

## viewpoint

### TRACKING THE HEALTH OF SUPPLIERS

Original equipment manufacturers (OEMs), especially in North America, have developed effective mechanisms to monitor their direct suppliers for signs of financial stress. The reliability of such systems declines rapidly at the next level of suppliers—the place where the supply chain is most vulnerable during these difficult economic times. Yet detecting problems quickly and taking preemptive action has never been more critical.



**Jeff Ficks**

Jeffrey Ficks, Senior Manager with the Transaction Advisory Services Practice of Ernst & Young's Global Automotive Center in Detroit, offers perspective.

#### **Don't OEMs already monitor their supply chains?**

Yes, OEMs have been doing this for years with their direct suppliers. The challenge is monitoring companies further down in the supply chain, particularly those not directed by the OEM that may serve multiple OEMs and suppliers. Helpful tactics include supply-base mapping, requiring suppliers to use specified sources for raw materials and components and making direct suppliers more responsible for their own supply base.

#### **What is the immediate challenge?**

The combination of significant reduction in new-vehicle demand and recent market-driven production adjustments at several OEMs continues to strain the financial and operational sustainability of the supply base. The big question is: Will these suppliers reach out and when? Will they let their customers know they have a problem, or will they just suddenly stop supplying parts?

OEMs and suppliers are very concerned. Most have been proficient at handling small numbers of troubled suppliers, but they are concerned about being overwhelmed by the potential for a higher volume of supplier failures and the risk of assembly line shutdown because of failure of critical suppliers to deliver parts.

The biggest worry is the smaller, thinly capitalized companies that run into liquidity problems very quickly when they are not producing. It will become more challenging when the OEMs are ready to ramp up production and the supply base needs to respond. Sourcing alternative suppliers could take weeks or months.

#### **Is this mainly a North American problem?**

No, it's a global issue. Practices for handling creditors, labor and other key stakeholders varies by international location. There also are complex insolvency laws to understand. In the U.S., for example, there is bankruptcy court but no formal supervised out-of-court process to handle a company's financial crisis. Most European jurisdictions have both options. In some countries, you might have a court-sponsored reconciliation process, which, if unsuccessful, could result in an administrator/receiver taking control of the company and being liable if the company's value declines as a result of restructuring.

#### **How are U.S. companies responding?**

OEMs and suppliers are increasing resources in supplier risk management and leveraging their corporate development, credit and internal audit functions to help. They're beginning to use retirees to help assess supplier quality and operational health, and they're increasing their use of outside advisors. We're also seeing more cooperation among OEMs in handling shared distressed supplier situations.

No one knows whether traditional solutions will still apply and be effective if the volume of suppliers in distress multiplies by a factor of two or four or more. We have begun to see that more resources, combined with proactive and comprehensive measures, will likely be necessary.

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#### **What does Ernst & Young recommend?**

Companies should consider implementing some form of routine data collection procedures for mission-critical suppliers. This data should include key financial sustainability and performance metrics, operational performance, quality, delivery and other qualitative measures to help assess a supplier's health on a predictive and proactive basis. Proactively engage troubled companies to assess their condition and validate contingency plans. When suppliers are in crisis, leverage a cross-functional team, including outside legal counsel and quantify financial exposure and risk of production interruption. Ernst & Young actively advises global OEMs and suppliers through all stages of distressed supplier management.

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