Report by the
Comptroller and Auditor General

HM Customs and Excise

Improving VAT Assurance

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Executive summary

1 Value Added Tax (VAT) is a self assessed tax that is collected by 1.6 million registered traders who are required to keep adequate records to calculate their VAT liability correctly and to enable the Department to verify their VAT returns. This Report examines the Department's changing approach to assuring VAT receipts from the vast majority of these traders. It does not examine arrangements for assuring receipts from around 1,800 large traders who, together, contributed £12.1 billion in 1998-99 and are subject to enhanced systems of control. We reported on these arrangements in our Report: "Checking Large Traders' VAT Liability" (HC368 1996-97) in March 1997.

2 Through the targeting and conduct of their work the Department seek to maximise their direct impact by identifying trader errors and their indirect impact - both preventive and deterrent - by encouraging trader compliance with VAT regulations. Their approach is based on risk analysis, making use of information and intelligence, and traders' past performance. Risk analysis has been used for the selection of VAT traders for assurance audits since the early 1980s. Over time, the analysis has become more comprehensive and more reliable. Currently the whole of the trader population is subject to a twice a year risk assessment, which examines 29 different data items including, turnover, trade classification and visit related information. The Department's methodology is being considered for adoption by a number of other countries and has been benchmarked in co-operation with the Australian Tax Office (**paragraph 1.4**).

3 In 1994-95, a review of the Department's main business activities, including VAT, suggested that, by shifting the emphasis of assurance effort towards higher risk traders, the Department could save over 700 staff years by March 1996 whilst maintaining revenue receipts and trader compliance at existing levels. The review further suggested that by improving their assurance support arrangements, including trader education, and their risk assessment methodologies the Department could save a further 1,100 staff years by 1998-99. Building on these proposals, the Department initiated the Revised Assurance Process project in June 1995. Subsequently, under the "Spend to Save" initiative, announced by the then Chancellor of the Exchequer in November 1996, the 1,100 staff were retained in the expectation that, by using revised working practices, they would generate £1,470 million in additional revenue by 31 March 2000 (**paragraph 1.5 to 1.7**).

4 During the period from 1992-93 to 1998-99:

- VAT receipts from the general trader population increased from £14.9 billion, 35 per cent of total VAT receipts, to £29.6 billion in 1998-99, 57 per cent of total VAT receipts;

- the registered trader population remained at about 1.6 million traders;

- VAT assurance staff numbers increased from 4,548 to a peak of 5,013 in 1994-95 before declining to 4,179 in 1998-99;

- the number of audits undertaken by these staff each year fell by around 50 per cent from 350,000 to 180,000; while

- the net additional revenue generated by these audits increased by 15.1 per cent from £862 million to £992 million, at 1998-99 prices.

In all years but one the impact of the increase in average revenue per audit has been greater than the impact of the reduction in the number of audits. Over the whole period, the increase in the average revenue per audit has more than recovered the decline due to the reduction in audits undertaken (**paragraphs 1.12 to 1.15**).

5 In 1996, the Department estimated that the direct benefit of revising their approach to trader audits and maintaining staff at existing levels would be to increase additional revenue from trader audits by a further £210 million in both 1998-99 and 1999-2000. In 1998-99, the figures reported to the Department's Board showed that they exceeded this additional revenue target by some £5 million. (**paragraph 1.16**).

6 To maximise the results of their assurance programme, the Department need to ensure that the revised working methods are introduced successfully at all local offices, that there is a continuing shift towards higher risk traders in the mix of audits undertaken, and that effective use is maintained of officers engaged on assurance work. Against this background, we investigated the Department's performance in auditing the general trader population, including the management of the changes to working practices (**paragraphs 1.23 and 1.24**). Our examination considered:

- the focusing of audit resources, including the efficiency of staff utilisation; and
- the selection and auditing of individual traders.

Focusing audit resources

7 The audit strategy adopted by the Department since the early 1990s, and given added impetus by the 1994-95 review, required a shift in auditing effort towards those traders presenting the highest risks to the revenue. In their report for the Comprehensive Spending Review, in July 1998, the Department identified problems of trader compliance with VAT regulations as one of a number of growing threats to the revenue (**paragraphs 2.1 to 2.2**).

8 To assist them in their work, the Department employ a centralised risk analysis system that allocates traders to risk groups, one of which is for newly registered traders. In 1995-96, the Department replaced their policy of visiting all newly registered traders within three years of registration with one of offering such traders a range of options most suited to their individual needs, including a visit by VAT staff. Most other traders are allocated to four other risk groups designated low, medium, high or exceptional risk. The number of traders in the highest two risk groups remained fairly steady throughout the period, together averaging some 211,000 traders (**paragraphs 2.5 to 2.9**).

9 During the period 1994-95 to 1998-99, the Department achieved a steady increase in the average revenue yield per audit across all risk groups and there was a change in the broad balance of audits undertaken. The proportion of audits directed at high and exceptional risk traders increased from 31 per cent to 38 per cent, with a corresponding decrease in the proportion of audits directed at lower risk groups. The level of attention given to higher risk traders has not, however, matched the coverage envisaged by the Department (**paragraphs 2.9 to 2.16**).

10 The Department have improved their operational effectiveness, with net additional revenue discovered by assurance staff rising from £5.98 per £1 spent in 1994-95, to £7.48 in 1998-99. We found on average, however, that audits are taking 20 per cent longer and staff are spending more time on activities such as trader selection and enquiries. Overall, direct audit activities accounted for 62 per cent of staff time in 1998-99 compared to 74 per cent in 1994-95. We calculate that there has been a 40 per cent reduction in the number of audits carried out during this period compared with a 17 per cent reduction in available assurance staff years. In November 1997, the Department undertook research into the possible diversion of assurance resources to overhead tasks. In their responses, local offices suggested that targeting less compliant traders, in line with the revised strategy, had led to longer, more complex audits and reductions in their number. The Department intend to continue to monitor the effective deployment of assurance resources. There may be scope for the Department to increase the use of audit staff on direct activities, leading to additional revenue benefits. (**paragraphs 2.17 to 2.25**).

11 **On the focusing of audit resources, we make the following key recommendations** (further details are at paragraph **2.28**):

Recommendation 1

To maximise additional revenue assessed per audit

The Department should test the impact of concerted action to increase the proportion of high and exceptional risk traders audited each year, and of separate quantified performance targets for errors found within each trader group.

Recommendation 2

To continue improving their operational effectiveness

The Department should ensure, as far as possible, that trained assurance staff are not diverted to undertaking work not necessarily requiring their skill levels and should examine the scope to deploy a greater proportion of existing resources on direct audit work. The Department have undertaken to continue to monitor these issues as part of their research into the effective use of resources.

Selecting and auditing individual traders

12 Following trials at selected local offices, the Department implemented revised assurance procedures at all offices from 1 April 1998. Under the revised approach, responsibility for selecting traders for audit rests with centralised teams within each local office, rather than with individual assurance officers as before. These teams, working under the guidance of locally appointed risk managers, sift traders prioritised for audit by the computerised selection system and pass on to assurance staff only those traders whom they assess as being potentially non-compliant. This is known as the Sift process (**paragraph 3.6**).

13 The risk manager is responsible for ensuring an appropriate balance of coverage of the local trader population. To test the soundness of judgements made by the sift teams, local offices are also required to audit a three per cent random sample of traders initially assessed as compliant. Samples examined during the trial phase were insufficient to allow the Department to draw any firm conclusions

about the effectiveness of the sift process and they are to monitor local office performance and the results of the sample audit programme (**paragraphs 3.11 to 3.14**).

14 As with the Sift process, trials have been undertaken of the use of central teams to arrange individual audit visits. The Department have introduced such centralised booking at many locations and will evaluate the results in due course. In undertaking audits, assurance officers carry out such tests as they judge necessary to gauge both a trader's credibility and the accuracy of the VAT returns being examined. While the Department's assurance programme remains primarily based on visits to traders' premises, staff may use alternative means of gaining assurance, such as telephone calls, where they might enhance revenue returns with minimum effort. The volume of detailed testing of traders' accounts and subsidiary records depends upon the original reason for the audit and on any concerns subsequently identified. In the sample of 294 trader files examined, we found only 6 folders out of a possible 115 contained a proforma audit planning document summarising the risk concerns of assurance staff and how these have been addressed during the visit. As part of their revised assurance procedures, the Department have enhanced the risk information held on traders' folders to include details of risks identified during the Sift process (**paragraphs 3.15 to 3.25 and 3.35**).

15 Assurance staff record the outcome of their audit checks on a standard visit report. These reports serve several purposes, including recording assurances about the trader and the consistency of testing with the perceived risks. In the majority of folders we examined, although completed audit reports described areas and types of transactions audited, supporting tests were not clearly focused on trader risks and the amount of testing was not always clearly visible from the reports. The Department are to consider the quality of visit reports as part of their review of the published Departmental auditing standard (**paragraphs 3.26 to 3.28**).

16 Some managers interviewed by us were concerned that they had no objective measure by which to assess the quality of work undertaken by their staff. For example, they were unable to gauge whether the particular skills and experience of their staff were commensurate with the inherent risks presented by their trader populations and whether there was a need for further training or recruitment. The Department expect to address these concerns through the development of the national audit standard and the continuation of the quality visiting project. This project is aimed at identifying the factors that make an assurance visit successful and developing ways of measuring these factors on a nationally consistent basis (**paragraphs 3.30 to 3.32**).

17 When officers raise assessments for additional tax they record the related error under one of a number of classifications. The Department draw on this information to compile a list of common trader errors in their public notice advising newly registered traders, and others, about how to complete a VAT return. They also plan to include a similar list in a revised public notice about correcting errors on VAT returns which was due for publication during 1999 (**paragraph 3.34**).

18 **On selecting and conducting audits we make the following key recommendations** (further details are at **paragraph 3.40**):

Recommendation 3

To ensure that the selection process remains effective

The Department should include the results of local offices' sample audits in measuring the outcome of Sift procedures.

Recommendation 4

To maintain the best use of experienced audit staff

The Department should continue to promote centralised booking of trader audits, ensure that local offices maintain adequate, accurate and up to date data in trader folders, and investigate the scope for streamlining the trader audit reporting process.

Recommendation 5

To ensure that the quality of the work is of a sufficient standard

The Department should ensure that audit completion reports record sufficient key information about the level and nature of testing undertaken; review the quality control arrangements in place at local offices; and issue guidance on good practice.