

# Import Compliance: The Need for Automation

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## Section 1

# Executive Summary

The U.S. Customs and Border Protection Agency continues to increase both its diligence and its effectiveness in ensuring that importers comply with the myriad regulations affecting imports. Numerous factors demonstrate the growing risks of non-compliance, including use of the Automated Commercial Environment and requirements of the Sarbanes-Oxley Act.

Given that many importers continue to rely on manual classification and processing systems that are fraught with systemic errors, government audits typically present a real threat to the financial well-being of importers.

Leading edge automated import compliance systems promise to remove the “random guess” factor from import compliance. By building on past transactions and providing feedback between the relevant parts of an organization and its third-party partners, effective automation systems reduce classification errors, document classification choices based on official rulings, and share that information with all involved parties. Using automated systems also provides a basis for asserting the Reasonable Care required of importers by current regulations.

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## The Import Compliance Environment

In 2004, over \$1 *trillion* worth of imported goods entered the United States, generating over \$26 billion in government revenue from customs duties. This volume of imports corresponded to an average of over 75,000 commercial import entries each day during 2004.

Given the importance of these goods to the U.S. economy, as well as increased scrutiny of our nation's borders because of national security concerns, it comes as little surprise that President Bush's Fiscal Year (FY) 2006 budget provides the U.S. Customs and Border Protection Agency (U.S. Customs) with a 4.8% increase in funding—one of the largest increases in government. This increase brings the FY2006 budget for U.S. Customs to \$6.7 billion, which 42,000 U.S. Customs employees use to enforce over 400 legal provisions administered by over 40 different federal agencies.<sup>1</sup>

### Regulation at the Port

In the early years of U.S. Customs, customs duties funded virtually the entire government and paid for the nation's early growth and infrastructure. Prior to 1993, U.S. Customs rather than importers assumed the responsibility for reviewing the accuracy of documentation and markings, assessing appropriate duties, and finally releasing goods into the United States. Local port authorities interpreted compliance under the guidance of the National Headquarters directives and rulings, and reviewed entries on a transactional basis. Customhouse brokers were considered coordinators and acted as the runners, filing paperwork in the various ports to comply with regulatory requirements. Importers were able to skirt ultimate responsibility and chose to focus their efforts and attention on their core operations.

### Regulation Enters the Boardroom

This system was significantly altered in 1993 by the Customs Modernization Act (called in this paper the Modernization Act).<sup>2</sup> The Modernization Act shifted responsibility for import compliance from government officials to the importer. Suddenly, businesses that had \*formerly relied on dedicated government employees and third-party brokers were burdened with the task of

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<sup>1</sup> The Customs and Border Protection agency is now part of the Department of Homeland Security.

<sup>2</sup> This Act was part of the North American Free Trade Agreement Implementation Act, 19 U.S.C. § 3301, Pub. L. 103-182. The Modernization Act begins at § 631 of the larger Act.

interpreting the many complicated laws, regulations, and rulings applicable to the various goods that each was importing.

To educate importers and aid them with the challenges brought on by this transition in responsibility, government agencies provided books, compliance manuals, guidelines, warnings, and outlines of rules and regulations. Most importers, however, did not take seriously the changes imposed by the Modernization Act. At the executive level, few organizations were cognizant of the responsibility—and the liability—that came with ‘informed compliance.’ In fact, for many years following passage of the Modernization Act, importing executives continued to defer to third-party providers. Outsourcing thrived as customhouse brokerage services expanded rapidly.

Though the Modernization Act significantly altered the legal landscape in which importers operate, several years passed before the full impact of these changes was felt. Four events, in particular, have brought these changes into focus in the last two years:

- Customs audits are now being conducted regularly and can result in large fines.
- The terrorist attacks of September 11, 2001 have focused renewed attention on our nation’s borders.
- The Sarbanes-Oxley Act of 2002 imposed significant new reporting and financial requirements on all public companies (and by association, many privately held companies).
- U.S. Customs is implementing the Automated Commercial Environment (ACE)

The next section of this paper explores in more detail the challenges presented by these developments.

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## Regulatory Challenges Facing Importers

Importers today face increasing compliance challenges as they strive to run a profitable and sustainable business. Though many of these challenges have their roots in the Modernization Act of 1993, most are only now having a significant impact on importers. Increased scrutiny of our nation's borders and technological innovation by government agencies mean that importers are more accountable for compliance. This section examines the most important challenges brought about by the government's increased ability to monitor import activity.

### Audits & Penalties

Under the Modernization Act, the importer of record must exercise "Reasonable Care" to ensure proper valuation, classification, and compliance with all laws and regulations applicable to imported goods.<sup>3</sup> While the acts required by a legal standard of Reasonable Care are subject to some dispute, the fact remains that many—if not most—importers have not expended the necessary effort to reach that standard.

U.S. Customs conducts importer audits to evaluate compliance, often with only 30 days notice. It can also audit importer's agents, suppliers and third party logistics partners. Circumstances that can trigger an audit include:

- Type of industry involved
- Value of imported goods
- Whether the goods are considered "High Risk"
- Country of origin
- Country of transit
- Prior Disclosures
- Volume of Supplemental Information Letters
- Inconsistent classifications
- Relations or links to third parties who have been found non-compliant in other audits

U.S. Customs may assess audit penalties not only for incorrect payment of duties, but also for failure to produce appropriate records that sufficiently document the importer's Reasonable Care. If the importer is negligent in its documentation, the assessed penalty can be \$10,000 or 40% of the value of each release of goods and doubles if the entry is NAFTA-related. The financial impact of an audit on larger importers can easily reach hundreds of thousands of dollars.

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<sup>3</sup> See § 484(a)(1) of the Modernization Act. For a review of the Reasonable Care legal standard, see William J. Kovatch, Jr., *The Duty of Reasonable Care Under the Customs Modernization Act of 1993*, 28 Denv. J. Int'l L. & Pol'y 67 (2003).

Of course, importers incur significant operational costs in an audit, in addition to actual duties, damages and penalties. Importers may have to reconstruct records and lose sales due to detained shipments or late delivery. If the audit shows that a company is considered a higher-risk importer, it could be placed on the Enforced Compliance Level, making it subject to a higher level of ongoing CPB scrutiny.

Audits are a lucrative source of revenue for CPB, which collects approximately \$7 for every \$1 spent conducting an audit. Accordingly, we expect these audits to continue apace.

## **The Automated Commercial Environment**

Over the next several years, U.S. Customs will spend \$305.5 million to implement the Automated Commercial Environment (ACE), and another \$16.2 million on the related International Trade Data System (ITDS) program. These two modernization initiatives, begun in 2001, focus on cargo import and export operations and operate in conjunction with the Customs Trade Partnership Against Terrorism (C-TPAT). The overarching goal is to redesign the automated systems that support U.S. Customs operations for all goods and people crossing U.S. borders.<sup>4</sup>

The ACE Secure Data Portal will be similar in structure and interface to popular internet sites like AOL and Yahoo. It will offer a broad array of services and features, including search engines and on-line tools. ACE will provide importers with a universal dashboard for data, tools, and information. The system will track examination and enforcement results and distribute them immediately to authorized users. It will extend targeting to cover the vast majority of the cargo and conveyances entering the country.

While no one would dispute the importance of protecting the nation's borders from terrorism and illicit goods, importers who are caught off guard by these government initiatives face significant business risks because of these new programs. Automation and integration with networked information systems means that U.S. Customs can significantly increase enforcement activity and scrutiny of a much larger number of importers at a greater level of detail than was possible previously.

## **Sarbanes-Oxley**

Developed in response to accounting scandals that continue to affect financial markets, the Sarbanes-Oxley Act of 2002 implements numerous measures that improve the transparency and accuracy of financial accounting and record keeping in publicly traded companies.

Sarbanes-Oxley (often referred to as "SOX") 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

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<sup>4</sup> A recent report to Congress exploring the status of the ACE is available at [http://www.cbp.gov/linkhandler/cgov/toolbox/about/modernization/quarterly\\_reports/ace\\_report\\_to\\_congress\\_062004.ctt/ace\\_report\\_to\\_congress\\_062004.pdf](http://www.cbp.gov/linkhandler/cgov/toolbox/about/modernization/quarterly_reports/ace_report_to_congress_062004.ctt/ace_report_to_congress_062004.pdf).

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.

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.”<sup>5</sup>

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 U.S. Customs may also reveal that the organization is in violation of Sarbanes-Oxley.

## **Other Government Agencies**

While this section has focused thus far on the increasing involvement of U.S. Customs and the requirements of the Sarbanes-Oxley Act (which is enforced by the Securities and Exchange Commission), numerous other federal agencies also monitor import transactions. Unfortunately, these agencies create a virtual sea of regulations with which importers must comply. Noncompliance can lead to goods being detained in port, the imposition of fines, and even sanctions on future activities. Depending upon the nature of the goods that an importer works with, an importer may be subject to regulations from the following federal agencies:

- Federal Aviation Administration
- Department of Defense
- Department of Transportation
- Federal Communications Commission
- Food and Drug Administration

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<sup>5</sup> Thomas Craig, *Sarbanes-Oxley and Supply Chain Management*, World Wide Shipping (May 2004) available at <http://www.ltdmgt.com/mag/sarbanes.htm>.

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## Seeking Technical Solutions

As the challenges discussed in the previous section demonstrate, organizations should recognize that using well-managed technical solutions to process and track import transactions is the only viable way to maintain compliance with the myriad of regulations and record keeping requirements imposed on today's importers. Such a system is as important to an organization's continuing success as their Marketing, Merchandising, Operations, Legal, and Finance groups.

Surveys repeatedly demonstrate that the vast majority of importers and related service providers do not consider import technology a priority. This is true even in companies that have relied on technology in other areas of their business.

By every measure, government requirements for accurate and transparent importing have become increasingly complicated. And yet, an organization's import technology typically lags far behind the rest of an organization's IT systems.

Most companies had fully operational ERP systems, bar coding, EDI, satellite communications, and warehouse automation long before the first electronic interface between brokerage firms and importing companies. Many importers are still waiting for that connection. As Michael J. Mandel explained in a recent *Business Week* article on the promise of innovation,

“The march of technological progress has been uneven. In recent years, change has been more rapid in information processing and health care than in energy, transportation, and other industries. There are many industries that still depend on older technologies that date back to the 19th and early 20th centuries.”<sup>6</sup>

In the sections that follow, we review some of the technical challenges that importers face. We then explore several system components that offer a promising solution.

## Poisoned Processes

Manual classification and review processes are fairly standard for the majority of importers. Despite the tens of thousands of rulings issued by U.S. Customs that are intended to guide importers of specific products, product classification continues to be subject to often ill-informed

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<sup>6</sup> Michael J. Mandel, *The Innovation Economy – The Promise of Innovation*, *Business Week* (October 11, 2004).

personal interpretations at the port level. In many cases, the expert who \*could make a more accurate and informed decision—such as the licensed broker—doesn't have enough information to make that decision. Rather than examining imported merchandise, such experts typically rely on inadequate, shorthand invoice descriptions. Further, using manual processes without any computerized tracking inevitably leads to inconsistent classifications of identical products.

The *International Tax Review* described this type of commonly seen classification process as nothing more than a “random guess.” \*The risk of such processes is that an organization is unlikely to be in compliance with the legal requirement of Reasonable Care with regard to its record keeping, and will never be sure whether it is overpaying duties or underpaying them (and thus subject to penalties when audited). Common inaccuracies seen with manual processes include:

- Inaccurately noting the \*value of merchandise
- Improperly classifying merchandise
- Incorrectly documenting and paying duties

These “poisoned processes”—anathema to effective import management—produce an abundance of “toxic data” that importers and their partners then rely upon for future decisions. This data is also fed into existing automated systems that are \*used for managing the business and for financial reporting (for example, systems located in the purchasing and accounting departments). There is rarely any feedback or integration between disparate customs-related databases and systems spread across multiple divisions, organizations, and disciplines. The risks and subsequent costs resulting from this inaccurate information, as maintained within an organization's financial systems and U.S. Customs, can be staggering.

Several understandable but troubling factors contribute to this cycle in most import operations. These include:

- Outdated Technology
- Inadequate resources
- Staff shortages
- Insufficient training
- Lack of empowerment

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The complexity of rulings and guidelines that affect processing of a typical import transaction requires that the individual processing the transaction know the origin of goods, the intended use of the goods, the product components, and the relationship between all these factors. Without adequate information, employees cannot make an informed judgment. The mismatch between insufficient resources and complicated requirements leads to inadequate due diligence, reactive judgments, and blatant classification errors.

## Setting Technical Standards

Fortunately, by leveraging high-capacity computing and Internet-based integration strategies, organizations can effectively deal with the twin burdens of government compliance and intense global competition. Effective technical solutions require that an organization optimize the compliance, accuracy and transparency of international transactions and accounting.

In this section, we discuss four technical standards or pillars on which an effective import compliance system can be based. Ideally, a computerized import compliance system not only

identifies past issues that need correction, but applies that information going forward in order to effectively automate processes and prevent problems from recurring.

With effective solutions in place, importers should be able to create information once, verify that it is correct, and automatically use it everywhere that it is needed.

### **One—Expert Information**

Automation of import procedures requires accurate information. An effective way to generate information that is relevant and tailored to a particular importer is by reviewing past transactions.

Data mining techniques can help importers learn from the past and apply that knowledge to future transactions. In a preferred system, the following steps are used to analyze existing transaction data:

1. The system electronically recreates years of past transactions from paper and electronic records (paper or stored electronically).
2. Errors and non-compliant activities are identified. Errors and anomalies that an effective data mining operation can identify should include incorrect valuation, \*incorrect or inconsistent classifications, and duty-drawback opportunities.
3. Past problems are categorized and quantified to assess their effect on the importer's business and to assist management in properly allocating resources to fix the underlying causes of errors.

As the system identifies errors and their causes, it should also provide a basis for measuring the performance of vendors, brokers, carriers, warehouses and any other third-party agents. The effectiveness and accuracy of each partner can then be evaluated and appropriate corrective actions suggested.

### **Two—Fact-Based Analysis**

Careful analysis of an importer's past transactions provides a factual basis for truly *accurate classification* of products. Each classification should then be documented via *ruling that supports the classification*. This documentation provides a level of confidence in the classification and provides management with a legal basis for asserting Reasonable Care in the face of an audit or dispute with U.S. Customs over a classification.

The real value of automating an import system lies in preventing future errors. To do this effectively, an automated import compliance system must permit *transparent communication between involved parties*. The relevant parties typically include multiple departments in the organization, such as Finance, Purchasing, and Marketing, as well as partners outside the organization. Note that many of these third parties may have contributed information to help analyze past transactions and determine accurate classifications. Without ongoing communication, the information gathered by one party will not benefit other parties, leading to more errors and omissions in the future.

Management should also insist that automated import compliance systems create executive-level reporting that summarizes status and identifies trends. By allowing the management team to see the status of the import operation, decision makers can quickly evaluate options, prioritize resources, and, where necessary, implement corrective actions.

### **Three—Connectivity**

To provide transparent communication between relevant parties and provide timely reporting to management, an import compliance system must be networked. Connectivity must include all components of the import process, other business systems in the same organization, partners in the supply chains, and—ideally—other external systems that can provide up-to-date information on regulatory rulings and similar information that will continuously improve the effectiveness of the system.

By relying on networked systems, the importer of record can manage and control the flow and accuracy of information used throughout the supply chain. The Internet is an ideal network model for this purpose, though virtual private networks and dedicated connectivity may be appropriate for some connections within and between large importers and their partners.

Connectivity between partners in the supply chain lets importers share information and *direct* their brokers and other service providers in their functions. This direction can include alerting partners to changing regulations and to changing product characteristics.

By using technology effectively, importers can streamline the classification process by integrating classification information with enterprise software throughout the import supply chain. Automation of manual processes creates precise classification coding and matching to supportive rulings, dramatically improving operational effectiveness and overall compliance.

The data mining processes discussed previously must rely on sophisticated pattern-matching algorithms to electronically review every transaction and identify all areas of potential noncompliance. Finally, the logic required to create data mining algorithms is \*typically similar to the logic required to correct the root cause of the problem. By following this model, importers can define requirements for system-wide corrections and improvements. Computer programmers can then leverage data mining logic and results to design internal controls that correct the root cause of non-compliance and eliminate re-occurrence.

### **Four—Speed and Scale**

Importers traditionally have not had the time, resources, or skills to provide a comprehensive compliance review of every transaction. By relying on superior information technology, *every transaction* can be reviewed with a speed, scale, and precision that manual operations cannot match. It is this level of attention that importers must consider in view of the requirements imposed by increasing government scrutiny and the financial risks that that scrutiny poses. Given that so many other parts of an organization are fully automated, networked, and integrated, one might well ask how an importer can leave import compliance in the dark ages, yet assert that it has taken Reasonable Care in following import regulations. Yet, with appropriately integrated systems in place, errors can be proactively corrected before they lead the excessive \*errors or audit-triggering lapses.

Fortunately, costs for high-speed computing continue to fall. The transaction costs associated with internal compliance review have accordingly been reduced exponentially. Once an importer has in place the necessary expert information—based on past transactions—and the importer's precise product line and partner relationships, effectively designed computer systems allow the importer to apply that information in ways that were virtually impossible using traditional methods.

Data mining systems using off-the-shelf computer hardware with accurately assembled importer data can review hundreds of thousands of line-item transactions in a matter of minutes. Such systems can identify each non-compliant transaction, whether the error is a factor of 10% or 0.01%—a level of discernment rarely matched by even well-trained staff. As a further example, systems based on data mining technology can detect errors as small as two different ports classifying the same item using two different HTS codes, or as large as an entire category of items being classified incorrectly. This is the speed and scale of import automation that should be considered *de rigueur* in the future.

## Conclusions

Importers face significant financial risks if they disregard compliance with government regulations. Because these regulations emanate from multiple agencies and are more likely each year to be subject to automated review and audits, importers should be wary of leaving compliance to chance or relying on manual, error-prone processes.

Automation via advanced data-mining techniques and networked systems provides the most promising solution when faced with myriad import compliance requirements and the risks of an audit for non-compliance. Ideally, such systems should build a knowledge base using past transactions and then apply that knowledge base proactively throughout an organization and its partners. Classifications should be documented using rulings that demonstrate Reasonable Care, and managerial reporting should enable decision making based on real-time status and evaluation of import processes.

Given the increasing push to automation by U.S. Customs, as well as the requirements and scrutiny of other government and private actors, failure to automate import compliance processes poses an unacceptable risk to the ongoing viability of any organization.

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### ***About Global Data Mining***

Global Data Mining (GDM) helps import professionals who are frustrated with inadequate resources, and struggling to improve compliance and increase the transparency of import data feeding financial systems and executive leadership. Our service provides a comprehensive overview of importing systems, processes, data, guidelines and documentation. We turn unorganized data into executive-level reporting that can't be ignored so decision makers can evaluate, prioritize and implement corrective actions. Contact us as [www.gdmllc.com](http://www.gdmllc.com).