

**For information on
3 January 2003**

**Paper for Bills Committee on the
Dutiable Commodities (Amendment) Bill 2002
Matters arising from the Bills Committee meeting
on 18 December 2002**

PURPOSE

This paper provides the Administration's response to the questions raised by Members at the meeting of the Bills Committee on the Dutiable Commodities (Amendment) Bill held on 18 December 2002. It addresses questions on the implementation of the Open Bond System (OBS) as well as certain legal and drafting issues relating to the Bill.

(A) IMPLEMENTATION OF THE OBS

Inspection, audit, record-keeping and risk management under OBS

2. Members have requested supplementary information on the new control mechanism and the use of risk management under the OBS. A paper setting out the detailed arrangements about inspection, audit, record-keeping and risk management under the OBS prepared by the Customs and Excise Department (C&ED) is provided at the **Annex**. The new arrangements/requirements will help to ensure compliance by warehouse operators and minimise the risk of duty evasion.

Validity of OBS licence

3. It has been suggested that the validity of an OBS licence should be extended to beyond the current proposal of one year. As explained at the Bills Committee meeting, we consider it prudent in the initial stages of full implementation of the OBS to maintain the practice of renewing a warehouse licence on an annual basis. The reasons are set out below.

4. Currently, all licenses for bonded warehouses are valid for one year. The C&ED reviews the licensing status and conditions in the annual licence renewal exercise. After implementation of the OBS, C&ED will, in renewing licence, review the financial status and fitness and propriety of the warehouse operator, and the sufficiency and appropriateness of the books of account, systems, procedures and standards in accordance with the proposed section 8A in clause 3 of the Bill. C&ED will also conduct an annual comprehensive audit on the warehouse records. The review and audit help C&ED to identify any revenue fraud and high-risk areas for revenue loss. Where necessary, C&ED will tighten its control over individual warehouses by imposing revised licence conditions. For example, C&ED may require a warehouse operator to submit returns on the movement and stock of dutiable goods more frequently, e.g. on a weekly basis instead of monthly for auditing. C&ED may also take enforcement action or revoke a warehouse licence in accordance with the Dutiable Commodities Ordinance as appropriate.

5. While conducting licence renewal on a less frequent basis will reduce the workload for both the traders and C&ED, we consider it important that under the OBS, a sound risk-based management system is in place to enable C&ED to effectively identify risks and revenue fraud in a timely manner, and take proactive measures to minimise the risk of revenue loss. The annual licensing arrangement is one important element of the risk-management system. We therefore consider it appropriate to maintain the validity of a warehouse licence at one year, especially for the initial stages of implementation of the OBS. We may review the need for an annual licence in the context of a review to be conducted on OBS after its full implementation. In order for the annual licensing requirement to be implemented as efficiently as possible, C&ED will keep the requirement for information from warehouse operators to the minimum.

Record keeping requirement on warehouse operators under new regulation 98A

6. It has been suggested that the Administration should consider

whether the proposed requirement for warehouse operators to keep records for two years (under the new regulation 98A) is adequate in providing a sufficient audit trail of records.

7. Under the new OBS, C&ED will carry out comprehensive audit checks on warehouses and the checks will be conducted at least once a year for each individual warehouse. In these periodic audit checks, C&ED will examine the full range of documents required under the Ordinance to be kept by the warehouse operator. A two-year record-keeping requirement will allow C&ED to examine the documents at least in two consecutive annual audit checks. We consider that this will be sufficient for auditing purpose. We do not propose a longer record-keeping period in order to minimise the compliance cost on warehouse operators. That said, C&ED will keep in view the scope for adjusting the record-keeping period in the light of operational experience gained after the full implementation of the OBS.

Submission of application/renewal for OBS licence in electronic form

8. It has been suggested that the Administration should consider accepting applications/renewal for OBS licence submitted in electronic forms.

9. Under our proposed arrangements, record kept in electronic form by traders/operators are acceptable in addition to printed forms. Traders/operators may also apply for dutiable commodities permits through electronic means (Electronic Data Interchange system). C&ED has expanded its IT capability to cater for these arrangements. We have not proposed to accept licence applications via electronic means because this is not very practicable.

10. After the full implementation of the OBS, the information to be submitted by applicants for new licence or renewal will become more comprehensive. C&ED will require information on the financial status of the applicant, the books of account, and systems, procedures and standards in respect of inventory control, record-keeping and security. The information may include a certified copy of the plans of the bonded warehouses, insurance documents, tenancy agreement, audited financial

statements, etc. We expect such information to come in different printed forms, which may not be readily transmissible through electronic means. C&ED will need to discuss with traders the electronic formats and systems involved, making sure that those of the traders and C&ED will complement each other and that electronic submission is after all feasible and secure.

11. As we undertook at the last Bills Committee meeting, we will give further consideration to the feasibility of allowing applicants and licensees to submit applications in electronic form in the context of the review to be conducted after the full implementation of the OBS.

(B) LEGAL AND DRAFTING ISSUES RELATING TO THE BILL

Background to section 8A

12. The Administration commissioned a consultancy study in 1999 on the feasibility of extending the OBS to all bonded warehouses in Hong Kong, taking into account overseas experience and practices. In the context of that consultancy, we learnt that the international practice is to set eligibility criteria for warehouse licensees at a higher level under OBS than under the closed bond system (CBS) due to the relatively higher level of self-assessment associated with OBS. Other jurisdictions have commonly imposed requirements for licensees and those involved in warehouse management and control to be fit and proper and to have appropriate financial status. They have physical security requirements. They also require the books of account and record-keeping and inventory control systems to provide an adequate audit trail of all goods.

13. We have therefore reflected the above requirements of other OBS jurisdictions in our proposed section 8A, with particular reference made to the relevant section of the Customs Act 1901 of Australia, as the Australian OBS has been identified by the consultant as having particular relevance to Hong Kong because of the similar principal commodities and control systems of the two places.

14. The C&ED has consulted the warehouse operators in Hong Kong

on the tightened eligibility criteria and the information required for supporting their applications for licences which would be necessary under the OBS. The operators consider the requirements to be reasonable and do not envisage any difficulty with compliance in general.

Clauses 5 & 6

15. In discussing clauses 5 and 6 of the Bill at the last Bills Committee meeting, a number of legal and drafting issues on the existing compounding arrangements were raised. As suggested by the Chairman of the Bills Committee, the Administration undertook to follow up on these issues with the ALA outside the Bills Committee meeting.

16. The Administration met with the ALA on 23 December 2002 to discuss the operation of the existing sections 17, 34A, 47A and Schedule 3 as well as their inter-relationship. These are set out in detail below.

17. Section 17(1) provides that no person shall, inter alia, possess goods to which the Ordinance applies except in accordance with the provisions of the Ordinance or unless he has discharged all the obligations with respect to the goods imposed upon him by or under the Ordinance. Section 17(2) provides that no person shall have in his possession, custody or control any goods knowing that in respect of the goods an offence against the Ordinance has been committed. Section 17(6) requires that no person shall have any dutiable goods in his possession, custody or control unless he is holding a removal or export permit for the goods and personally conveying the goods under the circumstances prescribed therein; or he is the licensee of a general bonded warehouse personally conveying the goods under the circumstances prescribed therein; or if the goods are under one of the five circumstances specified in that provision. It should be noted that section 17 may be applied to a variety of cases, for example, a person entering Hong Kong who fails to comply with section 34A (see below) and in possession of dutiable goods, or a person possessing in Hong Kong cigarettes or hydrocarbon oils where the duties thereof have not been discharged.

18. Section 34A provides for the declaration requirements in relation

to the dutiable goods carried by persons entering Hong Kong. That section covers two scenarios. The first scenario is provided for in section 34A(1). It is in relation to a person entering Hong Kong at an “entry point”, e.g. Lo Wu or the Airport, where C&ED officers are permanently stationed to carry out their duties. People entering Hong Kong shall declare to those officers any goods carried by them that are in excess of the duty-free quantities. The second scenario is provided for in section 34A(2). It is in relation to a person entering Hong Kong at a place other than an “entry point”. This may include the case where passengers on board a vessel berthing at a place within Hong Kong territories entering Hong Kong without passing through a customs “entry point”. An example is where passengers of ocean liners use the Ocean Terminal as the point of disembarkation. C&ED officers in uniform may randomly board any ships for customs clearance. People who are questioned by C&ED officers shall reply when asked whether or not the quantity of the goods they possess are in excess of the duty-free quantities allowed.

19. We need different declaration requirements for the different customs clearance arrangements at entry points and places other than entry points. The requirement under section 34A(1) is based on the fact that passengers can easily locate the whereabouts of C&ED officers when they are entering Hong Kong at the “entry points”, and hence they are expected to take the initiative to declare to C&ED officers the goods they possess in excess of the prescribed quantities.

20. The requirement under section 34A(2) is, on the other hand, based on the fact that ships do not necessarily berth at designated places for customs clearance and that due to practical reasons, C&ED officers in uniform may only randomly board the ships. In other words, not every passenger may come across C&ED officers to whom they may make declarations. Due to this practical reason, section 34A(2) requires that passengers entering Hong Kong shall declare only when asked by C&ED officers. They are required to make a declaration on whether or not the goods they possess are in excess of the duty-free quantities allowed. Without this requirement, it would be very difficult for C&ED officers to know whether a passenger who remain silent was refusing to comply with the declaration requirement or did not have goods in excess of the

quantities allowed.

21. Section 47A and Schedule 3 are related to the “compounding scheme” under the Ordinance where the Commissioner of C&E (CCE) may choose to impose an administrative monetary penalty on offenders of minor offences contained in Schedule 3 to the Ordinance in lieu of prosecuting them in court. The rationale of the scheme is to allow speedy disposal of minor cases so as to reduce the administrative work of C&ED and relieve the Judiciary from the workload of trying these minor cases. Section 47A provides the authority for CCE to compound an offence. Section 47A(3)(a) provides that on acceptance of the compounding penalty, further proceedings on the relevant offence shall not be taken against the person. The Section states that only the offences contained in Schedule 3 to the Ordinance may be compounded by CCE. Schedule 3 provides that the offences for the failure to comply with sections 17(1), (2) and (6) and section 34A(1) and (2) may be compounded. With respect to section 17, since this provision has a general application to the possession of the relevant goods otherwise than in compliance with the requirements of the Ordinance (see paragraph 17 above), it is necessary to prescribe in Schedule 3 the “specific circumstances” under which the offence may be compounded, otherwise, other circumstances under which section 17 may be contravened may also become compoundable. This is not the policy intention. The circumstances under which a section 17 possession offence may be compounded are that the dutiable goods: -

- (a) must be carried by the offender at an entry point or on board any ship, vehicle, train or aircraft arriving in Hong Kong boarded by a C&ED officer;
- (b) the offender fails to declare or makes an incomplete declaration;
and
- (c) the duty value of the goods does not exceed \$10,000.

A section 34A offence may be compounded under the circumstances already specified in section 34A itself.

22. Section 47A further provides that as CCE has accepted from a person payment of the money listed in Column 4 of Schedule 3 in satisfaction of the duty and the balance as a penalty for an offence compounded by CCE, CCE shall release the dutiable goods seized in connection with the offence and that no further proceedings on the offence shall be taken against the person or the goods.

23. Possession (i.e. sections 17(1), (2) and (6)) and failure to declare / misdeclaration of goods (section 34A) in excess of the duty-free quantities allowed are different criminal acts. They are provided for as separate offences with different penalties in the existing Ordinance. They could not be combined as one offence for the purpose of the compounding scheme since there may be circumstances where only one of them is committed.

Whether duty-free quantities allowed are prescribed by means of subsidiary legislation

24. As it is stated in regulation 12(1A) that a notice on the allowed duty-free quantities published in the Gazette by CCE under regulation 12(1)(e) or (ea)(ii) is a subsidiary legislation, and given the context of the Ordinance, it is sufficiently clear that the duty-free quantities referred in section 34A are prescribed by means of subsidiary legislation.

Conclusion

25. Having heard the Administration's explanation on the policy intention as regards sections 17, 34A, 47A and Schedule 3 of the Ordinance and having considered the Committee Stage amendment that we have proposed in paragraph 15 of our letter of 28 February 2002 on clause 6(b) of the Bill, the ALA raised no further queries on the legal and drafting aspects of these provisions.

**Financial Services and the Treasury Bureau/
Customs and Excise Department
December 2002**

**Supplementary Information to the Bills Committee on
the Dutiable Commodities (Amendment) Bill 2002**

**Inspection, Audit, Record-keeping and Risk Management
under the Open Bond System**

INTRODUCTION

This paper provides further information on the new control mechanism and the use of risk management under Open Bond System (OBS) by the Customs and Excise Department (C&ED) in the protection of government revenue on dutiable commodities.

2. Currently, there are 44 warehouses licensed for the storage of dutiable liquor and tobacco. They are operating under the Closed Bond System where Customs officers are stationed to supervise all movement/processing of dutiable goods. There are also nine warehouses licensed for the storage of dutiable hydrocarbon oil and locally manufactured beer. In view of their well-established internal auditing and inventory control systems, these nine warehouses are allowed to operate under OBS where no Customs officer is stationed. Subject to passage of the Dutiable Commodities (Amendment) Bill 2002 (“the Bill”) by LegCo, OBS will be extended to all warehouses for storing dutiable goods.

CONTROL MECHANISM UNDER OBS

3. Under the OBS, no Customs officer will be stationed at the warehouses for the supervision of movement/processing of dutiable goods. Through the application of risk management, C&ED will adopt a three-pronged control strategy on these warehouses, namely:-

- (a) tightening of licensing requirements;
- (b) comprehensive Customs audit and compliance checks; and
- (c) other control measures.

The concept of risk management is to deploy more resources to control areas of high risk while maintaining general control on areas of low risk.

4. Specifically, with the tightened licensing requirement, C&ED will prevent traders who would bring high risk of revenue loss from acting as warehouse operators. C&ED will also be able to impose different licensing conditions on warehouse licensees in accordance with their risk levels. C&ED will next consider the physical security, books and record-keeping systems of the warehouses, and the results of the previous comprehensive audit and compliance checks in developing an audit plan. The audit plan will facilitate C&ED's risk-based monitoring and enforcement over individual warehouse. Finally, the other control measures, including permit control, customs attendance on vanning and devanning, storage requirements, record-keeping requirements and periodic review on risk indicators, will complement the licensing requirement and audit and compliance checks in minimizing the risk of revenue loss under the OBS.

5. In devising the control mechanism under OBS for Hong Kong, C&ED and the consultant commissioned by C&ED in 1999 have made reference to the experiences of overseas Customs administrations where OBS has been successfully adopted, including Australia, Canada, New Zealand, Singapore, UK and USA.

Tightening of Licensing Requirements

6. As a safeguard to protecting government revenue, C&ED will impose strict requirements on applicants when granting licences. Factors to be considered will include:-

- (a) the financial status of the applicant;
- (b) the suitability of the documents that the applicant proposes to keep for C&ED's auditing, the systems and procedures in respect of inventory control, record-keeping and security of the warehouse; and
- (c) the fitness and propriety of the applicant and the responsible personnel.

7. In considering the financial status of the applicant, C&ED will ascertain whether the applicant can operate the warehouse with sufficient financial backup or by nature of his current business as a going-concern. Documents including the profit and loss account, balance sheet and bank statements of the applicants will be examined.

8. C&ED will consider whether the documents kept by the applicant will facilitate C&ED's auditing work. C&ED will also consider whether the inventory control, record-keeping and security procedures are maintained at a satisfactory level so that no unaccountable loss or mishandling of dutiable commodities will occur.

9. C&ED will give due consideration to any conviction and bankruptcy record of the applicant/responsible personnel when considering whether a person is a "fit and proper" person. Conviction on fraud and corruption offences will likely disqualify the applicant to be a "fit and proper" person.

Comprehensive Customs audit and compliance checks

10. The Bill will allow C&ED to adopt the System-based Approach (SBA) in auditing the systems and records of the warehouses. The objective of SBA is to obtain a high level assurance on the integrity of the information supplied to Customs through in-depth evaluation of the warehouse records, practices, processes and systems. This, in turn, will enable Customs to obtain a high level assurance on the warehouse's compliance with the legislative requirements.

11. Under OBS, C&ED will conduct a comprehensive audit on individual warehouse systematically on an annual basis. Customs officers will first perform the audit planning to assess the level of reliance to be placed on the internal control systems and operational procedures adopted by the warehouse. The warehouse business will also be analyzed through comparison with its past performance as well as that of other warehouses to identify anomalies.

12. Detailed audit procedures are then formulated for individual warehouse based on the result of the audit planning. In conducting audit checks, more emphasis will be placed on areas of high risk, e.g. records vulnerable to manipulation. Audit checks will include testing on the warehouse's internal control systems and examination of the warehouse records by cross-checking with source documents such as payment records, invoices and confirmation by third parties.

13. In view of the professionalism required in Customs audit, two accounting professionals have been recruited. They will formulate the audit planning, give professional advice on audit issues and provide training to Customs officers on relevant audit techniques.

14. To supplement the audit check, Customs officers will also conduct surprise compliance checks at least once a month on each of the warehouses. During the surprise check, Customs officers will examine documents against physical stocks on selected items. They will also inspect all facilities and records of the warehouses to identify irregularities.

15. On selection of items for checks, Customs officers will pay special attention to key items such as goods that attract high duty potential, goods of popular brands and goods pending destruction and export on which duty-exemption will be granted. Descriptions and packing of the dutiable goods will also be examined on selected stock items to detect possible substitution of goods.

16. More frequent compliance checks will be conducted for new warehouses and those with unsatisfactory results in previous compliance checks. The results of the compliance checks will also be used as an important basis for risk assessment during audit planning.

17. If an offence involving revenue fraud is discovered during the course of a check, C&ED will promptly conduct a detailed study on the internal control and operating systems of that warehouse. Appropriate enforcement action will be taken in accordance with the Dutiable Commodities Ordinance. Where necessary, additional licence conditions will be imposed to strengthen the control on the warehouse. The licence of the warehouse can also be revoked in a serious case of non-compliance with licence conditions.

Other Control Measures

18. Other control measures will also be in place to ensure a tight encirclement of Customs controls over the warehouses under the OBS.

Permit control

19. Currently, a comprehensive permit system is in place to control the movement of dutiable goods from importation until duty payment or exportation, including all movement into/out of warehouses. The same control will continue to apply under the OBS.

20. C&ED has also enhanced its computer database to monitor the issuance of all permits and inventory positions of the warehouses.

Customs attendance on vanning/devanning operations

21. Vanning/devanning operations are the processes of loading/unloading of dutiable goods into/from containers. The purpose of Customs attendance on such operations is to ensure the particulars of the dutiable goods in the containers tally with that declared on the related permits to prevent duty evasion on under-declaration of imports, over-declaration of exports or false report of damage and shortage of dutiable goods.

22. Under OBS, Customs officers will attend the vanning/devanning operations on a selective basis and without giving prior notifications to the traders. In selecting such operations for Customs attendance, C&ED will use sophisticated sampling techniques and give due regard to high risk traders.

Other administrative controls

23. To further reduce possible revenue risk, C&ED will require permit holders to submit landing certificates after export shipments have reached destinations and documentary cross-checking on shortages and breakage of dutiable goods on import shipments to ensure that dutiable goods are not diverted to local consumption without duty payment.

Storage requirements

24. Under OBS, C&ED will tighten the storage requirements by spelling out in the Dutiable Commodities Ordinance the manner of storage in order to reduce possible risk of revenue loss caused by poor storage controls. Except with written permission from C&ED, the warehouse licensees should:-

- (a) not alter the packaging in which the goods were first entered;
- (b) arrange the goods in a tidy manner to ensure safe and easy access to and from the goods; and
- (c) mark all packaging legibly and uniquely so that the goods can be easily identified by reference to the stock account or record.

25. These enhanced storage requirements are essential for the warehouse licensee to maintain proper inventory control and for Customs checks to be conducted in a speedy and effective manner. The Bill will also require warehouse licensees to promptly produce any goods stored in a warehouse for C&ED's inspection when required.

Record-keeping requirements

26. The current legislation requires the warehouse licensees to maintain and produce documents which have a bearing on the quantity, origin, value and nature of the dutiable goods. It also requires stock accounts that record all movements into and out of the warehouses to be kept and produced. Periodic warehouse returns on the stock positions of the warehouses are required. C&ED vets the returns to detect irregularity. The same requirements will be retained under OBS. To enable a full audit check to be performed, we have proposed in the Bill to expand the list of information required to be kept and produced to include all the movement and payment records, balance sheets and audit reports.

Periodic Review on Risk Indicators

27. C&ED will conduct periodic reviews on the risk indicators, e.g. trend on duty collection on a commodity or by individual warehouse, claims of shortages and breakages on import shipments, movement statistics of warehouses and the black market situations, etc. The performance statistics under Closed Bond System will also be used as the yardsticks for comparison. When there is an unusual trend on a risk indicator indicating possible revenue loss, C&ED will take immediate investigative actions, e.g. surveillance, surprise checks, search, etc. The periodic reviews will act as a whistle-blowing system in monitoring the performance of OBS and C&ED will maintain versatile control measures over warehouses, with flexible and immediate adjustments when required.

CONCLUSION

28. The above comprehensive control mechanism has reflected the recommendations of the consultant and the experience of other advanced economies operating OBS. With the comprehensive control mechanism in place, C&ED is confident that the possible risk of revenue loss under the OBS can be kept at a manageable level. In effect, C&ED will be taking a more pro-active and modernized risk management approach under OBS, which provides an equally effective control on warehouses in protecting government revenue on dutiable commodities.

29. Nevertheless, C&ED will make sure that any problems and necessary improvements will be identified in the initial stages of full implementation of the OBS. ICAC will conduct a review three months after the implementation of the new system. C&ED will also conduct two reviews, the first one taking place three months after the implementation of the new system, while the second one taking place three months after the implementation of any improvement measures suggested in the first review.

**Customs and Excise Department
December 2002**