SOME ISSUES to CONSIDER in the DEVELOPMENT of RISK MANAGEMENT and POST ENTRY AUDIT SYSTEMS[*]

I. Risk Management From the Customs Viewpoint

- The definition of risk from a customs viewpoint: the risk that an importer would submit a fraudulent declaration or one that violates customs rules and regulations thereby causing loss of revenue and/or harm to trade and industry.
- Characteristics of risk:
    - It is not absolutely known. Therefore measures taken can only minimize risk. It cannot be completely eliminated.
    - It is dynamic. The risk confronted by customs changes as trade and customs laws, industries, economic conditions and importers change over time.
    - It can be managed. Customs can undertake measures to address risk and reduce it to acceptable levels.
- The objective of a customs risk management system is to try to manage events and activities that have the potential to generate risk in order to minimize the overall risk level that customs has to face.
- The ability to put in place an effective risk management system becomes more critical in a situation where customs is confronted with having to process increasing trade volumes with no commensurate increase in resources.
- In a developing country setting where resource constraints are usually severe and frontline personnel are typically underpaid, the risk from within (mainly as a result of corruption) could be substantial and should be identified, officially recognized and addressed aggressively. The best practices from a systems standpoint usually involve measures that try to minimize a) discretion especially of frontline officials and b) the interaction between these officials and the transacting public. These measures are best implemented together with a program of improving the renumeration of customs officials to enable them to better resist corruption.

II. Features of an Effective Risk Management System

- To be effective, a risk management system should be:
    - Comprehensive, well-defined and officially instituted
    - Applied systematically
    - An intelligent system. It should be capable of evolving into an increasingly better system through an effective tracking, feedback and learning mechanism.

- The basic components of a risk management system are:
    - A comprehensive database of importers and their compliance history. The ability to document the historical behavior of each importer is critical to the development of an effective risk management system since such a system requires that importers be classified into risk categories on the basis of the potential risk that they pose. Such a database should also allow an analysis of trends in import products, the values applied to them and their tariff classifications, among others. An important objective in analyzing these

trends is the identification of exceptions to them, as these exceptions may warrant enforcement measures. In building such a database, one should take advantage of an important strength of government: the ability to access various other databases, particularly those maintained by other government agencies. Such cross- referrals could be used effectively to detect fraudulent declarations (for instance, cross-referral with a database of remittances through the banking system would help detect undervaluation).

The development of such a database need not be dependent on the establishment of a fully computerized processing system. The electronic data presently being captured at the border by most customs administrations in the region could serve as an initial input. However, the infrastructure necessary for the data to be stored systematically in order for it to be mined and analyzed in a meaningful way has to be built. A choice of data mining software could be bought off the shelf to construct a data warehouse for this purpose. Software tools for more sophisticated statistical analysis are also available off-the-shelf. Mechanisms for collecting relevant data from other sources and for classifying importers into risk categories could eventually be built around such an initial system.

o Effective measures to address risk. These measures are usually taken to encourage compliance. The strategies adopted to accomplish this fall into two categories: informed compliance and enforced compliance. Informed compliance strategies view customs compliance as a shared responsibility between the importer and customs: Customs is responsible for communicating its requirements to the importing community, while importers, in turn, are responsible for complying with these requirements. Those who fail to respond positively to informed compliance measures are subjected to enforced compliance. Although there are various tools used to encourage compliance, the most basic are: document scrutiny at the border, physical examinations and post entry audit. These tools may be applied in varying intensity and in various combinations depending on the risk category of the importer and the seriousness of the possible violations detected through an analysis of the database.

o A feedback mechanism that allows the system to "learn" from experience. Figure 1 below shows how such a feedback mechanism could generate more accurate importer profiles and risk rating as a result of incorporating into the importer profile database the outcomes of border scrutiny (document scrutiny and physical examinations) and post entry audit findings. The importer profile, on the other hand, serves as input into a selectivity system which determines the level of scrutiny to be applied to the importer's shipments at the border. The importer profile is also an important input into a mechanism for selecting firms for post entry audit. The same feedback principle may be applied for other compliance tools that may be developed as the risk management system becomes more sophisticated.

Figure 1
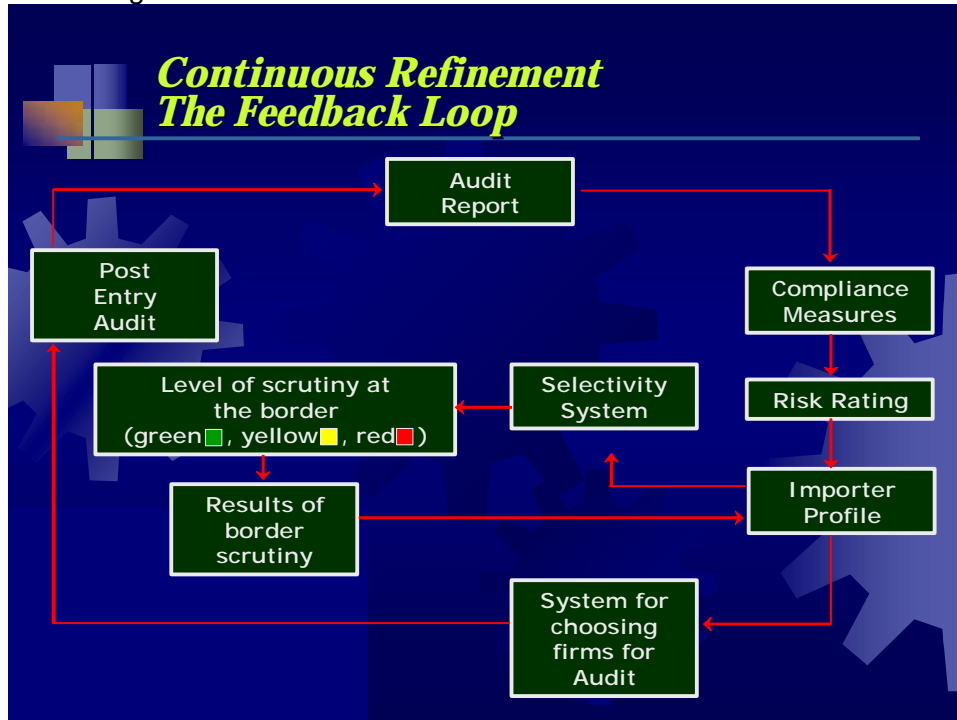
- Software that automates the important processes of the system shown above could also be bought off-the-shelf and tailored to fit local requirements.

III. Post Entry Audit

- The audit of an importer's records is an important tool for encouraging compliance especially if customs laws on valuation follow the WTO Valuation Agreement since the Agreement is seen to be most effectively implemented using an account based system (as opposed to one that is transaction based).
- The audit process should be carried out in accordance with plans that are developed at both the strategic and tactical levels. Plans at the strategic level lay out the deployment of audit resources within a certain time frame. Audits may be time-consuming and available resources may not be sufficient to carry out the number of audits required. The strategic plan describes how these resources are to be allocated in order for them to have the most impact. Plans at the tactical level, on the other hand, describe how individual field audits are to be carried out. The objectives of the audit are identified, the issues to be addressed are defined, the methodology for carrying out the audit is described in sufficient detail and the responsibilities of each member of the audit team are clearly laid out. These plans are usually guided by the result of profiling exercises that are carried out on the database prior to the audit. The formulation and effective implementation of these plans are necessary to meet resource allocation and control (to ensure that field audits remain above board) objectives.
- Field audits are ideally conducted by teams consisting of specialists in different areas as required by the audit objectives. Some of the important skills needed include:
  - o Auditing skills
  - o Knowledge of valuation, classification and other compliance issues
  - o Familiarity with the industry
  - o Skill in analyzing computerized data and in scrutinizing internal systems

The need for these and other skills may of course vary depending on the degree of sophistication of the importer and the compliance issues to be addressed.

- Audit procedures should be clearly defined and published in a manual. The audit process should be broken down into distinct stages and should be time-bound. Reporting requirements at certain stages of the process should be specified to give monitors at headquarters a sense of how the audit is progressing.

- The success of the audit program depends to some extent on the cooperation of the importing sector, as well as their willingness and ability to adopt compliant behavior. Some effort should therefore focus on helping the importer under audit identify corrective measures needed to achieve compliance. A system of monitoring the implementation of such measures should also be developed.

- The audit is in many ways the last line of defense against non-compliant behavior. It also involves close interaction with importers. It is therefore a highly sensitive function. The members of the audit office should therefore be carefully chosen and sufficiently trained. They should also be given the rank and salary that are commensurate with their responsibilities. The office should be organized in a manner that maximizes checks and balance in order to discourage abusive and corrupt behavior. Measures should also be taken to insulate them from political and other outside influences that would tend to keep them from doing their job with integrity.

IV. The Compliance Program

The above systems should be carried out under a program of encouraging compliant behavior. The program should target the major revenue contributors and those who account for the majority of trade. In most countries, this would consist of a relatively small number of large firms. A system of assigning risk categories to reflect relative success in achieving compliance should be put in place. To further encourage compliant behavior, this should be complimented by a set of incentives and sanctions designed to reward compliance and punish non-compliance in a calibrated fashion. To ensure public acceptance and support, the launch of the program should be accompanied by an information campaign that encourages importer and industry groups to enter into self-compliance agreements with customs, whereby these groups would take some responsibility for the self-compliance of their members.