

Will the 2007 HS Reform Derail Your Supply Chain?



What executives & trade professionals need to know about the 2007 HS Reform and how it can Impact Supply Chain Performance, Bottom Line Profits & Executive Liability

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Executive Summary

Many CFO's and corporate executives may not be aware that a supply chain slowdown is looming in their very near future. If not properly managed, this could have a significant impact on their business, including a slowing of the international purchase-to-delivery supply chain, incorrect tariff classification of goods, incorrect declarations of duties and taxes due, and ultimately inaccurate records – all of which can put companies at a competitive disadvantage and executives at personal risk.

The World Customs Organization's (WCO) third major reform of the Harmonized Tariff Schedule will be implemented on January 1, 2007. The new version includes more than 350 amendments to the HS Nomenclature and triggers a massive chain reaction of critical trade data changes that, if not managed effectively, may threaten first quarter or even 2007 profit projections.

The 2007 HS Reform will affect each of the 169 member countries of the WCO and may result in thousands or even hundreds of thousands of updates, corrections and changes in current corporate databases critical to the efficient flow of the global supply chain. For large multi-national corporations, this will impact an enormous amount of data, systems and processes, and strain already limited global trade resources.

It is expected that many more shipments will be detained compared to the previous Tariff Reform five years ago. Significant changes in world trade volume, computer automation, and enhanced government oversight and enforcement have created conditions that can seriously impact the supply chain.

Delays in the supply chain hit the bottom line. A Purdue University Study has concluded the average cost per day of shipping time is approximately 0.5 percent ad-valorem*. For a company importing \$500 million, an average delay of just one additional day could squander as much as \$2.5 million per year from the bottom line, not including the operational costs associated with late shipments, inventory outages, and lost sales.

With the deadline for this enormous task just a few months away, brokers, forwarders, and other trade professionals can easily become overwhelmed with the scope of reclassifying and re-documenting thousands or hundreds of thousands of items for multiple countries, updating enterprise-wide computer systems, notifying all trading partners and service providers, and managing differing government regulations and effective dates. All these are necessary steps to assure a smooth transition and an un-interrupted chain of supply.

We offer this simple advice to CFO's and other C-level executives concerned about the financial and operational performance of their companies. Get involved now to determine the scope of the 2007 HS Reform on your global business. Determine the tasks that must be completed to achieve compliance and create a plan. Assign the personnel needed to accomplish each task and allocate the budget required to accomplish the job within the timeline provided. Failure to act may have unintended consequences that will ultimately be reflected on your bottom line, put your company at a competitive disadvantage, and even put executives in your company at personal risk.

* Time as a trade barrier, David Hummels, Purdue University, July 2001, pg 25

Critical Supply Chain Data will be Affected

The 2007 HS Reform is about a lot more than simply changing a few tariff classification codes. It is a significant overhaul of critical data elements that modern global trade information systems require to communicate through the international supply chain, that trade professionals need to complete import and export documentation for the 169 member countries of the WCO, and to document reasonable care[†] requirements established by national governments.

The Harmonized Tariff System has become the method of codifying merchandise on all international transactions and documenting a company's rationale for classification decisions that govern duty payments to governments, qualification for free trade agreements, licensing determination, and meeting other government agency requirements.

The Harmonized Tariff System has become the method of codification that connects processes (both manual and computerized) across an entire supply chain in order to facilitate efficient global trade.

Suddenly, on January 1, 2007, the system that provides this universal language for you and your suppliers, forwarders, carriers, brokers, and governments will undergo a major overhaul. Let's explore a hypothetical transaction to demonstrate the intrinsic web of codification that has been created by the Harmonized Tariff System and the challenges the 2007 Reform presents to companies involved in international trade, especially large multi-national corporations.

Example

The hypothetical Electronic Distribution Company's major line of business involves importing cell phones into the United States.

8525.20.90 EN CAN MX	Other	Free
20	Radio telephones designed for installation in motor vehicles for the Public Cellular Radiotelecommunication Service	No.
	Other radio telephones designed for the Public Cellular Radiotelecommunication Service:	
60	Units weighing over 1 kg	No.
70	Other	No.

The Electronic Distribution Company's import trade professional has assigned US HTS number 8525.20.9070 to classify 82 different cell phone model numbers in her corporate parts database. She has researched a *supportive ruling* #NY K84321, issued by US Customs on March 23, 2004 to justify and document her classification decision.

She has also researched HS number 8525.20.9070 against Other Government Agencies (OGA) databases and determined that the Federal Communications Agency requires a regulatory

Example of 2006 US Harmonized Tariff Schedule

[†] (U.S. Customs) A key component of the U.S. Customs and Border Protection (CBP) Informed Compliance program that states that the importer of goods to the U.S. is expected to exercise reasonable care in his or her importing operations.

Section 2

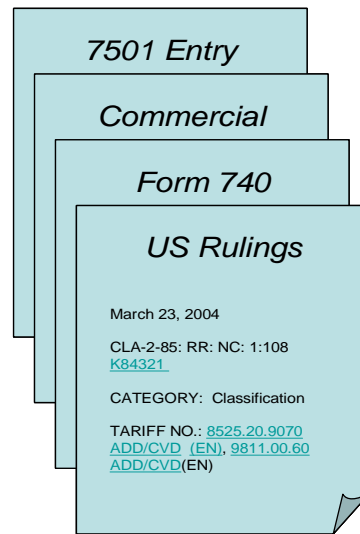
document (*Form 740*) to be completed and on file in order to import this item into the United States.

She has provided her four brokerage firms with the company's current parts database to be certain 8525.20.9070 is assigned to all imported cell phones on the *7501 Consumption Entries* reported to US Customs & Border Protection (CBP). US HTS number 8525.20.9070 has a 0% duty rate according to the US Harmonized Tariff Schedule, and this will be reflected on all entries.

She has also provided her supplier with the designated US HTS code for the cell phones and other items in order for the *commercial invoice* to be properly labeled to facilitate entry into the United States.

It is clear that many different documents (*supportive rulings, commercial invoices, Form 740's, and 7501 Entries*), different entities (*Electronic Distribution Company, its brokerage firms, the cell phone supplier, CBP and the Federal Communications Agency*), using many different systems and databases will all be affected when the US classification for cell phones is suddenly changed from 8525.20.9070 to 8517.12.00 on January 1, 2007. (The final ten-digit code has not yet been released by the US International Trade Commission.)

This is a very simple example of a single item being imported to a single country. Imagine the work involved for a company with thousands and thousands of parts, importing into multiple countries.



Randell Carr, President of the International Trade Bureau attended the WCO 2007 Reform Conference in Brussels, Belgium in September, 2006. He reports that one of the very first questions asked by an attending delegate was, "How are importers and exporters supposed to get through this *Mt. Everest of re-classification* that will be triggered by the WCO Reform?"

The scope of reclassifying and re-documenting thousands or hundreds of thousands of items for multiple countries, updating enterprise-wide computer systems, notifying all trading partners (*suppliers, forwarders, carriers, brokers, and governments*), and managing differing government regulations and effective dates is enormous.

No doubt the Electronic Distribution Company's trading partners will be inundated with many similar change requests from other customers and will be challenged to make all necessary changes accurately and in a timely manner. This will likely be an event where proactive planning and aggressively securing suppliers attention and commitment will help secure a smooth transition and an un-interrupted supply chain. Late comers may find themselves in the back of a very congested queue.

Added Compliance Risk

One trade professional confided that “overburdened carriers/brokers working on a company’s behalf, if not given the correct updated HS data in advance, might well end up guessing for correct tariff codes to avoid delays or clear backlogs.” This raises an important compliance issue - if incorrect entries are filed by brokers and not corrected by the importer, the importer could face a CBP audit and/or enforcement action for reporting incorrect data on 7501 entry documents.

Import regulations require importers to invest the time and effort required to understand the rules, keep track of changes in the rules, and actively ensure compliance with the rules. The importer must exercise *Reasonable Care*.

Unintended Financial Impact

The stated purposes of the 2007 HS Reform are to:

- reflect technological developments
- take account of current trade practices
- clarify texts to ensure uniform application
- cater for social and environmental concerns
- assign code numbers

However, executives and trade professionals must be vigilant to assure they will not be adversely affected by the unintended consequence of duty shifting. Duty shifting is the inadvertent change in duty and tax rate of an item as a result of re-assigning the HS classification code of the item; for example, if the 2007 HS classification code for a cell phone had a 2% duty rate when the 2006 version was duty free.

While the intent of the HS Reform is clear, mistakes do happen that sometimes effect duty rates and taxes. Companies should apply due diligence and pursue automated screening tools[‡] to identify all affected tariff classifications, compare 2006 and 2007 duty and tax rates, and confirm there has not been a significant duty shift that presents an unintended and unfair financial burden on the company.

The 2007 HS Reform presents very significant challenges to large multi-national corporations. Executives and trade professionals failing to grasp the scope and impact of the 2007 HS Reform will be doing so at their own peril.

[‡] Global Data Mining, LLC Provides 2007 HS Reform Screening to Help Importers & Exporters update corporate databases to Prevent Global Supply Chain Slowdown. To request an ORDER FORM, please email us at: torreyschoel@gdmlc.com and put HS Reform Screening in the subject box

Expect Delays in Supply Chain Performance

Most companies count improving the speed of their supply chain as a major corporate objective, and for good reason. Delays in the global supply chain of any company have two detrimental consequences: unplanned expenses and reduced revenues.

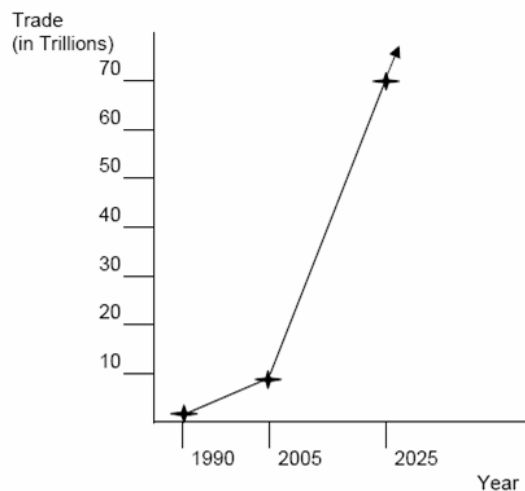
The 2007 HS Reform is poised to have a greater impact on slowing the worldwide supply chain than any of the previous HS reforms for three reasons.

1) Total world trade volume in 2007 is approximately double as compared to 2002 when the last HS Reform was implemented. More than 200 million containers are shipped between the world's seaports annually according to a recent study by the National Association of Manufacturers and the IBM Corporation. Our ports are simply more congested than in 2002 and are more reliant on accurate and timely data in order to process import and export transactions.

2) The continual advancement of computer automation in international trade is more effectively connecting governments to the trade community and governments to other governments as compared to 2002. When a trade document contains an obsolete or inconsistent HS number, computer systems will raise a red-flag and the shipment may be delayed until the discrepancy is resolved. Computer systems have more connectivity and screening capacity than in 2002.

3) Governments the world over are more prepared to exercise oversight and enforcement as compared to 2002. There are three primary factors that account for greater government commitment and capacity for oversight and enforcement:

- On September 11, 2001, the President of the United States immediately recognized the world had changed forever, and that new policies, new organizations and new tools would be required to protect America against terrorism. CBP responded with the Customs-Trade Partnership Against Terrorism (C-TPAT)³, other new programs such as the National Targeting Center



The consulting firm McKenzie & Company recently estimated that international trade will reach \$70 trillion by 2025.

³ Learn more about C-TPAT:

http://www.customs.gov/linkhandler/cgov/import/commercial_enforcement/ctpat/ctpat_strategicplan.ctt/ctpat_strategicplan.pdf

(NTC)⁴ and increased funding to secure its twin goals: security and facilitation of trade moving into the United States.

- The second factor is the impact of the corporate corruption scandals that lead to the Sarbanes-Oxley Act of 2002 (SOX) which imposed new responsibilities on corporate executives and boards, the violation of which can lead to both civil sanctions and criminal penalties for the officers and directors involved. (Section 5 of this paper will provide further information related to SOX).
- The third factor is the WCO's unanimous adoption by all 169 Members of the Framework of Standards to Secure and Facilitate Global Trade⁵. Governments the world over have increased their commitment to stronger compliance and enforcement initiatives than compared to 2002.

These three reasons, world trade volume, computer automation, and enhanced government oversight and enforcement create conditions that can seriously slowdown the supply chain for un-prepared companies, and the costs of delays can be significant.

⁴ Learn more about NTC: <http://www.dhs.gov/dhspublic/display?content=3989>

⁵ Learn more about the WCO Framework of Standards to Secure and Facilitate Global Trade <http://www.wcoomd.org/ie/En/en.html>

Supply Chain Delays hit Bottom Line Profit

Delays in the supply chain have a direct impact on a company's profit. As mentioned in the opening section, the average cost of shipping time has been estimated to be approximately 0.5 percent of the value of goods per day. For a company importing \$500 million, an average delay of just one additional day could squander as much as \$2.5 million per year from the bottom line.



Another study, by the Boston Consulting Group, reports that waiting times at ports are already getting much longer and less predictable... The study, *Avoiding Supply Chain Shipwrecks: Navigating Outsourcing's Rocky Shoals*, concluded that backlogs at ports and at railroads were at all time highs in 2005, stating, "With freight volumes increasing faster than the ports can handle them, the situation will only worsen."

At a recent symposium on Supply Chain Management, Beth Enslow of the AberdeenGroup added to the growing concern when she stated that, "Companies need to be careful about LCCS (Low Cost Country Sourcing) decisions; anticipated savings are not necessarily being realized because of unanticipated supply chain costs." She confirmed that the number one problem area is transportation.

The changes brought about by the 2007 HS Reform will only add delays, confusion and additional hidden costs to moving products through already burgeoning ports throughout the world. Corporate profit and loss plans have not budgeted for these additional expenses.

For the average Fortune 1000 company, a 5 percent decrease in supply chain management cost can increase profits by \$20 million and market value by \$405 million...

FinListic Solutions

Each dollar lost in the unexpected and unplanned supply chain slowdown is pulled directly from a company's profits. The unexpected losses can run into the millions of dollars!

Additional Risk to Executive Liability

Many CFO's and executives remain unaware of the breadth of liability imposed on them by the Sarbanes-Oxley Act of 2002. Developed in response to accounting scandals that continue to affect financial markets, Sarbanes Oxley implements numerous measures designed to improve the transparency and accuracy of financial accounting and record keeping in publicly traded companies.

The Sarbanes-Oxley Act provides the U.S. government with sweeping access to corporate operations and processes in order to detect misconduct which does not necessarily require "criminal intent." Important to this discussion is language that refers not only to criminal activity but also to violations of government regulations. For logistics and supply chain managers, that includes import/export compliance[§].

While many public companies have hired consultants and implemented extensive Sarbanes Oxley compliance initiatives, the financial implications of poorly controlled global trade processes often remains overlooked.

Tariff classification decisions and declarations made by or for a company govern the duty payments for all international transactions and are the basis for free trade agreement qualification, licensing determination, and other government requirements. Errors in classification have a direct impact on the accuracy of corporate financial results and fall squarely in the scope of Sarbanes Oxley.

Accounting Comparison

Most major corporations have tight internal controls, sophisticated technology, and well managed organizations overseeing its various accounting processes. In fact, corporations have become so competent at self-auditing every invoice for complete accuracy that error rates typically discovered by outside auditing firms are only *one-tenth of one percent*.

Executives may be surprised to learn that error rates in global trade processes approach 10 to 20 percent.⁶ The effective control of global trade processes is often **100 to 200 times worse** compared to domestic accounts payable processes in the same company (see box on left). Surprisingly, this fact has gone unnoticed by many executives, and the costs of ineffectiveness are growing.

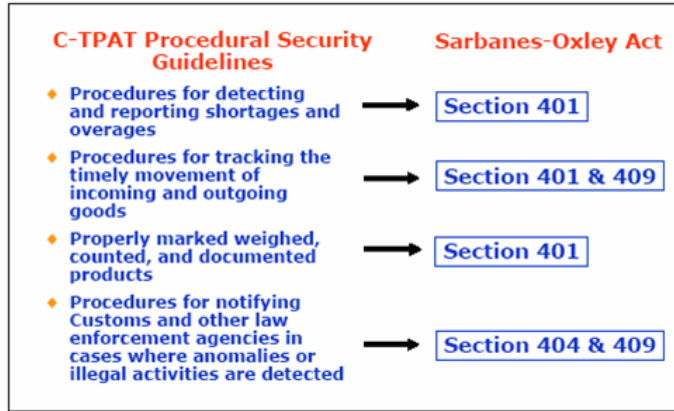
Sarbanes-Oxley

Sarbanes-Oxley imposed new responsibilities on corporate executives and boards, the violation of which can lead to both civil sanctions and criminal penalties for the officers and directors involved. Market analysts and the investing public are also becoming savvy about the reporting requirements of Sarbanes-Oxley. This increased public awareness has meant that even some non-publicly traded companies have been expected to comply with many of the transparency and reporting requirements of Sarbanes-Oxley.

[§] Raising the Stakes On International Trade, Written by: Perry A Trunick, July 2005

⁶ Creating a Competitive Advantage in Global Trade. By Matt Gersper and Jim Meehan

Specifically, Section 404 of Sarbanes-Oxley, titled Management Assessment of Internal Controls, requires that companies *create extensive policies and controls to secure, document, process, and verify material information affecting their financial results*. One astute commentator has noted that “Technology without process is not internal control. Companies should assess their supply chain, looking at gaps and also redundancies that can compromise control. Inefficient processes should be identified and remedied.”⁷



Source: *Linking Supply Chain Security with Sarbanes-Oxley and The Bottom Line*, by Adrian Gonzalez, ARC Strategies, Aug 2004

The effect of these requirements on importers and affiliated third parties is apparent: Without effective internal controls on the flow of goods that an organization manages, an audit by CBP may also reveal that the organization is in violation of Sarbanes-Oxley.⁸

The changes brought about by the 2007 HS Reform will only increase the likelihood of incorrect tariff classification declarations that govern duty payments to governments, free trade agreement qualification, licensing determination, and other government requirements. Incorrect tariff classification decisions and declarations brought about by the 2007 HS Reform will be an added burden to already poorly controlled global supply chain systems.

The 2007 HS Reform has the very real potential to expose companies and their executives and board members to additional risk of inaccurate corporate financial results and to violations of Sarbanes-Oxley.

⁷ Thomas Craig, Sarbanes-Oxley and Supply Chain Management, World Wide Shipping (May 2004) available at <http://www.ltdmgt.com/mag/sarbanes.htm>.

⁸ Import Compliance: The Need for Automation. By Matt Gersper and Jane Kriwinski

Recommendations

There are simply too many details in an effective HS Reform project to provide comprehensive advice in the context of this paper. Therefore, this section will be limited to defining the scope or outline of an HS Reform Project plan. Determining the scope should at least identify the tasks, personnel, and budget required to build and implement an effective plan to assure a smooth transition and an un-interrupted chain of supply.

Step 1: Assign a project leader and give him or her executive support.

Step 2: Identify all global content that will be affected... Use automated screening services⁹ to identify current HTS classifications that are scheduled to be changed... Determine what items are affected and which ones will need to be reclassified... Determine in what countries are you importing or exporting those items... Determine the staff and resources required to complete reclassification.

Step 3: Identify all internal company systems and databases that will be affected... Determine the staff and resources required to update the databases and modify company systems as required.

Step 4: Identify all trading partners that rely on accurate classification data to support your global business (*suppliers, forwarders, carriers, brokers, and governments*)... Develop a communication plan to keep them informed of this project... What can they expect from you...? What do you expect from them...?

Step 5: Identify all Other Government Agencies (OGA) that currently govern your imports or exports (automated screening services are available)... Identify all items and HTS codes that are governed by each... Identify all regulatory documents on record for each... Determine the staff and resources required to update regulatory documentation as required...

Step 6: Identify all Trade Agreements that currently apply to your imports (automated screening services are available)... Identify all items and HTS codes that are governed by each... Identify all certification documents on record for each... Determine the staff and resources required to update regulatory documentation as required.

Step 7: Determine the timeline for each task: Steps 2 through 6

Step 8: Assign the personnel needed to accomplish each task

Step 9: Allocate the budget required to accomplish the job within the timeline provided

This simple scope outline cannot possibly address every issue that will be faced but provides a good starting point for serious discussions. The next step is up to you... January 1, 2007, is just around the corner!

⁹ Global Data Mining, LLC Provides 2007 HS Reform Screening to Help Importers & Exporters update corporate databases to Prevent Global Supply Chain Slowdown. To request an ORDER FORM, please email us at: torreyschoel@gdmlc.com and put HS Reform Screening in the subject box

Additional Comments & Resources

1. “Trillions of dollars are lost annually to supply chain ineffectiveness”... Paul Albright, Commerce Inc.
2. The Hidden Cost Guide, Business Performance and Efficiency:
[http://www.anixter.com/AXECOM/AXEDocLib.nsf/\(UnID\)/8F95A7169B68276A86256FF50067FBE C/\\$file/hidden_cost_guide.pdf](http://www.anixter.com/AXECOM/AXEDocLib.nsf/(UnID)/8F95A7169B68276A86256FF50067FBE C/$file/hidden_cost_guide.pdf)
3. “Companies spend more than 20% of the production cost in the supply chain”... World Bank
4. The average mid-sized company (\$0.5 to \$1 billion) can trim \$2 million in procurement costs by automating the process... Internet Week
5. Best-in-class companies (defined as the top 20% in efficiency) spend only 5.8% on their supply chains, compared to the average of 12.2%. This meant an additional 6.4% of revenue (which increases working capital) fell to the bottom line... the Performance Measurement Group.
6. Many executives underestimate the magnitude of hidden costs in long supply chains and their impact on productivity... the Boston Consulting Group
7. The first draft of the 2012 HS Reform will be submitted to WCO sub-committee in November, 2006. It will be approved in June 2009, and the comparison tables will be published in early 2010. Companies need to become active now if they want to affect the 2012 changes.

Thank You

Special “thanks” go out to the many global trade professionals that volunteered their time and knowledge to help us write this educational paper. We greatly appreciate your contributions!

Matt Gersper & Randell Carr



About the Authors

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Matt Gersper, Founder and President of Global Data Mining, LLC, has more than 20 years of experience optimizing processes and helping customers turn unorganized data into information managers and executives need to improve performance. His vision and expertise have driven successful results in retail, wholesale, trade, logistics and manufacturing sectors. He founded a practice for reengineering and automating business processes for a worldwide leader in recovery auditing. Matt is an enthusiastic contributor to the global trade industry as an author and frequent speaker at industry conferences and events. Mr. Gersper is also an owner of CUSTOMS Info, LLC and director for the International Trade Bureau. Matt obtained his degree in Economics from University of California – Davis.

Randell Carr is President of the International Trade Bureau, LLC. He is an experienced senior manager who has provided financial data analysis and consolidated reporting services to the world's largest companies. Randell speaks English, French and Spanish and has developed an international network of business contacts, living and working in Toronto, Atlanta, Dallas, Brussels, London, Paris, Madrid, Milan and Stockholm. He currently resides in Montreal.

About Global Data Mining

Global Data Mining is the leading authority in providing comprehensive data services to the global trade community. GDM helps companies with high-volume, high-value global trade businesses build effective trade databases, create extensive trade reporting and conduct comprehensive electronic auditing of global trade processes. The data experts at GDM have an intense focus and commitment to the technical levels of knowledge required to automate and control processes in large multi-national corporate systems. GDM helps its clients organize and manage massive amounts of global trade data. Visit us at www.gdmlc.com.