

The Changing Landscape for Trade Compliance—Enterprise Risk (and Opportunity) Management

API International Trade and Customs Conference

H. Michael Leightman, Partner
Customs and International Trade Practice

27 - 29 MARCH 2011

 **ERNST & YOUNG**

Quality In Everything We Do

The Changing Landscape for Trade Compliance

- ▶ Trade compliance risk is evolving (no longer “compliance as usual”)
 - ▶ Globalization increases exposures (despite recent events)
 - ▶ Notable increase in enforcement in US and foreign countries due to need for tax revenues
 - ▶ Increased margin compression due to rising material input costs makes ad valorem trade planning more valuable, but businesses are forcing trade professionals to “do more with less”
 - ▶ “Known importer” programs such as AEO and ISA becoming expected
- ▶ The need for improved governance, risk and opportunity management and compliance is a business imperative
 - ▶ Business sees it as a core process through which strategic objectives are met
 - ▶ Investors want to understand the risks and ensure the return on their investment is protected
 - ▶ Stakeholders require greater accountability and transparency of risk management activities
 - ▶ Board of Director, corporate officer, Audit Committee responsibilities

The Changing Landscape for Trade Compliance (cont'd)

- ▶ Lack of coordination across risk or operational functions can create overlap, redundancy and increased costs
 - ▶ Siloed risk functions reduce value, increase costs, and impact business performance
- ▶ Aligned, integrated risk management activities lead to improved business performance
 - ▶ Integrated risk functions increase value, reduce costs, and improve business performance
- ▶ Holistic, enterprise-wide view of risk is seen as advantageous to managing risk and providing value
 - ▶ All entities face uncertainty which may hinder value growth
 - ▶ Uncertainty presents both risk and opportunity
- ▶ Companies that effectively deal with uncertainty and the associated risks and opportunities stand to enhance over enterprise value
- ▶ This is achieved through the use of an Enterprise Risk Management Framework

The Enterprise Risk Management Framework (“ERM”)

- ▶ COSO ERM is the process of *identifying* and *managing* risk across the overall enterprise
 - ▶ Developed by The Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) in 2004
 - ▶ Many companies have adopted the ERM framework
- ▶ COSO ERM Builds upon the COSO Internal Control – Integrated Framework but broadens the view
 - ▶ COSO Framework developed in 1992
 - ▶ Provides a standard for evaluating the effectiveness of internal controls
 - ▶ Principles used in many contexts: E.g., Sarbanes 404, SAS 78, CBP ISA & FA
 - ▶ Currently being updated

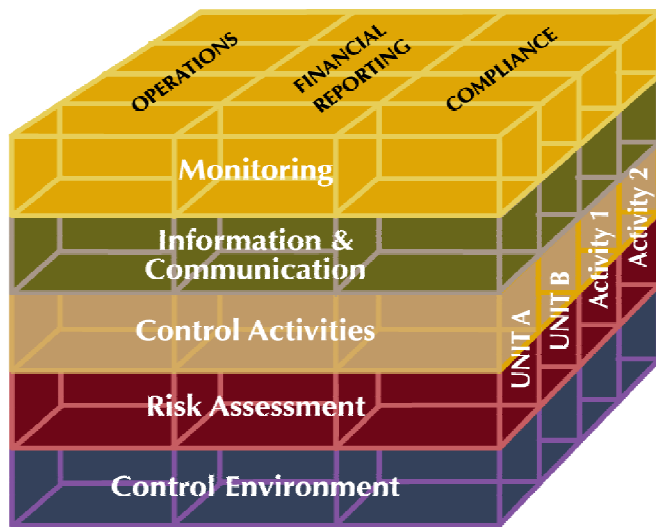
The Enterprise Risk Management Framework (“ERM”)

- ▶ ERM goes beyond evaluating internal controls to address risk management on an enterprise level:
 - ▶ *Enterprise risk management is a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives*
- ▶ Same principles can be employed to examine opportunities
- ▶ COSO ERM incorporates COSO Framework elements, but expands them

Comparing the COSO Internal Controls Framework to the COSO ERM Framework

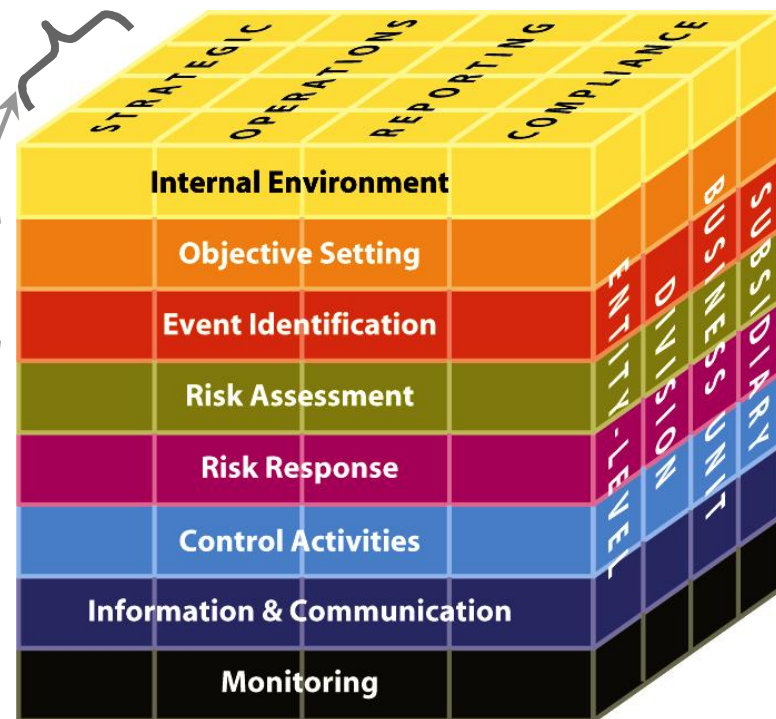
COSO Cube

Internal Controls



Absent in the COSO IC

Enterprise Risk Management



Key elements of ERM

- ▶ The “Strategic” Objective

- ▶ A fourth objective relating to the high-level goals and strategy of an enterprise

- ▶ Three additional components

- ▶ Objective Setting

- ▶ A process to set objectives and align those objectives to the entity’s mission/vision, keeping in mind the entity’s risk appetite

- ▶ Event Identification

- ▶ A methodology to consider internal and external factors that affect event occurrence

- ▶ Risk Response

- ▶ A process of considering potential event likelihood and impact, and how management considers both within an entity’s risk tolerance

Using Internal Audit to your advantage

▶ COSO ERM

- ▶ Where your company is using the COSO ERM model, it will be examining macro risk across all topical areas and geographies.
- ▶ Internal audit is often involved, although ERM may be led by others (Chief Compliance Officer, etc.)
- ▶ By working with Internal Audit, you can embed appropriate trade risk and control questions to determine risk and missed opportunities across the enterprise
- ▶ Where ERM includes the right trade questions, import/export often is found to be a key risk area for many companies
 - ▶ Demonstrates to upper management the necessity of trade professionals and data to lower risk and take advantage of trade planning
 - ▶ Demonstrates to upper management the need for trade professionals to be involved in business planning

Using Internal Audit to your advantage, cont'd

- ▶ Even where company is not employing an ERM methodology, the trade function can use the ERM approach in evaluating risk
 - ▶ speak in a language upper management understands

Using Internal Audit to your advantage, cont'd

- ▶ COSO Framework
 - ▶ Use of COSO Framework when drafting procedures allows you to leverage Internal Audit to perform trade reviews
 - ▶ Internal audit usually lacks awareness of trade laws and, therefore, trade risks
 - ▶ COSO Framework focuses on risk and effective controls to address each risk; if properly structured:
 - ▶ Trade compliance personnel can assist with examining risks and whether controls exist to address the risk and
 - ▶ Internal audit personnel can perform testing to determine whether the controls are operating as designed and whether trade has a mechanism for periodically evaluating risk
 - ▶ Allows the trade function to “do more with less”

Keys to successful risk resolution

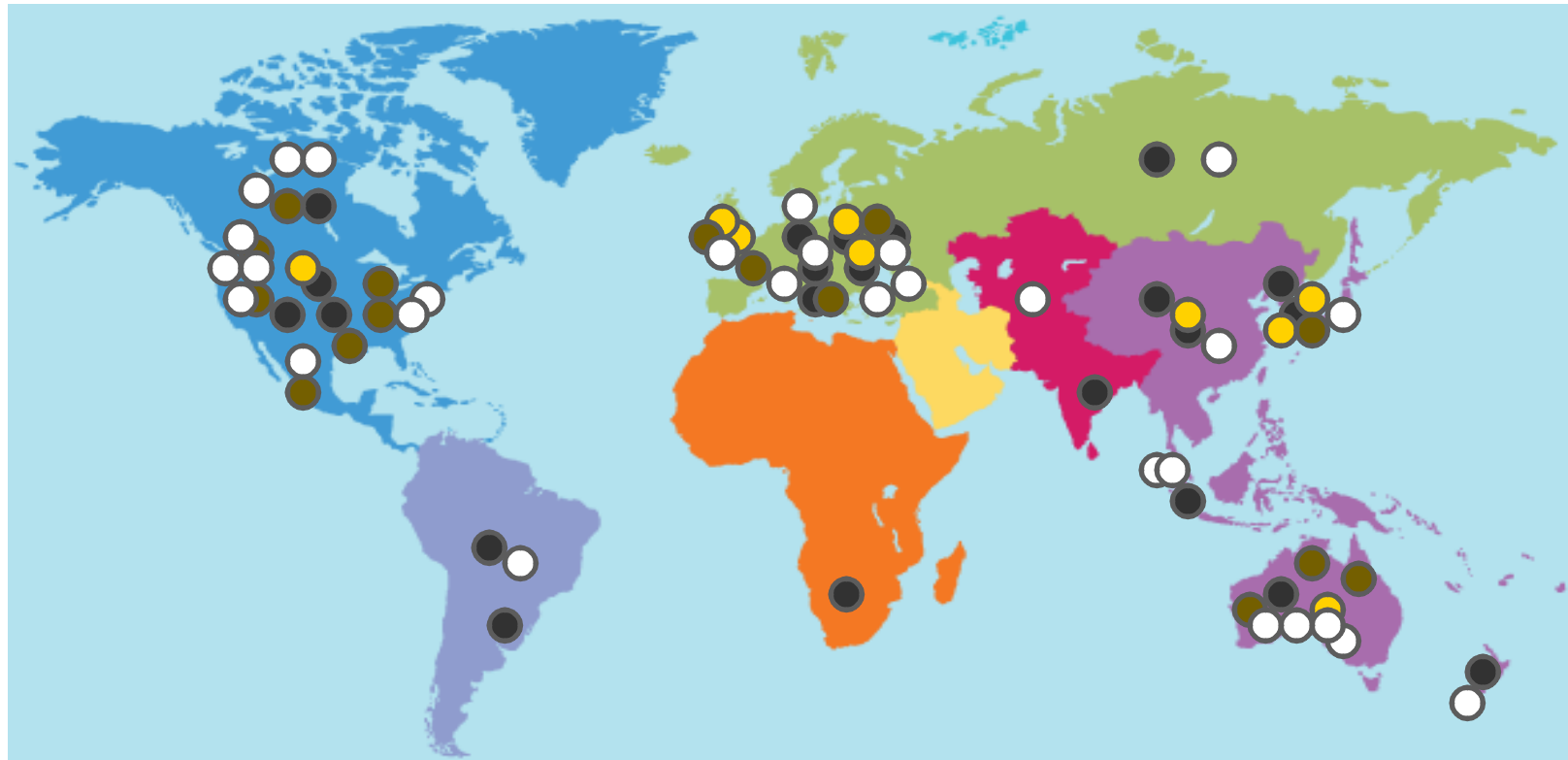
- ▶ Companies that move products or has access to controlled technology or data should
 - ▶ Conduct a risk assessment
 - ▶ Identify and prioritize risks and opportunities
 - ▶ Focus on risks and opportunities that matters the most
 - ▶ Involve trade in ERM process to substantiate trade compliance and planning value; use ERM approach when conducting global risk assessments
 - ▶ When implementing controls, have a global, enterprise-wide framework with localized, business-specific content
 - ▶ Uniformity across the enterprise of general requirements
 - ▶ Local laws and regulations specifically outlined as necessary for certain jurisdictions
 - ▶ Needs of each business addressed
 - ▶ Use Internal Audit resources effectively to assist with ERM and controls evaluation

Example approach

- ▶ Conduct a Qualitative Analysis
 - ▶ Questionnaires / Risk Assessment tools through Internal Audit
 - ▶ Online survey concept
- ▶ Focus on Risk and Process
- ▶ Utilize a standard question set for Import/Export/Combined
 - ▶ Provides uniformity / consistent framework
- ▶ Results in the identification of Locations/Facilities/Regions requiring further review

- ▶ When conducted in the right context, provides the company with a comprehensive view of its key import and export compliance risks worldwide
 - ▶ This visibility can serve as a roadmap for company to use in prioritizing its focus as it relates to trade

Countries and Segments Represented



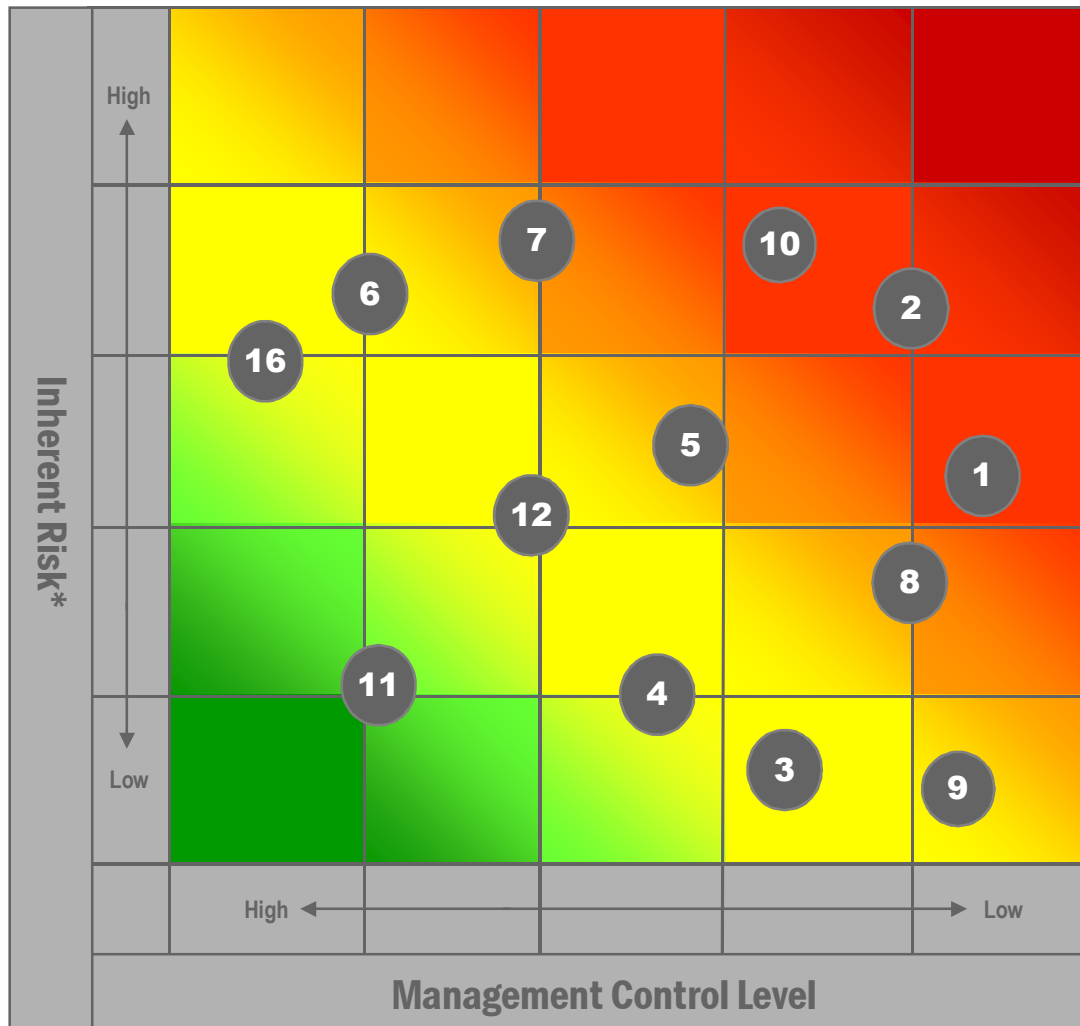
- [Business Segment 1]
- [Business Segment 2]
- [Business Segment 3]
- [Business Segment 4]

| Business Segment | Number of Facilities |
|----------------------|----------------------|
| [Business Segment 1] | 22 |
| [Business Segment 2] | 9 |
| [Business Segment 3] | 29 |
| [Business Segment 4] | 15 |

Global Import and Export Activities

- ▶ Various functions, both corporate and at the local / divisional level, influence import and export activity
 - ▶ How does the enterprise gain visibility to the global activity?
- ▶ An analytical diagnostic exercise can:
 - ▶ Identify how processes are actually conducted
 - ▶ How personnel responsible for processes view performance, and
 - ▶ How personnel responsible for processes view internal controls
- ▶ When designed with weight and scoring of responses, a risk profile results that considers:
 - ▶ Inherent risk – level of activity, seriousness of an issue
 - ▶ Existing internal controls – against expected norms, leading practices
- ▶ The risks can then be viewed as a heat map

Company Customs Risk By Category



| Risk Categories | |
|-----------------|---|
| 1 | UNSUPPORTED TRANSACTION VALUE |
| 2 | UNDECLARED VALUE: COMMISSIONS/ROYALTIES/LICENCE FEES |
| 3 | UNDECLARED VALUE: ASSISTS |
| 4 | UNDECLARED VALUE: OTHER |
| 5 | IMPROPER DEDUCTIONS FROM VALUE |
| 6 | OTHER VALUATION METHODS |
| 7 | INCORRECT CLASSIFICATION |
| 8 | INCORRECT COUNTRY OF ORIGIN |
| 9 | UNRESOLVED QUANTITY OVERAGES/SHORTAGES |
| 10 | UNSUPPORTED FTA CLAIMS |
| 11 | UNSUPPORTED DUTY DEFERRAL, RELIEF, or REFUND REGIMES |
| 12 | IMPACT OF NON-TARIFF BARRIERS |

* Risk level reflects the combination of severity of impact and likelihood of occurrence.

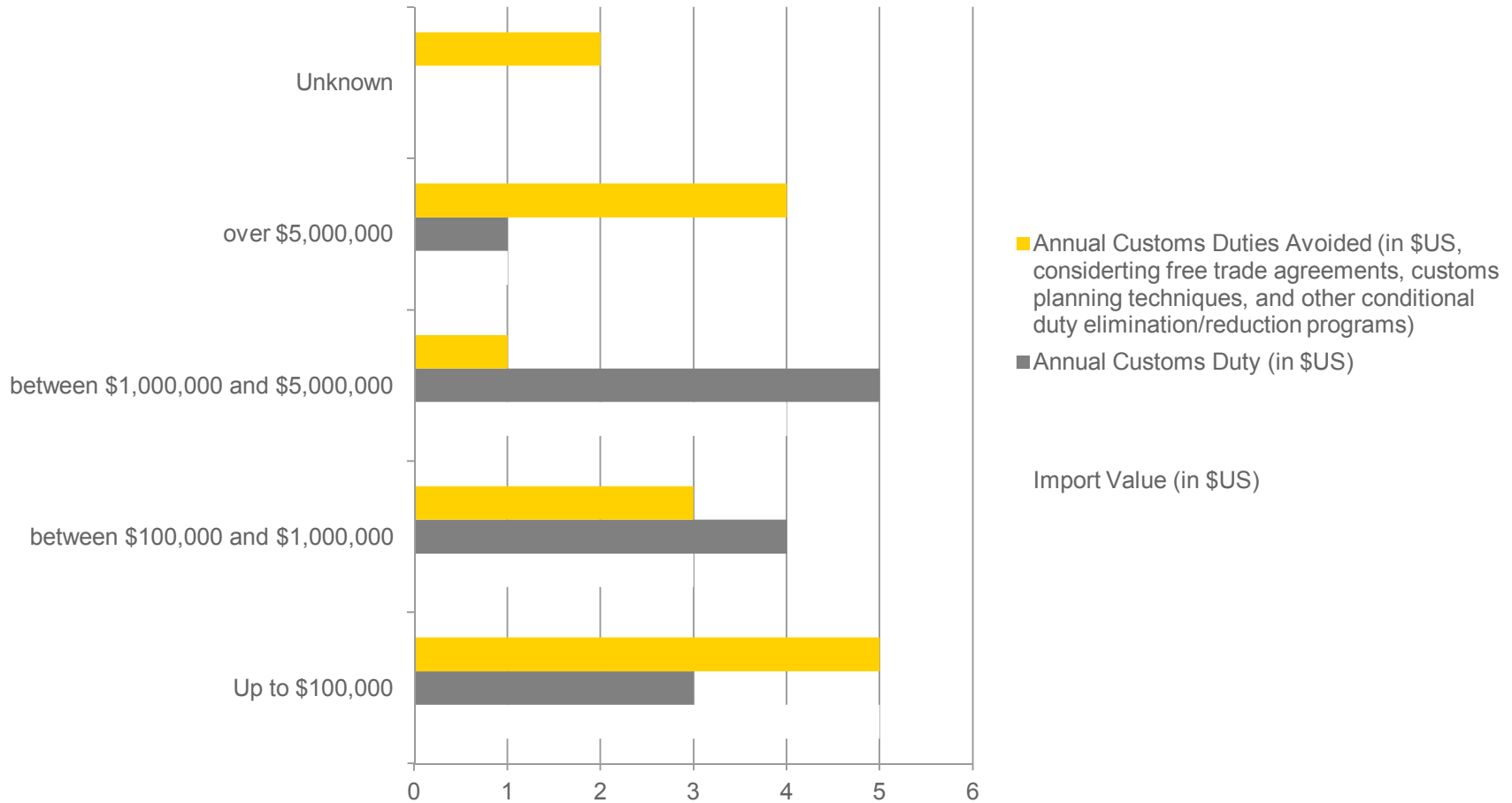
Risk and Opportunities May Vary by Business Units

- ▶ Multiple import and export locations may result in varied exposure and opportunity levels
 - ▶ Factors include trade regulations, particular trade flows, geographic risks
- ▶ An analytical diagnostic exercise allows:
 - ▶ Broad coverage over multiple businesses and locations
 - ▶ Reduces expenses for numerous on-site visits
- ▶ When data is compiled for decentralized activity, in a common format and in a central database, the risks can then be viewed by business unit, geography or topic

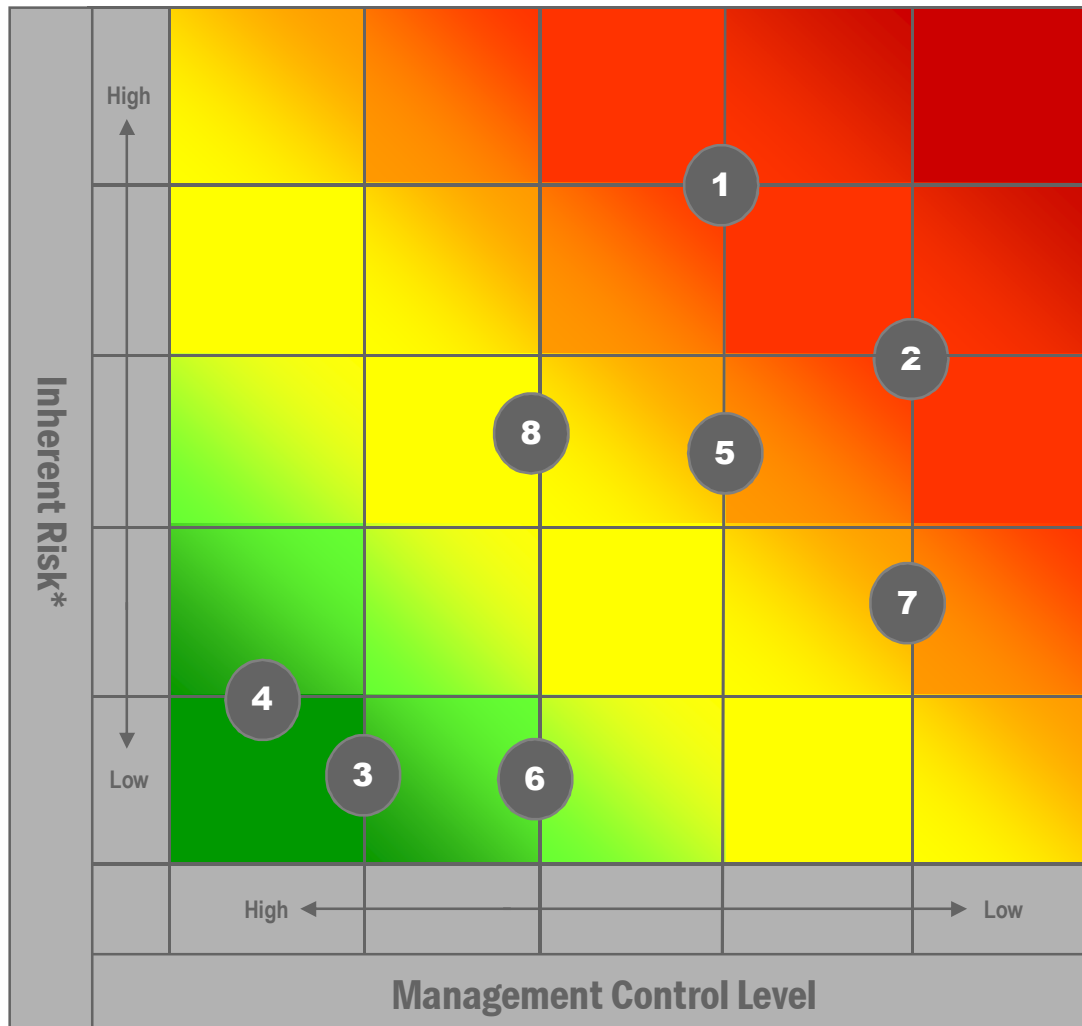
Prioritizing an approach to managing trade risk

- ▶ Utilizing an ERM approach for assessing risk from multiple import and export activities, a company can:
 - ▶ Identify areas for immediate focus
 - ▶ Prioritize resources and activities to address concerns
 - ▶ Execute on identified areas of opportunities
- ▶ Viewing overall results provides a global roadmap of the company's international trade issues which:
 - ▶ Gives direction to trade professionals to manage day to day activities
 - ▶ Provides executive management with a clear, enterprise wide understanding of the trade function as it relates to the company's overall strategy, pursuit of opportunities and inherent risk tolerance

Customs Duties Paid or Avoided



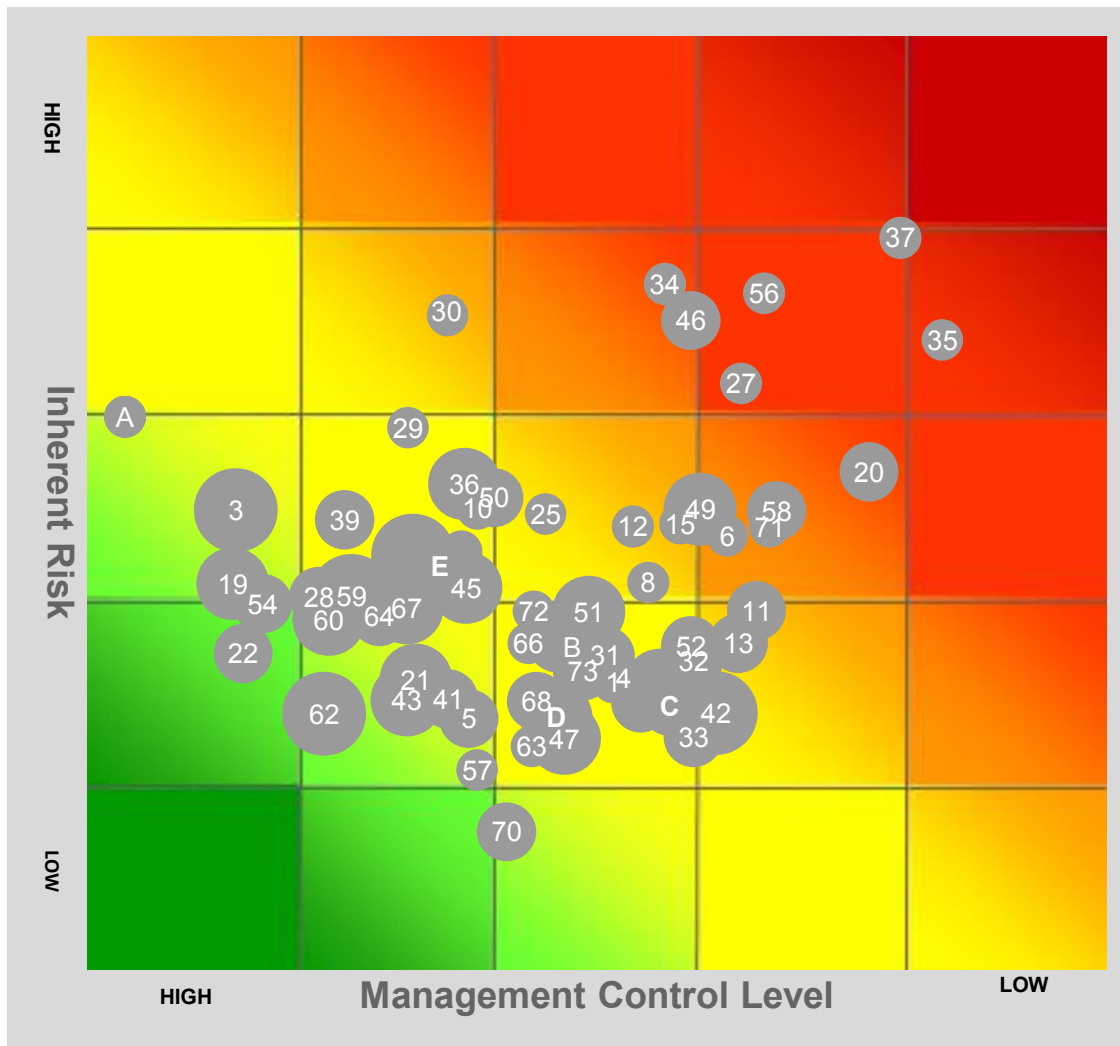
Overall Risk and Control Environment by Country



| Country | |
|---------|----------------|
| 1 | Brazil |
| 2 | Russia |
| 3 | Mexico |
| 4 | Canada |
| 5 | Chile |
| 6 | United Kingdom |
| 7 | Netherlands |
| 8 | South Korea |

* Risk level reflects the combination of severity of impact and likelihood of occurrence.

Combined Overall Risk and Control for Import and Export by Facility



Risk Category Description

The Combined Overall Risk and Control for Import and Export by Facility measures a facilities overall risk by combining and averaging the scores to all questions in all categories surveyed.

The heat map denotes facilities with larger import and export volumes as comparatively larger plots on the graph. Responses by Facilities indicating “do not know” to inherent risk or management control questions are treated as high risk.

Legend

See Heat Map – Legend of Facilities

- A:** 2,7,9,17,18,44
- B:** 14,26,44
- C:** 16,23,61
- D:** 38,55
- E:** 40,65,69