Navigating tariffs: strategic insights for retail risk management and compliance

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For chief risk officers, chief audit executives and other key risk leaders, navigating the tariff landscape requires a strategic blend of risk management and adaptability to protect the integrity of retail operations and foster enduring brand loyalty

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The challenges retail companies face

The introduction of new tariffs in the geopolitical climate has created significant uncertainty and risks for the retail sector, necessitating that retailers proactively define their risk tolerance and develop approaches to manage impacts on the supply chain, cost and pricing. Chief risk officers (CROs) and chief audit executives (CAEs) must understand these implications for effective enterprise risk management (ERM) and internal audit, remaining vigilant and proactive in monitoring tariff risks amid market volatility. This article will explore current and emerging tariff risks in retail, offering actionable insights for CAEs and CROs.

Understanding risks in a volatile market

The tariff risks faced by retailers are changing rapidly due to the recent volume and speed with which tariffs are being imposed on countries, industries and products, creating significant market uncertainty. This rapid evolution complicates strategic planning and operational stability, making it difficult for retailers to keep up and adapt effectively.

- **Navigating tariff-induced cost increases:** While suppliers and distributors may be able to absorb some of the costs, the size and breadth of tariffs poses a significant cost to retailers that will require complex modeling and difficult management decisions. For retailers with private-label brands, the reliance on specific suppliers and manufacturers could pose an even greater cost exposure, and risk management approaches may be more complex.
- **Sourcing and supply chain challenges:** Tariffs introduce a variety of sourcing risks for retailers, and they may struggle to adapt their sourcing approaches in response to increased costs and supply chain disruptions. While some retailers may seek tariff-free alternatives, these changes can take time, and a reliance on historical vendors could lead to challenges in securing alternative sourcing options or misaligned product assortments.
- **Pricing and merchandising approaches:** The introduction of new tariffs can present significant risk, causing retailers to re-evaluate pricing, merchandising and promotional approaches. Retailers will have to make decisions on how much cost to absorb and how much to pass on to consumers, while adjusting product assortments, sourcing alternatives and maintaining brand loyalty.
- **New regulatory and compliance risks:** Rapidly changing tariff requirements can lead to increased compliance risk around trade regulations, as businesses must continuously monitor and adapt to new tariff rates and trade agreements across different countries and products.

Act now: a retailer’s essential to-do list

To navigate these challenges effectively, organizations need to evaluate tariff exposure, conduct scenario analysis and develop response plans to manage risk and financial exposure.

1. **Risk planning:** CROs and CAEs should take an active role in guiding the organization to identify tariff risks. They should have a seat at the table, facilitating cross-collaboration among functional groups to identify risks and prepare for effective scenario and response planning.
2. **Scenario planning:** Retailers should identify their tariff exposure and pressure test exposures under potential future scenarios. These scenarios should be regularly updated, as this is not a one-time exercise. As risks are addressed through other measures, scenarios should be revised and re-evaluated, especially as risks continue to evolve. This process should consider the following:
   - Obtain import and export data to model the impact of tariffs using U.S. Customs import/export data (e.g., ACE data).
   - For imported products, determine customs value, classifications and origins to understand potential exposures.
   - Model the economic impact of tariffs using multiple exposure scenarios (e.g., baseline, moderate, severe escalation). This could include varying tariff rates for retaliatory escalations and evaluating high-exposure products where the company relies upon single source suppliers.

Illustrative example of CAE impact: One retail CAE participated in scenario planning meetings with the head of commercial and representatives from tax and supply chain, among others. The CAE asked several questions to challenge the accuracy of the data being reviewed, leading to one adjustment that specifically impacted the outcome of the analysis. She also raised questions around how certain indirect risks were being considered and incorporated (e.g., how to quantify the likelihood that consumers in Europe may choose to switch to European products). Her involvement fostered a deeper understanding of the potential challenges and opportunities the company may face.

3. **Develop a response plan:** Prioritize the creation of a robust customized response plan that outlines the exposures and approaches to navigate risk for your organization. Key considerations may include the following:
   - Evaluate inventory and procurement adjustments. This could include, based on business needs, stockpiling of certain tariff-affected products before tariffs go into effect and evaluating alternative suppliers going forward. It will be important to understand vendor agreements as a part of this analysis.
   - Understand consumer demand sensitivity and evaluate cost management. This could include absorbing costs, passing them to consumers or offsetting costs through promotions. Retailers may also consider bundling strategies to maintain consumer loyalty.
   - Assess the implications on private label. This could include the feasibility of shifting private-label production and warehousing locations and could involve introducing private-label alternatives to reduce dependency on affected imports.

Illustrative example of CRO impact: At one retail company, the CRO joined a cross-functional task force focused on response plans. He emphasized setting risk tolerance levels — “How much risk are we willing to tolerate? Where are our limits?” — and defining key risk indicators (KRIs). He also challenged the group on how they would monitor the plans to make sure they were prepared to pivot quickly as new tariff-related announcements came out.

Embracing new challenges: the risk function response

Enterprise risk management

As with other emerging risks, an ERM program can enable the organization to manage the strategic, financial, operational and compliance risks of tariffs. ERM can serve as a unifying force, bringing together functional areas of the business to drive a coordinated approach and response. ERM involvement could include:

- **Risk identification and response planning —** facilitating the identification of risks in the scenario and response planning activities. Given the broad exposure of ERM and the importance of a cross-functional evaluation, this can include consideration of risks across various functional groups, including supply chain, merchandising and pricing, and support teams, such as legal, tax, third-party risk management and internal audit. As response strategies are developed, the ERM function should work closely with risk owners to monitor implementation, fostering a culture of accountability.
- **Evaluating risk appetite —** evaluating new exposures and plans to address. This is an important step to understand the retailer's appetite for risk. The ERM function can help facilitate the quantification necessary to identify when the company needs to implement a contingency plan.
- **Risk monitoring —** integrating monitoring of tariffs and trade agreements into ERM reporting and dashboards. This could include developing KPIs and key risk indicators for the impact of tariffs on cost, margin and sales.

The ERM function is often well-positioned to lead or facilitate communications with the board and senior leadership regarding new and emerging risks. Communication of tariff exposure risks and management approaches should be done in the context of the company's broader ERM risk framework.

Internal audit

In today's volatile tariff environment, internal audit plays a crucial role in enhancing oversight and controls to effectively manage tariff-related risks. As companies grapple with the complexities of changing trade policies, internal audit teams should consider providing assurance that the company is proactively managing tariff exposure and maintaining compliance. Examples of internal audit projects at retailers:

- **Risk assessment:** Internal audit can evaluate whether tariff exposure has been properly conducted through an ERM program or otherwise. Additionally, internal audit can review whether risk ownership is clearly defined among functional teams, including supply chain, procurement and compliance.
- **Supply chain audit:** The introduction of new tariffs can increase the risks associated with supplier concentration risk, contractual clauses related to tariffs and inventory management, including safety stock strategies. Internal audit may incorporate these risks into existing audits or introduce a new audit to validate the effectiveness of the company's processes.
- **Global trade audit:** Given the dynamic and fast-paced nature of tariffs in the current environment, compliance is becoming more complex. Internal audit could consider performing an audit of the import processes, including risks associated with classification, valuation, free trade agreement use, country of origin, drawback and record-keeping. Internal audit could also evaluate the company's customs broker monitoring, management and procedures.

Summary

Tariffs significantly impact the retail sector, making it essential to navigate the current landscape to sustain operations and brand loyalty. CROs and CAEs must adopt proactive risk management approaches, including robust scenario planning and response tactics, to manage financial and operational impacts. Integrating these approaches into ERM and internal audit functions will enhance oversight and compliance with changing regulations. A coordinated effort will empower retailers to thrive in an uncertain environment.

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