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US-CHINA TRADE WAR: RESPONDING TO UNCERTAINTY

The US-China trade war has caught the world's attention in recent months, and even more so recently with the US announcing its plan to increase tariffs to 25% for US$200 billion of Chinese goods. The proposed expansion of 25% tariffs to another US$300 billion of Chinese goods, including clothes, shoes and electronic components, has led some global retailers and manufacturers to publicly express concerns. Because of the inability to pass the additional tariff costs fully to consumers, the profit margins of multi-national companies' Chinese subsidiaries and Chinese exporting businesses are being squeezed, and pressure is on both managers and executives to meet internal and external targets.

Combined with the deleveraging of the Chinese economy, the expansion of tariffs creates a perfect storm of tension, leading to a marked increase in channel stuffing, round-tripping, falsified transactions, and other illicit means of inflating reported revenues and earnings.

Companies must be prepared for the risks and compliance issues that may arise as attempts are made to reduce the impact from tariffs.

One example of a method some companies are employing and its potential implications follows.

REDUCING THE DUTIABLE IMPORT PRICE BY SELLING GOODS THROUGH AN INTERMEDIARY

Some exporters, in order to manage and reduce the additional costs relating to the tariffs, are coordinating with US importers. The arrangement may involve the China exporter setting up a trading company (the 'intermediary'), or using an independent trading company (often based in Hong Kong), to sell its goods to the intermediary at a lowered price. This lower price is subjected to the 25% tariff duties which results in an effective lowered duty paid (First Sale for Export)[1] and not the final price purchased by the US importer.

The tables below illustrate how the 25% tariffs would wipe out the US importer's entire profit margins (table 2) and by selling through an intermediary at the lowered price (table 3), the US importer has reduced the impact from trade tariffs and maintained a minimal profit.

TABLE 1: BEFORE ANY TARIFFS

	A (SELL SIDE)	B (BUY SIDE)
Price sold (CIF)	100	200
COGS		-100
Other costs		-75
Profit		**25**

TABLE 2: TARIFFS AT 25%

	A (SELL SIDE)	B (BUY SIDE)
Price sold (CIF)	100	200
COGS		-100
Tariffs @ 25%		-25
Other costs		-75
Profit		**0**

TABLE 3: TARIFFS AT 25% (USING AN INTERMEDIARY)

	A (SELL SIDE)	INTERMEDIARY	B (BUY SIDE)
Price sold (ex-factory)	80	100	200
Insurance and freight	20		
COGS		80	-100
Tariffs @ 25% (of 80)			-20
Other costs			-75
Profit			**5**

1. First Sale for Export is a duty reduction program designed to reduce the dutiable value of eligible products imported into the United States

SALES TO SANCTIONED PERSONS OR COUNTRIES VIA AN INTERMEDIARY

Instead of selling direct to the end customer, the exporters may sell products to an intermediary without knowing who the final customers are. Regulatory enforcement actions emphasize that compliance cannot be outsourced to third parties, with circumvention of regulations through third parties often expressly prohibited by statute. This places the onus on companies to take reasonable steps to ensure their supply chains and distribution channels remain compliant. Although the sales may not be subjected to the trade tariffs, if the products are ultimately sold to sanctioned countries or sanctioned persons, the exporters could end up in breach of the Office of Foreign Assets Control ('OFAC') regulations. If an OFAC violation is confirmed, the penalties could be significantly higher than the premium paid on trade tariffs.

Due to the inherent bribery, misappropriation of assets, financial fraud and OFAC sanctions-related risks associated with the use of intermediaries, companies must continually monitor the evolving risk landscape in order to maintain an effective compliance program.

Such a program should include inculcating an organization-wide culture of compliance and maintaining a robust third-party oversight program, holding individuals accountable for lapses in third-party supervision and other compliance failures.

PREPARE NOW

Both US and Chinese companies are facing a rough road ahead.

The current market conditions make it difficult to understand how best to adjust short-, medium- and long-term plans in order to meet strategic objectives. A holistic approach is necessary to assess and respond to the regular- and rapidly-changing economic environment and risk landscape and will require an evaluation of a wide range of strategic, operational, financial and other factors — including possible changes to operating models, trading terms, supply chain transparency, and steps taken to ensure compliant M&A and BAU activity. Only time will tell if US or Chinese consumers or companies will bear the brunt of the tariffs, but companies based in both locations need to remain agile and adept at identifying the ever-evolving risks to their businesses, and take actions to mitigate uncertainty and the impact of tariff increases.

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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