CUSTOMS GOALS OF AUDITS:
What is the government looking for when it does these audits?

The Current Compliance Environment

For most major corporations, import/export requirements remain an arcane area of knowledge, an alternative tax scenario, a potential source of a meddlesome penalty or an occasional delayed shipment. However, late in 1993 the rules changed and importers, who had previously relied on their brokers/forwarders or traffic managers to oversee their customs matters, were handed a sobering new mandate. The Customs Modernization Act (“Mod Act”), effective in January of 1994, shifted the full burden of providing accurate information to the U.S. government to the importer and exporter of merchandise crossing U.S. borders. This means that, regardless of what service provider (i.e. customs broker) completed submissions to the Bureau of Customs & Border Protection (“Customs”), all importers would be held liable for incomplete or inaccurate information. And, regardless of the importer’s level of knowledge, deficiencies - perhaps even minor errors or omissions - would count against the importer’s compliance record, potentially generating increased import examinations, delayed shipments, investigations, monetary or criminal penalties.

The Mod Act’s emphasis on importers exercising “reasonable care” resulted in Customs initially conducting significant importer outreach and issuing much guidance to fulfill its responsibilities to provide information (“informed compliance”). But the emphasis has shifted to the importer’s obligation to inform his firm on all import/export matters, and Customs has begun to revert to the less friendly compliance incentive of “enforced compliance,” e.g., civil or criminal penalties, intensified import examination.

In addition to the “reasonable care” standard of the Mod Act, Customs also revised its recordkeeping regulations, which demand that all importers/exporters be able to support and substantiate statements (i.e. entries) or claims (i.e. trade agreements) made with Customs & Border Protection. New penalty provisions were created,
allowing Customs to assess penalties of up to $10,000.00, per transaction, for simple inability to produce a required record as provided for in the Customs Regulations.

Along with the Mod Act, Customs was encouraged by Congress to improve its effectiveness in measuring and improving import compliance. Customs initiated an aggressive program of importer compliance audits, called Compliance Assessments ("CAT"), and began a significant change from screening individual import transactions, independently from port to port, to aggregating corporate transactions and assigning Account Managers to examine corporate trends and analyze compliance. The Compliance Assessment has now become Focused Assessments ("FA"), which concentrates on each area of compliance (classification, valuation, preference programs, quantity, country of origin declaration, etc.). During a FA, Customs will evaluate the company's internal controls (compliance procedures manual) and then will review a small sample (3-20 transactions) for each compliance area to ensure that the controls are being followed and tested. The compliance rating of the sample will determine the importer's risk to the government. Where errors or deficiencies are found, the importer will be required to determine the loss of revenue over the prior five years, which is the statute of limitations, and implement a Compliance Improvement Plan ("CIP").

The most recent compliance enforcement initiative taken by Customs is the Quick Response Audit ("QRA"). The QRA is another form of regulatory review employed by CBP's regulatory audit division. QRAs are single issues audits with a narrow focus designed to address a particular limited objective within a reasonable short period of time (six months or less). QRAs may encompass a single review area of the Focused Assessment process, such as classification, value, preference programs etc. During a QRA, Customs will audit the importer's operations and processes to determine if there is a potential for risk to the government in one of these areas or for a very specific concern, such as assists within the area of valuation. Most QRAs will be initiated based on a referral from someone within Customs such as a Commodity Specialist. It is important to note that, although companies approved for the Importer Self-Assessment Program ("ISA") are exempt from Focused Assessments,
they are not exempt from Quick Response audits. QRAs can be initiated at anytime with little notice. Therefore, it is more important than ever for all importing companies to ensure that they have documented and tested internal controls.

In the same way that we see increased scrutiny of imports to the U.S., we are also seeing increased review of U.S. exports. Due to heightened risks to U.S. security interests, there has been a sharp increase in the oversight and enforcement of U.S. export laws and regulations by all governing agencies, including Customs, Bureau of Industry & Security, Office of Foreign Asset Control and the State Department. These agencies are issuing stiff criminal and administrative penalties to exporters when violations are found.

Limiting liability is a matter of corporate survival. Limited or lack of knowledge and/or organized processes throughout the company can prove to be very costly. The risks are high, but can be mitigated with the proper direction of policies and resources towards developing and maintaining trade compliance programs within the corporation. By actively seeking to assess, formalize and improve internal processes, importers and exporters are taking important steps toward limiting exposure to possible fines and penalties.

This paper will address what the government is looking for when it performs these audits. Specifically, we will address Customs’ goals in assessing the following areas:

- **Reasonable Care Standard**
- Protecting the Revenue, Ensuring Supply Chain Security and Priority Trade Issues
- Implementation of Internal Controls, Policies and Procedures
- Ensuring Qualification for Duty Exemption Programs
- Training of Personnel
- Proper Monitoring of Brokers

**Reasonable Care Standard**

Whether conducting a FA, QRA, NAFTA verification, preference program review or an “old fashioned” audit, Customs’ primary goal is to determine the importer’s exercise of “reasonable care” in providing CBP with
the correct tariff classification and duty rate, value, preferential duty claim and country of origin with respect to their import entries (declarations). “Reasonable Care” is a lawful Customs term, which, if this responsibility is not discharged in the compliance areas previously mentioned, is tantamount to Negligence, at a minimum, for purposes of 19 U.S.C. 1592.

With the advent of electronic processing of imported goods and “paperless” entries, importers were granted expedited releases of their goods in exchange for being on an “honor system”. Customs has adopted the ISO standard of companies implementing sound internal controls for properly declaring their imported products. If an importing firm has sound procedures in place and follows them with every shipment, then it should hold that every transaction will be correct. The purpose of conducting an assessment is to determine whether the company is following and testing their procedures, or exercising “reasonable care”, with their declarations.

Being on an honor system, the importer has received and distributed their goods well before Customs makes any inquiries about a particular shipment or performs an overall compliance assessment of the importing firm. Therefore, the only avenue to test the accuracy of the information is through documentary evidence provided by the importer. Importers are required to keep and maintain records pertaining to their import shipments for five (5) years from the date of entry. Upon Customs’ request for records, they must be able to produce the documentation within thirty (30) days of the request. The official list of records required by Customs is referred to as the (a)(1)(A) list. These records are subject to penalty if they cannot be produced within the time allowed. In addition to these records, importers are also required to produce documents to support their entry declarations such as purchase orders, product specifications, payment and receiving records, as well as contracts or agreements to substantiate the dutiability of commissions, royalties, etc. Having a well established recordkeeping system is part of a company’s exercising of reasonable care.
Protecting the Revenue, Ensuring Supply Chain Security and Priority Trade Issues

The compliance assessment or verification of a preferential duty claim (i.e. preference and free trade agreements, reduced duty claims) will determine the importer’s risk to the government. Customs is charged with protecting the revenue collected from duties, taxes and fees assessed on imported goods. It is imperative that the goods are properly classified with the correct duty rate and the value is correctly calculated. When free or reduced duty claims are made, Customs must determine that the goods qualify under the specific rules of eligibility for each program or agreement. If the claim cannot be substantiated, the claim is removed and regular Normal Trade Relations duties are assessed upon the imported product.

During the assessment process, Customs will also inquire about the relationships and contracts the importer has in place with their suppliers. Aside from compliance concerns, Customs has also been tasked by Congress to work with importers in ensuring the security of their supply chain in regards to possible terrorist acts. Importers can voluntarily participate in the Customs-Trade Partnership Against Terrorism (“C-TPAT”) program, where they assess and improve their supply chain security from manufacturer’s facility to final destination in the United States. There are separate teams within Customs for purposes of validation of this program with the importer. However, during a FA, the regulatory audit team of Customs will inquire as to the importer’s C-TPAT involvement and keep an eye open for any apparent or obvious concerns.

Customs is also concerned with any products that may present a threat to the health and safety of the American people. All significant importers will eventually be audited by Customs in one form or another. It is not a matter of “if”, but a matter of “when”. In addition to traditional importer assessments, Customs prioritizes which trade issues to look at most carefully by using a strategically layered risk management approach based on the potential impact of noncompliance. Customs’ Office of International Trade is tasked to focus resources on seven designated Priority Trade Issues (“PTI”). PTIs are high-risk areas that can cause significant revenue loss,
hurt the U.S. economy, or threaten the health and safety of the American people. These PTIs are reviewed periodically as Customs constantly assesses new risks and how it can best enforce the trade laws of the U.S.

The seven current Priority Trade Issues are described as follows from Customs’ website:

*Agriculture Programs*

The goal of the Agriculture PTI is to prevent the importation of contaminated, diseased, infested, or adulterated agricultural and food products that could harm the American people, plant and animal agricultural resources, or the economy, while facilitating lawful trade.

*Antidumping and Countervailing Duties (AD / CVD)*

When the Department of Commerce finds that imported merchandise was sold in the U.S. at an unfairly low or subsidized price, CBP is responsible for collecting the AD/CV duties timely to level the playing field for U.S. companies injured by these unfair trade practices. The goal of the AD/CVD PTI is to detect and deter circumvention of the AD/CVD law and to liquidate final duties timely and accurately, while facilitating legitimate trade.

*Import Safety*

The priority mission of Customs and Border Protection (CBP) is to prevent terrorists and terrorist weapons from entering the United States while facilitating the flow of legitimate trade and travel. To support this mission, the Import Safety PTI is designed to ensure that unsafe products do not enter the commerce of the United States by working collaboratively and collectively with other government agencies, other foreign governments and the trade to better define and assess risk through increased automation and the sharing of information to encourage greater use of partnership and best practices to protect the U.S. consumer.
Intellectual Property Rights

The Intellectual Property Rights PTI is focused on the use of targeting, training, audits, international cooperation, and other means to stop the importation of counterfeit and pirated goods that harm our economy and threaten the health, safety and security of the American people.

Penalties

The goal of the Penalties PTI is to ensure that penalties are effective in deterring noncompliance. This requires national direction and uniformity among the 326 ports of entry and 41 Fines, Penalties and Forfeitures field offices, as well as the use of appropriate compliance alternatives and a focus on violations involving other Priority Trade Issues.

Revenue

The goal of the Revenue PTI is to ensure that CBP has effective internal controls to protect the duties and taxes (over $32 billion in 2007) it collects for the U.S. Government, and that its financial reports meet the highest accounting standards.

Textiles

The goal of the Textiles PTI is to ensure that textile imports, which generate more than 40% of the duties collected by CBP, fully comply with applicable laws, regulations, quotas, Free Trade Agreement requirements, and Intellectual Property provisions.

Implementation of Internal Controls, Policies and Procedures

Prior to the development and implementation of formal procedures and internal controls, it is strongly suggested that importers undertake an internal compliance assessment of their import program. This internal assessment will evaluate the Customs compliance level of the importer and will assist in the implementation of sound processes. The importer will be able to determine their risks and liabilities in the areas of compliance and will assist them in preparation for a possible Focused Assessment by Customs.
The scope of the review should include all key import compliance areas: Harmonized Tariff Schedule ("HTS") classification, valuation, country of origin determination and marking, preference program eligibility, quantity reconciliation and recordkeeping systems.

One of the best ways for an importer to demonstrate the use of "reasonable care" is through the documentation of their internal policies and procedures. Their compliance manual should be comprehensive in the explanation of the Customs laws and regulations and how they relate to the activities of the importer. In many cases, the development of the manual is the key to the creation of internal processes that were non-existent within the importer’s firm. In fact, the first step in a Focused Assessment by Customs is the importer providing them with their import manual of internal controls and procedures.

Components of the Compliance Manual should include the following:

- Statement of Corporate Policy
- Import: General Information (purpose, organizational)
- Administration (manual updates, reasonable care)
- Communications (internal parties, customs brokers, agents, vendors)
- Import: Preliminary Considerations (Customs bond, importer’s liabilities)
- Classification
- Valuation
- Country of Origin Determination and Marking
- Quantity Discrepancies
- Special Requirements: Free Trade Agreements, Preference Programs, Samples & Prototypes, Trademark and Trade Name Recordation, Wood Packaging Requirements, Other Government Agency (OGA) Requirements
- Antidumping/Countervailing Duties
- Drawback
- Purchasing Foreign Merchandise (detailed description of internal processes from product conception to fulfillment)
• Customs Service Communications (Binding rulings, CF28, CF29, Post Entry Amendments, Liquidation, Protests, Prior Disclosures)
• Recordkeeping
• Training and Reference Materials
• Post-Entry Review; Internal and Customs Audits; ACE; ITRAC Data Requests
• Customs-Trade Partnership Against Terrorism (C-TPAT)
• 10 + 2 Importer Security Filing (ISF)

Testing procedures should be included in each area of compliance for the importer’s internal audit process. Annual reviews of the importer’s procedures should be conducted to evaluate the overall effectiveness of the firm’s Customs Compliance Program including their educational training programs and operating procedures.

During the audit or assessment process, Customs will review the area of compliance concern along with the established and documented procedures the importer has in place. They will determine whether the accuracy of the entry declaration was a result of following the importer’s internal control. They will determine whether any error found is the result of not following the importer’s stated procedures. Customs will require the importer to demonstrate that their procedures are tested (description of testing methodology and frequency) and appropriate corrective actions are taken for any errors found. This is a weighted factor in determining the importer’s compliance rating and risk to the government. If Customs finds that a procedure is not sound or has not been implemented and tested for an adequate period of time, they will require the importer to implement a CIP for the specific compliance area (classification, valuation, origin, etc.). The audit team will return to perform a follow-up assessment of that area and determine whether the CIP was implemented and tested.

Importers should establish corporate policy on the use of documented processes in its government compliance areas. There needs to be demonstrated recognition at the executive levels within the importer’s firm of the importance of compliance and adherence to government regulations. The President or a corporate officer should sign the policy portion of the manual (or a separate policy letter to be included in the manual) and issue a
corporate directive to all personnel that these procedures have been approved by management and are to be adhered to. This action would convey the commitment to compliance from the executive group to both company personnel and to Customs.

**Ensuring Qualification for Duty Exemption Programs**

Preferential and Free Trade Agreements can provide reduced duty and duty-free benefits to importers. Along with these benefits come strict requirements and potential liabilities if not adequately monitored and managed. Each agreement has unique rules of qualification for the eligible products as well as specific documentation requirements. With the passage of the Customs Modernization Act, effective in 1994, the requirement to submit the documentation (certificates, declarations or affidavits) *with the entry documentation* to Customs at the time of entry was eliminated. However, the Customs regulations continue to require that importers have the required documentation in their possession at the time the claim is made (time of entry).

There has been a strong concentration by Customs on preferential duty claims, such as GSP, in recent years. Customs requires that the importer must have internal controls in place to validate claims with the producer or exporter and must be able to demonstrate that the internal controls are periodically tested. Upon request, and usually during a Focused Assessment, the importer must be able to submit source records and documentation from the producer to support the eligibility and claim for the imported goods. The importer bears the responsibility to produce production records, upon request by Customs, for preference claim eligibility. Failure to produce these records can result in duties being assessed as the claim is denied for these products.

Eligibility of products exported under preference programs should be reviewed and substantiated. Importers are urged to perform in-depth product verifications for each program utilized. During their internal audit or post-entry programs, products should be selected for determination of eligibility and recordkeeping requirements. Verification of preferential trade agreement claims are performed by Commodity Specialists on a specific entry or by the regulatory audit team during an assessment.
Free trade agreement claims, such as NAFTA, are performed by a separate audit team within Customs. NAFTA eligibility of products is the responsibility of the exporter of the goods. The exporter is responsible for demonstrating how they determined their products qualify for NAFTA. The importer is responsible for having a duly executed NAFTA Certificate of Origin in their possession at the time the claim is made. The United States, Canada and Mexico all have NAFTA verification teams that will travel to the exporting country to audit the exporter.

The U.S. has entered into free trade agreements with countries outside of North America. For most of these agreements, the importer is responsible for producing the records that evidence the eligibility of the product being imported into the U.S. These countries include Israel, Jordan, Singapore, Chile, Australia, Morocco, Central America (DR-CAFTA), Bahrain, Oman and Peru. Importers should take caution when claiming the free or reduced duty for products involving these agreements. They must ensure that their supplier is willing, upon request and within 30 days, to submit the source production documents, such as bill of material, purchase orders, payment records and inventory records.

**Training of personnel**

As part of its commitment to Customs compliance, importers should establish and will make available a formal training program to ensure that new employees involved in matters pertaining to Customs receive training on import issues and are updated on changes in internal compliance procedures and U.S. Customs laws and regulations.

Such training programs may be instructed by firm personnel or by outside experts. A log should be maintained of those who attend each training program and identifies the topic of the session, the date, and the instructor’s name. During an assessment, Customs will require these logs to establish that proper training occurs within the company.
Maintaining a satisfactory level of compliance requires an ongoing effort to keep current as to changes in the regulations governing importation and exportation. The importer should maintain an appropriate Customs resource library, which will include:

- Customs Regulations (Title 19 C.F.R)
- Harmonized Tariff of the United States (current edition)
- Trade Publications
- Access to Customs’ Website – www.cbp.gov
- Other Agency News Releases
- Seminar Materials
- Computerized Databases (e.g., CD ROMS, Custom Bulletin Board, etc.)
- Other reference materials made available through importer’s customs broker, consultant firm or customs attorney

**Proper Monitoring of Brokers**

Most importers utilize the services of customs brokers to submit import entry documentation to Customs on their behalf and ensure that imported goods are properly declared and cleared.

The customs broker must be in possession of a duly executed Customs Power of Attorney prior to representing an importer as their appointed agent for purposes of conducting customs business. The importer should maintain a list of authorized customs brokers who hold valid Powers of Attorney for their firm. It is the importer’s responsibility to be aware of all customs brokers who are conducting customs business on their behalf. This information is easily available through ACE or through obtaining the importer’s ITRAC data from Customs.

As indicated earlier, Customs holds the importer responsible for the accuracy of the information declared on their import transactions. While the importer may use their broker for assistance with classification and other entry declarations, they remain responsible. It is imperative that the importer and their customs broker(s) communicate on a regular basis regarding their commodities, relationships with suppliers, valuation issues, origin of products and adherence to free and preferential trade agreements being claimed. Procedures should be
established that state how tariff classifications are established (importer or broker assigned) and valuation is calculated. It is important to remember that the customs broker only receives the commercial invoice for the imported goods and there may be other payments made that the broker would be unaware of unless notified by the importer.

The most effective way of monitoring the customs broker is through an aggressive post-entry program. The importer can audit each entry or establish a sampling methodology for audit purposes. At a minimum, the review should entail an audit of the C.F. 7501 (Entry Summary) and will consist of verification that information contained in the entry summary is accurate and substantiated by supporting documentation.

If a trend of entry errors is discovered during the audit process, a root cause analysis should be performed. The findings of the root cause analysis are to be communicated to the customs broker and/or supplier, and corrective actions implemented to avoid further reoccurrences.

During an assessment, Customs will expect the importer to demonstrate how they monitor their entries and the services provided by their customs broker(s).