

# **Appropriation Accounts 1999 - 2000**

## **Volume 16: Class XVI**

### **Departments of the Chancellor of the Exchequer:**

## **HM Customs and Excise**

**Report of the Comptroller and Auditor General**

**HC 25-XVI**

**9 February 2001**

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# executive summary

## Audit of the HM Customs and excise under Section 2 of the Exchequer and Audit Departments Act 1921

- 1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of Customs and Excise to establish that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue and to satisfy myself that any such regulations and procedures are being duly carried out. This report sets out the results of my examination in fulfilment of these requirements.
- 2 In April 2000, the Accounting Officer, Richard Broadbent who was appointed in February of that year, introduced a new management framework the aim of which was to clarify accountabilities, streamline decision-making and support the more rapid implementation of decisions. On 17 January 2001, the Department announced their reorganisation into two core activities: Business Services and Law Enforcement. Support functions will comprise logistics, finance and strategy, Human Resources and Legal and the new structure is to be in place by 1 April 2001.
- 3 During 1999-2000 I have performed examinations including reviews of the impact of corporate governance developments and the operation of the Landfill Tax Credit Scheme. I also annually review the operation of key accounting functions such as the VAT Central Unit and Credibility Unit for making VAT repayments as well as reviewing the operations of a selection of local offices.

### Excise diversion fraud

- 4 On 1 June 2000, Richard Broadbent, the Chairman of HM Customs and Excise, informed the Paymaster General, Dawn Primarolo, that a series of excise diversion frauds between 1994/1998 appeared to have been mishandled. He had commissioned an internal review to investigate the matter. The weaknesses in controls over the collection of duty and the failings of Customs' management had contributed to the loss of substantial amounts of revenue estimated at around £668 million from diversion onto UK markets. A further £216 million was lost resulting from diversion onto overseas markets where duty would have been due in the country of import had the goods not been fraudulently diverted. **Figure 10** provides the breakdown of these amounts.
- 5 Although Customs became aware of the threat of outward excise diversion frauds as early as 1994 they did not take effective action to curtail these frauds until 1998. About half of the revenue could have been protected if fraudulent consignments had been intercepted rather than letting the investigations continue in order to obtain sufficient evidence to prosecute those involved or if effective action had been taken earlier.
- 6 In the normal course of events my report would be published in the Appropriation Accounts volume containing details of Customs' administration costs and would also cover Customs' Trust Statement, my audit of which fulfils the requirement for me to be satisfied as to the correctness of revenues brought

to account. The Trust Statement for 1999-00 recording revenue receipts and payments and produced under the direction of the Treasury has now been signed by the Accounting Officer. Because of my continuing investigation into diversion frauds, I am as yet unable to conclude under Section 2 of the Exchequer and Audit Act 1921 either that:

- adequate regulations and procedures have been framed to secure an effective check on the assessment, collection, and proper allocation of revenue and to satisfy myself that any such regulations and procedures are being duly carried out; or
  - the sums brought to account in respect of such revenue are correct.
- 7 I propose to produce a further Report to Parliament on the causes and the lessons to be learned from the Department's handling of diversion frauds and on the action planned by Customs.

## Key accounting functions and selected local offices

- 8 I found that controls were operating satisfactorily in these areas but there are significant issues which I brought to the attention of management. These included:
- weaknesses in the way that departmental standards have been applied to some traders and which ensure that they have systems and procedures in place to record and pay taxes at the right time;
  - problems on re-payments to traders of default interest on underdeclarations of VAT;
  - the need to improve checks by Customs on consignments imported from outside the European Union which ensure that the correct amount of duties have been paid by importers;
  - the need for improved procedures to ensure that potential liabilities and provisions have been properly considered, recorded and reported in the accounts produced by the Department.

## Developments in corporate governance

- 9 In line with other central government departments, Customs produce a Statement on Systems of Internal Financial Control for their two accounts which record their administrative expenditure (the Appropriation Account records voted cash administrative expenditure and the Resource Account shows resources utilised on an accruals basis). This statement confirms that the Accounting Officer has satisfied his responsibility to ensure that effective management systems, including financial monitoring and control systems, have been put in place.
- 10 In June 2000, Treasury issued guidance extending this requirement to all accounts that have to be laid before Parliament for the 1999/2000 financial year. However, departments were allowed to defer the application of this guidance until the year ending 31 March 2001 if the required systems were not in place for the year ending 31 March 2000. The Department have chosen to extend the scope of their Statement on Systems of Internal Financial Control to cover their Resource Account. However, they do not plan to widen the statement to cover the systems in place for the assessment, collection and allocation of revenues until the 2000-01 financial year, because the timing of the Treasury's guidance meant that they were not in a position to retrospectively

seek evidence about the internal financial controls relating to revenue systems in operation throughout 1999-2000.

- 11 Most major organisations use an audit committee to enhance and evaluate the internal control systems in operation. The Treasury have issued guidance on the formulation of such committees in the public sector and have recommended they be set up. Customs and Excise are in the process of developing the role of their audit committee further. The National Audit Office have recently been invited to attend the Committee on a permanent basis.

## The operation of the Landfill Tax Credit Scheme

- 12 The operation of the Landfill Tax Credit Scheme and the Landfill Tax from which credits can be deducted has been the subject of considerable Parliamentary and media interest, especially about the effectiveness of the scheme and the projects paid for by contributions ie the tax foregone. The regulations for the scheme as well as the workings of the scheme itself are complex and payments for projects that fall within the scheme's rules do not count as public expenditure which makes external examination of the value-for-money achieved by the scheme difficult for anyone to assess. I have examined principally how Entrust regulate the scheme and Customs' monitoring of Entrust's activities as regulator of the Scheme. Although I am satisfied that Entrust fulfils its duties satisfactorily, I have made recommendations on the way Entrust can improve their review of projects and enrolled environmental bodies and in the way Customs monitor Entrust.



# Part 1

## Basis of the audit

### Introduction

1.1 This part of my report describes the audit work undertaken by the National Audit Office to support my opinion on the systems established by HM Customs and Excise and discharges my responsibility to report to the House of Commons under the Exchequer and Audit Departments Act 1921 as described in more detail below.

### Statutory basis for the audit

1.2 Section 2 (1) of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of Customs and Excise on behalf of the House of Commons. This is to establish that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue and to satisfy myself that any such regulations and procedures are being duly carried out. The legislation also requires me to examine the correctness of the sums brought to account and to report the results to the House of Commons (Section 2(2)).

1.3 For 1999-2000 under Section 5 of the Exchequer & Audit Departments Act 1921, Customs and Excise have prepared Resource Accounts giving details of their administrative expenditure and resources used and I have provided a clear audit opinion on these. A Trust Statement detailing revenues received and repayments made is also produced by the Department and audited by agreement with the Treasury.

### Audit approach and scope

1.4 Each year, the work I perform to fulfil the statutory requirement under Section 2 (1) of the 1921 Act includes:

- the examination of the Department's internal controls;
- periodic in-depth reviews of existing systems covering any significant changes and the evaluation of new systems;

- reviews of quality assurance work including the work of Internal Audit and other checks carried out by the Department;
- reviews of the Department's computer installations and networks and specific information technology applications; and
- test examinations of individual transactions and balances.

1.5 I also examine the economy, efficiency and effectiveness with which Customs and Excise have used their resources under Section 6 of the National Audit Act 1983. The results of these value-for-money examinations are published in separate reports to the House of Commons under Section 9 of that Act. Since my last report on the Department's systems and procedures (HC11-XVI, 1999-2000), I have reported on VAT Assurance (HC15, 1999-00), on Betting and Gaming Duties (HC352, 1999-00) and on the Regulation of Freight Imports from Outside the European Community (HC 131, 2000-01). Other reports where there has been coverage of Customs and Excise include: Performance Measurement (HC272, 1999-00) and Risk Management (HC864, 1999-00).

1.6 My review of new Budget Assumptions and the cyclical review of those used in the past involves coverage of the work of the Department and has included assumptions about the forecast VAT yield, the expected revenues from tobacco anti-smuggling measures and revenues from the Spend-to-Save programme (HC348 and 959, 1999-2000).

1.7 At present the Trust Statement recording tax revenues and repayments is drawn up on a cash basis. I perform my audit by agreement with the Treasury but, with the activation of the relevant clauses of the Government Resources and Accounts Act (expected to apply to accounts for 2000-01 and beyond), my audit of these accounts will move onto a statutory basis. I anticipate that the introduction of Whole of Government Accounts over the coming years and, with a Central Government Account due for 2002-03, the revenues reported under

the Trust Statement will be reported on an accruals basis. I am already working with both the Department and Treasury on the form of account and the accounting policies to be applied as a result of this significant development.

## Work carried out for 1999-2000

- 1.8 My audit approach ensures coverage of every revenue regime each year, and details are provided in **Figure 1** below:
- 1.9 Information Technology is integral to the administration of indirect taxes. I perform specific IT reviews in support of the work outlined above and further details are included at Parts 2 and 3.
- 1.10 The main findings from our work are set out in the following parts of my report and include those areas where I have conducted more in-depth inquiries and which therefore warrant separate mention:
  - Part 2: The results of my audit work in detail including where I have relied on other auditors including Customs' own internal audit function;
  - Part 3: Corporate Governance developments;
  - Part 4: The operation of the Landfill Tax Credit Scheme;

- Part 5: Losses to the revenue from excise duty diversion fraud.

## Conclusions

1.11 In the normal course of events my report would be published in the Appropriation Accounts volume containing details of Customs' administration costs and would also cover Customs' Trust Statement, my audit of which fulfils the requirement for me to be satisfied as to the correctness of revenues brought to account. The Trust Statement for 1999/2000 recording revenue receipts and payments and produced under the direction of the Treasury has now been signed by the Accounting Officer. Because of my continuing investigation into diversion frauds, I am as yet unable to conclude under Section 2 of the Exchequer and Audit Act 1921 either that:

- adequate regulations and procedures have been framed to secure an effective check on the assessment, collection, and proper allocation of revenue and to satisfy myself that any such regulations and procedures are being duly carried out; or
- the sums brought to account in respect of such revenue are correct.

1.12 I propose to produce a further Report to Parliament on the causes and the lessons to be learned from the Department's handling of diversion frauds and on the action planned by Customs in response.

### 1 Summary of coverage

Function	Tax/duty										
	VAT	HCO	Tobacco	Spirits	Wine, cider and perry	Beer	Betting & gaming	IPT	APD	LFT	Customs Duty
Receipts 1999-2000 <sup>1</sup>	56.8bn	22.5bn	5.7bn	1.8bn	1.8bn	2.8bn	1.5bn	1.4bn	0.9bn	0.4bn	2.0bn
VAT Central Unit	✓										
Central Deferment Office	✓	✓	✓	✓							✓
Central Collection Unit					✓			✓	✓	✓	
Greenock Accounting Centre							✓				
Drawback Processing Centre		✓	✓	✓	✓	✓					
Errors and adjustments	✓										
Credibility unit	✓										
Insolvency unit	✓										
Large Payers Unit	✓							✓	✓	✓	
National Import Duty Adjustment Centre											✓
Regional Offices	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Note: 1. Figures are provisional.

# Part 2

## Audit findings

### Audit coverage

- 2.1 The Department operates major systems to assess and collect revenues from VAT, Excise and Customs duties, imports and separately for large payers. My review of the Department's key functions is shown under these headings at **Figure 2**.
- 2.2 Significant issues which I have already brought to the attention of management include:
- weaknesses in the way that departmental standards have been applied to some traders and which ensure that they have systems and procedures in place to record and pay taxes at the right time (paragraphs 2.4-2.7);
  - problems on re-payments to traders of default interest on underdeclarations of VAT (paragraphs 2.8-2.10);
  - the need to improve checks by Customs on consignments imported from outside the European Union which ensure that the correct amount of duties have been paid by importers (paragraphs 2.11-2.23);
  - the need for improved procedures to ensure that potential liabilities and provisions have been properly considered, recorded and reported in the accounts produced by the Department (paragraphs 2.24-2.29).
- 2.3 I have also taken assurance from my review of the work of Internal Audit and the results of this are summarised in paragraphs 2.30-2.33.

#### Weaknesses in the application of the departmental standards to checking traders

- 2.4 The Department's approach to making sure the correct amount of revenue is received is to check the systems and accounts of those traders thought to be at greatest risk. They identify these traders by reviewing factors such as the complexity of the business, the results of previous visits and payment history. Customs also take a

random sample of traders which is not related to risk to monitor the general level of compliance.

- 2.5 From the information held by Customs, staff consider the most appropriate method of gaining assurance, either through a visit to the trader or office based enquiries. Following their checks they may make recommendations to traders for any improvements and if necessary raise assessments if errors have been identified. To ensure that Customs' procedures are efficient and effective, national rules govern the conduct of audits and are contained in the Departmental Audit Standard.
- 2.6 In reviewing the Department's approach I found that this Standard was fully applied to large traders and the Department is actively working towards introducing an adapted form for the assurance on the compliance of medium and small traders. The amount of work carried out on these classes of traders depended on the individual judgement of staff and as a result there were wide variations in the way that individual traders were audited. Until then, there is a risk that in some cases the Department might not be gaining sufficient assurance that the correct amount of revenue is being paid. It also makes it difficult for both traders and departmental staff to know whether the standards they are working to are sufficient.
- 2.7 For those large traders audited, we found areas of good practice although the documentation produced by Customs' staff was not in all cases up to the Departmental Audit Standard. In my view, this was likely to create most difficulties when a trader's affairs moved between Customs' staff which could make it harder to confirm that the trader had paid the correct amount of tax, and could also give a poor impression of the Department's performance to traders. I have recommended that departmental standards for documentation should be applied consistently to all large traders.

**2 Customs and Excise Functions Reviewed**

**VAT**

**VAT Central Unit:**  
Recording  
Processing: and  
Allocation of VAT receipts/repayments

**Credibility Unit:**  
Credibility checks on repayments

**Error and Accounting Adjustments:**  
Dealing with incomplete or erroneous returns

**Insolvency Unit:**  
Ensuring returns are received  
Confirming accuracy of debt  
Receipt of large dividends

**EICS**

**Central collection unit:**  
Processing receipts and repayments for Landfill Tax  
Insurance Premium Tax  
Air Passenger Duty; and  
Wine, cider and perry duty

**Central Deferment Office:**  
Processing duties covered by duty deferment system

**Drawback Processing Centre:**  
Duty drawback claims

**Beer Duty Accounting Centre:**  
Controlling and checking the receipt of beer duty returns and monies, including the assessments and penalties

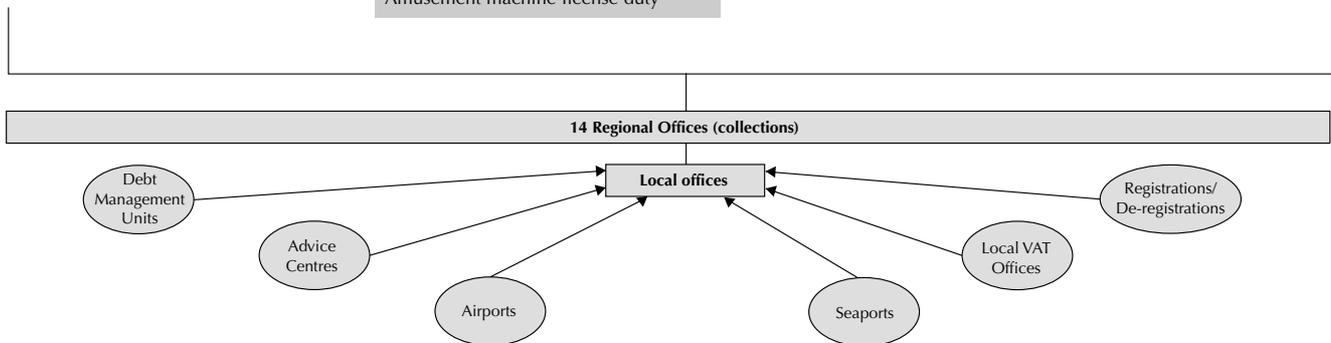
**Greenock Accounting Centre:**  
Collection, processing and allocation of:  
Bingo duty  
Gaming duty  
National lottery duty  
General betting duty; and  
Amusement machine license duty

**Imports**

**National Import Duty Adjusting Centre:**  
Processing goods brought into UK under the preference system which do not have the appropriate certification

**Other**

**Large Payers Unit:**  
Ensuring compliance in submitting returns and repayments (mostly VAT traders)



Source: HM Customs & Excise

**Re-payment of default interest owed to taxpayers**

2.8 Traders are liable for default interest if they under-declare their VAT and in 1999-2000 the Department recovered £48.5m in default interest. Following a VAT Tribunal decision in 1993, Customs' declared policy has been to charge default interest on net amounts due but in practice they have not always done so. As a result, the Department have charged interest in some cases without making allowance for overdeclared tax.

2.9 Overpayments have been made mainly by the larger traders, and could affect interest charges back to 1990. The Department estimate that they may have overcharged up to 930 large traders and are now liable to repay both the primary sum and compensatory interest. The repayment liability is estimated by the

Department to be around £34m, including £7m in compensation. Customs have repaid some £18.4m to date and expect to repay the balance during 2001-2002.

2.10 The Department are looking at ways to improve the calculation of default interest and are developing changes needed to their computer systems. In the meantime, they are calculating the amount of overcharges using separate standalone systems and procedures which may require significant manual intervention. I have raised with the Department the adequacy of management checks and recommended that they consider implementing more rigorous checks of the manual input to reduce the risk of error. The Department assure me that appropriate management checks are being carried out to ensure that the system is operating correctly.

## Checks by Customs on consignments imported from outside the European Union;

2.11 Since 1993 and the commencement of the single market, imports ("consignments") into the UK are only subject to checking if they come from outside the EU. Importers make declarations to Customs on "consignments" received for the duty and VAT due. At the extremes a "consignment" could be a small parcel or the cargo of a large ship.

2.12 I have reported separately to Parliament (HC 131, 2000-01), on the regulation of freight imports from outside the European Community into Great Britain. In my report, I have recommended that the Department should improve their risk management systems and focus more closely on their objective for securing compliance with regulations from importers.

2.13 Some 7.1 million consignments of goods were imported from outside the European Union in 1999-2000. Revenue collected on these imports totalled £20.6bn. Airports such as Heathrow/Gatwick and East Midlands are by far the busiest offices, handling 2.1million and 700,000 consignments respectively. Ports are likely to handle smaller numbers of consignments, although these will on average be larger.

2.14 At the local office level, I visited 6 offices (out of a total of 47) which perform checks on consignments imported from outside the European Union. While offices are normally at the UK's ports and airports, warehouse premises can also be operated at some distance from the actual port of entry to facilitate the operations of importers and the businesses they serve.

2.15 In one region (Belfast Docks) I found the level of control over the operations of traders to be ineffective. While this office is relatively small, accounting for less than one per cent of receipts totalling some £35m in 1999-2000, it is only one of two offices covering Northern Ireland. The office also has responsibility for remotely-situated warehouses (called remote transit sheds) and temporary storage facilities on or close to the border with the Republic of Ireland. The main weaknesses I found and reported to management are summarised in paragraphs 2.16-2.23 below.

### (a) risk assessment

2.16 Local offices should have procedures to identify the risks to the revenue from the importation of consignments, for assessing those risks for the likelihood that duties will not be paid, and based on this to identify which consignments should be selected for checking. In Belfast this was not being done adequately and instead there was significant reliance on operators to pay the correct amount of duty.

2.17 Unlike the rest of the United Kingdom, the Belfast office was not making full use of a key facility on the Customs computer system, designed to assist staff with selecting those consignments which present risks to the revenue. Local Customs staff can use markers called "profiles" (which can also be set nationally) within the computer system to identify consignments for checking. But, at the time of my visit, operational staff based in the Belfast local office rarely set markers for consignments to be checked, and markers set by other staff were not being regularly reviewed. I have recommended that local staff use the opportunities available to set up and amend markers held on the computer system to make better use of their local knowledge and that all markers should be regularly reviewed.

### (b) reviewing systems for tracking movements of goods

2.18 Commercial port operators will normally operate "inventory-linking" systems to notify Customs of movements of consignments. These key systems record all movements of goods but we found no evidence that staff in Belfast had reviewed them during 1999-2000. Where warehousing facilities are based away from the port area, our experience elsewhere in the UK is that the Department insist on the operation of an inventory-linking system as they allow goods, wherever they are physically located, to be traced for Customs' inspection. However, operators of remote transit sheds or temporary storage areas in the Belfast Docks region do not use these systems, and in the absence of regular Customs inspections the assurance that the Department have on consignments moving through these facilities must be limited.

2.19 During our visit we also observed that the "gate pass" system at Belfast Docks, which should ensure that all consignments leaving port are properly authorised, was not operating effectively. In the past this weakness in the system has allowed goods to be removed from the port without authorisation and I have recommended that the Department review the control of removals from the port.

### (c) checks on traders using Customs Freight Simplified Procedures

2.20 In 1997 Customs introduced the Customs Freight Simplified Procedures which allows consignments to enter the United Kingdom without being stopped by Customs for fiscal purposes. At a later date the importer submits supplementary declarations to Customs of all goods imported over the period, and makes payments for the amount of duty on those goods. Customs may subsequently visit the importer to confirm that they are complying with the requirements for using the simplified procedures. We found that, at the time of our audit, no visits had been undertaken or planned to the one operator using these procedures in the Belfast Docks region, for example to check the operation of the inventory linking systems in place at these operators.

**(d) Customs approvals provided to the operators of remotely-situated transit sheds**

2.21 The Department should agree locally with port operators and owners of registered premises their responsibilities and duties including for the operation of remotely-situated transit sheds. In the Belfast Docks region, key contract and approvals documentation could not be found or was out of date in a number of significant areas, for example - the absence of documentation would be important in cases where checks were not being carried out properly and where Customs would be seeking to enforce action either to halt movements or obtain revenue where there had been losses.

**(e) checks of consignments to ensure correct revenue payments**

2.22 Goods that are imported will arrive on a variety of types of ships and can be palletised or held in containers. Customs will check the cargoes of ships either before unloading (often physically difficult) or after individual consignments have been unloaded. In 1999-2000 there were 16237 import entries made at Belfast of which 5445 were subject to documentary checks. Three examinations of ships' holds were also conducted and 549 individual consignments were physically examined. This is a similar proportion to those checked at other docks.

2.23 Importers provide lists of consignments expected to be brought into the country and these are checked to detailed manifests from carriers of goods that arrive. The local office in Belfast Docks could develop a procedure to ensure that differences between the two sets of information are investigated. This may help to direct the work of the office to areas of potential risk in areas where checking is resource-intensive, and where only few physical examinations take place.

The need for improved procedures to ensure consideration and the completeness of recording and reporting contingent liabilities and provisions.

2.24 The Resource Accounting and Budgeting initiative requires Government departments to report their income and expenditure on an accruals basis for the first time. The aim is to help improve the way departments both manage and report on their resources and the disclosure of information on their actions and performance. Whereas previously the accounts of many departments (including Customs) were cash-based, Resource Accounts disclose income and expenditure on an accruals basis as well as Notes covering for example creditors, liabilities and contingent liabilities, in line with generally-accepted UK accounting practice (UK GAAP).

2.25 In any business the requirement to disclose information about provisions and contingent liabilities requires a considerable amount of consultation especially between operations, finance, legal and not least senior management. Published accounting standards require that active consideration be given to the impact of possible future calls on the resources of the entity and to evidence this. For Customs, closer communication between policy branches and the finance function is important because, for example, costs and interest arising from revenue-raising action may fall on the Resource Account of the Department.

2.26 To illustrate this, incomplete notification of information to the finance and accounts branch meant that a significant contingent liability of £15 million should more accurately have been accounted for in the 1999-00 Account opening balances as a provision. The delay of some 4 months before finance staff were informed of the impact of this award against the Department also meant that the full financial implications of the decision came as a surprise. This significant and unexpected charge on resources available for administration had implications for management and could have had serious repercussions for the Department to remain within their cash limit. The anticipated development of accruals accounting and reporting of revenues, as part of the initiative to produce accounts which consolidate the operations of central government, may further increase the number of instances where contingent liabilities and provisions will need to be recognised.

2.27 For 1999-2000, the Department have successfully produced a Resource Account which I have provided with a clear opinion. However, my review revealed that the initial summary of contingent liabilities was incomplete and required revision. Whilst the Department had introduced procedures designed to identify, track and classify such transactions in accordance with Financial Reporting Standards I found that these had not been properly followed in all locations and that not all cases had been properly identified and evaluated. The monitoring and management procedures operated by the Department did not identify these issues and gave no mechanism for management to ensure that information was complete and accurate. Because of these difficulties I had to carry out significant additional unplanned audit activity to ensure that the Resource Accounts presented a true and fair view and the Department made a number of amendments to the accounts.

2.28 A further consideration is where management judges that the disclosure of any contingent liabilities, as required by accounting and auditing standards, could prejudice the outcome of legal action. Management's consideration of all potential contingent liabilities and any judgement to withhold information needs to be fully documented, appropriately reviewed and available for the audit of the accounts.

2.29 The Department has agreed that the Audit Committee will review management's processes in this area as part of their remit to look at the financial statements as a whole. I support this approach and recommend that early consideration is given by all those involved to the need for reporting requirements to be met whilst protecting Customs' legitimate concerns to fulfil their proper responsibilities.

## Review of the operation of Departmental Internal Audit

2.30 As part of my audit I review the work and independence of Internal Audit. The Head of Internal Audit reports directly to the Principal Finance Officer of the Department and also has access directly to the Chairman and Board of the Department if necessary. Internal Audit provide a variety of reports to the Department, including an annual report on their own performance, and a certificate of assurance covering the internal controls. They are split into seven branches in two locations with a compliment of sixty-three staff of which there were sixty-one in post at the time of my review. The majority of staff in the internal audit function are qualified or studying for Institute of Internal Audit qualifications at member and professional levels.

2.31 I have taken assurance from the work of Internal Audit in a number of areas both for the audit of administrative expenditure and receipts and for my review of systems supporting taxation receipts and repayments. The range of investigations in 1999/2000 included: VAT Unregistered Traders, Excise and Inland Customs operations, drawbacks, Authorisation of Inland Customs Traders, Debt Management Information systems, the Whisky Export Refund scheme, REDS and Occasional Importers, EC Own Resources and National Investigation Service management review. In several areas, such as for staff expenditure on travel and subsistence and on Regional Office systems, Internal Audit have performed testing on my behalf.

2.32 The Head of Internal Audit has provided positive assurance to the Accounting Officer that the overall control framework continues to remain at an acceptable level. 95 per cent of Internal Audit recommendations on the outcome of systems audit work and 96 per cent on management audits were accepted, covering for example the need for management information to be accurate and timely, and that management assurance programmes are not always in place.

2.33 I have noted Internal Audit's future plans and the re-focusing of work along Modernising Government themes including "Information Age Government". I hope to be able to develop our co-operation with Internal Audit further in particular to take additional assurance from Internal Audit's work on information technology aspects of the Department's organisation and operations.



# Part 3

## Developments in internal control

3.1 In this part of my report I examine:

- Developments in corporate governance, looking particularly at;
  - Statements of internal financial control;
  - The role of the Audit Committee;
- Year 2000 results.

### Statements of Internal Financial Control

3.2 In line with other central government departments, Customs and Excise have to produce a Statement on Systems of Internal Financial Control. This initiative follows moves to improve the governance of private sector companies begun with the introduction of the Code of Practice developed by the Cadbury Committee. The purpose of the statement is to confirm that the Accounting Officer has satisfied his responsibility to ensure that effective management systems, including financial monitoring and control systems, have been put in place.

3.3 For 1998-99, Customs and Excise along with other departments had to make this statement only in connection with their voted cash administrative expenditure, recorded in the Appropriation Account. In June 2000, Treasury issued guidance extending this requirement to all accounts that have to be laid before Parliament for the 1999/2000 financial year. However, departments were allowed to defer the application of these requirements to "certain other accounts" until the year ending 31 March 2001 if the required systems were not in place for the year ending 31 March 2000.

3.4 The Department have chosen to extend the scope of their Statement on Systems of Internal Financial Control to cover their Resource Account. However, they do not plan to widen the statement to cover the systems in place for the assessment, collection and allocation of revenues until the 2000-01 financial year, because the timing of the Treasury's guidance meant that they were

not in a position to retrospectively seek evidence about the internal financial controls relating to revenue systems in operation throughout 1999-2000.

3.5 In September 1999, the Turnbull Committee issued "Internal Control: Guidance for Directors on the Combined Code". One significant, and new, aspect of the Combined Code is to extend the directors' statement on internal financial controls to cover all internal controls. Treasury have adopted this change and all departments, including Customs and Excise, will be required to make this broader statement for the year 2001-2002. The Department have told me that they will be in a position to give this assurance and are already working to establish systems to ensure evidence to support such a statement can be provided by the Accounting Officer.

3.6 The widening of the statement to include not just internal financial controls is a major development and there is a considerable amount of work to be done both to gather the evidence to support a statement, and to ensure that it can withstand scrutiny.

### Audit Committee

3.7 Customs' Audit Committee is formed by members of the Board of Commissioners and one of Customs' two non-executive directors. In the past the Committee has been led by the Chairman and has normally met twice-yearly, although only once in 1999-2000.

3.8 Matters discussed by the Committee have included: Internal Audit plans, their annual assurance report to the Chairman, and a review of the previous year's performance. Other items have included progress on current audits, clearance of Internal Audit recommendations, feedback from audit clients, follow-up on how Internal Audit should respond to new initiatives such as Modernising Government as well as liaison with the National Audit Office.

3.9 Most major organisations use an audit committee to enhance and evaluate the internal control systems in operation. The Treasury has issued guidance on the formulation of such committees in the public sector and has recommended they be set up. Customs and Excise are in the process of developing the role of their audit committee further as suggested by best practice, for example: their terms of reference, membership and chairmanship. The National Audit Office have recently been invited to attend the Committee on a permanent basis.

## Impact of the Year 2000 date change on departmental systems

3.10 Preparations to counter the potential Year 2000 threat for the Department's systems were successful and no major difficulties were encountered. I have continued to monitor the effect of the date change on the key systems of the Department and am satisfied that no significant failures have occurred.

3.11 In February 2000, the Department carried out an internal review of their Millennium project and a further review was performed by consultants. While both reviews concurred on the success of the project, recommendations were made which included:

- Retention of the cross-departmental and external working groups which were set up primarily for the Millennium project but which have a continuing role;
- Business recovery plans at both the site and process level adopted for the millennium should not be wasted but developed further as they were relevant to all risks of breakdown;
- Details of inventories and system owners should continue to be kept and updated regularly.

3.12 The millennium project team has since dispersed. As the recommendations made in the above reviews are significant for the internal control of the Department, I recommend that the Audit Committee (through Internal Audit) monitor implementation of the recommendations made and that reports in these areas be made at least annually to the Committee.

# Part 4

## Landfill tax credit scheme

4.1 This Part of my report examines the operation of the Landfill Tax Credit Scheme. Specifically it looks at:

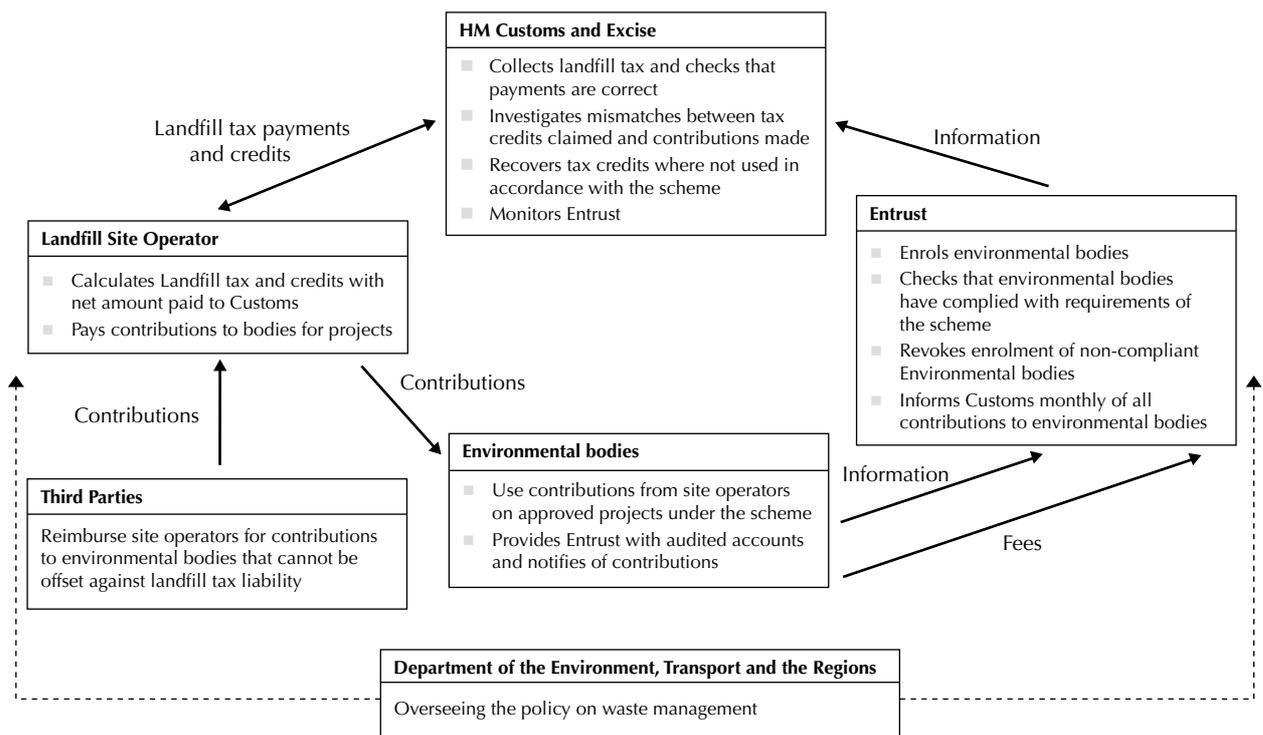
- How Entrust regulate the scheme (paragraphs 4.9 - 4.21)
- Custom's monitoring of Entrust's activities as regulator of the scheme (paragraphs 4.22 - 4. 25)
- Monitoring of the impact of the scheme by the Department of Environment, Transport and the Regions (paragraph 4.26)

### Background

4.2 The Landfill Tax Regulations 1996 established Landfill Tax as the first UK tax with specific environmental purposes. Waste material is liable to landfill tax if the producer of the waste intends to discard or throw it away and the disposal is by way of landfill or at a licensed landfill site.

4.3 The 1996 Regulations also introduced the Landfill tax credit scheme. **Figure 3** sets out the administrative arrangements for the Landfill Tax Credit Scheme. It shows that the operation of the scheme involves complex and novel relationships between the private and public sector.

**3 The administrative arrangements for Landfill tax and the Environmental Bodies Tax Credits Scheme**



Source: National Audit Office

**Waste liable to landfill tax**

Waste liable to landfill tax is divided into "inert" and "active" waste.

Inert waste includes soil, brick and stone which does not decay, pollute groundwater or contaminate land (as listed in the Landfill Tax (Qualifying Material) Order 1996). It is subject to landfill tax at £2 per tonne.

Active waste includes all taxable waste not listed in the 1996 Order, such as household waste. The standard rate of tax is £11 per tonne which is due to increase by £1 per annum to £15 per tonne in 2004.

The tax is payable by licence holders/operators of landfill sites on each tonne of taxable waste they receive. There are some 1500 licensed landfill sites receiving taxable waste and 838 operators registered for landfill tax. In 1999-2000, Customs collected some £430 million in landfill tax.

4.4 The Scheme permits landfill site operators to re-claim contributions, made to environmental bodies enrolled with Entrust. The contribution must be used for approved environmental projects under the Landfill Tax Regulations. Operators of landfill sites can claim credits of 90 per cent of the contributions made, subject to a limit of 20 per cent of Landfill site operators annual tax liability. The take-up has been high with site operators claiming back in credits almost all of the landfill tax they are entitled to under the Scheme (some £93 million (provisional) in 1999-2000). Third parties, including local authorities and government agencies, can make contributions to the site operator for the 10 per cent of contributions that the operators are unable to claim in tax credits. An example of how the tax credits and contributions are calculated is set out in **Figure 4**.

4.5 To prevent possible abuse of the Scheme, for example projects gaining funding unfairly at the expense of other equally suitable ones, environmental bodies are precluded under the Regulations (amended in 1999) from applying their funds for the benefit of third party contributors. Site operators are also required to disclose the name and addresses of the third party contributors and the amounts contributed. Complex relationships can develop on the funding of schemes (**Figure 5**). Entrust, the regulator of the Landfill tax credit scheme recognise that these need to be carefully monitored to ensure that the requirements of the scheme are complied with.

4.6 Individual site operators and/or environmental bodies decide on the type of projects that should receive funding under the scheme. Because the contributions are made by private sector companies to schemes operated by environmental bodies the tax credits are not classified by government as public expenditure. Some 1,050 environmental bodies (less than one half of all bodies) have received contributions from site operators for around 3,700 projects. Bodies may receive no funding if the projects they propose are unpopular with site operators or are considered unlikely to provide worthwhile benefits.

<b>4 Example of the calculation of the Landfill tax and tax credit</b>	
	<b>£</b>
Landfill tax payable by Landfill site operator	<b>100</b>
Landfill site operator contributes £20 and claims tax credits on 90 per cent of the amount contributed	<b>18</b>
Net landfill tax paid to Customs by site operator	<b>82</b>
<b>The net cost to the landfill site operator of contributing to the environmental body</b>	
The contribution to the environmental body	<b>20</b>
Less Landfill tax credit	<b>18</b>
Net cost of contribution to landfill operator	<b>2</b>
Third party contribution may be made to Landfill tax operator representing 10 per cent of the amount paid to the environmental body	<b>2</b>
Net cost of contribution to landfill site operator	<b>0</b>

Source: National Audit Office

**5 Case Study – Normanton Library and Environmental Centre**

Landfill tax credits of £300,000 are being used to fund an environmental centre that will form an extension to a building currently in use as a community hall and sports centre in Normanton, near Wakefield in South Yorkshire. The project is being implemented by an environmental body called Groundwork Wakefield Trust Limited, and Wakefield Metropolitan District Council (MDC) are funding the refurbishment of the existing buildings which will become a library as part of the scheme.

The contributions which are funding this project were originally made available by Yorkshire Water who passed the funds to Yorkshire Environmental Trust. The latter made the initial commitment to finance the project in 1998. When Yorkshire Water was sold to Global Environmental Limited in 1998 the funding was transferred to an Environmental Body who committed themselves to the project. In turn, Global Environmental Limited's sale of its landfill operations to Waste Recycling Group has seen the funding transferred to a third environmental body, Waste Recycling Environmental.

Wakefield MDC has invited five contractors, including Wakefield Public Services Department, to tender for the construction work. The regulations only allow contributing third parties such as Wakefield MDC to bid for construction work providing the contract is awarded by open tender. If this was not the case, then third parties could gain an unfair competitive advantage by providing partial funding for environmental projects.

The regulator, Entrust, a company limited by guarantee, and appointed by Customs and Excise enrolls Environmental Bodies and checks they are complying with regulations and that projects are eligible for landfill tax credits. They have decided that this scheme falls within the rules that currently operate.

Source: National Audit Office

4.7 It is up to site operators and/or environmental bodies to decide whether individual projects represent value for money including where appropriate by awarding contracts for projects by open tender and for controlling administration costs. Entrust's data shows that the administration costs of environmental bodies average around nine per cent of total expenditure.

4.8 From the start of the Scheme in 1996 to August 2000 environmental bodies have received total contributions from site operators of £285 million of which £135 million or 47 per cent has been spent on projects. The main reason for the difference is that environmental bodies have committed funds to projects but have not yet incurred the expenditure. Where environmental

bodies are holding funds Entrust, the regulator of the Scheme, expects them to commit these contributions to projects within two years after receipt, although this is not specified under the Landfill Tax Regulations. Any bank interest earned on the funds also has to be spent on activities in accordance with the Credit Scheme.

## The role of Entrust in regulating the Landfill Tax Credit Scheme

4.9 Entrust is the body responsible for regulating the Landfill Tax Credits Scheme. They enrol environmental bodies in the scheme and monitor their expenditure and activities to ensure that they act within the rules of the scheme. To carry out its responsibilities Entrust has 26 staff operating in four regions of the UK, Northern; Central; Wales and West, and Southern. In 1999-2000 their running costs were £1.3 million, which was funded by charging environmental bodies an enrolment fee of £100 and two per cent of all contributions they received.

4.10 As a private sector company limited by guarantee, Entrust have a Board of Directors that has increased from 9 to 13 members. Under Customs' Terms of Approval with Entrust at least one and not more than three Board members should possess direct experience and knowledge of the waste management industry; local authorities; environmental groups; finance/accountancy; academia, industry generally and the legal profession.

4.11 While individuals with a background in the waste management industry form a large group on the Board they do not have a majority (Figure 6). There is a risk, however, that the decisions of the Board on the regulation of the scheme could be influenced unduly in favour of site operators by such a large grouping, especially as the waste management industry provides the funds to the scheme. This could lead to bias, even unintentional, against certain types of schemes or environmental bodies. Customs consider that they would notice if this risk occurred because senior officials attend the Board meetings on a regular basis as observers. They also consider that the recent appointment of four directors (reflected in Figure 6) with backgrounds in sectors other than the waste management industry should help to reduce this risk.

4.12 Entrust's staff and their contractor Lodge Service make compliance visits to environmental bodies which look at the structural, financial and project compliance of the body. The environmental bodies are selected for visits on the basis of a risk assessment carried out by Entrust. In 1999-2000 Entrust and Lodge Service visited some 420 environmental bodies of which around one third were found to be fully compliant with the requirements of the Regulations (Figure 7).

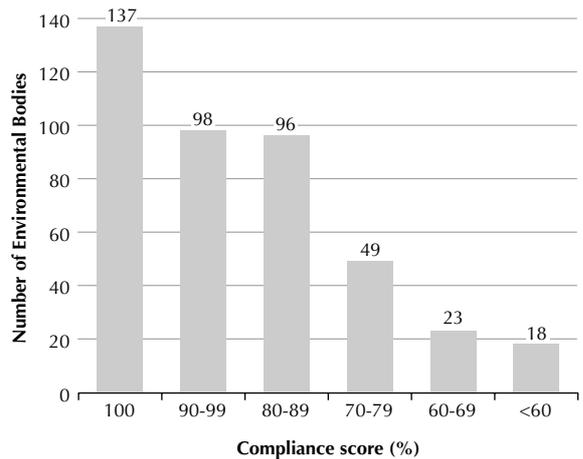
### 6 The background of Entrust's Board of Directors

Waste management industry	3
Local authorities	2
Environmental groups	3
Academics	1
Lawyer	1
Accountant	1
Industry generally	1

Note: The Chairman of Entrust is not included in the data above. Lord Cranbrook who was appointed the Chairman in 1996 has experience and knowledge of both the waste management industry and environmental organisations.

Source: Entrust

### 7 The result of Entrust's compliance visits to environmental bodies



Source: National Audit Office analysis

### 8 The information environmental bodies should provide to Entrust

Notification of contributions received within 7 days so that they can be matched to tax credits. This information is passed to Customs to enable them to carry out their checks on site operators claiming tax credits

Audited annual accounts

Certificate by auditor body complies with scheme

Information on funding received and funding expended

Source: Entrust

4.13 The main reason why bodies failed to comply was because they did not provide Entrust with information required under the Regulations (see Figure 8). The information allows Entrust to monitor regularly whether these bodies are complying with the requirements of the Scheme.

- 4.14 Entrust have responded to this problem by taking account of whether an approved body provides the information required in their risk assessment. This is used to select bodies for compliance visits by Lodge Service. If a body has not complied with Entrust's information requirements, it is more likely to be selected for a visit. However, the provision of information receives a low weighting in the assessment and failure to provide it would not by itself cause a body to be selected. Most weight is given to the amount of funding provided and the number and value of projects that a body is managing.
- 4.15 The type of information Entrust require is important for checking whether the environmental bodies are acting within the rules of the scheme. For example, the audited annual accounts should allow Entrust to check that the body is spending all the contributions received on approved activities. We found, however, that it is often not possible for Entrust to do this check because the accounts of environmental bodies do not disclose income from the scheme separately from other income and bodies. In addition, the bodies are failing to notify Entrust of transfers of contributions to other environmental bodies that are reflected in their accounts.
- 4.16 Where compliance visits show that an environmental body has failed to comply with the scheme in a significant way, Entrust usually follow up cases by visiting the body to agree an action plan to rectify the problems found. In 1999-2000 Entrust carried out follow-up visits to 55 bodies. We looked at 12 of the least compliant environmental bodies and found that:
- in ten cases Entrust had carried out visits and agreed action plans;
  - in two cases visits had not been undertaken by July 2000, eight months after the visit by Lodge Service.
- 4.17 Entrust recognise that they have not undertaken sufficient follow-up work because of a shortage of staff. For part of 1999 Entrust only had one member of staff in the audit and inspection section. Since then six further staff have been recruited.
- 4.18 Entrust have a three stage process to check that individual projects comply with the Regulations. It involves examining projects before being implemented; during work in progress and following completion. The shortages in staff that Entrust have experienced have occurred because they have used more resources than expected on work prior to projects being implemented. This was considered necessary as site operators have been unwilling to contribute to projects unless Entrust gives its prior approval. Since 1996 Entrust have given prior approval to over 11,000 projects.
- 4.19 Since the changes to the Regulations in January 2000 Entrust require environmental bodies to include a clause in their constitution explicitly precluding them from applying funds for the benefit of contributors including third parties. This is intended to ensure that the funds cannot benefit contributors. We noted that Entrust have carried out checks on the constitutions of bodies enrolling with them but have not followed up on all cases where they have required further changes. Entrust have also not checked whether those bodies previously enrolled have constitutions which meet the new requirements.
- 4.20 Entrust can revoke an environmental body's enrolment in the Scheme where the body fails to comply with the scheme rules, voluntarily wishes to leave the scheme or ceases operating. In 1999-2000, Entrust revoked the enrolment of 26 bodies of which five had failed to comply with the scheme rules. Two of these bodies are under investigation by the police for irregularities in dealing with funds on projects amounting to £4 million. Entrust and Customs are looking into two other cases to confirm that contributions have been spent on approved projects. In the remaining case Entrust have confirmed that there were no irregularities in the way contributions have been used. There has been no case where Entrust have revoked a body's enrolment purely due to failure to provide the information listed in figure 8. This is because in the vast majority of cases Entrust consider that such action would be too extreme.
- 4.21 If Entrust identify practices which are undesirable because of the potential for abuses of the Credit Scheme, it can make representations to Customs to help bring about changes in the Regulations. Amendments to the Regulations were made in January 2000 partly as a result of Entrust's concerns. For example the amended Regulations now require that the work of an environmental body must not benefit a third party contributor which contributed to it whereas previously this requirement only applied to the contributing Landfill site operator. Entrust are currently concerned that successful bidders for local authority waste disposal contracts have been required to make contributions under the landfill tax credit scheme to specified environmental bodies. Although this is permitted under the Regulations, Entrust consider that the practice is undesirable because it could lead to claims by contractors of unfair treatment and have suggested to Customs that the Regulations should be amended to prevent this.

## Customs' monitoring of Entrust as regulator of the Scheme

- 4.22 Customs staff have reviewed Entrust's systems and their work to ensure that Entrust is fulfilling its responsibilities of regulating the Credit Scheme. This has included looking at Entrust's arrangements for enrolling

environmental bodies; for verifying that contributions received by environmental bodies have been spent only in the course or furtherance of their approved objectives; and where appropriate for removing an environmental body from the register.

4.23 Customs' reviews have confirmed that Entrust have carried out appropriate checks on environment bodies which have applied to enrol with it. Before enrolling a body, Entrust should check that it is non-profit making and that it is not controlled by a local authority; by bodies controlled by one or more authority; by registered landfill operators or by a person connected with any of these bodies. Some 2,136 environmental bodies are enrolled with Entrust.

4.24 Customs are satisfied that Lodge Service have undertaken sufficient visits to provide assurance on whether environmental bodies are complying with the requirements of the scheme. We noted, however, that Customs staff have not accompanied Lodge Service on a sample of visits to see whether the checks are being adequately carried out.

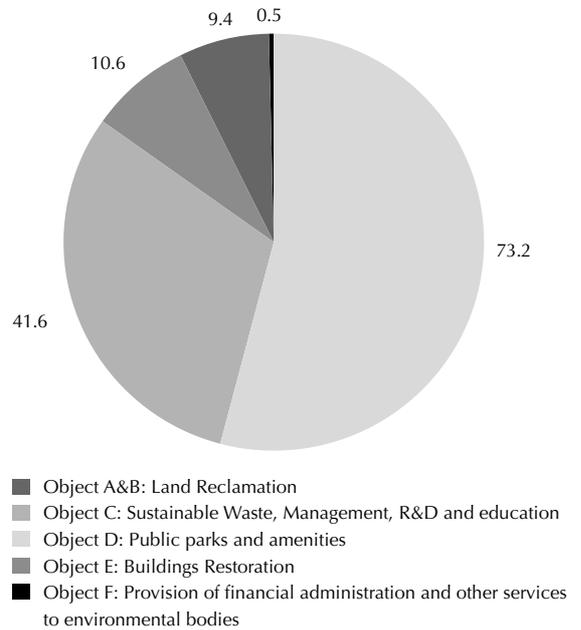
4.25 Customs have been concerned that Entrust have not always received information which the environmental bodies are obliged to submit. It is particularly important that the notification of contributions received by environmental bodies is sent on time as it can affect Customs' ability to match contributions to the tax credits claimed by site operators. As at January 2000 Customs' checks have found unmatched credits with a value of almost £8 million (209 cases) with some cases dating back to 1997. Having looked into the reasons, Customs found that:

- over £500,000 (24 cases) of this amount did not comply with the regulations and assessments have now been raised;
- over £2 million (48 cases), of tax credits had been notified to Customs but had not been recorded on their computer system for matching; and
- of the remainder all but £50,000 (4 cases) which is still being investigated by Entrust, was the result of the environmental bodies having failed to notify Entrust of the contributions received.

## Department of Environment, Transport and the Regions' view of the Scheme

4.26 The Department of Environment, Transport and the Regions (DETR) are responsible for developing and overseeing the implementation of the Government's strategy for delivering sustainable waste management of which the Landfill Tax and the associated Credit Scheme form a part. DETR consider that there is scope for site

**9 Expenditure by Environmental Bodies on different types of projects 1996 to August 2000 (£millions)**



Note: The full data on expenditure by environmental bodies during the period 1 January to the end of August 2000 is incomplete at the present time.

Source: HM Customs and Excise

operators to target their contributions at more strategic projects. **Figure 9** shows how £135 million or 47 per cent of the total contributions has been spent since the scheme started. DETR are working with the waste management industry to ensure that more contributions go towards projects concerned with sustainable waste management such as waste minimisation, reuse, recycling and the development of markets for recycled products.

## Conclusions and recommendations

4.27 The operation of the scheme involves complex and novel arrangements between the private and public sector. A key part of Customs' role is to ensure that Entrust, a private sector company limited by guarantee, is fulfilling its role of regulating the Credit Scheme. As a result of their monitoring, Customs consider that Entrust have been effective in ensuring that environmental bodies are complying with the requirements of the scheme. I consider however that there are some fundamental weaknesses in the design of the Scheme and in the arrangements for its oversight by Entrust on which Customs should act as indicated below.

IDENTIFIED RISKS	RECOMMENDATIONS
<p>The complexity of the scheme may result in high transaction costs. Administration costs are borne by the Landfill site operators, environmental bodies; Entrust and Customs which in total could be considerable.</p>	<p>Customs should examine whether the scheme could be simplified without loosening key controls over tax credits and expenditure on projects. (Figure 3 and paragraphs 4.3, 4.4 and 4.22).</p>
<p>The complexity of the arrangements may lead people to suspect that there are irregularities in the operation of the scheme. Investigating these concerns entails more transaction costs.</p>	<p>Customs should look at whether the organisational responsibilities could be more clearly separated to avoid concerns over conflicts of interest (Figure 3). For example the waste management industry plays a key role in deciding which types of projects to fund; is represented on environmental bodies which carry out the projects and on the Board of Entrust which oversees the scheme.</p>
<p>There is a risk that Entrust's Board may appear to be biased - even unintentionally - against certain types of scheme and environmental bodies. This is because the decisions of the Board on the regulation of the Scheme could be influenced unduly in favour of site operators with their large grouping on the Board and especially as the waste management industry also provides the funds to the Scheme.</p>	<p>The recent changes to the composition of the Board should go some way to reducing the risk of decisions unduly favouring one group over another (paragraph 4.11 and Figure 6). Customs should consider further whether groups such as the waste management industry have too dominant a role whereas local community interests are less well represented.</p>
<p>There is a risk that environmental bodies may not be following Entrust's requirements for regulating the scheme.</p>	<p>Customs should:</p> <ol style="list-style-type: none"> <li>a) ensure that Entrust review whether all environmental bodies meet the most recent requirements for enrolment as set out in the amended Regulations (paragraph 4.19);</li> <li>b) consider ways to provide Entrust with a greater range of options for taking action against environmental bodies who do not comply with the requirements of the scheme such as in cases where these bodies persistently fail to provide information on a timely basis to Entrust (paragraph 4.20). This would require ministerial approval and changes to the Regulations;</li> <li>c) Consider whether to make it a condition of the scheme that: <ul style="list-style-type: none"> <li>■ Environmental bodies must commit contributions to projects within two years after receipt. This would ensure that large surpluses are not built up by bodies which could lead to abuses of the Scheme (paragraph 4.8);</li> <li>■ local authorities should not be allowed to require successful bidders for waste disposal contracts to make contributions to specified environmental bodies (paragraph 4.21).</li> </ul> </li> </ol>
<p>Entrust has approved 11,000 projects since 1996 with a staff of 26 from August 2000. There is a risk that the kind of examination that it is possible to do in these circumstances is only superficial.</p>	<ol style="list-style-type: none"> <li>d) accompany Lodge Service on a sample of visits to see whether the compliance checks on environmental bodies are being adequately carried out (paragraph 4.24)</li> </ol> <p>Customs should:</p> <ol style="list-style-type: none"> <li>a) ensure that Entrust devote sufficient resources to carrying out follow up visits to all bodies where there are serious issues of non compliance. With Entrust they should look at in particular whether Entrust should continue to use its scarce resources to give prior approval to projects (paragraph 4.18);</li> <li>b) make it a requirement that environmental bodies should prepare their audited accounts in a way that allows Entrust to check whether notifications received during the financial year have been fully accounted for (paragraph 4.15)</li> </ol>

# Part 5

## Losses to the revenue from excise duty diversion fraud

5.1 On 1 June 2000, Richard Broadbent, the Chairman of HM Customs and Excise, informed the Paymaster General, Dawn Primarolo, that a series of excise diversion frauds between 1994/1998 appeared to have been mishandled. He had commissioned an internal review to investigate the matter. The weaknesses in controls over the collection of duty and the failings of Customs' management had contributed to the loss of substantial amounts of revenue estimated at around £668 million from diversion onto UK markets. A further £216 million was lost resulting from diversion onto overseas markets where duty would have been due in the country of import had the goods not been fraudulently diverted. **Figure 10** provides the breakdown of these amounts.

5.2 The losses had arisen mainly between 1994-1998 from the growth in outward excise diversion frauds which took advantage of weak controls over the movement of alcohol. Customs' methods to investigate the frauds contributed to the level of losses although they were successful in prosecuting a number of criminals. In

1998, Customs tightened controls and the incidence of fraud declined but Customs did not issue assessments in a number of cases where the Department had carried out investigations. Customs also did not take appropriate action to note the extent and circumstances of the losses in their accounts as required under Government Accounting.

5.3 As a result of the findings of Customs' internal review, the Paymaster General was not convinced that sufficient action had been taken. She announced that an independent investigation, headed by John Roques, ex senior partner of Deloitte and Touche, had been commissioned to look into the matter.

### 10 Total identified revenue evaded and subsequent recoveries

	Excise Duty £m	VAT (estimated) <sup>1</sup> £m	Total £m
National Investigation Service cases	732	95	827
Regional Office cases	49	8	57
<b>Total revenue evaded</b>	<b>781</b>	<b>103</b>	<b>884<sup>2</sup></b>
<b>Recoveries</b>	<b>Confiscation £m</b>	<b>Cash £m</b>	<b>Total £m</b>
Amount recovered	25	23	48
<b>Net losses</b>			<b>836</b>

Note: 1. This is an estimate of the VAT evaded. This is because goods may have been sold to consumers and VAT may have been charged and paid over to Customs by the retailer who purchased the diverted goods either knowingly or unknowingly from the fraudster.

2. This figure includes 2 cases of £179m and £37m which arose from diversion onto overseas markets where duty would have been due in the country of import had the goods not been fraudulently diverted.

Source: HM Customs and Excise

5.4 Customs have undertaken a number of internal reviews on the revenue losses from excise diversion which I have examined. They have now produced an action plan to improve their controls over the collection of excise duty. In January 2001, the Department also announced significant changes to their management

#### Definitions

**Outward excise diversion frauds** involve the diversion from bonded warehouses to the home market of duty suspended goods which are destined for export. Inward diversion frauds involve the import of excise goods to a bonded warehouse but which are diverted onto the UK market without the payment of duty.

**Duty suspended revenue goods** are goods such as alcohol and tobacco where the payment of duty is postponed until they are released onto the UK market for consumption.

**A bonded warehouse** is one approved by Customs under the Customs and Excise Management Act 1979 or the Alcoholic Liquor Duties Act 1979 for the storage of goods without payment of excise duty (ie duty is held "in suspense"). Customs have given approvals to about 1100 in the UK. Such warehousing is allowed to facilitate the storage of goods until they are due for consumption enabling manufacturers and wholesalers to time the payment of the duty due nearer to the time when they will sell on their goods.

**Revenue losses** arise in cases where Customs raise an assessment for duty on a trader or an individual but the amounts cannot, or will not be collected by Customs. The losses are calculated by totalling the revenue evaded and then deducting any cash subsequently collected or expected to be collected. The losses include excise duty and VAT. The average amount of duty lost on a diverted consignment of spirits (a 40 foot trailer load) is approximately £100,000 and a similar consignment of high strength beer about £20,000.

structure (from 1 April 2001) which are designed to provide greater accountability and transparency. At this stage my report deals only with the extent of and accounting for the revenue losses. I will report again to Parliament once I have reviewed all the evidence on the causes and lessons to be learned in this case.

## Background

- 5.5 Since the advent of the Single Market on 1 January 1993 excise goods have not been subject to detailed checking at borders within the European Union, while at the same time regulations have placed the onus for reporting and controlling such goods passing through bonded warehouses on the owners of the warehouses, called warehousekeepers.
- 5.6 Once excise goods leave the bonded warehouse, duty is due unless they are validly exported or transferred to another bonded warehouse. Warehousekeepers are liable, together with the owners of the goods, for the duty due on any goods that are not properly (ie fraudulently) exported or transferred. A crucial problem when fraudulent activity has taken place has been that the owners of the goods were often the fraudsters and therefore either disappeared or had no available assets, leaving the Department with recourse only to warehousekeepers for the duty due.
- 5.7 Following the inception of the Single Market there was a rapid growth in the UK of fraud in the movement of predominantly spirits from bonded warehouses. To tackle this, the strategy of Customs' National Investigation Service was to take concerted actions against those perpetrating the frauds and obtain their conviction through court proceedings. Suspect consignments of goods were allowed to leave warehouses under observation, in some cases over a period of months, in order to gather sufficient evidence to support prosecution. In one case the illegal removal of goods from the warehouse continued for two years. While some fraudulent movements were disrupted others were not and substantial amounts of duty-suspended goods were allowed to leave warehouse

premises which then made their way onto the home market.

- 5.8 At the time, the view within the National Investigation Service was that letting consignments leave the warehouses was justifiable if it led to successful prosecutions and the duty was collected later through confiscation orders. They did not however make any assessment of the costs and benefits of their approach which would have helped them decide whether to continue to allow goods to leave the warehouse or disrupt the fraudulent activity more quickly and protect the revenue. When it became apparent that substantial losses were occurring these were not reported to Customs' senior management and there was a failure to monitor the scale of losses closely. Where losses were not covered by indemnities, assessments for duty were not issued. Losses were also not being written off or reported where it had been decided that assessments could not be raised.

## The extent of the revenue evaded

- 5.9 Work by Customs' Internal Audit has confirmed that available records indicate the revenue evaded at the present time from these cases of diversion frauds amounts to £884 million (**Figure 10**) and my review confirms this. However the records available were not complete and Internal Audit could not provide assurance that this was the full extent of the problem. Some £350 million of the losses (over 40 per cent of the total) had occurred at one warehouse. To date, Customs have recovered some £48 million or about 7 per cent of the total evaded giving the total net loss to the revenue at the present time of around £620 million. This does not take into account the £216 million of goods diverted onto the overseas markets. **Figure 11** provides an analysis year by year.
- 5.10 Internal Audit have attempted to distinguish the losses between those which arose during the course of investigations, where cases were "allowed to run"<sup>1</sup>, and losses which came to light after a case had been

### The National Investigation Service

The National Investigation Service is the criminal investigation arm of Customs. It provides a response to criminal activity in every area of Customs' operations. Many of the cases investigated by the Service are highly complex and are among the most significant criminal cases brought before the courts. To undertake this work the Service has over 1500 staff based in 15 key locations throughout the United Kingdom. It also has a network of 50 staff based overseas. The Service's running costs are over £100 million a year.

The work of the service is broadly divided into two functional groups: drugs and commercial fraud. Almost half of the Services' resources are directed towards investigations concerned with drug trafficking and the remainder on commercial fraud cases. Currently, the commercial fraud group targets primarily excise fraud and in particular criminal organisations involved in cigarette smuggling. It also investigates cases involving significant VAT fraud and Customs offences involving arms, paedophilia and breaches of strategic export controls. The commercial fraud group tackles many of these cases in co-operation with Customs Services in other European countries.

**11** Analysis of identified revenue evaded by financial year (£million)

	93/4	94/5	95/6	96/7	97/8	98/9	99/00	Total
Revenue evaded due to excise diversion onto UK markets	0.2	10.4	94.0	201.8	333.7	14.2	13.7	<b>668.0</b>
Revenue evaded due to excise diversion onto overseas markets		37.0			179.0			<b>216.0</b>

Source: National Audit Office analysis of HM Customs and Excise data

"knocked"<sup>2</sup>. They were unable to do so due to the lack of detailed information available but one estimate, based on the level of indemnities issued, is that roughly one half of the revenue evaded could be attributed to each category.

## How Customs have accounted for the revenue that cannot be recovered

5.11 Where Customs are unable to collect duty, or a decision is made not to collect it, Government Accounting requires that they must account for it as a loss. The total amount of losses incurred by Customs on all of their activities are aggregated and included in an annual losses statement, which I audit. They present this to the Treasury, and from 2000-01 this will form part of Customs' financial statements (Trust Statement). The 1999-2000 financial statements will include a note (instead of a statement of losses) on the existence and extent of the losses from outward diversion frauds while the full statement of losses is reproduced below.

5.12 Customs' Losses Statement for 1999-2000 discloses losses and remissions of some £1.34 billion of which £500 million relates to outward excise diversion frauds (**Figure 12**). Customs are attempting to recover the remaining £336 million lost to outward excise diversion frauds but if they are unsuccessful they will have to write off further amounts in the future.

5.13 The Losses Statement only records losses from outward diversion frauds where assessments could be made, that is those cases where Customs could identify an individual or business who should be assessed for the duty. The Statement does not provide the full picture of the scale of evasion. For example, on alcohol duty, Customs do not have the information in many cases which would enable them to raise assessments where frauds have occurred. Although the level of outward excise diversion frauds has reduced since 1998, Customs have found that inward diversion frauds and smuggling in freight into the UK have increased. Customs believe, for example, that there are significant revenue losses on alcohol imported to the UK.

5.14 Customs also found large-scale inward diversion when they were carrying out investigations into outward diversion at warehouses. However, for the inward excise diversion fraud cases identified by Customs, Internal Audit were again unable to give an assurance on the completeness of the schedule of losses because of the lack of sufficient documentation maintained by the

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### 12 Amounts of Revenue remitted or written off by Customs

	1998 £m	1999-2000 <sup>1</sup> £m
VAT write-offs	571.8	739.7
■ Insolvent traders	526.6	661.8
■ Missing traders	23.4	49.9
■ Other	21.8	28.0
Customs and other write-offs	3.4	7.1
Penalties and cost write-offs	50.5	65.3
Excise diversion	0.0	500.0
Remissions <sup>2</sup>	5.6	34.2
■ VAT	4.7	32.9
■ Other duties	0.7	1.2
■ Penalties and costs	0.2	0.1
<b>Total</b>	<b>631.3</b>	<b>1,346.3</b>

Notes: 1. From 2000 reporting of losses has moved onto a financial year basis and therefore the Department have produced a schedule to cover the 15-month period from 1 Jan 1999 to 31 March 2000. Figures are provisional.

2. Remissions are cases where Customs decide not to collect the debt because of equity (where a strict application of the law would be oppressive or unfair) or compassion (where a strict application of the law would result in severe deprivation or hardship to a trader of small means). Write off action is taken in cases where it is not possible to collect the debt.

Source: HM Customs and Excise

National Investigation Service on investigations. They also found it difficult to determine the exact amount of revenue lost in individual cases. The National Investigation Service is now developing a central case handling system but this will not be fully operational until late 2001.

## Conclusions

5.15 There has been a serious breakdown of controls within Customs which has led to a substantial loss of revenue. Although Customs became aware of the threat of outward excise diversion frauds as early as 1994 they did not take effective action to curtail these frauds until 1998. About half of the revenue could have been protected if fraudulent consignments had been intercepted rather than letting the investigations continue in order to obtain sufficient evidence to prosecute those involved or if effective action had been taken earlier.

5.16 I shall report separately to Parliament on the causes and lessons learned in this case.

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1. "Allowed to run" means Customs, as part of their investigation, allowed goods to be moved under observation in order to gain sufficient evidence to support prosecution.  
2. "Knocked" is the colloquial term used by Customs for disrupting criminal activity and arresting the suspected criminals.