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MANAGING RISK IN THE CUSTOMS CONTEXT

David Widdowson

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In recent years the international trading environment has been transformed dramatically in terms of the manner in which goods are carried and traded, the speed of such transactions, and the sheer volume of goods now being traded around the globe. This, together with mounting pressure from the international trading community to minimize government intervention, has caused customs authorities to place an increasing emphasis on the facilitation of trade.

In an effort to achieve an appropriate balance between trade facilitation and regulatory control, customs administrations are generally abandoning their traditional, routine "gateway" checks and are now applying the principles of risk management, with varying degrees of sophistication and success.

This chapter examines the basic principles of risk management and identifies practical ways of putting the theory into practice. The first section discusses the importance of managing risk in customs. The second section examines the two key objectives of customs—facilitation and control. The third section identifies risk management as the means of achieving a balanced approach to facilitation and control. The fourth section deals with managing compliance and describes a risk-based compliance management strategy. The fifth section concentrates on putting the theory to practice and thus draws together the various elements of a risk management style to provide a structured approach to the management of compliance. The sixth section links compliance assessment with trade facilitation. The next section provides an example of risk management. The final section summarizes the chapter's main conclusions.

David Widdowson is Chief Executive Officer, Centre for Customs and Excise Studies and Adjunct Professor, School of Law, University of Canberra, Australia.

The Importance of Managing Risk

The concept of organizational risk refers to the possibility of events and activities occurring that may prevent an organization from achieving its objectives. Customs authorities are required to achieve two primary objectives—provide the international trading community with an appropriate level of facilitation, and ensure compliance with regulatory requirements. Risks facing customs include the potential for noncompliance with customs laws such as licensing requirements, valuation provisions, rules of origin, duty exemption regimes, trade restrictions, and security regulations, as well as the potential failure to facilitate international trade.

Customs, like any other organization, needs to manage its risks. This requires the systematic application of management procedures designed to reduce those risks to ensure that its objectives are achieved as efficiently and effectively as possible. Such procedures include the identification, analysis, evaluation, treatment, monitoring, and review of risks that may affect the achievement of these objectives.

Sound risk management is fundamental to effective customs operations, and it would be true to say that all administrations apply some form of risk management, either formal or informal. Drawing on intelligence, information, and experience, customs has always adopted procedures designed to identify illegal activity in an effort to reduce its risks. The more traditional procedures include physical border controls over the movement of goods and people consisting of documentary checks and physical inspections aimed at detecting illicit trade. The introduction of such controls constitutes a form of risk management, but not necessarily an effective or efficient one.

Recently, the increasing complexity, speed, and volume of international trade, fueled by the technological advances that have revolutionized global trading practices, have significantly affected the way customs authorities carry out their responsibilities. As a consequence, many administrations have implemented a more disciplined and structured approach to managing risk. This has also helped them to increase the efficiency of their operations and to streamline their processes and procedures, minimizing intervention in trade transactions and reducing the regulatory burden on the commercial sector.

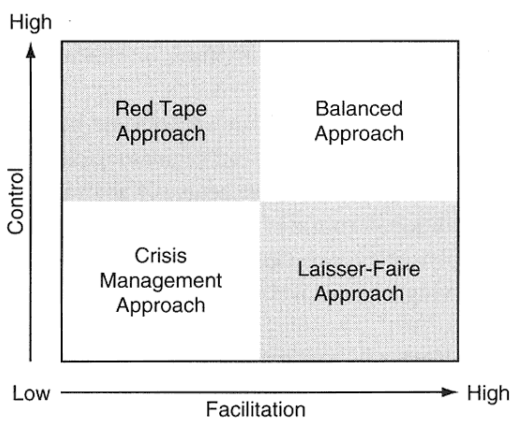
Facilitation and Control

The two key objectives of customs are commonly referred to as "facilitation" and "control." In seeking to achieve an appropriate balance between trade facilitation and regulatory control, customs must simultaneously manage two risks—the potential failure to facilitate international trade and the potential for noncompliance with customs laws. The application of risk management principles provides the means of achieving this balance.

Note that the phrase "facilitation *and* control" has been used in this context, rather than the phrase "facilitation *versus* control." It is a commonly held belief that facilitation and control sit at opposite ends of a continuum, and it is not uncommon for commentators to refer to the apparent "paradox" of achieving both facilitation and control. It is often assumed that, as the level of facilitation increases, the level of control decreases. Similarly, where regulatory controls are tightened, it is commonly assumed that facilitation must suffer. This is an extremely simplistic view, as it assumes that the only way a process may be facilitated is by loosening the reins of control. Such a contention is fundamentally flawed, because the concepts of facilitation and control represent two distinct variables, as depicted in the matrix in figure 5.1.

The top left quadrant of the matrix (high control, low facilitation) represents a high-control regime in which customs requirements are stringent, to the detriment of facilitation. This may be described as the red tape approach, which is often

FIGURE 5.1 Facilitation and Control Matrix



Source: Author.

representative of a risk-averse management style. In most modern societies such an approach is likely to attract a great deal of public criticism and complaint, due to the increasing expectations of the trading community that customs intervention should be minimized.

The bottom left quadrant (low control, low facilitation) depicts the approach of an administration that exercises little control and achieves equally little in the way of facilitation. This crisis management approach is one that benefits neither the government nor the trading community.

The bottom right quadrant (low control, high facilitation) represents an approach in which facilitation is the order of the day, but with it comes little in the way of customs control. This *laisser-faire* approach would be an appropriate method of managing compliance in an idyllic world in which the trading community complies fully without any threat or inducement from government, because such an environment would present no risk of noncompliance.

Finally, the top right quadrant (high control, high facilitation) represents a balanced approach to both regulatory control and trade facilitation, resulting in high levels of both. This approach to compliance management maximizes the benefits to both customs and the international trading community. It is this approach that administrations should be seeking to achieve.

Achieving a Balanced Approach

Effective application of the principles of risk management is the key to achieving an appropriate balance between facilitation and control. As the use of risk management becomes more effective (for example, more systematic and sophisticated), an appropriate balance between facilitation and control becomes more achievable. Thus, those administrations that are able to achieve high levels of both facilitation and control (the balanced approach quadrant of the Facilitation and Control Matrix) do so through the effective use of risk management. Similarly, administrations in a state of total crisis management (that is, zero facilitation, zero control) would essentially be adopting a compliance management strategy that is devoid of risk management.

However, any movement away from a state of total crisis management implies the existence of some form of risk management. For example, recognizing that risk is the chance of something happening that will have an impact on organizational objectives, a regulatory strategy that achieves some degree of control, however small, represents a method of treating potential noncompliance with customs laws. Equally, a strategy that achieves some degree of facilitation represents a method of treating the potential failure to facilitate trade. This relationship is depicted in the three-dimensional Compliance Management Matrix in figure 5.2.

Managing Compliance

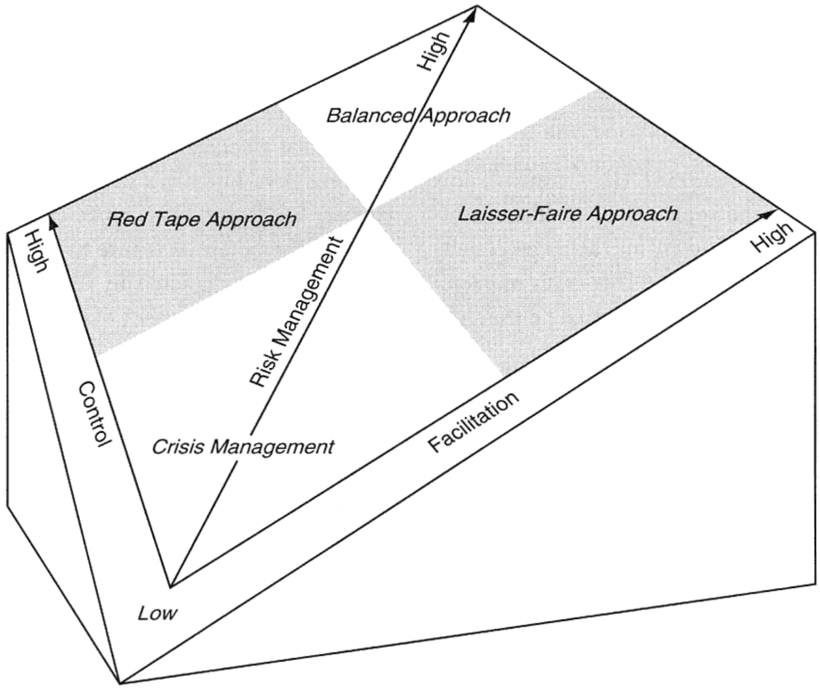
The customs role is, therefore, to manage compliance with the law in a way that ensures the facilitation of trade. To achieve this, many administrations have already implemented compliance management strategies that are based on the principles of risk management.

The Compliance Management Matrix provides a useful conceptualization of the interrelationship between facilitation, regulatory control, and risk management. The next step is to identify the components of a risk-based compliance management strategy.

The underlying elements of such a strategy are summarized in table 5.1, which compares key elements of a risk-management style of compliance management with the more traditional gatekeeper style, which is typically characterized by indiscriminate customs intervention or a regime of 100 percent checks. Similarly, payment of duties and other taxes is a prerequisite for customs clearance under the gatekeeper model, and such clearance is invariably withheld until all formalities and real-time transactional checks are completed. A risk management approach, however, is characterized by the identification of potentially high-risk areas, with resources being directed toward such areas and minimal intervention in similarly identified low-risk areas. Such regimes adopt strategies that break the nexus between physical control over goods and a trader's revenue liability, and permit customs clearance to be granted prior to the arrival of cargo.

The various elements of each style of compliance management can be broadly grouped into four main categories—a country's legislative framework, the administrative framework of a country's customs organization, the type of risk management

FIGURE 5.2 Compliance Management Matrix



Source: Author.

framework adopted by a country's customs organization, and the available technological framework. Collectively, the four categories represent key determinants of the manner in which the movement of cargo may be expedited across a country's borders, and the way that customs control may be exercised over such cargo.

An appropriate legislative framework is an essential element of any regulatory regime, because the primary role of customs is to ensure compliance with the law. Regardless of the compliance management approach that it is supporting, the legislative framework must provide the necessary basis in law for the achievement of the range of administrative and risk management strategies that the administration has chosen to adopt. For example, an appropriate basis in law must exist to enable customs to break the nexus between its physical control over internationally traded goods and the revenue liability (that is, customs duty and other taxes) that such goods may attract. This does not necessarily imply, however, that such a differentiation must be explicitly addressed in the relevant statutory provisions. For example, if the legislation itself is silent on the relationship between customs control over cargo and revenue liability, sufficient scope is likely to exist for administratively flexible solutions to be implemented.

Underpinned by the relevant legal provisions, the various elements of the administrative and risk management frameworks employed by customs essentially reflect the underlying style of compliance management being pursued by the administration, with an increasing use of risk management principles as the administration moves away from the traditional, risk-averse gatekeeper style of compliance management to a more risk-based approach.

The available technological framework represents an enabler that, while not critical to the achievement of a risk management style, serves to significantly enhance an administration's ability to adopt such a style.

Putting the Theory into Practice

The Risk-Based Compliance Management Pyramid (figure 5.3) draws together the various elements of a risk management style (that is, those on the right side of table 5.1) to provide a structured approach to the management of compliance. It provides a

TABLE 5.1 Compliance Management Styles

	Traditional Gatekeeper Style	↔	Risk Management Style
Legislative Framework	Legislative base provides for a "one size fits all" approach to compliance management	↔	Legislative base provides for flexibility and tailored solutions to enable relevant risk management and administrative strategies to be implemented
Legislative Framework	Onus for achieving regulatory compliance is placed solely on the trading community	↔	Legislative base recognizes responsibilities for both government and the trading community in achieving regulatory compliance
Legislative Framework	Sanctions for noncompliers	↔	Sanctions for noncompliers
Administrative Framework	"One size fits all" compliance strategy	↔	Strategy dependent on level of risk
Administrative Framework	Control focus	↔	Balance between regulatory control and trade facilitation
Administrative Framework	Enforcement focus	↔	Dual enforcement–client service focus
Administrative Framework	Unilateral approach	↔	Consultative, cooperative approach
Administrative Framework	Focus on assessing the veracity of transactions	↔	Focus on assessing the integrity of trader systems and procedures
Administrative Framework	Inflexible procedures	↔	Administrative discretion
Administrative Framework	Focus on real-time intervention and compliance assessment	↔	Increased focus on post-transaction compliance assessment
Administrative Framework	Lack of or ineffective appeal mechanisms	↔	Effective appeal mechanisms
Risk Management Framework	Indiscriminate intervention or 100 percent check	↔	Focus on high-risk areas, with minimal intervention in low-risk areas
Risk Management Framework	Physical control focus	↔	Information management focus
Risk Management Framework	Focus on identifying noncompliance	↔	Focus on identifying both compliance and noncompliance
Risk Management Framework	Post-arrival import clearance	↔	Pre-arrival import clearance
Risk Management Framework	Physical control maintained pending revenue payment	↔	Breaks nexus between physical control and revenue liability
Risk Management Framework	No special benefits for recognized compliers	↔	Rewards for recognized compliers
	Risk Management Enablers		
IT Framework	Legislative provisions provide the trading community with electronic as well as paper-based reporting, storage, and authentication options. Such provisions should enable regulators to rely on commercially generated data to the greatest extent possible.		
IT Framework	Appropriate communications and information technology infrastructure to provide for automated processing and clearance arrangements. Regulators should seek to achieve maximum integration with commercial systems.		
IT Framework	Consultative business process reengineering prior to automation.		

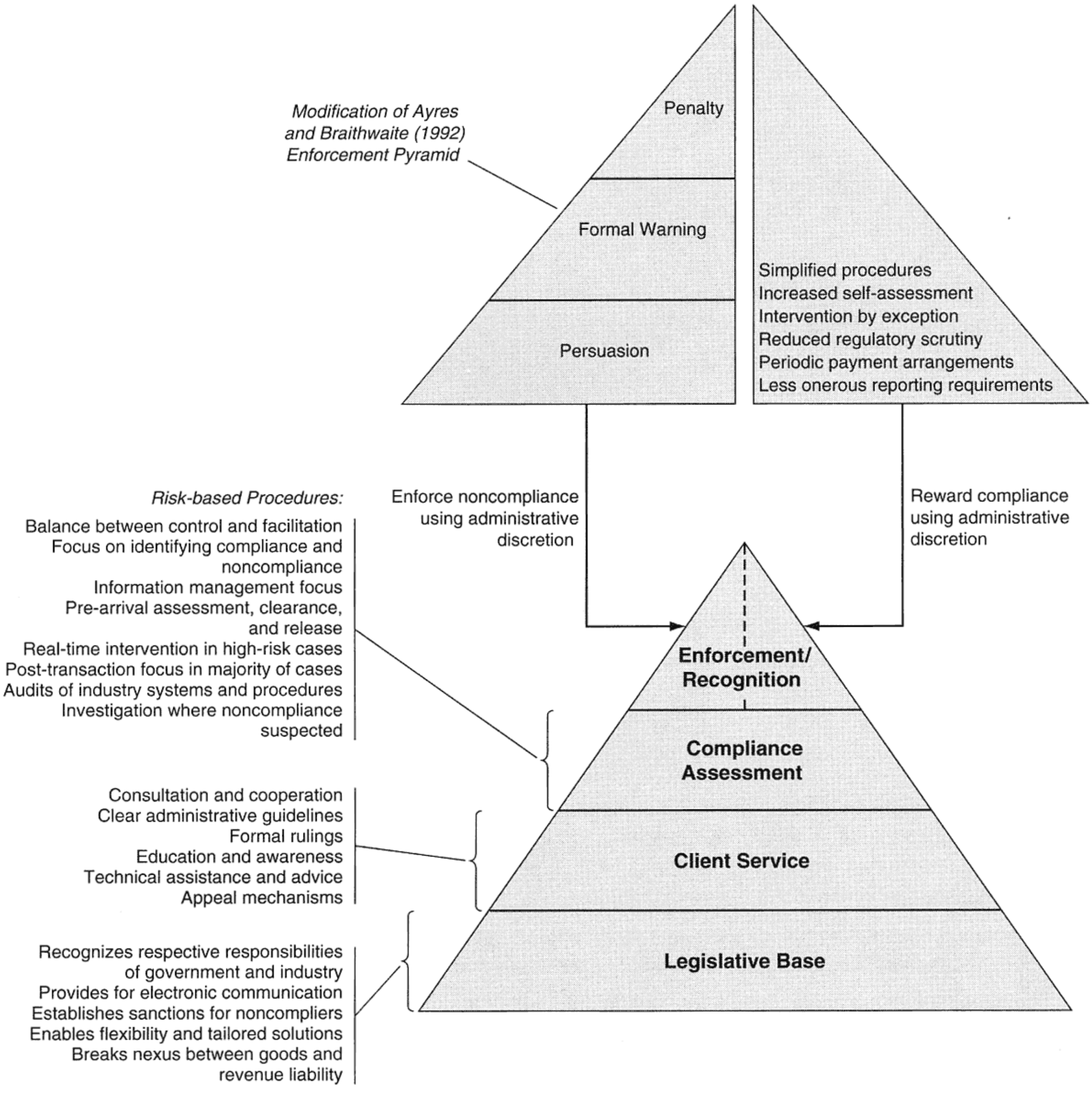
Source: Author.

logical framework for demonstrating how various types of risk-based strategies, including nonenforcement strategies such as self-assessment, may be used to effectively manage compliance.

Fundamental to this approach is the need to provide the commercial sector with the ability to comply with customs requirements. This involves establishing an effective legislative base (the first tier of the pyramid) and an appropriate range of client service strategies (the second tier), including effective consultation arrangements and clear administrative guidelines. Such strategies are necessary to provide the commercial sector with the means to achieve certainty and clarity in assessing liabilities and entitlements.

At the third tier of the pyramid, the elements of compliance assessment come into play, including risk-based physical and documentary checks,

FIGURE 5.3 Risk-Based Compliance Management Pyramid



Source: Author.

audits, and investigations. Such activities are designed to determine whether a trader is in compliance with customs law, and these are discussed in more detail in the next section.

At the peak of the pyramid are strategies to address both identified noncompliers and recognized compliers. Strategies for the identified noncompliers include a range of enforcement techniques (see Ayres and Braithwaite 1992), while strategies for the recognized compliers include increased levels of self-assessment, reduced regulatory scrutiny, less onerous reporting requirements, periodic payment arrangements, and increased levels of facilitation (see Industry Panel on Customs Audit Reforms 1995 and Sparrow 2000).

In assessing the level of compliance, customs will encounter two situations: compliance and noncompliance. The noncompliance spectrum will range from innocent mistakes to blatant fraud. If the error nears the fraudulent end of the spectrum, some form of sanction will need to apply, including administrative penalties or, in more severe cases, prosecution and license revocation.

Before determining the need for, or nature of, a sanction, however, it is important to identify the true nature of the risk by establishing why the error has occurred. For example, the error may be the result of a control problem within the company due to flawed systems and procedures, or it may be the result of a deliberate attempt to defraud. It also may be that the relevant legislation is unclear or the administrative requirements are ambiguous. The type of mitigation strategy that customs should employ to ensure future compliance will depend on the nature of the identified risk. Unless the error is found to be intentional, it may be appropriate to address systemic problems within the company, or to provide the company (or perhaps an entire industry sector) with advice on compliance issues, or provide formal clarification of the law through binding rulings or other means (Widdowson 1998).

In this regard, it is important to recognize that different solutions will be required to address honest mistakes on the one hand, and deliberate attempts to evade duty on the other. For example, industry familiarization seminars and information brochures may adequately address errors that result from a lack of understanding of the relevant regulatory provisions. However, if someone is actively seeking to commit revenue fraud, seminars and information brochures will have absolutely no impact on their activities. Indeed, such members of the trading community are likely to have an excellent understanding of their obligations and entitlements. To treat the risks posed by such individuals (or organizations, for that matter), a rigorous enforcement approach is likely to be required.

Compliance Assessment and Trade Facilitation

In applying the principles of risk management to the day-to-day activities of customs, one of the most critical areas is that of compliance assessment—determining whether an entity or transaction is in compliance with regulatory requirements. This represents the third tier of the Compliance Management Pyramid in figure 5.3. When developing strategies to assess compliance, it is important to consider a key principle of the Revised Kyoto Convention—that customs control should be limited to what is necessary to ensure compliance with the customs law (WCO 1999). Administrative regimes should be as simple as practicable, and should provide the trading community with cost-efficient ways of demonstrating compliance with the law. This principle applies to a range of customs controls, including physical control over goods, information requirements, timing and method of reporting, and timing and form of revenue collection. The use of documentary controls (information management) to monitor and assess compliance generally represents a far less intrusive and hence more facilitative approach than the use of physical controls. Similarly, post-transaction audit generally represents a more facilitative method of verification than checks undertaken at the time of importation or exportation.

For many developing countries, however, the task of introducing risk-based strategies can be daunting, particularly for those administrations that do not yet have the capacity to undertake post-transaction audits, or that currently rely heavily on manual processing systems. While it is clear that such impediments will limit the effectiveness of any risk-based strategies, applying a risk management approach to existing manual systems will prove far more effective and efficient than continuing to apply a gatekeeper approach to those same systems. For example, despite the fact that an administration may undertake all customs examinations and assessments at the time of importation, there is nevertheless an opportunity to replace an indiscriminate or random method of examining goods with one that takes account of the potential risks. Similarly, it is quite possible to apply documentary checks prior to the arrival of goods despite the fact that manual methods of processing are employed.

A case in point is Sri Lanka, which was successful in introducing pre-arrival screening and clearance for air express consignments prior to the availability of its automated systems. This consisted of a combination of manual documentary assessment, selective examination, and the establishment of x-ray facilities to address the potential risk of misdescription. Consolidated manifests were manually submitted to customs prior to aircraft arrival, together with advance copies of air waybills and invoices. These were manually screened by customs to identify potentially high-risk shipments (based on intelligence, emerging trends, the previous compliance record of consignees and consignors, and so on). Any consignments that were considered to be high risk were identified for further examination upon arrival, together with certain dutiable and restricted goods that were held pending formal clearance. All

BOX 5.1 Managing Risk: Customs Valuation

Following its adoption of the WTO Valuation Agreement, customs needs to ensure that importers comply with the new provisions. Its task is therefore one of *compliance management.* To effectively manage compliance, it decides to follow the principles of *risk management,* which require it to identify, analyze, evaluate, and treat risks to the achievement of its objectives. In this case, the overriding *risk* is that traders fail to comply with the valuation provisions.

To accurately *identify the risk,* customs considers in further detail what could happen that may result in incorrect valuation, and how such an event could occur. One such risk is undervaluation due to certain traders deliberately failing to declare the cost of assists (includes materials, tooling, or other costs provided by an importer to a foreign producer). Customs then *analyzes the risk* by determining the *likelihood* of it occurring and *the consequence* if it was to occur. Its next step is to *evaluate the risk* by determining whether it is an acceptable risk—that is, does customs need to do anything about it? (Some prefer to use the term *risk assessment* in lieu of *risk evaluation.* Others use the term *risk assessment* to describe the combined process of *risk analysis* and *risk evaluation.*)

Customs decides to *treat the risk,* and determines that the best way is to *target* shipments that are likely to include undeclared assists. Based on its research, customs identifies a number of criteria or *risk indicators* (for example, type of goods, supplier, consignee, origin) that, collectively, are likely to indicate a potential nondeclaration of assists. When combined, these indicators represent a *risk profile* that customs uses to select suspected *high-risk* consignments. Such *selectivity* ensures that *low-risk* consignments are facilitated.

Source: Author.

other consignments (that is, low-risk shipments) were available for delivery on arrival.

Administrations that have adopted a risk-based approach to compliance management, regardless of whether their systems are automated, are also selective in their use of the broad range of controls that are available to them. In being selective, they recognize that individual members of the trading community present customs with varying levels of risk in terms of potential noncompliance with relevant laws. For example, traders with a good record of compliance are unlikely to require the same level of scrutiny as those with a history of poor compliance. Consequently, if a trader is judged to be relatively low risk, customs may reduce its level of regulatory scrutiny and place greater reliance on the company's self-assessment of compliance.[1] This particularly effective strategy is a commonly used method of recognition, and forms the right half of the peak of the Compliance Management Pyramid.

Risk-based compliance management results in a situation where low-risk traders are permitted to operate under less onerous regulatory requirements and may anticipate little in the way of customs intervention, and therefore receive relatively high levels of trade facilitation. Transactions of high-risk traders, however, are more likely to be selected for higher levels of customs intervention and control. Customs intervention for high-risk traders may include documentary checks or physical examinations at the time of importation or exportation, higher levels of audit activity, physical controls at manufacturing premises, and relatively high security bonds. In all cases, however, the level and type of intervention should be based on the level of identified risk.

Risk Management: An Example

Sometimes confusion arises over the terms used to describe the management of risk, and often terms are used interchangeably. The simple scenario in box 5.1 of a country that recently accepted the WTO obligation on valuation is designed to clarify the more common terms.

Conclusion

Effective risk management is central to modern customs operations, and provides the means to achieve an appropriate balance between trade facilitation

1. Allowing low-risk traders to self-assess their revenue liability does not imply that no customs checks will be made. It does, however, imply that a decision to clear the goods will generally be made on the basis of the traders' own assessment of their liability or entitlement.

and regulatory control. The principles of risk management can be applied by all administrations, regardless of whether they operate manual or automated systems, if they adopt strategies that incorporate the key elements of a risk-based approach to compliance management.

To manage risk effectively, administrations must gain a clear understanding of the nature of risks to the achievement of their objectives and devise practical methods of mitigating those risks. Finally, there needs to be a demonstrated commitment from the highest level of the organization to support the transition to a risk-based approach to compliance management.

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