normally be visible — from origins of materials to conflicts of interest and from criminal records to politically exposed persons. The EY Global Fraud Survey 2018 showed that only 58% of automotive industry respondents felt that their company had a “tailored risk-based approach to due diligence.”7 The fact that 42% evidently felt that this was not the case would suggest that, given the risks inherent in the industry, this is an area of potential weakness for the automotive sector.

The conclusion is that legal compliance on its own is clearly not enough. At the root of the supply and sourcing policies, and the sales and marketing policies, must be an “Integrity Agenda” which permeates each decision made by every manager, whether at headquarters, in the field, or among the distributors, suppliers and agents that are part of the supply chain.

New technology

The automotive industry has always been an innovator. From its inception in the 1910s, it has revolutionized the way we live and work. Today, the industry’s disruptive role continues as new

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7 EY GFS 2018 Automotive sector analysis p34
If compliance protects companies from existing risks, integrity creates a framework for managing future risks. Compliance without integrity or integrity without compliance will not protect the company effectively.

Tobias Schumacher
Partner, Ernst & Young GmbH, EY Global Automotive Sector Leader, Forensic & Integrity Services

Finally, there is the most complex issue of all: the company’s position when the technology has outpaced legal regulation. The introduction of a new technology may not be illegal, but its consequences may be unethical. This is the kernel of the public outcry against the technology industry, where the friction between freedom of enterprise and regulation is as yet unresolved.

As Tobias Schumacher has said: “If compliance protects companies from existing risks, integrity creates a framework for managing future risks. Compliance without integrity and integrity without compliance will not protect the company.”
Keep ahead of the curve! Introducing the Integrity Agenda

Clearly the industry is on a new trajectory. Many of the companies within the industry are likely to confront the integrity challenges of managing the supply chain expansion and rapid technological development. EY teams can offer some initial recommendations about what companies can do to manage the risks and opportunities of this rapidly changing market.

As a starting point, it is recommended that companies in the industry adopt an Integrity Agenda, which puts the Agenda into practice at all levels of the organization.

The Integrity Agenda will help companies bridge the gap between intentions and behaviors. It is a framework for success built on a core set of elements that align an individual’s actions with an organization’s objectives. To develop the Agenda, companies should focus their efforts on four elements: assessing the corporate culture, controls and governance from an integrity perspective, and leveraging new technologies to provide better data insights.

A clear Integrity Agenda that is based on communication, leadership commitment, strong training and interaction, as well as technology-based procedures, can address the challenges posed by customers and society. This is done by enabling the entire workforce to be more aware of ethical risks which the company is confronting. A well-thought-out Integrity Agenda enables successful companies to stay true to their missions, keep their promises, respect laws and ethical norms, and foster public trust in the free enterprise system.

Companies can manage technology risks by designing and establishing around their Integrity Agenda a Digital Integrity Strategy. This is a business model which combines a vision for technological development with foresight into its social and ethical impact. Creating and managing a Digital Integrity Strategy will allow companies to innovate while remaining sensitive to external and internal pressures.

The Digital Integrity Strategy enables the company – from the CEO, to every member of the team – to consider the broader ramifications of their technical, scientific and financial decisions. At the root of the Strategy are a number of simple and interrelated questions – each requiring highly complex answers – which need to be asked on an ongoing basis, about the relationship between technology and the underlying data sets at each stage of the R&D, production and marketing process.

As we have highlighted, many of the technological outcomes and their social and ethical impact cannot realistically be foreseen. Over time, a Digital Integrity Strategy allows the company to be flexible in balancing innovation and ethics, and to manage unexpected challenges.

In practice, a company’s Digital Integrity Strategy will be constructed from many different and complex building blocks, and will be specific to each company. For example, creating a Digital Integrity Strategy will require a fresh look at the basic tenets of internal control in the age of AI – due diligence, audit, accountability and transparency will all need to be looked at anew.
Gathering speed!
Turning risk into opportunity

As usual in discussions about compliance, the costs of noncompliance come over more strongly than the benefits of compliance. However, the benefits are very real. In conclusion we would like to share a few opportunities for growth, directly and indirectly attributable to compliance.

Clearly, chief among the benefits is the ability to avoid prosecution and the concomitant costs of litigation, penalties, recalls and loss of business. Following that, is the ability to reduce penalties and fines, thanks to taking "adequate measures," as they are referred to in the UK Bribery Act. There are examples of financial services companies that have reduced their fines, because of their robust compliance programs and training programs for employees. Downgrades in credit ratings which have a negative impact on the ability to obtain external financing, can be avoided with visible compliance programs.

Beyond that, here is a selection of examples (not exhaustive) of how companies have derived commercial benefits from strong compliance programs. From reputational gains and more competitive bids, and greater access, to multinational supply chains and longer-term business sustainability – increasingly integrity is a source of competitive advantage.8

Having a reputation for integrity is one of the factors that lead companies to care about this issue, which is essential for building the trust that underpins successful long-term commercial relationships. This trend is only going to accelerate as companies seek out commercial partners who share and demonstrate the same values and commitment to integrity. According to Forbes, ethical behavior, fairness, product value and transparency are among the most important factors in determining a company’s reputation.9

Even, and in some cases, especially, in countries with a high corruption risk, a strong ethical reputation will act as a differentiator between the multinational and the local competitors. A clear and believable zero-tolerance policy is particularly attractive to purchasers who are tired of the frequent solicitation of domestic players or government officials. A survey conducted in three emerging or developing markets which is usually regarded as having relatively higher levels of corruption, such as Zimbabwe, Egypt and India, revealed that stakeholders – customers or investors – placed a higher value on ethical behavior, than on corrupt behavior. Being ethical in such a market was not seen to put the company at a competitive disadvantage, but on the contrary, to be a differentiator.10

Another study of 9,141 public firms with assets of more than US$ 10 million listed on the New York Stock Exchange (NYSE), NASDAQ and American Express (AMEX) from 1990 to 2011 found a significant correlation between strong corporate governance and transparency with firm value.11 Companies with high integrity standards and good-quality internal governance mechanisms could partially compensate for high levels of corruption in their markets of operation. Again, we see integrity as a differentiator. Good companies do not necessarily have to have their reputations tarnished in a market where ethical values are weak. On the contrary, their reputations are strengthened.

There are other examples from around the world of how doing business with integrity can bring competitive advantages. Some national laws, such as those in Argentina, state that any company wanting to participate in a major infrastructure project or a public-

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private partnership (PPP) must have an adequate integrity plan in place. In Brazil, under a new law, compliance programs have become mandatory for companies cooperating with the public administration.

Research has shown that companies with strong integrity systems give more favorable access to capital. Potential investors see a company’s robust compliance system as an indicator of a firm’s risk profile, the strength of its management and corporate governance, as well as its “potential for long-term value creation.” In fact, companies which act with integrity and transparency typically enjoy the benefits of a lower risk profile – a number of studies conclude that corporate transparency is positively associated with cheaper access to capital. By the same token, there is a positive impact on funding opportunities from sustainable or responsible investment funds, insurance premium reductions and cost of capital reductions for companies performing well in the Dow Jones Sustainability Index (DJSI).

A strong Integrity Agenda, and commitment to responsible business practices, attracts the best human resources. The younger generation, less tolerant of corrupt behavior than previous generations, values employers committed to values and ethics. It makes for successful recruitment and longer-term retention. Studies have shown a clear correlation between employees’ perceptions of senior management’s trustworthiness and integrity on one hand, and productivity and profitability on the other.

In conclusion, the automotive sector is going through many challenges. The disruption created in the markets offers growth opportunities – as long as the industry keeps one foot ahead of the technology and can control it rather than be controlled by it. New entrants into the market are both competitors and potential partners – understanding precisely the relationship and sharing common values will be essential for managing risk. Suppliers and distributors and other supply chain players are all part of the brand and reputation of the automotive companies and the industry – they need to be brought up to the same level of compliance as the best employee. Finally, the Integrity Agenda is not a constraint on development of new markets and technologies, but a complement to them. With the Integrity Agenda and accompanying compliance policies and processes, automotive companies can move forward with the development of electric vehicles, car-sharing technologies and autonomous machines, confident that their new products will result in fewer deaths and injuries, lower environmental costs, and increased social benefits. The industry’s turnaround as a net contributor to social development will be complete.

The Integrity Agenda goes a long way toward creating a corporate culture. With people on the same ethical page, internal processes and working practices are rendered more efficient and can reduce costs. The Integrity Agenda can double over or reinforce the code of conduct or ethics: it is a useful tool to reinforce the key messages of the objectives, values and mission of the company.

13 Brazil: Compliance programs mandatory for companies cooperating with public administration, Global Compliance News, 9 February 2018. globalcompliancenews.com/brazil-compliance-programs-mandatory-20180209/
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