FORENSIC

Fraud in the Automotive Industry in Central and Eastern Europe

ADVISORY
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Introduction

Fraud is a serious problem causing significant losses for many companies. It is also a problem which is considered a taboo subject by many. As a result, executives either don’t admit that fraud exists or view it as a low priority.

In this report we take a look at specific aspects of fraud along geographic and industry lines – focusing on the automotive industry within the countries of Central & Eastern Europe (CEE). The purpose of our research is not necessarily to determine the existence or extent of fraud, either within the industry or the region, but rather to identify the similarities, differences, and distinguishing factors.

Not surprisingly, however, our research did indicate that fraud is a significant issue within the automotive industry in CEE. Despite a majority of company representatives interviewed, either not experiencing fraud, or being unaware of its existence, one in five companies surveyed nevertheless recently experienced instances of fraud in excess of EUR 50,000.

Perhaps more interesting than the extent of fraud, was how and why it seems to be happening. For example, the image of fraud among both management and the public tends to be that fraud is typically either external corruption – in the form of bribery or kick-backs – or related to accounting and financial activities – in the form of embezzlement or misstatement of earnings and profits.

One area, however, that may be less visible on the radar screen is non-cash misappropriation of assets. This is an area where fraud may be particularly ripe in a manufacturing environment where warehouses of various parts and machinery are often at arm’s reach.

Another popular conception of fraud is that it involves the personal enrichment of those who commit fraud. Again, an aspect of fraud that may be overlooked is that it does not have to personally benefit those committing the fraud. For instance, a fraud may benefit friends, colleagues (such as one’s supervisor), or external organizations, and while it may not be perceived as fraud, such actions are just as damaging to the company. For the CEE region this is potentially a significant aspect of fraud – given the not-so-distant transformation from socialism – because a certain sense of entitlement and community ownership appears to still exist.

Given the potential for significant losses due to fraud, why is it so prevalent? There are a number of reasons including the willingness of executives to overlook the issue when times are good or to refuse to acknowledge it for a variety of reasons ranging from social norms to acceptance of a perceived, undocumented employee benefit. In the automotive industry, however, one issue which may significantly influence the prevalence of fraud is the intense pressure that suppliers are under to meet a variety of customer demands including high quality, delivery deadlines and cost metrics. Quite often this means issues like fraud – which are by definition less than transparent – fall to a distant second, or even third, on the executive priority list.

Given that global business generally, and the automotive industry even more so, is in the midst of the worst financial crisis in at least a generation, it is tempting to imagine that fraud is even less of a priority than when times are good. Paradoxically, however, now is a time when the automotive industry first of all must do anything and everything to preserve cash, and secondly, has the time available to commit to programs and activities that prevent or detect fraud. Ironically, though, now is also the time where employees are more likely to be careful or concerned about committing such actions, given that unemployment is high and new jobs scarce. Conversely, it may be that instances of increased financial difficulties are on the rise giving further motive and rational for committing fraud. On balance one could imagine that levels of fraud will persist, albeit in different guises, more or less in the same way as they always have.

For those in the industry and in the region who are concerned about fraud, the reality contains both good news and bad news. Unfortunately, the elimination of fraud within an organization is most likely impossible, and not a realistic goal, considering that human nature is the ultimate root cause. However numerous tools, methods and programs exist that enable an organization to reduce the issue to an acceptable level.
Methodology

This report, which focuses on the issue of fraud in the automotive industry in Central & Eastern Europe, is an extension of an earlier study benchmarking broader business performance within the region’s automotive industry. The original research for this study includes a questionnaire which was answered by 25 companies in five countries within the Central and Eastern Europe region (The Czech Republic, Hungary, Poland, Romania and Slovakia) in 2008. Extensive interviews with select participants were carried out in 2009.

Our final analysis and interpretations are based on the data from the selected questions pertaining to fraud within the original surveys as well as supplementary interviews carried by the author with regional automotive executives, industry analysts and KPMG professionals. Finally, publically available data from market research firms, the media and KPMG International were used to assist in evaluating the proprietary data and provide qualitative examples in support of the quantitative analysis. Factors including, but not limited to, sample size, geographic structure, and the self-selection nature of interviews and survey responses are potentially limiting factors to our survey.
Executive Summary

Based on our survey of 25 companies in the Automotive industry in CEE, five companies, or 20 percent, admitted to experiencing fraud in the last year in excess of EUR 50,000. While it may be difficult to draw concrete conclusions about the extent and size and fraud in the region on such a sample, the evidence is a clear indication that a problem exists and has the potential for generating serious losses.

Figure 1: Has your organization experienced a fraud, in excess of EUR 50,000 that involved (percent of respondents answering “yes” – multiple responses accepted):

- External parties: 80%
- Management staff: 60%
- Non-management staff: 20%

Source: KPMG in Central and Eastern Europe 2008

- Of the companies who admitted experiencing fraud, 40 percent experienced it on more than one level, i.e. at the management, non-management or external party levels. This is not surprising and is consistent with anecdotal evidence that suggests that fraud can typically involve external parties ranging from customers and suppliers to government officials.

- Our participants indicated managers were more likely than non-managers to commit fraud, particularly when the fraud was of a significant value. While surveys differ as to what position is most likely to carry out fraud¹ there is anecdotal evidence that management is often a critical element of fraud, regardless of whether or not they are the direct perpetrator or beneficiary. Within the automotive industry, with high levels of blue collar workers, it may be the case that a prevalence of non-management ranks creates greater opportunities for fraud at the shop floor level.

Internally, both production and warehousing were areas where 40 percent of the victims reported fraud taking place internally. This was consistent with our view that the automotive business often deals with expensive materials and is a significant target for non-cash asset misappropriation, such as inventories.

- By the same token 80 percent of organizations where fraud occurred found that more than one department was involved. This is understandable as fraud can often be endemic in an organization where the culture or environment provides the foundation for certain behaviors.

- What was surprising, however, was that none of the companies mentioned either accounting or purchasing as a specific area within the organization where fraud was experienced. Other studies typically indicate that the finance department is one of the biggest perpetrators of fraud and our own experience indicates that sophisticated frauds, often involving conflicts of interest, occur in the purchasing department.2

- Internally, both production and warehousing were areas where 40 percent of the victims reported fraud taking place internally. This was consistent with our view that the automotive business often deals with expensive materials and is a significant target for non-cash asset misappropriation, such as inventories. Also, other studies indicate that the operations area is a traditional area where fraud is very likely to occur.3

- Externally, instances of fraud driven by customers were reported as slightly more prevalent than those committed by suppliers or other third parties. Anecdotal evidence indicated that these factors were highly dependent on where a company is within the ‘tiered’ supply chain of the industry, as well as in which geographical area a company or factory resides.


Defining fraud

When defining, “what constitutes fraud,” individuals and companies need to keep in mind that there are probably as many definitions as there are instances of fraud taking place. Michael Peer, partner at KPMG in the Czech Republic, prefers a layman’s definition. Peer points out that in practice fraud has the following characteristics:

- First of all, the act has to be deliberate. Accidental waste of material does not constitute fraud.

- Secondly, it must take away resources from the company, financial or non-financial, and thus inflict damage. The fraud must benefit someone. It doesn’t always have to be the individual or entity perpetrating the fraud, but someone other than the victim will almost always be benefitting.

- Finally, it must involve deceit and concealment.

To unravel the sometimes subtle distinction, consider a simple example – the proverbial raiding of office supplies. Such an instance potentially covers several scenarios. In the first scenario an employee takes office supplies so he or she can work at home. This would not constitute fraud in the eyes of most management teams. In the second scenario, office supplies are pilfered for the employee’s family member (perhaps for a child with a school project). This may very well constitute fraud.

In this situation a typical reaction could be: “Hold on, do you mean that the odd pencil or post it note that ends up in my brief case is fraud if it ends up at ‘show and tell’ for my daughter’s school project?”

“Not necessarily,” says KPMG’s Michael Peer. “If the incident isn’t carried out in a deliberate way, where concealment or subterfuge was part of the event, then it probably isn’t going to be considered fraud. This is typically covered as well by the norms or standards of the company where in many cases taking pencils and post-it notes is an accepted, if not explicitly stated, practice amongst the firm and its employees.”

Types of fraud

Fraud generally falls into one of three categories: asset misappropriation, corruption or financial statement fraud. It is generally believed that asset misappropriation is the most common although it is also often has the smallest impact.4

Asset misappropriation can further be divided into cash – for example skimming, false invoicing or payroll fraud; and non-cash fraud – for example misappropriation of supplies, inventory or equipment, or proprietary information such as intellectual property. It is possible that the automotive industry in CEE is most exposed to this type of fraud. This would be consistent with the survey data indicating that both production and warehousing departments were some of the most often cited departments where victims reported fraud. The anecdotal evidence also indicates that, although often small, this type of fraud is potentially ubiquitous and endemic.

Corruption typically involves misusing one’s position at an enterprise to receive or make bribes, involvement in extortion schemes or even behavior which causes conflicts of interest. Prior to many countries in the region joining the EU, this type of behavior was often linked to tenders involving foreign direct investment and tenders to locate new investments. With the advent of standard EU regulations and tax codes this may have lessened.

The third category of fraud, which is generally believed to be the most serious, but least reported, is financial statement fraud.5 Nothing in our survey has led us to believe that the automotive industry is in any way more or less likely to suffer from this type of fraud rather than from other types of fraud.

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Fraud in the automotive industry

To get deeper inside the specific issues we discussed in depth the issue of fraud in the region’s automotive industry with executives who participated in our survey. Based on their insight and experience there seem to be some potential trends concerning the key drivers of fraud.

The data from our survey seem to indicate that external fraud is the biggest driver of malfeasance in the industry, however the anecdotal evidence is somewhat mixed. Says one participant, “I see [fraud] in two ways – either as driven by external parties or internal ones. External, in my understanding, is driven by company contacts to authorities and other companies to misuse the position of the company, and the law, by doing something semi-criminal or at least unethical.” This type of fraud is along the lines of bribery, according to the survey participant.

External fraud

“In my experience, in terms of contacts with financial and legal authorities, in [the country where we are located] I have never had a bad feeling. And [our company] has a complicated legal situation because of subsidies, but I have never felt that fraud occurred. I have also never had a sense of fraud from the customer side either.”

But while local and regional regulatory authorities were not cited as an issue for this particular example, prior to the run-up to EU entry this was traditionally an area ripe for external collaboration which ultimately had the potential for fraud. Because of EU regulations and standard guidelines for subsidy and tax treatments it is quite possible that the risk of fraudulent activities from authorities has decreased. Equally the level of sophistication of such bribery may have increased to the extent that it’s simply more difficult to identify.

Customers are also not necessarily at the top of the external drivers of fraud, according to at least one executive. “In Central Europe any opportunity for fraudulent activities with customers doesn’t really seem to exist. You have to keep in mind that our customers are typically original equipment suppliers (OEMs) and their dealings occur in a pretty transparent way.”

The executive went on to say that, “I would say you have this kind of activity – this kind of ‘pay-to-play’ with customers more in southern European regions like Italy or Spain.
In certain countries, like the Czech Republic and Slovakia or Poland, the culture and the customers seem to be influenced more by German-style cultures and many producers are German as well. In some of the more south-east countries in the region this may be more common – we don’t really see it so much in the core countries of CEE.”

In terms of external parties, more so than either customers or regulators, it appears that suppliers may be one of the biggest risks. According to the same executive, “Where I did have concerns was with certain supplier companies, mainly with construction companies.” In this particular situation, where new facilities were being built and certain old facilities renovated, a lack of adequate suppliers, the inability to attract larger, more transparent multinationals, and the urgency of the requirements meant that a competitive bidding process was not an option – which is often the case in many parts of the region. Even though the project was a multi-million euro contract, in terms of the scale of global players it was still relatively small.

“In the end we could only find one company that was willing to work with us,” the executive reports. “Honestly, we were surprised to find that the price was similar to what you might find in Germany, or even higher. I felt, as did others, that the price was extremely high. I believe there is someone in the company who has benefited from this. I didn’t launch any investigation but I have the feeling that the market knows the situation, and key players at various suppliers know that we don’t have other suppliers, and that people from our company involved knew exactly what they could propose to be able to share the extra profit. I have to emphasize though that this is only my general sense.”

Other potential suppliers where there may exist an environment more susceptible to fraud is with logistics providers. “With transport companies there can be opportunities for price fixing between a few providers;” says one executive. “The companies typically know each other, and in a sense the customer makes it easier because they mandate a list of two or three suppliers to manage inventory, or sometimes only two. There is never an opportunity for a tender. In this way [the suppliers] can make sure prices are not too low – giving you two or three prices. This is quite often the case for raw materials and other commodities as well, for example bricks, concrete, glass – there is no control, and no clear tenders.”

Internal Fraud

In many cases it is possible that internal fraud is in fact a much bigger risk than external fraud. Typically these types of incidents are smaller, and don’t involve complex schemes, but nevertheless can be ongoing and add up to significant amounts over time. Non cash asset misappropriation is one such instance where the auto industry is particularly susceptible.

The anecdotal evidence seems to clearly back this up. According to one executive, “We know for sure we have a serious problem internally with the inventory. We have losses [in this area] certainly in excess of EUR 1 million per year. We are talking about a situation where inventory is physically removed from the warehouse and is not there anymore. It is in the SAP system but not in the stores.”

How this executive discovered the fraud is perhaps an interesting paradox relative to how many executives and the public perceive fraud taking place. The executive explains, “[Our factory] is located outside of [a major city] so I heard that some of our more expensive and complex parts were available in local shops. Essentially everyone in the city was using our parts and material for a number of...
This was not a onetime event but a permanent and ongoing situation involving a lot of criminal manpower.

“I believe that at [the time of the fraud] there were other big issues around satisfying the customer. This is always number one, and everything else is typically the second priority.”

To deal with the situation the executive felt it was essential to employ external advisors to carry out a series of investigations and determine exactly where security and protection were not up to standards. As the executive we interviewed explains, “Essentially [the advisors we hired] went into the company without any ID, loaded material from the warehouse into their private car – and even asked people to help them – and even went into a meeting room and took away the projector.”

One of the key issues the executive pointed to in terms of enabling this type of behavior and relaxed standards is the overall security culture at the organization. “This is both a serious issue and one that can easily get out of hand,” said the executive.

“For example we had a top manager from our customer [a major automobile manufacturer] show up without notification and received access to our entire production.”

Perhaps the most relevant issue in the situation described by this executive is how it remains either undetected or allowed to go on. In this case there was plenty of evidence to see there was a problem but no one was really willing to take action until a new executive came on board. In explaining this, the executive points primarily to priorities. “I believe that at [the time of the fraud] there were other big issues around satisfying the customer. This is always number one, and everything else is typically the second priority.”
Another interesting question for the auto industry in CEE is whether there are any regional dimensions to the fraud issue. This is a very difficult question to answer because there is no clear evidence. Nevertheless the anecdotal evidence may shed some light on aspects for consideration.

For example one characteristic of the CEE region is that its composed of many smaller nations, each with different languages and culture. This can be a challenge because it makes transparency more difficult. According to one executive we interviewed, “I believe the issue is at least somewhat specific to the region. For example the language and cultural issues means that everyone knows each other and has cooperated together. There are easy connections to all the other companies and the community. Essentially it is more of a closed community than you might find in bigger geographic regions such as Western Europe.”

Another question that may make the CEE region somewhat different than other, more developed regions is the historical legacy of socialism. “My sense from working in Eastern Europe for almost 10 years is that people are (less likely) to accept goods as private property, and are (more likely) to accept them as public or common property,” the executive explains. “People are not always perceiving this as a criminal act, but just taking a little bit here and there.”

This can be a difficult issue because it touches on the boundaries of what is fraud, versus what is a misconception of company norms. One of the clear issues that an executive pointed out was the need to communicate to managers three things: the facts regarding the issue – for example the amount and type of losses; the expectation of how this will change in the future; and finally the notion that managers responsible for specific areas or departments will be held accountable – either through monetary penalties or ultimately the loss of his or her position.

An executive offers an interesting anecdote from a company. “The lady who cleans my house also works at our company. Once I asked her to buy some stuff for cleaning the house and she said ‘no, we’ll take it from the company.’ I had to explain to her that this is not the way we do things.

Another time, when I was doing some work on my private car – one of the maintenance managers brought me a box of spare parts for my vacation. I asked him how much they cost so I could pay him and he told me not to worry about it, as they were from the company and ‘we are not well organized so it’s not a problem.’ It’s normal they are helping me and that they help everyone else as well – so it’s a culture – there’s no feeling that there is something wrong occurring or that it’s illegal.”

Another issue with companies in the CEE region, particularly with multinational companies, is their size and location relative to the overall company, including their distance from the home country. According to an executive “It’s a question of how to control (different parts) of the company, for example those who are close to headquarters who are used to more traditional styles of management (in Western Europe) are not always focusing on those branches in Eastern Europe, but allowing them to do things their own way. As long as they see profits they are focusing on the home front and letting smaller branches run the business as they see fit.” This may be starting to change however. As a service provider to the industry, KPMG in Central and Europe is witnessing an increase in requests to investigate the regional operations of multinationals headquartered abroad.
The first stage in addressing any problem is acknowledging a problem exists. On the basis that strong evidence exists that fraud is occurring, the issue is identifying the extent to which it is happening. One approach to quantifying the impact is to look to empirical studies that suggest approximately 5-8 percent of revenue will be lost to fraud in an uncontrolled situation. As few entities in today’s business environment have no controls, the losses should in theory be lower. However it is not always clear that controls are operating, or are effectively carried out.

Therefore an initial step in combating fraud is to conduct an assessment of the company’s operations. The assessment should consider the nature of the fraud risks facing the organization, based on both its industry and its geographical location. On the back of this assessment an analysis of the existing control environment should be conducted. In carrying out such an analysis, both the existence of controls to mitigate a risk should be considered, as should the effectiveness to which those controls are implemented. That is to say that often a seemingly comprehensive control environment exists in theory, but in reality those carrying out the controls adopt a checklist mentality negating the effectiveness of, for instance, a four eyes principle based control. The analysis must therefore, assess not only the theoretical environment but also test the work done against the theory.

The next step involves designing new, and possibly removing ineffective existing, controls to adequately address the risks identified and take into account management’s risk tolerance. Once a comprehensive control environment has been designed, this needs to be implemented. This will involve training staff on the new procedures and instilling in those individuals the need to carry out the prescribed procedures correctly. Finally the new environment needs to be tested and assessed as to its effectiveness. The entire process should be repeated whenever there are changes to operating procedures or changes in the business environment.

An effective fraud risk management strategy has three broad levels. The first is prevention. By setting a tone for the organization that clearly sets out what is considered acceptable behavior and establishes that it is expected that the standard will be adhered to, the work force is motivated to prevent fraud. Controls to prevent fraud from happening will then have the desired effect. The senior management must set the tone for the organization. This starts with establishing for the benefit of all staff - particularly in multi cultural situations such as foreign ownership of local production facilities employing individuals from multiple ethnic backgrounds - what is ‘acceptable’ and what is ‘unacceptable’ behavior. This standard must be communicated, and in some cases taught, to all staff. Then senior management must not only enforce the standard, but also be seen and perceived to be living by the standard. Only then will a tone become part of the organization’s culture and can the organization become resistant to fraud.

The second level of fraud management is detection of fraud that is not prevented. This requires active, as opposed to passive or tacit, involvement of management. Management must monitor and seek out potential fraud that is occurring.
Management needs to enlist the assistance of all stakeholders in the company, including employees, customers and suppliers. This can be done through the use of hotlines, but such mechanisms are more effective once the organization’s tone against fraud is imbedded in the organization.

This can be done through remaining alert to rumors and trends in the operations. This should involve formal procedures intended to highlight and follow up unusual transactions. However it is virtually impossible for management to do this on its own. Management needs to enlist the assistance of all stakeholders in the company, including employees, customers and suppliers. This can be done through the use of hotlines, but such mechanisms are more effective once the organization’s tone against fraud is imbedded in the organization.

The final stage of defense against fraud is effective follow up once instances of fraud are suspected. Part of the tone of an organization has to include its stance on dealing with suspected instances of fraud. Poor investigation, unwillingness to prosecute or conversely perceived overly harsh reactions will detract from an organization’s ability to prevent or detect fraud. Diligent investigation of suspected fraud coupled with fair and consistent responses commensurate with the findings will lead to individuals reporting suspicions for follow up.
Fraud is and will continue to happen in the automotive sector in CEE. This is no different than other geographical areas or sectors of the economy. What is different is the nature of fraud in the automotive sector in CEE. Our survey results suggest that physical theft of material is the current prevalent source of fraud. Our experience also suggests that the current financial conditions will increase motivation to commit fraud and the rationalization that it is not fraud, coupled with the perceived inability or lack of desire to prosecute fraudsters, will drive an increase in attempts, whether successful or not, to commit fraud.

Sample Antifraud Program Elements

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