

For information

Legislative Council Panel on Commerce and Industry

Open Bond System Follow-up issues on the Dutiable Commodities (Amendment) Bill 2002

Purpose

This paper serves to inform Members of the operation of the Open Bond System (OBS)¹ and report the result of a review by the Administration on three issues raised by Members for the Bills Committee of the Dutiable Commodities (Amendment) Bill 2002.

Background

2. The Bill introduced amendments to the Dutiable Commodities Ordinance (DCO) to implement OBS for bonded warehouses storing dutiable tobacco and liquors. The Bill was passed by the Legislative Council on 26 February 2003.

3. In response to Members' suggestions at the Bills Committee, the Administration has examined the following issues in the context of a review on OBS conducted after its full implementation in January 2004:-

- (a) whether the validity of OBS warehouse licences should be extended to beyond one year;
- (b) whether the Administration should allow applications or renewals for OBS warehouse licences to be submitted by electronic means; and

¹ Customs control over bonded warehouses under the Open Bond System is exercised by means of comprehensive annual audits and surprise compliance checks instead of physical supervision through full-time attendance at bonded warehouses by Customs officers.

- (c) whether it is necessary to extend the 2-year record-keeping period in the light of the operational experience on implementing OBS.

Operation of OBS

4. OBS is a trade facilitation initiative. In the first year after full implementation in January 2004, OBS warehouse operators and traders saved a total of \$71 million² as a result of the withdrawal of Customs attendance from bonded warehouses. Meanwhile, the Customs and Excise Department (C&ED) has saved around \$78 million of staff cost a year because of the downsized enforcement organization pursuant to a more risk-based regulatory mechanism.

5. After the implementation of OBS, C&ED and the Independent Commission Against Corruption (ICAC) conducted separate reviews on the new operations. The ICAC reviews concluded that there were reasonable safeguards in place to prevent abuse. ICAC commented in its review report that “while the operators of OBS warehouses are subject to stringent licensing conditions, special conditions are imposed on the dutiable commodities permits to abate the risk of abuse. The permits and related records are processed through a dedicated computer system – the Customs Control System – which facilitates the enforcement of the permit conditions, e.g. to detect non-compliance with individual requirements”.

6. C&ED’s internal reviews also concluded that the control system in force was considered highly efficient and effective. Between April 2003 and March 2005, C&ED conducted annual audits and 1,779 surprise compliance checks on all the bonded warehouses. No revenue fraud case under OBS was discovered.

7. There was no anomaly in the revenue collected from tobacco and liquors before and after the implementation of OBS³.

² In 2004, total Customs attendance fees amounted to \$342,660 whereas the fees collected in 2002 were \$71,765,646, representing a decrease of \$71,422,986. The figures in 2003 are not quoted for comparison because a transitional period was involved in 2003 when some bonded warehouses were controlled under OBS whereas others had full-time Customs attendance.

³ Total duty collected from tobacco and liquors in 2002, 2003 and 2004 were \$3,027.7 million, \$3,012.6 million and \$3,106.8 million respectively.

8. In an opinion survey conducted in February 2004, most bonded warehouse operators agreed that OBS had achieved its objectives of reducing their compliance cost, enhancing their operational flexibility and facilitating the trade and business of Hong Kong.

9. C&ED will review the effectiveness of OBS as an on-going effort and introduce further safeguards where necessary to prevent revenue frauds.

Review on specific issues

(a) Extending the validity of OBS warehouse licences to beyond one year

10. When the Bill seeking to implement OBS was deliberated by the Bills Committee, there was a suggestion that consideration should be given to extending the validity of an OBS warehouse licence to beyond one year.

11. Section 7(1)(a) of DCO states that the validity of a licence is one year.

12. The annual licence renewal arrangement allows C&ED to review the financial status, fitness and propriety of the licensees, and the sufficiency and appropriateness of the books of accounts, systems, procedures and standards in accordance with DCO. It provides a timely opportunity for C&ED to identify risks of revenue loss and take preventive measures to minimize the risks. These preventive measures include revising licence conditions and changing the amount of the security in cash or bonds. When the situation warrants, C&ED may consider taking enforcement actions or not renewing the licence.

13. While conducting licence renewal on a less frequent basis will reduce the workload for both bonded warehouse operators and C&ED, the Administration considers it important that under OBS, a sound risk-based management system should be in place so as to enable C&ED to detect risks and revenue fraud efficiently and effectively. Licence conditions are imposed at the time of granting or renewing of the licence. Extension of the validity period to beyond one year would make it difficult for C&ED to identify problems and change the licence conditions in warranted cases

expeditiously.

14. In a renewal case in March 2005, a bonded warehouse licensee's deteriorating financial status was exposed in its latest annual audited financial statements submitted during the licence renewal application. Renewal of the licence was approved after sufficient additional financial guarantee was produced to C&ED. This is a case in point demonstrating the need to maintain the arrangement for renewals of OBS warehouse licences on an annual basis.

15. C&ED strives to assist the trade by lowering its compliance cost under OBS. In the renewal of a licence, most of the documents required for the initial application are not required except the Business Registration Certificate, which is renewed annually, and financial records for assessment of the applicant's recent financial status.

16. The annual audit checks can reveal the level of compliance by the bonded warehouse operators and provide timely information for consideration of renewals of OBS warehouse licences. An extension of the licence renewal interval would inevitably impair the risk assessment capability of C&ED under OBS.

17. In the annual licence renewal exercises conducted in March 2004 and March 2005, all bonded warehouse operators stated that they were satisfied with the present annual renewal arrangement. No suggestion for extending the licence validity period was received.

18. The Administration therefore maintains its view that there is no compelling reason to extend the validity of an OBS warehouse licence to beyond one year.

(b) Submission of applications or renewals for OBS warehouse licences by electronic means

19. There was also a suggestion at the Bills Committee that consideration should be given to allowing submission of applications and renewals for OBS warehouse licences in electronic form.

20. Regulation 22(2) of the Dutiable Commodities Regulations (DCR) states that licence applications should be made in paper form.

21. In applying for a new OBS warehouse licence, the trader is required to submit a completed licence application form together with supporting documents to C&ED. The supporting documents include the Business Registration Certificate, tenancy agreement, layout plan of the premises, audited financial statements, management accounts, bank statements, operational manuals on inventory control system, record-keeping system and security measures, etc.

22. To apply for a renewal for an OBS warehouse licence, the licensee is generally required to submit its valid Business Registration Certificate and its latest annual audited financial statements for assessment of its recent financial status, provided that there has been no change in its internal control systems or structure of the bonded warehouse.

23. In the light of the experience gained since April 2003, C&ED considers that supporting documents such as the licensee's annual audited financial statements are essential for C&ED to assess the level of revenue risk for first-time applicants and licensees seeking renewals alike. Such documents must be supplied in their original form duly signed by an auditor in order to ensure their authenticity. Electronic transmission of these documents without the actual signature of the auditor will not be accepted for processing by C&ED.

24. Submission of applications or renewals for OBS warehouse licences by electronic means is not only a technical difficulty and a security concern for many traders, but will also incur additional cost to both the Administration and the traders.

25. In April 2005, C&ED conducted a questionnaire survey with OBS warehouse operators on the electronic submission of applications or renewals. 71 out of the total 85 OBS warehouse operators responded. Among the 71 respondents, 47 (66%) stated that they would not choose the electronic submission as they were satisfied with the existing paper mode application. The remaining 24 (34%) considered the electronic transmission as an optional means of furnishing licence applications. 44 respondents (62%)

were anxious about the security issues especially when personal data and sensitive company information were sent through the Internet.

26. 26 bonded warehouse operators (36%) had no compatible computer equipment and accessories for the electronic submission and 20 of the 26 operators did not intend to procure such equipment. 44 respondents (62%) would refuse to pay any additional fee arising from the electronic application.

27. In view of the trade responses, the Administration does not see an urgent need to adopt electronic submission of applications or renewals for OBS warehouse licences.

(c) Extending the record-keeping period

28. There was a suggestion at the Bills Committee that in order to allow C&ED to have an adequate and sufficient audit trail of records, consideration should be given to extending the two-year record-keeping period for OBS warehouse licensees to seven years, in line with the requirement in the Companies Ordinance (CO). It was also suggested that if the records were to be retained for seven years, it would help reduce the frequency of comprehensive audits and checks to be conducted by C&ED, and would eventually enhance the effectiveness of the requirement.

29. Under DCR, the following documents are required to be kept for two years -

- (i) the movement of goods into and out of the bonded warehouse, including delivery orders, goods receipt notes, invoices, credit notes, debit notes, bills of lading or air waybills and air consignment notes ; and
- (ii) payments made and received in the course of the business of the bonded warehouse, including ledgers, statements of accounts, profit and loss accounts, balance sheets and auditor's reports.

Under CO, the following documents are required to be kept for seven years

- (i) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place ;
- (ii) all sales and purchases of goods by the company ; and
- (iii) the assets and liabilities of the company.

30. The required documents set out in DCR relate both to the movement of goods and the corresponding payment records. These documents provide an audit trail for the examination of the effectiveness of the inventory control over the dutiable commodities stored in the bonded warehouse and the detection of revenue fraud. The required documents set out in CO relate to the company's accounting aspect, which are necessary for giving a true and fair view of the financial status of the company. Evidently, more documents are required to be kept under DCR.

31. Some overseas jurisdictions require all warehouse documents to be kept for at least five to six years. Such record-keeping requirements may enable Customs to recover revenue over a longer period of time and reduce the frequency of audit checks.

32. There are operational benefits to C&ED for a longer record-keeping period. In fact, there were a few successful cases on recovery of duty detected in the past, which involved transactions occurring over two years before. But requiring a much longer record-keeping period will increase companies' compliance cost.

33. C&ED has completed the first cycle of audit checks on all OBS warehouses in the first year after the implementation of OBS. No revenue fraud or irregularity was detected so far. There are pros and cons for and against extending the record-keeping period. In view of the short experience of C&ED in administering OBS and as there is no imminent need for an extension, we consider it prudent for C&ED to further review the issue after gaining sufficient experience with the audit checks. The Administration undertakes to examine the issue again after two years.

Conclusion

34. OBS has been operating smoothly and C&ED endeavours to manage the risk of revenue loss properly. The issues raised at the Bills Committee have been reviewed thoroughly by the Administration. The Administration submits that there is no need to change the current requirements on an immediate basis, having regard to the trade's response and operational experience. Nonetheless, C&ED will continue to nurture a better operating environment for the trade under OBS and keep in view chances for further improvement.

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