

# Preparing to Compete

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# Foreword

*The after effects of the worldwide economic and financial downturn have altered the business landscape and have challenged long-standing assumptions about successful operating structures. A popular notion today seems to be that there is a need to establish a new "normal" for the automotive industry.*

*Whatever the popular notion is, the reality is that the game has changed, and it requires new approaches in most everything that automotive companies do, from reporting to their stakeholders and the investment community at large, to making decisions about their tax and legal structures in a depressed market, and to rethinking their entire business structure to eliminate complexity that hinders competitiveness and stifles innovation.*

In this issue of *Global Automotive Perspectives*, we begin by discussing the reporting of annual results, and how the recent downturn can make this event anything but routine. Some examples include:

- Explaining changes in growth or profitability
- Highlighting the results of restructuring initiatives
- Addressing concerns about financial stability and cash position
- Developing a more strategic outlook on the impact of temporary incentive programmes

Establishing a regular information flow between companies and the investment community develops a climate of confidence, creating a virtuous circle of transparency and credibility.

In addition to thinking about how to address concerns about financial reporting, the new market reality may have altered the transfer pricing arrangements. Most companies have set rules to determine the prices for intercompany transactions so that the income of the entities in question can be accounted for properly. These rules work under stable economic conditions but might no longer be adequate during a downturn. Some questions you should consider asking yourself:

- Have you recently entered into renegotiations on contractual terms with third-party manufacturers, dealers, or other sales entities?
- Has group profitability significantly declined (or is it expected to decline significantly)?
- Are you dealing with excess capacity, significantly exceeding the company targets?
- Are you profiting from government subsidies instituted because of the crisis?

Finally, the new economic reality is an opportune time to take a serious look at your business operating model. It is no secret that the automotive industry is full of complexity, and many automotive companies have suffered greatly due to the changing market conditions. Some factors that have contributed to complexity include:

- Mergers & acquisitions, divestments, joint ventures
- An increasing burden of regulation and compliance, such as changing emission standards or REACH
- Complex, global supply chains coupled with low cost country sourcing to remain price competitive
- Multiple sales and distribution channels in a highly competitive global market

Fortunately, there are ways to simplify your business model, transform the value chain for tax optimisation, and take advantage of legal structures to make your business more competitive. While the changes outlined in the article on corporate simplification are not easy ones, automotive companies that have addressed their complexity have found the effort well worth pursuing.

These are only some considerations you should keep in mind as you drive your company out of the recent aftermath and into a future that will thrive on competition. We invite you to contact us to discuss your company's situation in light of these or any other business challenges you face on the road ahead.



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# Reporting 2009 annual results: Anticipating investor community concerns

Disclosure of annual information is a major event in the financial communication calendar of corporations. Indeed, through press releases, analyst slide shows, and the annual report, they convey a large amount of information regarding strategy, markets, and performance and their potential impact on the financial statements. The global economic crisis and its consequences for the automotive landscape are likely to make this exercise even more challenging this year.

In addition to looking at reports on mandatory areas such as the 2009 results and financial position, market participants will want insight into management strategy, exposure to risks, and outlooks. Communication on each field is challenging in today's environment and should be carefully prepared so that companies' messages are well-received by the opinion leaders, financial analysts, brokers and, more widely, the shareholders — stakeholders of the group.

## I – Presentation of 2009 results and financial position

### 2009 results will be scrutinised

To provide an accurate, true, and fair view of their financial performance, companies will need to disclose detailed analyses of the changes in consolidated sales, operating margins, and other relevant income statement items compared with 2008. In a difficult market environment characterised by overcapacity and price pressure, analyses will most likely show significant changes in sales and operating margins in the auto industry again this year.

Firstly, companies will need to discuss changes in growth and financial profitability indicators at a group level. This should be done in light of changes in volume, prices, mix, consolidation scope, or accounting policies and the impact of external factors, such as foreign exchange rates or commodities prices.

The analyses should then be done at business segment levels, whose number can vary depending on management's internal reporting, on which companies base external segment reporting under both IFRS and US GAAP. For illustration purposes, the number of reporting segments ranges from two to nine when looking at a sample of six European Original Equipment Manufacturers, "OEM" (Peugeot, Renault, Fiat, Daimler, BMW, and Volkswagen). Companies that do not intend to provide detailed analyses should prepare for tough Q&A sessions with analysts.

This year, investors' scrutiny will also be high on efficiency gains and the impact of restructuring schemes on financial performance. For the 2009 half-year reporting, management has at times dedicated an entire section of the slide show to analysts explaining cost-saving measures in detail and their financial impact on the group. However, based on PwC's discussions with analysts at the latest "Meet The Experts" Conference in London, it seems that disclosure of costs, benefits, and timing of restructuring programmes varied enormously from one group to another.

As a reminder, communication should be primarily based on GAAP figures, but financial disclosures often include additional non-GAAP indicators such as EBIT(DA) or free cash flows. These non-GAAP performance measures can

provide investors useful supplementary information if they are adequately presented and explained. Under certain circumstances they can allow a better understanding of a company's core financial performance when, for example, excluding one-off charges or noncore activities. When using such indicators, companies should ensure their definition remains consistent over time (with prior financial disclosures), and the differences with GAAP measures should be made explicit — through a reconciliation table, for example.

Disclosures based on operating indicators, such as units produced and units sold, occupy a large space in financial communication from the auto industry. In this regard, consistency between operating and financial indicators is crucial and should definitely be a point of focus in the validation process of financial disclosures.

### Cash situation and financial health should be fairly and clearly presented

In today's tough environment, particularly in the automotive landscape, it is important that companies explain how financially solid they are and how they manage their capital structure and cash flows. Since the beginning of the economic crisis, reporting has focused more on cash flow, and many companies have released enhanced information on debt maturity and covenants, cost-optimised liquidity and capital resources, their level of equity and refinancing measures, and their level of working capital and cash requirements.

However, based on PwC's discussions with analysts at the latest "Meet The Experts" Conference in London, one of the key gaps that would need to be filled to help capital markets understand a company's performance is explanation on how the net debt reconciles to the cash flow statement. More specifically, details on the impact of foreign exchange translation on debt on the one hand, and acquired (or divested) debt on the other hand, appear to be the key missing data items.

But financial disclosure must not consist solely of numbers and ratios, which are merely the consequence of past performance. The analyst community also needs to understand management's vision.

## II – Financial communication will be strategic

To obtain a better understanding of a company in an increasingly complex international environment, the players in financial markets must understand its strategy and be convinced that it is the best possible one and that it can be executed properly by competent managers. In short, communication must be, above all, strategic.

In this regard, analysts expect management to provide its strategic orientations for both the short and medium term. In analysts' notes on the auto industry, their strategic questioning often relates to the following topics:

- The impact of ending “cash for clunker” programmes in Europe as analysts expect car industries to slump sharply where and when these incentive programmes phase out;

- The recourse to strategic cross-border alliances and joint venture operations, especially as technology is increasingly complex and expensive to develop;
- The commitment to bringing to market fuel-efficient and eco-friendly products as consumers' sensitivity to reducing emissions gets stronger;
- The ability to generate economies of scale;
- The investment in strategically important markets;
- The quality of distribution networks, especially in BRIC markets; and
- New models and marketing initiatives.

Members of management need to communicate on their top priorities and the direction in which they are shaping the company's future. What is at stake? Convincing their shareholders they are creating lasting value for them.



### III – Information on risks

In the course of business, companies are exposed to various types of risks. A distinction should be made between a company's own risks, which are specific to it and are related to internal factors, and risks related to external factors that may have an impact on its business and/or its results.

Examples of these internal factors could be the risk of default of car dealerships or the risk of suppliers going bankrupt. External factors would be macroeconomic, such as currency risk, interest rate risk, liquidity risk or commodity-related risk, as well as risks related to changes in regulations and tax law. Country risks may also have an impact on a company's production, product distribution or supplies.

With regards to the auto industry, investors may at least see two big risks in investing in OEM shares. One risk is macro as unemployment rates and consumer confidence have a direct impact on demand. The other risk comes from large players that are going through significant downsizing by offering aggressive discounting and incentives, making the market much more difficult for competitors.

Disclosure of 2009 results will also give OEMs the opportunity to update financial market participants with regard to their sensitivity to macroeconomic risks. In principle, this should enable analysts to assess the impact of any upcoming change in macroeconomic factors on the company. As consumer confidence is highly difficult to predict, market size forecasts are a perilous exercise. It is therefore important that when making financial performance forecasts, the company discloses its assumptions on macroeconomic indicators and how they could potentially be affected by them.

Regarding market risks, sensitivity analyses to changes in foreign exchange rates, commodity prices or interest rates are crucial, as well as information on hedging strategies. With regards to interest rates, certain companies holding fixed-rate debt might also be exposed to this risk when a long-term fixed-rate financing reaches maturity, as the conditions for rolling it over may be less favourable. In such event, disclosures concerning fixed-rate credit lines that will need to be renewed in the 12 months following the end of the accounting period would seem to be relevant in the current environment.

Information on liquidity risks remains in demand by analysts. This should cover financial covenants on debt, availability of unutilised credit lines, and capacity to raise funds when and if necessary, as well as detailed maturity tables of debt repayments and financial instruments used.

Between reporting periods, a company should publish a press release as soon as it determines the existence of a risk that is not known to the market – if it considers the scope and potential financial impact of the risk to be material. This is particularly true with regard to the estimated impact on its performance and its financial structure under various risk scenarios, as well as to the potential impact on its share price, the estimated impact on its strategy and/or its organisation, or the potential impact on its reputation. As for periodic information, immediate market disclosures should include a description of internal control procedures put in place by the group and, if the assessment is sufficiently reliable, a quantified measure of the impact on the company's accounts and whether hedging action has been taken.

## IV – Prospective financial information

Whereas disclosure of objectives and prospective qualitative information to the market is a must, disclosure of prospective quantitative information concerning companies' own outlook remains optional. However, OEMs are under considerable pressure from market participants to be as specific as possible.

With the economic crisis and the uncertain future of auto markets, companies have generally tended to be less specific on future growth and profitability figures. Rather, they have focused communications on their proposed structure for capital and indebtedness and the level of investment budgets, as well as cost reduction objectives.

Whatever prospective financial data companies choose to disclose to the market when releasing their 2009 results and irrespective of the details furnished, they should always ensure that:

- The disclosure of prospective quantitative financial data clearly states the time frame and the nature of the indicators, especially if they are adjusted non-GAAP indicators;
- The description of major underlying assumptions is complete and transparent; and
- The reliability of the data has been checked internally prior to any communication to ensure the pertinence of the information shared and to avoid misleading the public on forecast results.

When a company regularly, in the context of periodic information, discloses to the market information related to its strategy and objectives, the characteristics of its business and its sensitivity to macroeconomic factors, the market should, in principle, be capable of measuring the impact of that information, or of any changes in relevant macroeconomic factors, on the company. In such case, the company will usually update its previously announced objectives through periodic information instead of an immediate and specific disclosure.

Nevertheless, should a company find that there is a difference, positive or negative, between previously disclosed objectives and the plausibility of results for any given period, and if that difference appears to be inevitable and material, a prompt communication to the market of that difference appears necessary. The difference can be measured in absolute amounts, as a percentage of the disclosed objective, as a percentage of the historical figure or in the rate at which the gap is widening between the forecast and actual figure.

It is therefore of the utmost importance that companies closely monitor actual figures versus prospective announced figures to decide quickly if publication of a profit warning is deemed necessary.

The purpose of this article is to address some of the hot topics CFOs and CEOs should focus on regarding disclosure and fair representation of financials for the year 2009. However, regular flow of information to the market is key for investor relations, and financial communication will not stop after the presentation of annual results. Companies will need to confer regularly with the market each time there is a significant change of scope in consolidation or it obtains a major contract, establishes a new alliance or is the subject of any other ad-hoc event that could affect its business and therefore its profitability.

To facilitate the successful flow of information to the market, the company should rely on the principles that provide the foundation of financial communication. These principles require that all shareholders have access to the same level of information and that the company has the obligation to inform the public of any fact that, if it were known, would be likely to have an influence on its share price. The regular flow of information between the company and market participants develops a climate of confidence, creating a virtuous circle of transparency and credibility.

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## Further recommended reading



Seizing opportunity  
Linking risk and performance



to the point  
Current issues for boards of directors



10Minutes  
on Post-Crisis Boardrooms



# Transfer pricing strategy in a crisis environment

## Introduction

Reading this article will not give you another view on recent developments in the automotive industry. It will provide you with a better understanding of the transfer pricing implications of the downturn and whether there is a need for action for your business to update its intercompany transfer pricing arrangements.

Most companies have set rules to determine the prices for intercompany transactions so that the income of the entities in question can be accounted for appropriately. These rules work under stable economic conditions but might no longer be adequate during a downturn. For example, typical transfer pricing arrangements may generate situations in which a large number of entities within the group are paying cash taxes while the group as a whole is loss-making.

Many companies treat income taxes as an unavoidable expense. Although they certainly are unavoidable, paying only the correct amount of tax is both legal and wise.

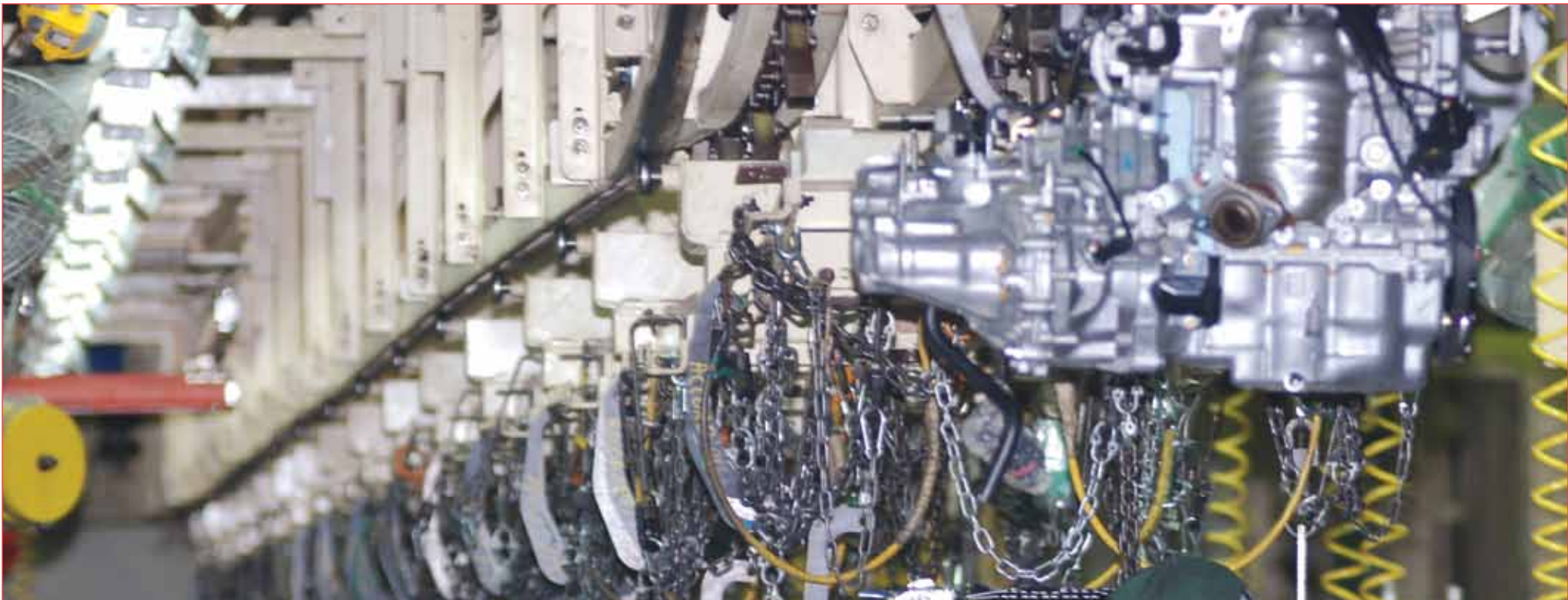
## Transfer pricing in the automotive industry

*The golden rule of transfer pricing (TP) is to set prices for transactions between related parties in such a fashion that independent parties also would have agreed to pay them — the so-called arm's-length principle. One of the main challenges of transfer pricing is to implement a transfer pricing model that satisfies the arm's-length principle but does not create a burden on operational activities. At the same time, TP can add significant value to a group by aligning its supply chain with economic realities and tax constraints/opportunities. In any case, during a tax audit the intercompany prices and resulting profits for the respective legal entities must survive the third-party comparison test, and it will be difficult to do that without preparation.*

Economically speaking, it is expected under the arm's-length principle that each entity in question is compensated according to the functions it performs, risks it assumes, and assets it employs. The starting point for a transfer pricing analysis is a so-called functional analysis, which determines which of the contracting parties' income should be examined vis-à-vis the income of third parties performing similar functions. For example, looking at the sale of a vehicle to a dependent distributor, who would then sell the vehicle to a local dealer, a functional analysis would determine whether the income of the distributor or that of the manufacturer should be compared with the price that a third party would agree to pay. Generally, the lesser complex of the two parties involved is analysed to verify whether its income is in line with the income realised by third parties under similar circumstances.

From a strategic TP perspective, however, generally it is first determined to which legal entity the residual profit of the value chain should be attributed (i.e., the profit that remains after all routine functions have been compensated). Usually, this is a central entity acting as the "spider in the web," with global or regional operational responsibility (people who call the shots), capital to make investments, and assets (including patents and know-how, i.e. IP) required for functioning as a global player.

In the automotive industry, many structures can be observed where assembly and distribution of vehicles are treated as a service to a central entity, interpreted as the entrepreneur in the value chain from a transfer pricing perspective.



## Does traditional transfer pricing still work in a crisis?

### Manufacturing

In the TP model illustrated above, assembly is considered a routine function with a focus on efficient and reliable work flows, for which the manufacturing entity is compensated with a low but stable profit mark-up on its production costs. This results in taxable income at the level of the manufacturing entity, regardless of how the group as a whole is performing. In addition, if there is a certain level of (excess) capacity being held available at the assembly unit to meet a potential rise in demand, then the costs of this reserve capacity are included in the cost base. Consequently, if demand drops suddenly, there may be no time to reduce capacity; at best the workforce may be reduced. Under the TP model described above, the central entity will thus face a redundancy cost and the cost of excess capacity.

Taking a slightly longer-term perspective, many Original Equipment Manufacturers (OEMs) have shut down or will shut down facilities, and intercompany agreements most likely will be terminated as well as a consequence of the closure of facilities of related parties. From a TP perspective, it should be determined which parties should participate in the closure costs. The dealings between independent parties can provide interesting and useful information for setting terms and conditions between related parties. For example, a recently created alliance gave one of the involved partners the ability to produce a successful model in-house, leading the OEM in question to terminate a manufacturing agreement with a third party manufacturer. Consequently, the third party manufacturer is now claiming damage compensation. Do your intercompany manufacturing agreements include damage payment clauses?

### Distribution

Distribution entities, i.e. either local dealers or the regional distribution units that supply the dealers, are usually characterised as entities with routine functions with entitlement to low but stable profits. They are typically rewarded such that they retain a gross margin high enough to cover their expected operating expenditure and deliver a positive operating margin expressed as a percentage of sales. Assuming that transfer prices are set so that distribution entities earn a positive operating margin not only on the basis of budgeted turnover and costs, but also on an ex-post basis, this again results in taxable income at the level of the distribution entity, regardless of how the group as a whole is performing. However, this transfer pricing model may fail when parking lots are full with vehicles that have been produced in anticipation of customers who have not yet purchased them and an abundance of used lease cars waiting for new owners who are not willing to pay the sticker price. As a result of traditional transfer pricing arrangements, the central entity will face losses because net customer proceeds from the sale of vehicles will not be high enough to cover their own expenses plus those of the other entities in the value chain. In fact, the losses absorbed by the central entity will be significantly in excess of the losses of the group on a consolidated basis.

One may wonder whether such consequences are intended or in line with third-party dealings. Of course, in good years the central entity would capture residual profits including a risk premium to cover financial hits in depressed economic times; however, the recent downturn has come so quickly and forcefully that it cannot be treated as a roller coaster, where you just hold tight and enjoy the ride.

## Reasons to revisit existing transfer pricing arrangements

Most TP models have been designed assuming a normal economic environment with ups and downs but no major disruptions. Therefore, it made sense to allocate the residual profit or loss (after compensation of routine functions) to the entrepreneurial entity. If volume drops, the profit in absolute amounts would go down for a distributor, but the central entity would be exposed to the major portion of the downside risk of a depressed market. However, is it economically realistic that manufacturers and distributors of automobiles should be almost fully insulated from the impact of the current market downturn? Would an automotive OEM not attempt to renegotiate its contracts with a third-party contract manufacturer in light of recent economic events? Would it be fair to say that a third-party contract manufacturer can ignore an attempt of renegotiation? Are third-party dealers realising profits in the current economic environment? Do OEMs guarantee profits to third-party suppliers and dealers?

The basis for the stable compensation of manufacturing and distribution entities and thus allocating residual profits to the entrepreneurial entity is that the value drivers in the value or supply chain are concentrated with the entrepreneur. Examples include the marketing intangibles (brand name, etc.), the core and applied product technology and designs, and the ability to manage innovation culture, strategy for partnerships, and product portfolio management. Capacity is considered to be a value driver, and excess capacity to accommodate increased customer demand is seen as a necessity. Consequently, the manufacturer has made specific investments in capacity that need to be flexible. If the contract manufacturing agreement would be terminated, alternative options could be explored, and the capacity could be put into the market. However, such may not be in the interest of the OEM, and thus alternatives may be limited. The same applies for distributors: Would they be allowed to sell competitive brands? The limitations to pursue alternative business opportunities created by being part of a group should be factored into the TP arrangements.

We have posed several questions in the preceding sections. If your answers are “no” or “maybe not,” it would make sense to revisit current manufacturing and distribution arrangements.

It should be noted, however, that the current downturn should not only lead to a reassessment of the remuneration of routine activities within a corporate group. In traditional transfer pricing models, IP owners often charge royalties to those who use the brand, patents, and other know-how. Although technology and customer recognition is required to be a player in the automotive market, with overall negative returns for many in the current market, the value of these intangible assets is not clear. One may argue that implicit value of existing IP is extremely low if consumers show no interest in current models. To stay in business and continue to be a player in the automotive industry, new IP is required (clean technology, different models, new features, etc.) for both OEMs and suppliers. Hence, to the extent that license arrangements or other arrangements pertaining to the provision of IP refer only to existing IP, it may make sense to reevaluate the premises on which the initial arrangements are based. Would a third party pay for obsolete technology or for an unpopular brand among consumers? Whether IP is centralised or not, the transfer pricing arrangements to compensate the owners of IP should be revisited to take market conditions into account.

Another complication with respect to traditional transfer pricing models is that when determining the remunerations for routine entities (e.g., mark-up on costs or return to sales) a comparison to the profitability of independent parties is made by using their historical financial information obtained from databases. If the profitability of the tested related party falls within a “benchmarked” range of profits achieved by the comparable companies, it is assumed that it meets the arm's-length principle. Using historical data to review profits of the current year or set prices for the following year might not be an issue if there is little market volatility and economic performance is stable. However, looking at financial data from 2005 to 2007 to review the arm's-length nature of the 2008 and 2009 profitability or setting the prices for 2010, might not be of much help. Many players in the automotive industry have gone out of business or are at the brink. Under current economic circumstances a break-even result would be good. When historical financial data are used to determine an at arm's-length profit range, adjustments will be required to accommodate the impact of the crisis in the automotive industry.

## What actions are required?

Are all legal entities suffering proportionally from the automotive downturn? Is the effective tax rate aligned to the consolidated group result? If by now transfer prices have not been revisited and adjusted, are you too late? Not necessarily. Adjustments are required for a central entrepreneur model. When there is extreme volatility in the market, independent parties revisit terms and conditions and possibly negotiate different prices. Hence, action should be taken to correct intragroup behavior that is not at arm's length.

Timing is important because third parties may be looking at revising the arrangements prospectively and might be less willing to correct prices retrospectively. Clearly, it is better to respond quickly and act prospectively, but if your company has entered into renegotiations with its suppliers and customers but neglected the internal arrangements, there can be arguments to align pricing retrospectively. If statutory accounts have been audited and closed, it might not be possible to reopen them with the simple argument that the TP arrangements should have been adjusted.

Changing your transfer pricing arrangements fundamentally or implementing new TP models might not be required, but a review of prices and resulting income for each of the parties could provide an answer to the question of whether price adjustments are needed. The following list may provide you with a few issues to consider. If your answer is “yes” to more than one or two of these items, it might be time to revisit your transfer pricing strategy.

- Have you recently entered into renegotiations on contractual terms with third-party manufacturers, dealers, or other sales entities?
- Has group profitability significantly declined (or is it expected to decline significantly)?
- Are you dealing with excess capacity, significantly exceeding the company targets?
- Are you profiting from government subsidies instituted because of the crises?
- Are significant discounts offered to clear out excess inventory?
- Are (intended) business reorganisations resulting in expenses today to reduce costs for tomorrow?

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## Further recommended reading



Intellectual property in the  
automotive industry  
Transfer pricing aspects



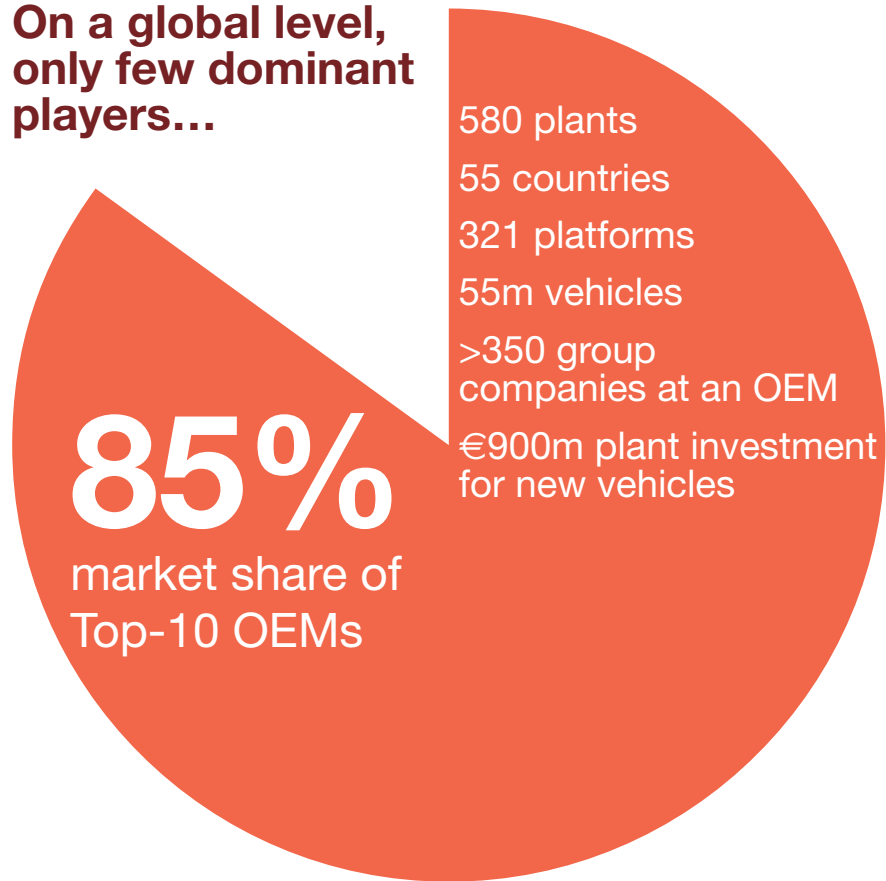
International transfer  
pricing 2009



Transfer pricing of intellectual  
property in the automotive industry  
A focus in India

# Rethinking the business operating model: Corporate simplification in the automotive sector

**On a global level,  
only few dominant  
players...**



### Introduction

Why is complexity such an issue for the automotive sector? The automotive industry is over 100 years old, and layers of complexity have been introduced at each turn of its evolution. It has one of the most complicated upstream and downstream value chains for a volume produced product, which becomes ever more complicated as the industry evolves.

**... run assembly operations around the world  
relying on fragile supply chains...**

>10,000 miles sourcing distance

50,000 companies making auto parts made in China

40 days shipping time

~1,600 companies supply an OEM

**... to produce a highly complex product for a  
buyer's market...**

>100,000 variants

146 brands

>80 regulations for the EU

1,036 name plates

~100 new patents for a premium vehicle

15 new patents per day at leading global supplier

**... sold through different channels to different  
customers with diversified demand and  
mobility patterns...**

€1,000–€1,6m price range

€43b net trade contribution in the EU

>25,000 official retailers for a global OEM

What is the role of local distributors, and what activities should they be focused on? Can centralised direct invoicing work for OEMs? Is it advisable to consider cross-border mergers across Europe or the establishment of an European Single Entity (SE) rather than operating separate legal entities in each country? These are some of the questions and opportunities which go to the heart of the operating model of companies in the automotive sector. To secure sustainable competitive advantage, automotive companies should focus on getting fit for the future. For many, this will mean breathing new life into the organisation by simplifying the operating model to strip out unnecessary cost and complexity in the business operations, tax and legal structures. The benefits will include enhanced flexibility, greater operating and tax efficiency, and long-term cost control— all essential qualities, for high performance in a fast-changing marketplace.

### Introducing simplification to an industry in structural change

As companies in the automotive sector have grown and evolved over time, so has the underlying complexity of their business models.

OEMs and suppliers need to have different strategies for mature markets versus emerging markets. In emerging markets, companies must have the most efficient market access platform to position themselves to benefit from growth opportunities. However, without the right strategy and execution in mature markets, it is clear that companies cannot profit from emerging markets – the persistence of structural cost and complexity in mature market operations will eventually rob all but the most resilient competitors of the opportunity to compete in emerging markets.

During the last decade, the underlying complexity in Automotive companies has been hidden by a benign business environment. However the global recession has challenged the core operating models responsible for delivering the business strategy of many companies.

### A combination of factors has contributed to this trend, including:

- mergers, acquisitions, divestments and joint ventures
- the increasing burden of regulation and compliance, such as changing emissions standards, REACH compliance
- complex, global supply chains and low cost sourcing, requiring cross border movements of goods for products that are increasingly built-to-order, and covering a staggering array of potential configurations
- testing and research facilities may need to be headquartered outside of a company's normal operational sphere.
- multiple sales and distribution channels in a highly competitive global market place covering a mix of channels such as national sales companies, wholly owned retailers, third party retailers, and including sales, after sales services, the provision of spares and financial services;
- increasing electrification of the industry: introducing the need for organisational relationships with non-traditional auto companies in non-traditional automotive specialisms

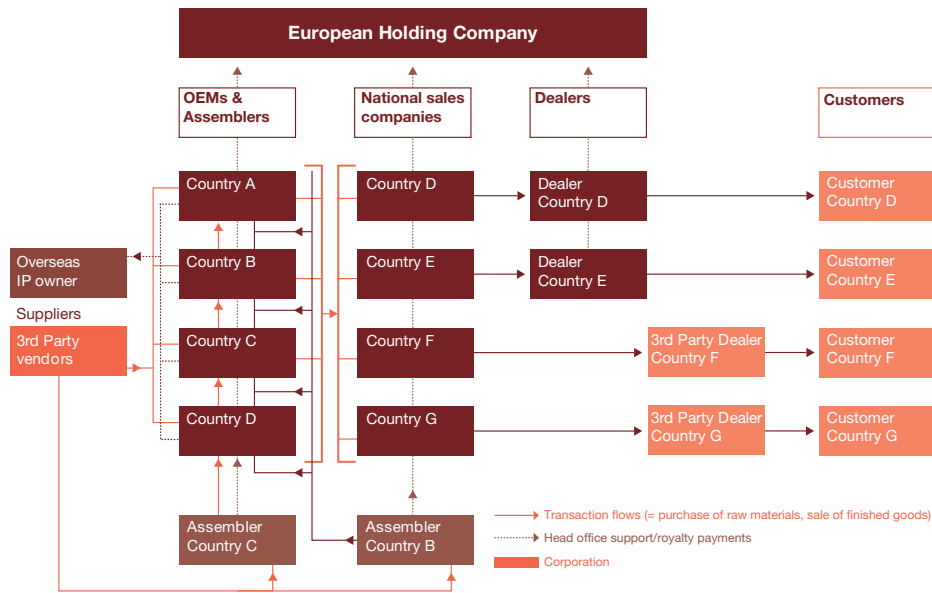
Instead of being equipped to cope with the profound challenges that arose, many companies found that their operating models were too complex to enable the flexibility and efficiency needed to *deliver business strategy* in an uncompromising market. For example, the ability to rapidly analyse and understand trends in the marketplace, and so make decision to reduce inventory and production levels, was hindered by the complexity in the organisation.

Figure 1 is a representation of the complexity in a European OEM in its simplest form.

As one executive in an OEM told us –

*“For every external transaction, we seem to have at least three internal transactions – it looks like we are our biggest customer!”<sup>1</sup>*

### Existing complexity in a European Automotive OEM



Source: PricewaterhouseCoopers

Further, unwieldy structures complicate the *process of doing business* with both customers and suppliers, for example in having a consolidated view of business being conducted with potentially “at-risk” suppliers. Excessive complexity can also hamper companies which need to adapt to changing regulatory environments. Proposed changes to the tax system in the US and other countries may also have profound implications for many corporations; we look at these in more detail in the section on tax optimisation.

*Cost reduction programmes bring the most benefit when they are part of an overall simplification strategy.*

Many automotive companies are already very aware of the level of complexity within their organisations, and over many years have embarked on projects such as lean manufacturing, which seek to simplify portions of their inventory management and production. While these have been useful steps on the journey towards a more streamlined organisation, companies need to take care. In response to the current environment, some organisations have effectively adapted their operating model by initiating cost cutting and change projects, sometimes without a thorough understanding of the impact each will have on the fundamental way they manage the business.

Ultimately the goal may be not only to simplify the existing business, but also to ensure that further growth of the business, be it through acquisitions, entering new geographic markets, or expanding the product line, does not add unnecessary complexity to systems or structures, and supports the overall business model. In order to ensure that individual projects are contributing to this overall goal, companies need to describe, in a clear, cohesive and comprehensive way, how the company will operate in future – the single *‘end-state’ solution* and vision integrating tax, legal and operations.

<sup>1</sup> PricewaterhouseCoopers Fortune 500 client

Once the end-state goal has been formulated, companies should identify and assess the impact of existing projects, and how these should be managed and redirected if needed, to remove conflicting priorities, objectives and duplication.

This document introduces a range of options which automotive sector companies could consider; which elements of simplification are most appropriate will depend in part on:

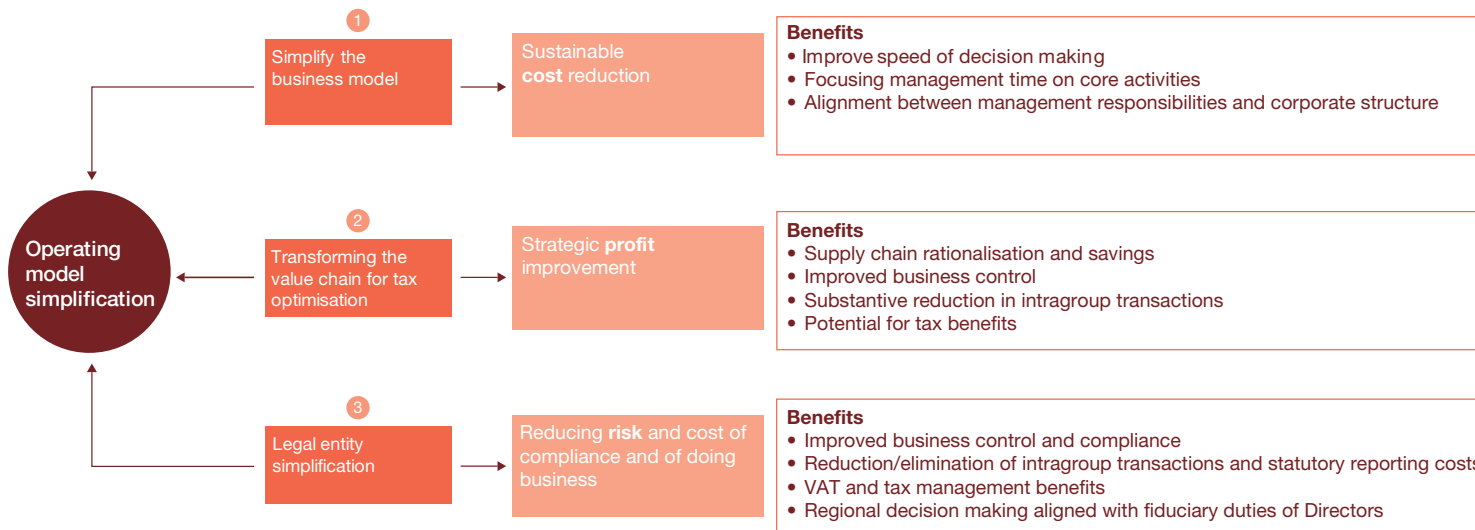
- simplification programmes currently in place,
- the level of ambition within the company as a whole, and
- the extent to which all countries and areas of operation are planned for inclusion.

Whilst the various approaches are illustrated by reference to the downstream distribution of OEMs, the principles outlined are applicable to any aspect of the OEM business chain, include manufacturing, sales, after market sales and services.

### Suggested approach to simplifying the business operating model

The diagram below suggests three ways in which automotive companies can set about rationalising their business operating models. Each is already being used to good effect by a wide range of companies to secure significant ongoing financial and operational benefits, and for some companies a combination of the solutions may be most effective. Automotive companies can choose to use any one or, most effectively, a combination of the simplification routes described.

### Routes to simplification



Source: PricewaterhouseCoopers Research

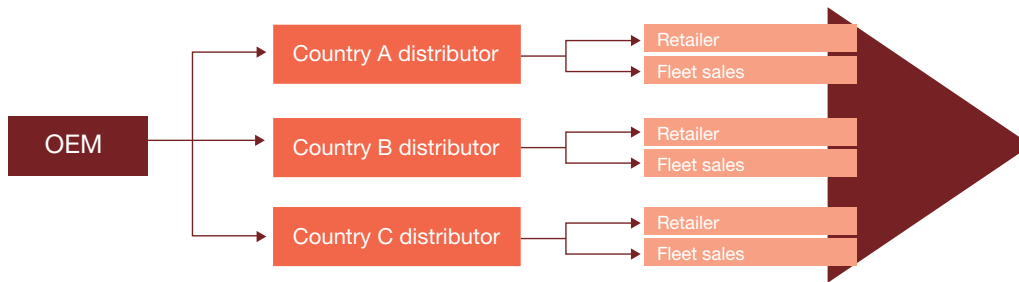
## Simplifying the business model

Every automotive company has its own history of growth, and its own management culture and degrees of autonomy between the centre and local operations. For example some companies tend towards wholly owned dealers, others have a mixture of wholly owned and third party dealers. However, winning companies are those which consciously map their operating model to the needs and priorities of the business.

Changing the management model requires a review of the business value chain to clarify and agree which decisions are owned centrally vs. locally, and where activities should be executed most effectively. Corporate level functions will likely include investor relations, brand management, statutory reporting, M&A, and strategic supplier relationships. By determining where consistency is needed, companies can achieve significant regional synergies in areas such as procurement and back office functions. Further, automotive companies may be able to better address product introduction and management, supplier management, and logistics by designing and implementing consistent regional structures.

One example is in sales and distribution. Today, most automotive OEMs typically still distribute their cars and spares via controlled wholly owned National Sales Companies (NSCs), who buy the goods and sell then in their own name and on their behalf to local retailers and fleet companies (such as hire companies, large customers etc), as shown below:

### Current sales channel model



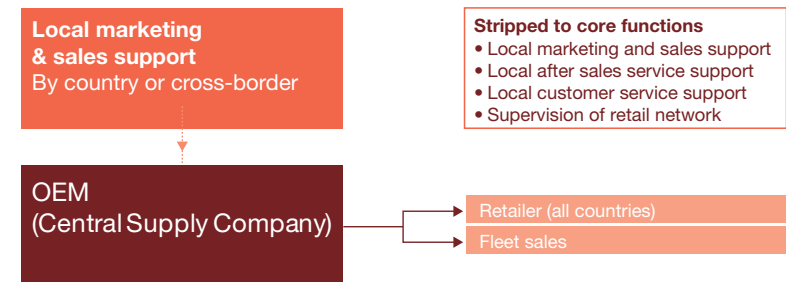
Source: PricewaterhouseCoopers Research

This model creates significant working capital needs, inefficient inventory management, significant administration costs (for example internal transactions, transfer pricing, statutory reporting), as well as making it harder to manage the business on a regional level. For example, trading with regional or global customers is harder via national companies. Until now, the automotive industry has been a slow mover, and other multinational companies (MNCs) in sectors such as high technology and consumer goods have increasingly been moving to a new distribution model, the most recent trend being towards a Central Supply Company.

In this model shown below, a Central Supply Company can sell products directly to retailers / wholesalers in each country. To facilitate and promote local sales, the Central Supply Company is supported by marketing and sales support services companies or sales agents (either one by local country, or a single marketing and sales support entity cross-border). The local service companies can be separate legal entities, however further benefits could be achieved from converting these into branches of the Central Company.

Since the inventory is owned centrally by the central supply company and the sales are made directly, such a model can optimise working capital, trade receivables and inventory management, as well as significantly reducing the administration costs and the group's overall business risks.

### Future sales channel model



## The new cross industry benchmark in distribution

Most automotive companies acknowledge the need for optimising their value chain and simplifying their legal structure. Nevertheless, the Automotive Industry has been a slow mover. The pace of value chain integration in other industries has been significantly faster. Tax optimisation has certainly been an accelerator for value chain integration in “high margin” industries.

Designing and optimising a network of operations takes time, and most benefits accrue over the life of investments. In the past, this certainly has been a blocker for initiating structural change in the automotive industry. Often, there still is significant segregation in management of functional, business unit and geographic divisions. On the positive side, it means that there is significant opportunity for supply chain redesign, legal simplification and, not to forget, tax-efficiency improvement.

A particular area of focus may be the distribution, marketing and sales channel. The consumer goods, electronics, pharmaceutical and chemical industries are actively streamlining their distribution and sales organisations. Over the last decade, they have gradually stripped functions, assets and risks from their national sales and marketing companies, to align them with business reality. Strategic and back-office functions, inventory, and major business risks have been centralised in a global or pan-regional principal company. The local force now primarily focuses on marketing support and customer servicing, though still with an entrepreneurial spirit.

Whilst so-called “commissionaire” structures have been the benchmark for many years, the latest trend is to move to local “sale agency” or “marketing services” companies, whereby the principal or central supply company directly sells to the customers.

The question is whether automotive companies should consider such wrenching change. The answer is yes, for many reasons. The automotive industry should benchmark its value chain against those of other industries that have proven to be successful. With the economic downturn, the international expansion into new markets, and the shortening product lifecycle, automotive companies will face mounting pressure to boost the efficiency of their value chain, to reduce costs and to avoid loss of competitive position. Pressured by competition in an oversupplied market, automotive companies should pursue opportunities to integrate (amongst other) their distribution and sales. The need to further streamline branding, marketing, pricing, inventory management, IT platforms, and the consolidation at the customers level (fleet and lease companies, retailers, other) on a pan-regional basis create an ideal momentum for automotive companies to revisit their current sales and distribution models. Business integration and legal simplification are therefore inevitable.

## Automotive industry

## Other industries: Manufacturing, Pharma and Chemical

1950 – 1970

### Independent Country Distributors

In the beginning, most multinational companies distributed their products in local markets via independent importers and distributors.

1970 – 1995

### Controlled Country Distributors

When sales had grown materially, many multinational companies have terminated the 3<sup>rd</sup> party distributors and have setup controlled country importers/distributors to distribute their products on the local markets.

1995 – 2008

### Commissionaire structures

In the mid '90ies, multinational companies have gradually converted their local country distributors into commissionaires to streamline their value chain. The tendency had started in high-margin industries, accelerated by tax-effective supply chain planning.

2008 – ...

### Central Supply Company

The most agile multinational companies have started to sell their products directly to the retailers/wholesale via a central supply company. The country distributors or commissionaires are being converted into local sales agents or marketing service providers supporting the local country sales and after sales. A recent trend is the cross border merger into cross country/regional sales and marketing entities.

## Transforming the value chain for tax optimisation

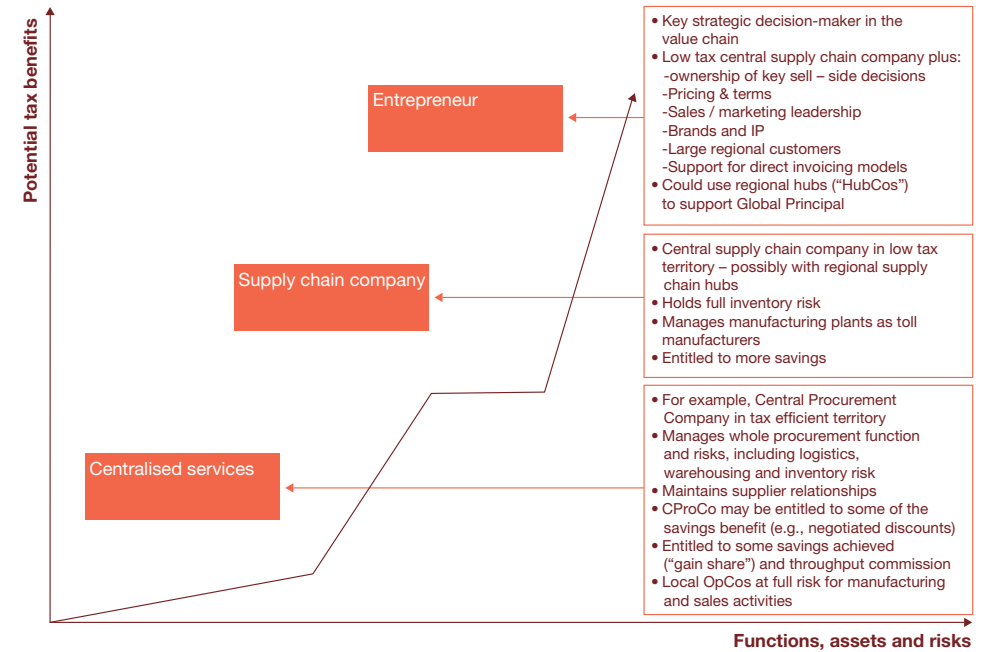
Tax optimisation projects design and implement a range of options that improve and simplify tax efficiency of the business, resulting in an optimised group tax strategy while being consistent with the operational and commercial business strategy.

Such efforts can also bring substantial operational cost benefits; they substantially reduce demands on finance and back office functions by reducing internal trading, reconciliations and administration, for example management service cross charges and internal contracts. Further, they can reduce local working capital needs and ensure cash flow is freely available to the group.

There are many non-financial benefits as well. Improving the tax structure of local entities enables these operations to focus on core local activities such as sales, as shown earlier in Section 1. This approach enables simplified in-country performance management and supports easier introduction of best practices across the business. A simplified business structure also facilitates an effective management compensations system and can reduce the negative behavioural impact of a transfer pricing policy that is set up for tax optimisation and does not reflect the economic realities of the business (such as the time and costs of tax compliance and defence)

There is a spectrum of tax optimised business models which Automotive companies can implement, as show on the diagram:

## Transforming the value chain for tax optimisation



Source: PricewaterhouseCoopers Research

Ensuring alignment between the tax model and how the business is actually managed (such as where key decisions are made, risks sit) is a fundamental pillar of a tax optimisation project. The tax model should have built-in flexibility to cope with turbulent economies. Some transfer pricing policies have proven to be tax-ineffective in an economic downturn; central entrepreneur companies in low tax countries incurring significant losses whilst the local entities in high tax countries continued earning guaranteed profits under net margin based pricing policies. Please see the article on Transfer Pricing in this issue.

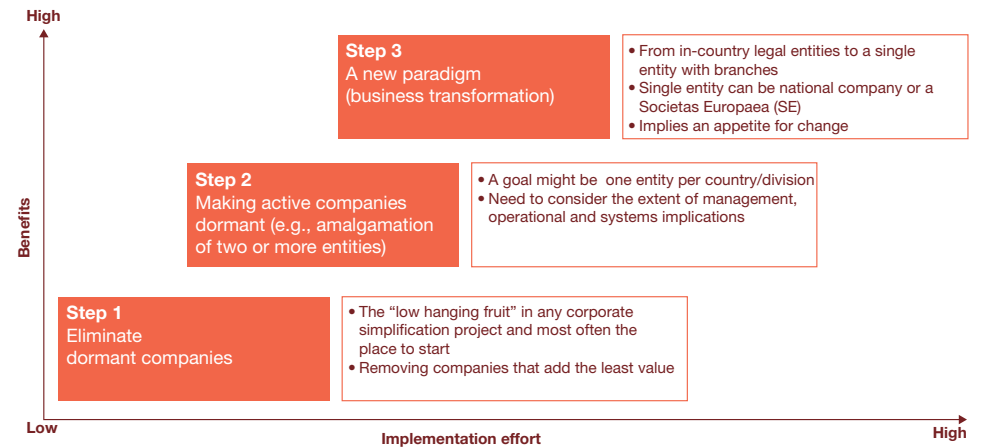
In some countries, changing tax laws and regulations may provide companies with a strong incentive to take a closer look at how their organisational structure impacts their tax strategy. In the US, for example, the Obama administration has proposed changes to its international tax regime which, if enacted, would affect US outbound corporate structures for tax years beginning after 31 December 2010. One of the proposals would restrict the ability of US multinationals to “check the box” to determine the tax classification, for US income tax purposes, of its foreign entities. If this proposal is enacted, many US owned foreign entities that are now disregarded for US tax purposes would be treated as corporations. This type of entity classification change could have adverse tax consequences on many US groups of companies. Accordingly, many companies are or will be considering additional changes to their current legal structure in order to avoid potential detrimental impacts. While certain tax planning options are being analysed and developed, this is an opportune time to further consider how such changes can provide additional tax and operational benefits.

## Simplifying the legal entity structure

Global companies are increasingly looking at a range of legal entity related simplification opportunities, including eliminating dormant entities, reducing the number of active companies, and using new legislation such as the Societas Europaea (SE) and the Cross Border Merger Directive in Europe as a means of driving entity rationalisation and aligning their legal and operational worlds, so unifying the management and financial reporting framework. This is particularly powerful when combined with moving to a local “sales agency” or “marketing services” company model described earlier, whereby the principal or central supply company directly sells to the customers, so moving from national sales operations into sub- or pan-regional operations. The European Union Merger Directive, is an accelerator by enabling such cross border mergers in a tax neutral way.

Simplifying the legal entity structure brings significant benefits. From a cost perspective, it can substantially reduce administration costs, including statutory and tax audits, complex internal trading such as intercompany transactions, intercompany contracts and transfer pricing arrangements. This in turn will reduce demands on finance and other back office functions.

## Simplifying the legal entity structure



Source: PricewaterhouseCoopers Research

Legal simplification may generate incremental tax savings, such as tax-optimised profit repatriation, potential cross border loss compensation, as well as profit and loss pooling in countries where there is no fiscal unity regime.

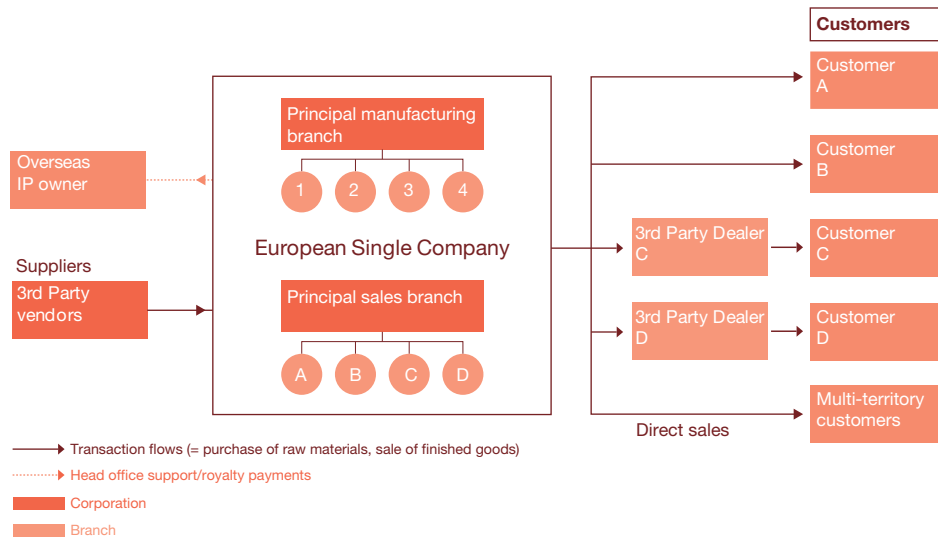
The ability to align management and legal structures may also substantially enhance risk management including Director accountabilities and risk, governance, controls and regulatory compliance, and also ease the transition to new regulatory, compliance and accounting regimes, for example IFRS.

Finally, while direct savings may be substantial, companies may also save significant indirect costs by becoming more flexible organisations which benefit from a common corporate culture and approach across multiple regions, and offering a single face to regional customers and suppliers.

## Bringing it all together into a future model

The following diagram shows a possible future structure, comprising the integration of the simplification approaches discussed earlier. This vision combines centralisation of business functions with tax optimisation, and with legal restructuring to a branch structure of a single European Company, which could be a European S.E or national company.

### Bringing it all together – a simpler model



Source: PricewaterhouseCoopers Research

The benefits of a such a structure can be significant – for one company, operational benefits and savings included: a reduction of more than 500,000 intercompany transactions, significant reduction in company reporting, administration and cost, opportunities to simplify and optimise local compliance, refocus of management time away from external accounting, and simplified treasury operations and improved cashflow.

## Making a successful case for change

When making any fundamental change to the business operating model, it is vital to be aware of the complex nature of such an undertaking, and the significant change management effort needed to ensure success. In our experience, the critical success factors are:

1. Effectively **engaging key stakeholders**, at all levels of the organisation, early in the process and maintaining engagement throughout the transformation
2. **Aligning the business, tax and legal structures** into one integrated operating model which supports the company's strategy, has strong sponsorship from senior management, fits the company's appetite for change and is within the company's ability to implement
3. Taking into account **local jurisdictional considerations**, understanding the specific legal requirements and approaches which different countries take to tax-efficient models. This assessment should including drawing comparisons, understanding and ideas from other organisations, in the automotive and other industry sectors.
4. Making **a compelling case for change**, including measurable benefits aligned to the proposed changes and assigned to specific owners to ensure realisation. Also seek operational 'quick wins' that link the programme to the front line.
5. Defining and embedding the **organisation impact** – the desired end-state may drive change throughout the organisation – roles, responsibilities and reporting lines, performance contracts and reward may need to be adapted. Take time to understand the impacts of the model on the way the business operates – including processes, systems and controls.
6. **Ensuring sufficient operational and functional support** is in place to enable the change – including prioritisation and phasing of change, minimising regret costs, on-going capacity of functional teams.
7. Building **strong central co-ordination** of the programme with alignment across operational, tax and support / back-office activities and across geographies

The next diagram shows a possible approach to structuring and delivering an operating model simplification programme, and details the outcomes of the first phase, Assess. This phase is critical, as it involves understanding the opportunity and potential benefits, aligning management support behind a compelling case for change, so laying the foundation for subsequent phases of the project.

## An approach



### Activities (Assess – typically 6-8 weeks)

- Review the current situation – the sources and cost of maintaining the existing complexity
- Define the options for simplification, and test senior management's appetite for change. Align senior management behind the need for change, with agreement on a future vision and integrated operating model
- Learn from peers and competitors – what others have done, and what has worked
- Have a clear picture of what needs to change from a people and organisation perspective, and if needed engage early with HR to address Works Councils communication and people transition issues
- Develop a compelling case for change, covering the business benefits and linked to the company's strategic goals
- Understand the legal and tax transition issues to be managed, and build these into an integrated project plan
- Ensure alignment to existing initiatives, and get support from back office functions such as IT and Finance, to ensure that required changes to support new model can be implemented in time
- Implement robust governance structure to manage and control the project
- Understand the organisation's current culture, capabilities and ability to implement change, and use this to develop a comprehensive change management strategy and plan

Source: PricewaterhouseCoopers Research

## Summary

A complex corporate operating model can be costly to manage and to maintain. It can create specific challenges as well, not the least of which is impaired operational efficiency. Change is never easy, and successfully implementing any (or all) of the three simplification routes outlined in this article represents a significant challenge.

Provided that the change effort is recognised and managed as described, the size of the prize at the end of a successful implementation can be significant—potentially enormous financial benefits, combined with a cost-effective, risk-compliant, tax efficient, and flexible organisation which is truly fit for the future, whatever it might hold. This is a reward that a growing number of Automotive companies around the globe have already judged to be well worth the effort.

### Corporate infrastructure costs

- 10-20% of related accounting spend
- 50-75% of legal spend on intra-group transactions
- 30-50% reduction in EU statutory audit costs
- 10-30% of back office (finance, HR, treasury, tax, legal, IT) spend

### Business control

- 10-30% of local management labour costs
- 100% of local board related costs
- 10-20% of current project spend

### Supply chain

- 5-15% of procurement spend
- 5-10% reduction in manufacturing costs
- 10-20% of distribution costs
- Working Capital – optimised above market – up to 5% improvement

### Agility

- “One culture” organisation – with a single regional face to customers and suppliers
- Simpler in-country reporting so reduced management effort on performance management
- Resolves conflicts between national and regional management
- Allows the business to be operated with one set of books

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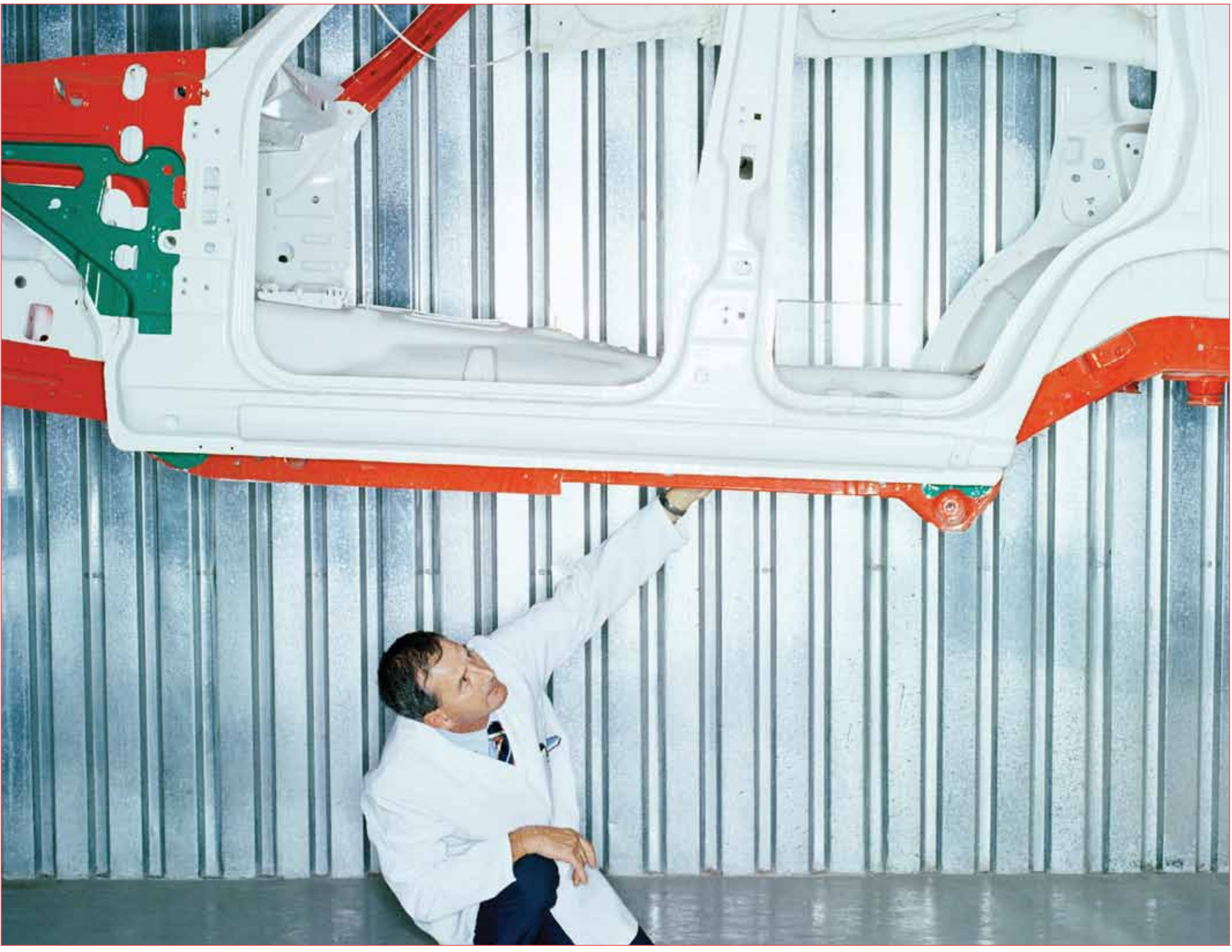


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Further recommended reading



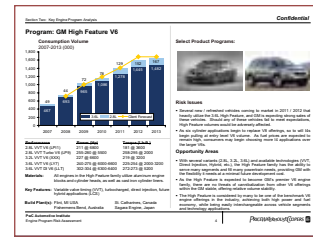
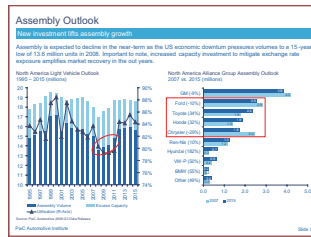
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Tried, tested and trusted detailed planning data and analysis on the global light vehicle sector:

- Assembly
- Capacity
- Powertrain

**Analyst Briefings**  
Issue-based analysis  
Regional market analysis

Covering key issues facing companies operating in the global automotive sector:

- Deep regional insights
- Trend analysis
- Powertrain technology trends

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Decision support  
Business planning  
Thought leadership

Working in tandem with PwC's automotive practice Autofacts can assist with:

- M&A valuation support
- Commercial due diligence
- Thought leadership studies

**Analyst Notes**

- Monthly distribution
- Engaging point of view
- Easily digestible format
- Free registration

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- An independent, unbiased global perspective
- A differentiating & refined industry viewpoint
- Proactive & informed dialogue with executives
- Access to sector specialists with deep knowledge
- Integrated with PwC's Global Auto Practice
- Leveraged in all PwC advisory automotive projects
- The embodiment of \*connectedthinking



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