

# HM Customs and Excise: Standard Report 2002-03

Report by the Comptroller and Auditor General 2002-03

# Executive Summary

1. Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Customs and Excise (Customs) on behalf of the House of Commons to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out; to examine the correctness of sums brought to account; and to report the results to the House of Commons. In 2002-03 Customs collected £154 billion<sup>1</sup> (gross) in taxes and duties, some £109 billion net after repayments.
2. No system can ensure that all taxpayers and potential taxpayers comply with their obligations. In considering risks to the assessment, collection and allocation of revenue, I review the way in which Customs itself manages these risks. The Department has developed robust methodologies for the identification and monitoring of key business risks (further details are set out in the Accounting Officer's Statement on Internal Control included within the departmental Resource Accounts and the Trust Statement).
3. During 2002-03, the National Audit Office examined systems for the assessment and collection and allocation of revenue across a number of Customs' areas of activity. The examination also covered the main information technology systems in place. This report sets out the results of the work carried out in relation to two key areas of Customs activities: assurance work with large businesses, and Customs' work to manage the risks of alcohol fraud.

## **Risks to revenue from Large Businesses**

- Customs have undertaken innovative restructuring, notably through the creation of the Large Business Group, to address the risks to revenue posed by large businesses. Initial signs are encouraging, with moves towards greater professionalism, better management control and substantial improvements in communications with traders. A sound foundation has been laid for future development. The key test is whether this will lead to improved revenue yield, and how this can be evaluated.
- Customs must maintain their focus on risks to revenue at both the trader and sector level. Good practice relating to risk assessment and planning should be integral to all assurance work, to ensure that resources are targeted where they can have the greatest impact. Performance measurement systems also need to be refined in order to provide an effective means of assessing assurance work. Customs are currently developing additional ways of measuring return on investment, so that the exact impact on revenue yield can be quantified. The results will also be important in comparing performance across the Department.

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<sup>1</sup> Source: HM Customs and Excise Trust Statement 2002-03

## **Managing the Risks of Alcohol Fraud**

- Customs' programme of measures to combat alcohol fraud is evolving. The various operational activities in this field are being brought together under a longer term Alcohol Strategy as set out in the Pre-Budget Report. Effective cross-departmental co-ordination will be required to bring together numerous existing anti-fraud initiatives under a strategic framework. The strategy aims to deliver a substantial reduction in the illicit share of the spirits market through new regulatory controls to be introduced during 2004, and the proposed introduction of tax stamps for spirits in early 2006 (unless an effective alternative is put forward by the industry).
- Establishing reliable estimates of fraud levels in relation to wine and beer is not a straightforward process. Customs are working to further enhance their methodologies in this area. In implementing the proposed strategy, other key areas for focus will include working to simplify and improve the regulatory framework, and managing and better communicating internally the role of the intelligence service within Customs in the fight against alcohol fraud.
- Customs' work on managing the risk of alcohol fraud has been a lower priority than that for tobacco and oils fraud, based on a relative assessment of the risk to revenue posed by each sector, and given overall resourcing constraints. Despite this, effective work has been carried out by the Department in prevention, detection and investigation of fraud against alcohol duty.

# Part 1: Scope of report

## Introduction

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Customs and Excise (Customs) to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue; to examine the correctness of the sums brought to account; and to report the results to the House of Commons. A detailed breakdown of gross receipts and repayments for each tax stream is separately reported within the Trust Statement account, included at section 6 in the Customs Annual Report.

## Audit approach and scope

1.2 In order to review the systems which Customs have put in place to secure an effective check on the assessment, collection and allocation of revenue, the National Audit Office undertake:

- examinations of Customs' internal controls, including the ongoing development of governance arrangements;
- reviews of quality assurance work and other checks carried out by the Department on the tax systems;
- periodic in-depth reviews of existing systems and significant changes to them, and the evaluation of new systems; including reviews of Customs' computer installations, networks and specific information technology applications; and
- test examinations of individual transactions and balances.

1.3 Information technology (IT) is essential to the administration of taxes and duties. Customs information systems hold data on all traders, process information, and produce a range of outputs designed to assist the trader and Customs to discharge their obligations accurately and efficiently. The National Audit Office, therefore, conduct regular examinations of how Customs manage the risks associated with the operation of their information systems. In 2002-03, the National Audit Office's coverage included the following examinations:

- Customs Handling of Import Export Freight (CHIEF);
- Alcohol IT Systems;
- VAT Systems;
- Customs IT Infrastructure; and
- Customs and Excise Core Accounting System (CECAS).

1.4 The topics covered in support of the C&AG's responsibilities under Section 2 of the Exchequer and Audit Departments Act 1921 in 2002-03 were:

- Customs' assurance work within large businesses;
- Managing the risks of alcohol fraud;
- Profiling of Revenue Receipts;
- Customs Freight Simplification Procedure (CFSP);
- Air Passenger Duty;
- Seizing the Proceeds of Crime; and
- Climate Change Levy.

This report details the findings and recommendations arising from the first two of these topics, which formed the main areas of our work for 2002-03. Issues arising from the remaining areas of work have been reported to Customs by way of management letters.

1.5 In addition to my examination of revenue systems under Section 2 of The Exchequer and Audit Departments Act 1921, I also examine the economy, efficiency and effectiveness with which Customs have used their resources. I report my findings to the House of Commons under Section 9 of the National Audit Office Act 1983. Since my last report on Customs' systems and procedures, I have also reported on Transforming the Performance of HM Customs & Excise Through Electronic Service Delivery (HC1267 2002-03).

### **Statements on Internal Control**

1.6 Each Accounting Officer is required to make a Statement on Internal Control covering all operations and financial systems. Customs produce two statements: one for the Resource Accounts covering administration costs and one for the Trust Statement, covering taxes and duties brought to account. The Statements report that Customs' framework of internal control is designed to manage rather than eliminate the risk of failure to achieve objectives or to account for public funds. Furthermore, they explain that a balance has to be struck between empowerment to achieve objectives, and controls to safeguard and account for public funds.

1.7 In previous years I have reported how Customs has updated its corporate governance structure, constructed a departmental risk register, and adopted a strategic approach to minimising the risks to revenue. Procedures are now in place to ensure that the risks the department faces are regularly reviewed, and that they are the responsibility of the Customs management team, who monitor and respond to these risks.

1.8 The Accounting Officer, in his Statements on Internal Control, states that he has responsibility for assessing the effectiveness of the control framework. In reviewing its effectiveness and formulating his Statements he has had regard to three tests: the benefit of any given control in safeguarding public funds; the impact of that control in terms of achieving objectives; and its cost. He has therefore considered whether any given control is providing benefit by reducing risk whilst allowing

Customs to deliver on its core objectives, and whether the cost associated with the controls is commensurate with the risk.

1.9 The Statements made by the Accounting Officer highlight one significant internal control issue, relating to the upgrading of Customs' Information Systems (IS) infrastructure, which is provided by Fujitsu under contract. Delays in concluding change negotiations for this contract have affected the delivery timetable for Customs' e-business programme. This has required Customs to deliver short-term tactical solutions to meet business requirements pending the full delivery of the e-business programme. The delay in replacing legacy systems has increased the risk of their possible failure. A major review of Business Continuity Planning has, however, been undertaken across the department to ensure that plans are in place to address risks arising out of the delay. No major system failures occurred during the 2002-03 year.

1.10 I am content that the Accounting Officer's Statements on Internal Control are consistent with the National Audit Office's knowledge of Customs and Excise. My report on Transforming the Performance of HM Customs & Excise Through Electronic Service Delivery considers in more detail a number of the issues associated with the delayed upgrading to Customs' IS infrastructure.

## Conclusions

1.11 I have given unqualified audit opinions on Customs' 2002-03 Resource Accounts and their Trust Statement on which taxes and duties are brought to account.

1.12 In discharging my responsibilities under Section 2 of the 1921 Act, I have regard to the Accounting Officer's Statements on Internal Control, and particularly to the statement that 'his system of internal control supports (within the resources available) the achievement of departmental objectives, as defined by statute and Ministers'.

1.13 The Accounting Officer has reported in his Statements on Internal Control how the Customs control framework operates, including controls associated with the collection of revenue, and significant control issues arising out of his own review of internal controls. Subject to those issues and in the light of matters outlined in the detail of my report, my work in 2002-03 provides assurance that Customs' regulations and procedures provided an effective check over the assessment, collection and allocation of tax.

1.14 The work of the Large Business Group marks a significant step by Customs to engage effectively with and manage large businesses, and to target risks to the collection of revenues. On alcohol fraud, Customs is seeking to develop a more strategic approach, building upon the range of operational measures already in place. The progress made by the Department in both areas is to be welcomed. We look to Customs to continue its work in developing measures of the impact of its work in these sectors, and through effective cross-departmental co-operation to build on the areas of good practice identified elsewhere in this report.



# Part 2: Addressing risks to revenue in the large business environment

## Executive Summary

Customs have undertaken innovative restructuring, notably the creation of the Large Business Group, to address the risks to revenue posed by large businesses. Initial signs are encouraging, with moves towards greater professionalism, better management control and substantial improvements in communications with traders. A sound foundation has been laid for future development. The key test is whether this will lead to improved revenue yield, and how this can be evaluated.

Firstly, Customs must maintain their focus on risks to revenue at both the trader and sector level. Good practice relating to risk assessment and planning should be integral to all assurance work, to ensure that resources are targeted where they can have the greatest impact. Performance measurement systems also need to be refined in order to provide an effective means of assessing assurance work. Customs are currently developing additional ways of measuring return on investment, so that the exact impact on revenue yield can be quantified. The results will also be important in comparing performance across the Department.

## Introduction

2.1 Revenue collection is Customs' core business and is delivered by the Business Services and Taxes Division. This is particularly challenging in the large business environment due to the complexity of the businesses concerned and the technical skills required. Large traders are defined by Customs as those businesses with over £12 million VAT throughput (and for those managed by Large Business Group, £100 million VAT throughput).

2.2 In its 1997-98 report<sup>2</sup>, the Public Accounts Committee (PAC) were concerned that Customs did not monitor separately the effectiveness of its large trader assurance activity. A series of strategic reviews resulted in the reorganisation of Customs' Business Services and Taxes Division in 2000-01. Just over 1,000 of the largest businesses<sup>3</sup> were allocated to Large Business Group which allowed specialised focus on the most significant traders. The remaining large businesses, about 1,300, were combined with small and medium enterprises within Regional Business Services in a sub-group called Trader Group 6. The structure of these groups is shown in Figure 2.1.

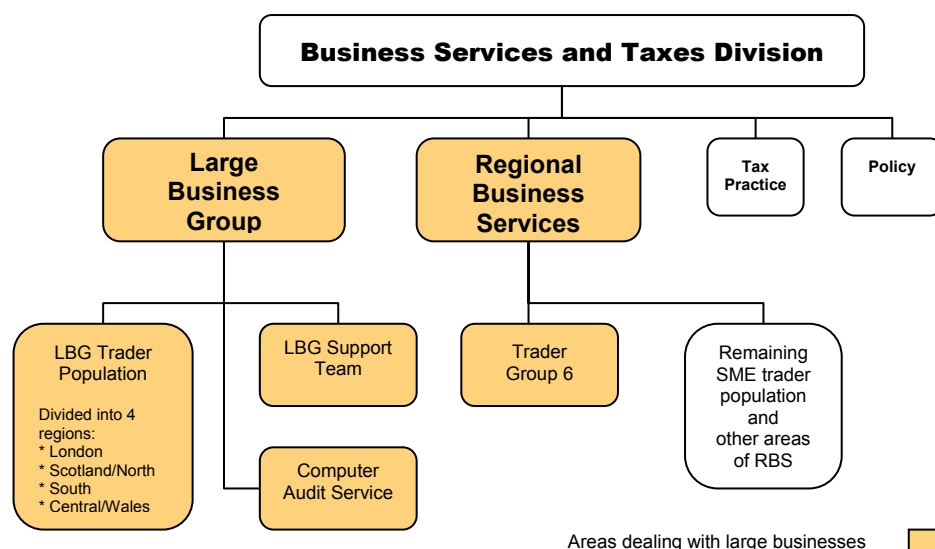
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<sup>2</sup> *Checking Large-Traders' VAT Liability* (HC 445 1997/98), Public Accounts Committee

<sup>3</sup> Selected on a combination of revenue throughput, tax yield, risk and significance.



Figure 2.1: Customs' revenue collection structure



Source: Customs

In 2002-03, Customs collected £109 billion net in taxes and duties. Figure 2.2 shows the breakdown of revenue collection by unit and tax function.

Figure 2.2: Revenue collection for 2002-03

	Large Business Group		Regional Business Services		Total (£bn)
	(£bn)	(%)	(£bn)	(%)	
<b>VAT</b>	22.5	34	43.5	66	66*
<b>Excise &amp; IT</b>	35	81	8	19	43
<b>Total</b>	<b>57.5</b>	<b>52.8</b>	<b>51.5</b>	<b>47.2</b>	<b>109</b>
<b>Number of Traders</b>	1,050		1.7 million (1,300 in TG6)		

Source: Customs \*VAT total includes £2.1 billion Insurance Premium Tax

2.3 The National Audit Office review examined the effectiveness of the restructured arrangements for large businesses. Initial signs are encouraging, with a move towards increased professionalism, better management control and improved relations and communication with large traders. It is too early for us to evaluate fully the impact of some of these initiatives, such as the introduction of National Business Managers and Trade Sector Consultants within Large Business Group and the development of sector projects throughout Business Services and Taxes.

2.4 This chapter considers the following issues:

- Differences in approach to assuring revenue from large businesses between Large Business Group and Trader Group 6;
- Approach to addressing risks to revenue in assurance work;
- Evaluation of Customs' work with large businesses;
- The focus on trade sector risk throughout the Department; and
- Recent initiatives within Large Business Group.

### **Organisation of revenue collection for large businesses**

2.5 Within the Business Services and Taxes Division, Large Business Group and Regional Business Services employ different approaches for assuring revenue from their trader populations.

#### ***The Large Business Group approach***

2.6 Large Business Group have pioneered a 'whole trader approach', which involves the assessment of risk across the trader's whole commercial structure, across regions and tax regimes. Customs hope to make significant gains from having one team assessing a large trader's entire tax concerns, including VAT, Excise and International Trade. This intensive approach generates regular contact between Large Business Group and the trader throughout the year so all communication, planning and assurance work is channelled through a single point of contact. A National Business Manager is responsible for the largest or most complex traders, which is a senior and technical role recently introduced by the Large Business Group. The remaining 30 per cent of traders have a less senior manager.

2.7 The central tenet of Large Business Group's strategy is to provide service to business by building a relationship between the trader and National Business Manager. Traders receive personalised advice, support and communication on all indirect tax matters, rather than the traditional audit approach. Early indications show a positive effect on compliance levels and increased revenue identification. Some examples of how National Business Managers provide service to business whilst securing revenue are shown in Figure 2.3.

**Figure 2.3: Examples of service to business from National Business Managers (NBM)**

- **Getting tax ‘on the boardroom agenda’:** An overseas-based company has grown recently in the UK by acquisition. The NBM was concerned that this trader was not focused on indirect tax affairs of the UK subsidiary. These concerns were escalated to director level and a decision was made by the Board to restructure the taxation department to address Customs’ major concerns.
- **Education & support:** Customs’ assurance staff identified significant areas of weakness in a manufacturer’s warehouse and production processes. These had implications both for Customs and for the company. The NBM persuaded the Production Director to investigate and draw up an action plan which included a specific objective on compliance with Customs’ requirements in every manager’s performance agreement.
- **Service to businesses:** The share price of a large trader was performing poorly. The trader advised the NBM of significant cash flow problems that prevented the company meeting its tax commitments. Sensitive handling of this information avoided a further collapse of share price and possible insolvency. The NBM facilitated discussions with Inland Revenue, Customs and the trader’s Board to find a solution to protect tax revenue and continuance of the business.

*Source: Customs*

### ***The Regional Business Services approach***

2.8 Regional Business Services undertake a two-tiered risk assessment process to determine which traders require assurance attention. A central risk assessment (‘Sift’) is conducted on the entire population to allocate traders to different groups prioritised by risk. This is followed by a more detailed local risk assessment by the regional offices, who will then decide which traders should be contacted. However, the sifting process is not always being correctly followed for Trader Group 6, with some regions not including Trader Group 6 traders within the sift exercise, because they are visited by a Customs Officer every year. A nominated regional Trader Group 6 officer is responsible for organising the trader visit and deciding on the extent of risk assessment and planning that takes place.

2.9 In 2002-03 the 1,300 businesses in Trader Group 6 paid £2.9 billion in taxes and duties (or 6 per cent of the total tax declared by those in Trader Groups 1 to 6) and received repayments of £3.5 billion (or 17 per cent of total tax declared by those in Trader Groups 1 to 6) because of the large number of colleges, universities and local authorities in this group. The group is therefore a net recipient of £600 million of VAT payments from Customs (based on trader returns for tax declared in credibility year September 2001-02).

## **Addressing risks to revenue in the large business environment**

2.10 To maximise the use of its resources and manage effectively the collection of revenue from businesses, Customs target their resources at areas of greatest risk. To ascertain the effectiveness of risk targeting of large trader assurance work, the National Audit Office carried out a review of Customs' documentation for large businesses in high-risk trade sectors during 2002-03. The trade sectors selected were those ranked by Customs as posing the highest risks to revenue for large businesses: Banking; Education; Health; Land/Property; and Motor Manufacturing, which are net payers of VAT and Public Authorities which are net recipients [see Figure 2.7]. The purpose of the review was to establish whether basic planning documentation was in place (Strategic Assurance Plans), whether key risk areas were targeted and prioritised, and whether work was completed as planned.

2.11 The test criteria were based on key information deemed necessary for an effective revenue assurance approach to large traders, according to external auditing standards and Customs' own internal guidance. The National Audit Office randomly selected 90 cases from Large Business Group, of which 60 were managed by National Business Managers and 30 by a less senior officer (non-National Business Manager cases); and 30 cases from Trader Group 6. Full Strategic Assurance Plans are not a formal requirement within Trader Group 6 because Customs believe that they would be disproportionately resource intensive for this category of trader, so the review focused on whatever documentation was available. Customs is introducing an adapted, abridged version of the Strategic Assurance Plan in 2004-05 geared towards Trader Group 6.

### ***Large Business Group well-focused on risk***

2.12 Strategic Assurance Plans produced by National Business Managers were generally of a good standard [see Figure 2.4]. Risk was nearly always addressed, although some assessments were not fully documented or prioritised. This was because there was no prescriptive format for planning documentation in 2002-03. The introduction of a standard electronic format for Strategic Assurance Plans in 2003-04 should improve the quality and value of key documents such as risk assessments.

2.13 The quality of information for non-National Business Manager cases tested (also part of Large Business Group) was generally of a high standard. They tended to have less documentation than National Business Manager cases, reflecting Large Business Group's differing investment priorities towards these less significant traders.

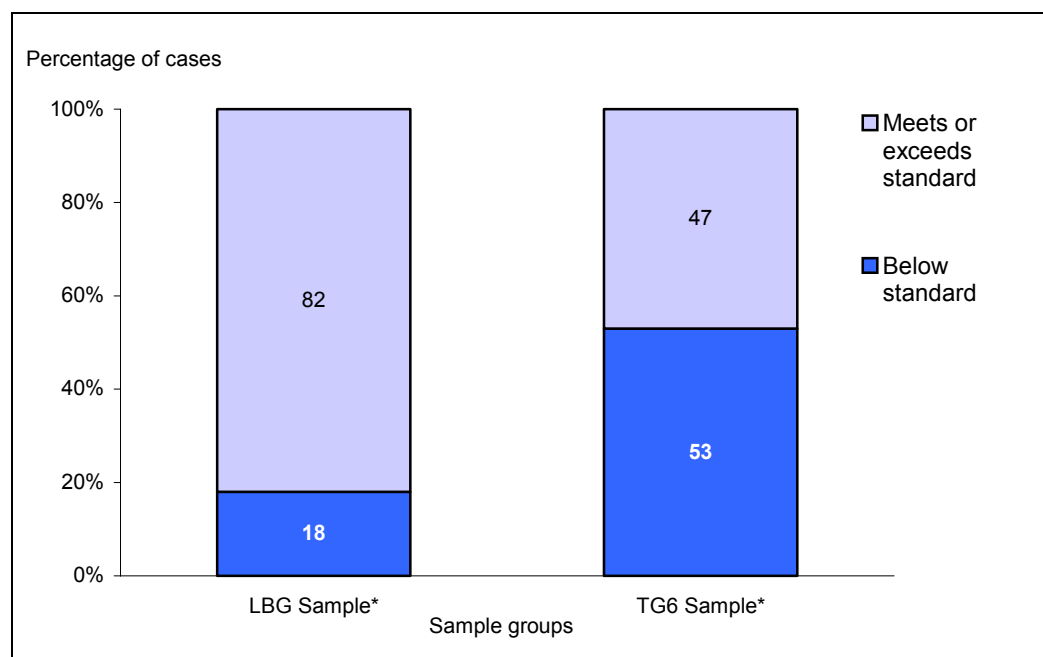
### ***Trader Group 6 to adopt standard approach to risk assessment***

2.14 There is a standard approach and guidance to assessing risk and planning assurance for small and medium sized traders generally that includes Trader Group 6 traders but nothing specifically tailored for large businesses (see paragraph 2.1) within Trader Group 6. Although specific instructions have been issued by the VAT Operations Team that resources should be pooled within each regional office to allow the flexible use of assurance time; our testing revealed that some regions had not

followed these instructions, and were allocating a standard amount of assurance time to individual traders. The quality and quantity of documentation relating to planning and assurance work was found to be variable in the large business examples that we examined. There were examples of good practice within the South-East and Midlands regions, where certain offices had adopted a risk-based approach to their assurance work with large businesses. The National Audit Office was encouraged by the initiatives now taking place to identify and disseminate good practice on Trader Group 6 assurance work.

2.15 In some cases the documentation for Trader Group 6 cases was insufficient to show what occurred during the visit and whether objectives were achieved. In the absence of a risk assessment, there was no evidence to indicate that assurance work had been addressing key risk areas. Following discussions with the National Audit Office, Regional Business Services are undertaking further work to standardise Trader Group 6 documentation and introduce a cost-effective form of risk assessment following on from a need already identified in 2002-03 through existing Customs internal assurance processes. Work is in progress to implement this within the 2003-04 financial year.

**Figure 2.4: Greater focus on risk assessment documentation in Large Business Group**



Source: National Audit Office

Note: \* Large Business Group sample was 90 cases and Trader Group 6 sample was 30 cases (see paragraph 2.11)

### Evaluating the impact of Customs' work with large businesses

2.16 Customs need to be able to measure the effectiveness of their work with large businesses. It is extremely difficult to ascertain a total measure of performance for revenue collection, as it must also include an estimate of prevention of revenue leakage. Customs must be able to assess the impact on revenue of all their work,

including the prevention of error, non-compliance, fraud and artificial avoidance, to produce a rounded view of their performance. Cross-divisional reporting within Business Services and Taxes to enable management to assess the relative cost effectiveness of the individual operations of Large Business Group and Regional Business Services is also important. The National Audit Office encourages Customs to continue their work in developing appropriate performance measurement systems.

### ***Customs' high-level targets***

2.17 A key objective for Customs is the delivery of year on year improvements in the level of compliance of businesses with their obligations to pay VAT. In the Pre-Budget Report for November 2002, the Government announced that it had set Customs a further target of "closing the VAT gap". Realistically there will always be an element of the total theoretical tax yield that will not be collected by Customs. This is because of the costs involved in totally eliminating losses and the need to strike a balance between applying effective controls to protect the revenue while not overburdening honest traders with compliance costs. Customs is required to stop "the long-term growth in the size of VAT losses as a percentage of the theoretical VAT yield, cutting it from 15 per cent to 12 per cent by 2005-06"<sup>4</sup>. Customs is seeking to meet this target by reducing VAT losses in four key areas – General Non-Compliance, Avoidance, Missing Trader Intra-Community Fraud and Failure to Register. The planned contribution of Large Business Group and Regional Business Services to this work is based on the estimated proportion of these problems in their trader populations.

2.18 Data recording the combined contribution of Large Business Group and Regional Business Services towards Customs' high level targets is consolidated in Customs' monthly Management Accounts. However, at present there is no central performance reporting within the Business Services and Taxes Division, bringing together results for Large Business Group and Regional Business Services on a comparable basis. Both groups require their own unique reporting systems given their distinct business priorities. However, central reporting on a consistent basis would assist management in decision making, particularly for future deployment of resources both between and within Large Business Group and Regional Business Services. It would also contribute to a Departmental overview of performance. Where there are feasible opportunities to have comparable performance indicators, Business Services and Taxes should develop forms of cross-divisional reporting.

### ***Measuring progress against these targets***

2.19 Customs are developing ways of measuring their progress towards the overall target for reducing the VAT gap. From 2003-04, the main indicator used by Customs to assess their performance is revenue yield, rather than "Net Additional Liability" which included large amounts of irrecoverable debt such as that relating to Missing Trader Fraud. Revenue yield represents net VAT and all other taxes and duties actually paid by businesses in any given time period.

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<sup>4</sup> *Pre-Budget Report* ("Protecting Indirect Tax Revenues"), HM Customs and Excise, November 2002.

2.20 Revenue yield, however, does not fully reflect all the work carried out by Customs. For example, it does not include the significant contribution made by Large Business Group's National Business Managers towards improving business compliance (such as the control of artificial VAT avoidance schemes and pre-emption of costly tribunal cases, with millions of pounds of revenue at stake). Customs are examining the challenging issue of how these qualitative achievements can be evaluated in 2003-04.

2.21 Large Business Group and Regional Business Services are also investigating ways of evaluating the overall quality of their performance. Regional Business Services are developing a system for their central support team to undertake quality assurance of regional work, to commence from 1 April 2004. Large Business Group are exploring the possibility of an independent quality assurance team, and are examining approaches adopted by the Department of Work and Pensions in assuring the quality of their benefit payments work.

#### ***National Audit Office review of performance management systems***

2.22 Prior to 2003-04 the two main performance indicators used within Business Services and Taxes were:

- Net Additional Liability - the net amount of tax that is found and assessed by an officer, as a direct result of assurance work; and
- Future Revenue Benefit - the estimated amount that will accrue to Customs, or the trader, as a direct result of assurance work, over the following twelve month period (for example, identification of an error in the method of apportioning VAT could result in increased VAT payments).

Regional Business Services did not introduce Future Revenue Benefit until 2002-03 after trialling and evaluating its effectiveness, whilst Large Business Assurance (the predecessor to Large Business Group) introduced it in 1999-00 (after trials they considered it to be a more effective indicator of their assurance work). Despite measuring Net Additional Liability, Large Business Group do not believe it is an appropriate measure of success, and do not have targets for it, although it is used for reporting purposes. There are also differences in the way that the two bodies *report* Net Additional Liability on VAT. Customs acknowledge the limitations of these measures and are identifying a consistent methodology for monitoring progress on tax yield targets.

#### ***Systems in place and targets met in 2002-03***

2.23 The National Audit Office review looked at operational performance against targets for large businesses during 2002-03. The main performance targets for Net Additional Liability and Future Revenue Benefit were met (within five per cent of target) or exceeded. The review also looked at systems for recording, monitoring and analysing performance within Large Business Group and Trader Group 6 in 2002-03.

**Figure 2.5: Net Additional Liability within Business Services and Taxes**

<b>Net Additional Liability £m</b>	<b>2001-02</b>	<b>2002-03</b>	<b>Achievement against target %</b>
LBG	527	1,065	102+
TG6	59	71	20+

<b>Net Additional Liability £m</b>	<b>Target 2002-03</b>	<b>Outturn</b>	<b>Achievement against target %</b>
LBG	*	*	
TG6	63.9	71.0	11+

Source: Customs

Note: \*Large Business Group did not set a Net Additional Liability target for 2002-03, because they wanted to shift the focus of assurance effort to achievement of Future Revenue Benefit

**Figure 2.6: Future Revenue Benefit within Business Services and Taxes**

<b>Future Revenue Benefit £m</b>	<b>2001-02</b>	<b>2002-03</b>	<b>Achievement against target %</b>
LBG	286	325.8	14+
TG6	*	26	*

<b>Future Revenue Benefit £m</b>	<b>Target 2002-03</b>	<b>Outturn</b>	<b>Achievement against target %</b>
LBG	314.6	325.8	4+
TG6	15.9	26.0	64+

Source: Customs and National Audit Office

Note: Figures for Trader Group 6 for 2001-02 were not collected.

2.24 Large Business Group have made good progress towards establishing a performance monitoring framework, and achieved generally good results against performance indicators and targets. Large Business Group are continuing to develop effective methods of tracking performance, feedback to management and early warning systems to ensure that problems are identified and investigated. There is an effective level of reporting on a monthly basis to the Large Business Management Group and staff. The Management Group are using this information on a regular basis for decision making.

2.25 There is potential to enhance further the format and focus of Large Business Group performance indicators to make them more specific and more easily measurable. With the introduction of electronic Strategic Assurance Plans in 2003-04, Large Business Group will be able to access further performance data in a more immediate fashion. This will allow the group to maintain timely performance information and enable management to respond quickly to any significant changes in performance.

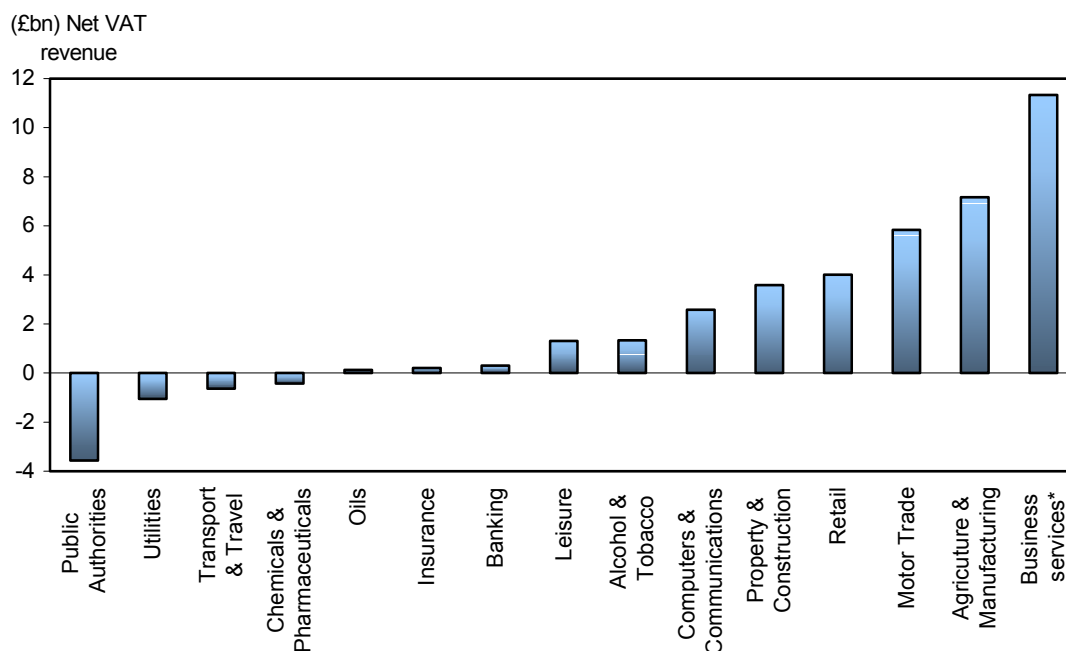


2.26 For Trader Group 6 in 2002-03, Net Additional Liability and Future Revenue Benefit targets were met. They also reported on the number of assurance events to traders planned and undertaken. During the period Trader Group 6 achieved 91 per cent of planned assurance events. Those which did not take place were due in part to trader insolvency or deregistration.

### Maximising sector impact

2.27 Customs operate across a wide range of trade sectors which raise complex issues in targeting risk. Figure 2.7 shows the significance of high VAT revenue paying sectors, and also those sectors attracting high repayments to traders (some of these traders are covered by Trader Group 6). Over the past two years, Customs have been developing their sector knowledge management, for example by deploying Trade Sector Consultants. These industry experts, hired both internally and externally, have identified many important sector risk projects.

**Figure 2.7: Net VAT receipts or repayments by trade sector**



Source: Customs

Note: Negative figures represent net VAT repayments in sectors where businesses are often zero-rated for VAT purposes, but are able to reclaim input tax.

\* Business services include legal, accounting, marketing, consulting, architecture, advertising, recruitment and other professional activities.

### Sector focus helps target risks to revenue

2.28 The increased focus on trade sectors has allowed better targeting of risk and more effective deployment of assurance activity within Large Business Group. Increasingly, National Business Managers handle a cluster of traders within similar sectors. For example, a single National Business Manager is responsible for Adidas, Manchester United, Umbro and JJB sports, with Nike soon to join this group. With the contribution of Trade Sector Consultants, National Business Managers are able

to assess trader risk against the sector profile and to identify risks at each stage of the supply chain, identifying the impact of assurance work at every stage.

2.29 Elsewhere in Customs, Trade Sector Consultants work with Regional Business Services, Tax Policy Branch, Units of Expertise and Law Enforcement on particular areas of concern. For example, the Banking and Finance Trade Sector Consultant has contributed significantly to a project within Law Enforcement on the financial networks behind Missing Trader Fraud. The work of the Public Administration Trade Sector Consultant provides a good example of the wider impact that sector specialisation can have in disseminating best practice within the business area and Customs [see Figure 2.8].

**Figure 2.8: The work of the Trade Sector Consultant for Public Authorities**

	<p><i>Kevin Brewer (left), Trade Sector Consultant for Public Authorities with Jim Ratty, Secretary to the CIPFA VAT Committee</i></p>
	<p><b>Knowledge Management Group</b></p> <ul style="list-style-type: none"><li>• Broadcasting the work of Trade Sector Consultants within Customs, identifying early good practice in the field and passing it amongst the existing consultants.</li></ul>
	<p><b>Creation of Community of Good Practice with the Chartered Institute of Public Finance &amp; Accountancy (CIPFA) looking at public administration</b></p>
	<ul style="list-style-type: none"><li>• On-line discussion group to resolve areas of difficulty before they become entrenched problems, including CIPFA, local authorities, tax advisers and Customs' operational staff.</li></ul>
	<p><b>Gaining the confidence and trust of public authorities</b></p>
	<ul style="list-style-type: none"><li>• Customs use the CIPFA website to interact with public authorities. The Trade Sector Consultant has completed an analysis of burdens on business, aided by local authorities.</li><li>• Lists of common tax errors (identified by Customs) sent to local authorities.</li></ul>
	<p><b>Working to promote a community of good practice within Customs</b></p>
	<ul style="list-style-type: none"><li>• Input to monthly magazine for Customs staff involved with public authorities.</li><li>• Project on Best Assurance and Service within the public sector. This seeks to promote a consistent approach to public authorities.</li><li>• Pilot for sector specialism: two Customs officers with public authority expertise advising other staff on assurance work, including accompanying them on visits to traders.</li><li>• Working with risk managers to focus on risk to revenue within the local authority sector.</li></ul>

Source: Customs

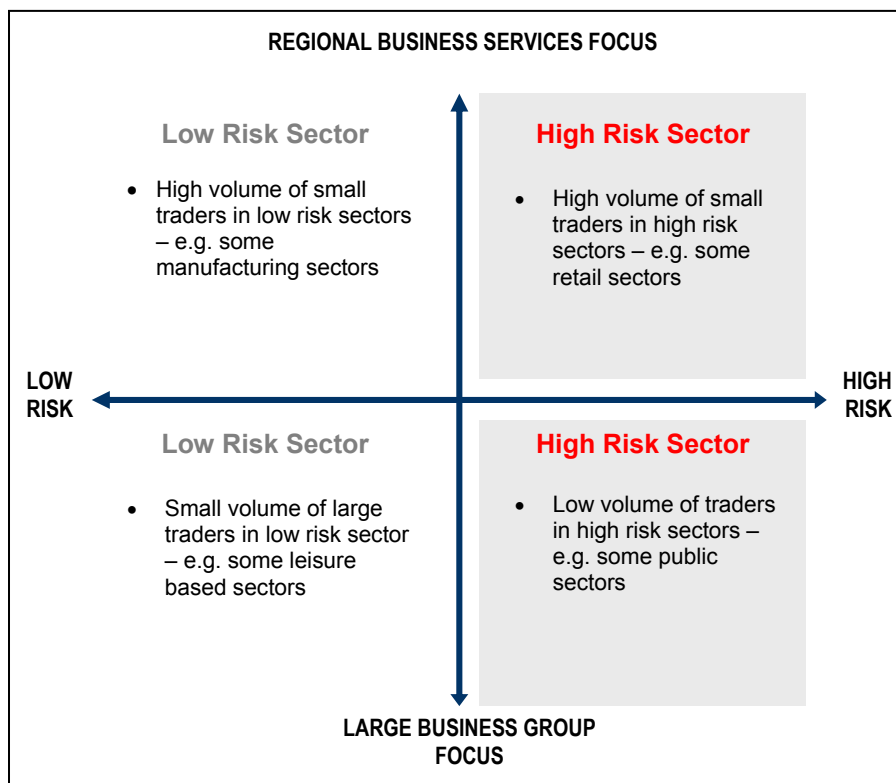
**Innovation in analysing sector risk**

2.30 One of the most important sector-based developments being carried forward by Customs in its work with both large and small businesses is an initiative called Project QUARTZ. It was launched by Regional Business Services and the Trade Sector Consultants to examine sector risk across the division. QUARTZ seeks to identify, quantify and compare risk to Customs' VAT revenue by sector. The project has been structured around two key phases;

- Phase 1 - Commissioning of in-depth sector risk reports which, for the first time, identified all the risks to revenue within each sector; and
- Phase 2 - Assessment of relative risks across sectors to prioritise risk areas for Regional Business Services and Large Business Group.

2.31 Project QUARTZ has been an important step forward for Customs. For the first time, it allows the Department to identify and prioritise sector risks affecting VAT revenue in either the large business or small and medium enterprise environment. The results matrix identifies two significant populations of trade sectors [see Figure 2.9]. The first category concerns high-risk sectors that are made up of a large number of smaller traders (top right of matrix), which is a focus for Regional Business Services. The second category isolates high-risk sectors in which fewer, yet larger traders operate (bottom right of matrix) and is the realm of Large Business Group.

**Figure 2.9: The QUARTZ matrix prioritising sector risk to VAT revenue**



Source: Customs

Note: There is some cross over between sectors between the Large Business Group and Regional Business Services.

2.32 QUARTZ has also generated interest in applying the trade sector approach to regimes other than VAT. One current Excise project called 'Cradle to Grave' dissects the spirits supply chain (where the main risks come from fraud and smuggling in the alcohol sector) from production to retail sale point. This involves the Trade Sector Consultants for Alcohol, Leisure, Retail and Transport. "Cradle to Grave" enables Customs to take a holistic look at the business processes from manufacture to sale, and to assess the impact of the different risks at each stage [see Part 3].

2.33 Where successfully applied, the pooled knowledge of QUARTZ will allow Customs to use their existing resources more effectively by targeting assurance work. Sector specialists within Customs can also assist assurance staff throughout the Department in dealing with complex tax situations. Customs should maximise the potential of this sector knowledge, and continue to develop the valuable sector projects that have been launched during 2002-03. This has already been reflected with the introduction of Quartz 2 in August 2003, which is examining risks presented by environmental and legal developments.

***External sector threats***

2.34 Sector analysis such as project QUARTZ has also identified 'external' risks to large business tax revenues over which the Department has limited control. These are derived in part from the complexity of VAT legislation, which is subject to regular review and change needed to tackle new ways which are identified by traders to reduce their tax exposure. Often this means that large businesses in the private and public sectors choose to hire VAT consultants to manage their indirect tax affairs. The challenge for Customs is to ensure that the same level of expertise is available to assurance officers in their dealings with large businesses. The National Audit Office examined trade sectors that have been ranked by Customs as posing the highest risks to revenue for large businesses - Banking, Education, Health, Land & Property, Motor Manufacturing and Public Authorities – and assessed the key VAT revenue risks posed by large traders in these sectors:

- Differing interpretations of VAT legislation;
- Complexity of the tax system; and
- Particular risks involving repayments to Local Authorities.

2.35 One of the more significant misinterpretations of VAT legislation occurs in relation to the apportionment of VAT between business and non-business activities, and also between taxable and exempt business supplies. Where goods or services are used both for business and non-business purposes, VAT must be apportioned so that only that related to business activities is counted as input tax. Furthermore, where input VAT relates to taxable and exempt supplies, businesses must apportion the input VAT between these supplies, and subject to certain lower limits, only recover from Customs the input VAT related to their taxable supplies. Some organisations have to undertake both apportionments.

2.36 Organisations with business and non-business activities, which include schools, universities and charities, are permitted by the legislation to change the basis on which they apportion the VAT they incur between their business and non-business activities. There is no limit to the number of times that the basis of apportionment can be changed. Whilst this offers them flexibility to deal quickly with changing circumstances, it does increase the scope for manipulation whereby they will seek to increase the VAT that is recovered.

2.37 Businesses making taxable and exempt supplies must apportion the input VAT in accordance with a partial exemption method. They can either adopt the standard method that is described in law, or agree an alternative special method that better meets their particular needs. Customs will accept any method provided the result is “fair and reasonable”. “Fair and reasonable” is not defined in the legislation; instead it is a matter for the judgement of the trader and the Customs Officer, guided by internal instructions, and Departmental practice as guided by the Courts. This allows Customs Officers to come to pragmatic solutions when negotiating with traders as to the appropriateness of the basis for the partial exemption method. Customs will only challenge an apportionment if it is outside what they perceive to be the acceptable range. However, businesses whose partial exemption methods are beneficial to them, often resist challenges from Customs, and this can in some cases lead to continued higher levels of recovery of input VAT until the methods are renegotiated and agreed.

2.38. Large businesses and Trader Group 6 traders seeking clarification of VAT regulations can approach their designated contact point. Traders may also contact the National Advice Service where they do not have a designated single point of contact, and it is important that Customs ensure that the service is able to offer appropriate advice.

2.39 The complexity of VAT legislation is particularly evident in certain trade sectors. In the Land and Property sector, for example, there have been over 30 changes to rules concerning VAT since 1989. Complexity often leads to avoidance, although legislation frequently needs amending to close up further loopholes identified by avoiders.<sup>5</sup> Customs believe that every business has the right to plan their tax affairs; however artificial avoidance is beyond what is termed acceptable by Customs and may lead to a Tribunal hearing. One area of concern is in the public sector where VAT ‘exempt’ activities (such as finance, health, education etc) are contrived to appear as business activities so that VAT can be recovered on costs.

2.40 There is great complexity in applying VAT to intra-European transactions as demonstrated by the UK motor manufacturing sector. The UK car manufacturing industry is part of a European Industry, with strategic decisions being made on a European level, and parts, which make up 80% of a car’s cost also being sourced on a European level. A manufacturing process that involves dozens of cross European transactions has a considerable exposure to VAT risk from the international nature of the process.

2.41 Tax avoidance schemes pose one of the greatest risks to revenue collection from large businesses. The Government’s approach to tax avoidance was set out in the Pre-Budget Report of November 2002. In its response to the problems of VAT avoidance, in August 2003 Customs began a national VAT anti-avoidance visiting programme designed to identify and challenge avoidance schemes. Customs have been able to adopt this strategy through the use of anti-avoidance officers, both at

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<sup>5</sup> Artificial avoidance involves use of “artificial schemes and devices for the purpose of reducing or delaying their liabilities, and thereby seeking an unfair advantage over their competitors” *Pre-Budget Report* (“Protecting Indirect Tax Revenues”), HM Customs and Excise, November 2002.

Customs Headquarters and in the Regions. As a component of the VAT Compliance Strategy, Customs recruited an additional team of expert anti-avoidance staff. These staff are employed solely to identify businesses who use avoidance schemes, and tackle vigorously these schemes in whatever way is appropriate – detailed analysis and investigation, litigation or the development of potential changes to tax law.

2.42 Unlike private businesses, local authorities may claim VAT refunds on ‘non-business’ activities. Some 93 per cent of the Public Administration Sector (local authorities, police and fire authorities) is classified as non-business. Although local authorities are not high tax payers, they receive the most in tax repayments of all sectors - £5.1 billion gross in 2002-03. Customs’ assurance work in the sector has become critical. QUARTZ reports suggest that the return on investment gained by investing staff time in assurance work on local authorities is one of the highest of all the sectors [see figure 2.10].

**Figure 2.10: Customs’ return on investment in high risk trade sectors at September 2002**

Trade Sector	Net Additional Liability per Staff hour (£)		Net Additional Liability per Staff hour (£)
Telecommunications	2,460	Insurance	1,234
Local Authorities *	2,030	Health **	1,130
Retail	2,004	Education **	1,050
Alcohol	1,880	Motor Trade	878
Land & Property	1,636	Construction	793
		Leisure	564

Source: Customs

Note: \* Includes Local Authorities, Fire and Police Services. \*\* Includes publicly funded bodies

### New initiatives within Large Business Group

2.43 Since the end of 2002-03 Large Business Group are taking forward a number of innovative programmes which include:

- Reorganisation of revenue collection into specialised tax and audit functions;
- Movement towards a professionally qualified workforce; and
- Introduction of sector specialisation to harness and develop expertise in specific tax areas.

2.44 A key initiative that is currently being developed within Large Business Group for 2003-04 is the reorganisation of assurance activity into two streams. **Compliance Management** will focus on revenue risk and aims to assure tax revenues and maintain a relationship with the trader. This work is co-ordinated by the National Business Manager. **Audit** work will focus on systems risk and addresses the trader’s systems using computer interrogation techniques. It is

proposed that the new Audit Service will comprise a central pool of specialists that target key risk areas rather than being assigned to particular traders. Audit work will be agreed between the National Business Manager and the Audit Service Client Manager and will be based on risk analysis of generic systems, as well as trader specific concerns.

2.45 The division of Large Business Group work into these streams has coincided with Customs' central project of increasing staff professionalism through accredited training and providing structured career paths for staff. Within Compliance Management and Audit, officers are encouraged to pursue formal tax or audit qualifications such as the Advanced Diploma in VAT Assurance, Legal and Technical Training and then the Associate of Institute of Indirect Taxation (AIIT) or Chartered Tax Adviser. Large Business Group has 361 staff that have either undergone, or are undergoing/nominated for, professional training. Increased professionalism will allow officers to deal with traders and tax professionals on an equal footing and increase their effectiveness in the large business environment.

2.46 Sector specialisation, which began with the hiring of Trade Sector Consultants (TSC), is developing throughout Large Business Group with most National Business Managers now handling a group of traders in similar sectors. In some regional offices, whole sectors have been clustered together, such as Local Authority traders in the London office, to take advantage of the sector expertise available.

## Conclusions

2.47 During 2002-03 Customs' work in the large business environment was encouraging; particularly further developments within the Large Business Group. Many innovative developments are being taken forward, which if successful, could be a blueprint for other parts of Customs and other Government Departments.

2.48 As with any newly restructured organisation, there are areas for development, and the National Audit Office have made some recommendations to assist in this process. The key test is whether these strategies will lead to improved compliance and revenue yield, and how this can be fully evaluated.

## Recommendations

2.49 National Audit Office recommendations based on work undertaken are that Customs should:

- Continue to consider how good practice within Large Business Group could benefit Regional Business Services and other parts of Customs, particularly through the development of effective risk assessment, staff training and development, a central point of communication and management of information to allow a good understanding of traders and the risks they pose.
- Enhance central quality assurance procedures within Large Business Group along the lines of the independent review process implemented by the

Department of Work and Pensions. Regional Business Services to implement planned quality assurance procedures, for Trader Group 6 this will mean the interrogation of electronic VAT records centrally.

- Continue to work to enhance the existing objective and performance measurement systems for Large Business Group with the aim of making objectives and performance measures clearer and more transparent. Trader Group 6 should select an effective range of performance measures to reflect the specific risks applying to large businesses (see paragraph 2.1).
- As part of their strategic approach to managing revenue loss or leakage, Customs should further reinforce their work to explain more effectively, the complexities of the VAT regime which increase the risks of revenue loss.



# Part 3: Managing the risks of alcohol fraud

## Executive Summary

Customs' programme of measures to combat alcohol fraud is evolving. The various operational activities in this field are being brought together under a longer term Alcohol Strategy as set out in the Pre-Budget Report. The strategy aims to deliver a substantial reduction in the illicit share of the spirits market, through new regulatory controls to be introduced during 2004, and the proposed introduction of tax stamps for spirits in early 2006.

Effective cross-departmental co-ordination will be required to bring together numerous existing anti-fraud initiatives under a strategic framework. Other key elements will be establishing reliable estimates of fraud levels for wine and beer, managing departmental expectations of the role of the intelligence service and working to simplify and improve the regulatory framework.

Customs' work on managing the risk of alcohol fraud has been a lower priority than that for tobacco and oils. Despite this, effective work has been carried out by the Department in prevention, detection and investigation of fraud against alcohol duty.

## Introduction

3.1 Though the estimated level of alcohol-related fraud perpetrated against the UK is much lower than that related to tobacco and similar to that for oils [see Figure 3.1], it is estimated by Customs that over £650 million in revenue is lost each year through abuse of the alcohol duty system.

**Figure 3.1: Revenue collection and evasion estimates in the major excise regimes for 2001-02**

	Revenue collected (£m)	Revenue evaded (£m)
Fuel (GB)	21,900	850*
Tobacco	7,800	3,180
Alcohol	6,900	650

Sources: *Customs Annual Report and Accounts 2002-03*, *Customs Pre Budget Report on Measuring and Tackling Indirect Tax Losses December 2003*.

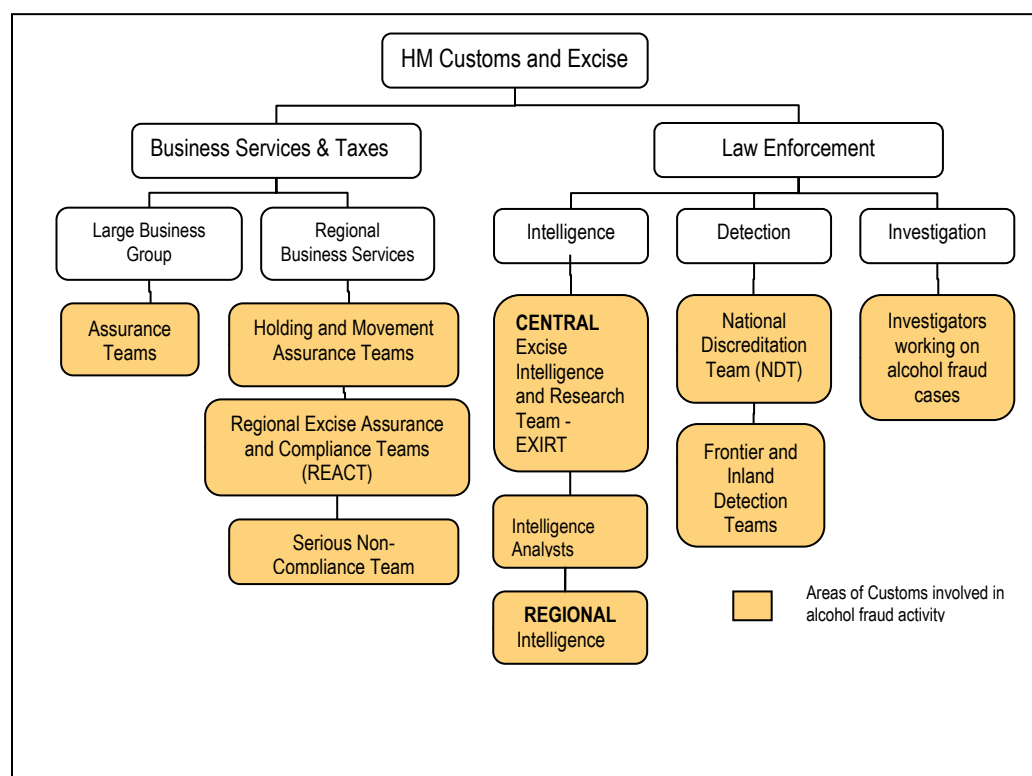
\*Calendar year 2001

A range of different sections of the department contribute to Customs' work to combat alcohol fraud. Figure 3.2 outlines this in detail.

3.2 Aspects of Customs' work in this area have been the subject of considerable scrutiny in the recent past. In June 2000, an internal Customs review identified serious weaknesses in the control of movements of duty suspended excise goods,

particularly the mechanisms for releasing alcohol from excise warehouses. Further reviews into these matters ensued; firstly in February 2001, the National Audit Office reported on the losses of £668 million that had arisen between 1993 and 2000 because alcohol destined for export had been fraudulently diverted onto the UK market without the payment of excise duty or VAT. Then in July 2001 the Government published an independent report by John Roques into the causes of these frauds and recommended actions to be taken forward by Customs. On the same day, the National Audit Office published its report 'Losses to the Revenue from Frauds on Alcohol Duty' (HC 178 2001-02), which was followed in May 2002 by the Committee of Public Accounts Report (HC331 2001-02) on the same subject.

**Figure 3.2: Operational teams involved in Customs' approach to alcohol fraud**



Source: Customs

3.3 Finally in January 2003, a number of prosecutions relating to major alcohol fraud perpetrated through London City Bond warehouses collapsed. As a result, the Chancellor asked Mr Justice Butterfield to examine the circumstances that led to the termination of the prosecutions. His report was published on 15 July 2003.

3.4 Good progress is being made by the Department in responding to the recommendations made by these reviews. The Government's 2001 and 2002 Pre-Budget Reports included details of the estimates of the level of losses from alcohol smuggling and fraud showing a sharp decline in the case of cross-channel passenger smuggling following increased Customs' activity at channel ports. However, Customs' revised estimates of spirits fraud detailed in the 2003 Pre-Budget Report show a steep rise since 1999-00. The associated announcement of a formal alcohol strategy, including the implementation of tax stamps in 2006, signals the

Department's intention to further and significantly enhance its approach to the combating of fraudulent activity in this area.

3.5 The National Audit Office carried out a review of issues relating to alcohol fraud that presented the highest risk in terms of fraud or loss of revenue. This review covered the effectiveness of communications between different groups in Customs involved in combating alcohol fraud [see Figure 3.2]. It also examined a sample of alcohol fraud investigation case files from 2001 onwards, considering how the frauds arose, how they were detected and how they were then dealt with by Customs. The scope did not include the work of the Solicitor's Office in preparing cases for prosecution. Findings are set out under the following headings:

- The dynamics of the alcohol fraud problem;
- Customs' response to alcohol fraud;
- Difficulties in measuring alcohol fraud;
- Producing a robust framework for delivering the Alcohol Strategy; and
- Investigation's role in tackling alcohol fraud.

### **The dynamics of the alcohol fraud problem**

3.6 Alcohol diversion fraud, particularly spirits, is attractive to criminals as the illicit product has not been subject to duty in the UK or elsewhere and is sold at or near legitimate duty paid prices. It is consequently difficult to differentiate illicit product from legitimate product at the retail stage. This makes this type of fraud both highly profitable and relatively uncomplicated. Alcohol frauds are undertaken by large organised crime syndicates and small scale operators alike. Sometimes these larger syndicates are involved in other types of illicit activity.

3.7 The risks associated with alcohol increase considerably when bulk alcohol products are packaged into finished goods. In order to facilitate legitimate trade, finished alcohol products may be held in duty suspension. Excise duty becomes due to Customs when the goods are released for consumption. European Union systems (operated in the UK by Customs) for collecting alcohol excise duty have been established to facilitate the legitimate trade. However, fraudsters have employed a number of methods to subvert the system and place illicit alcohol on the UK market. Diversion is the principal method of fraud.

#### **Excise diversion takes advantage of the holding and movement system**

3.8 Excise diversion fraud occurs where alcohol being transported is delivered to a destination different to that intended. Under the provisions of Council Directive 92/12 EEC, products can be moved under duty suspension. When duty suspended goods are removed to an approved excise warehouse within the EU, the movement must be underwritten by a guarantee, valid throughout the EU, to safeguard the potential amount of excise duty payable. This is supported by an Accompanying Administrative Document (AAD) for movements to other member states, or a form W8 for movements to other excise warehouses within the UK, which provides

documentary evidence to support movement guarantees and is required to be produced for audit by Customs or when a vehicle carrying a consignment is stopped en route. The movement of alcohol under duty suspension facilitates the legitimate trade by avoiding the need for fiscal controls at frontiers, and the vast majority of these movements arrive safely. Criminal elements have, however, targeted the system and have undertaken three major types of excise diversion fraud described in Figure 3.3 below.

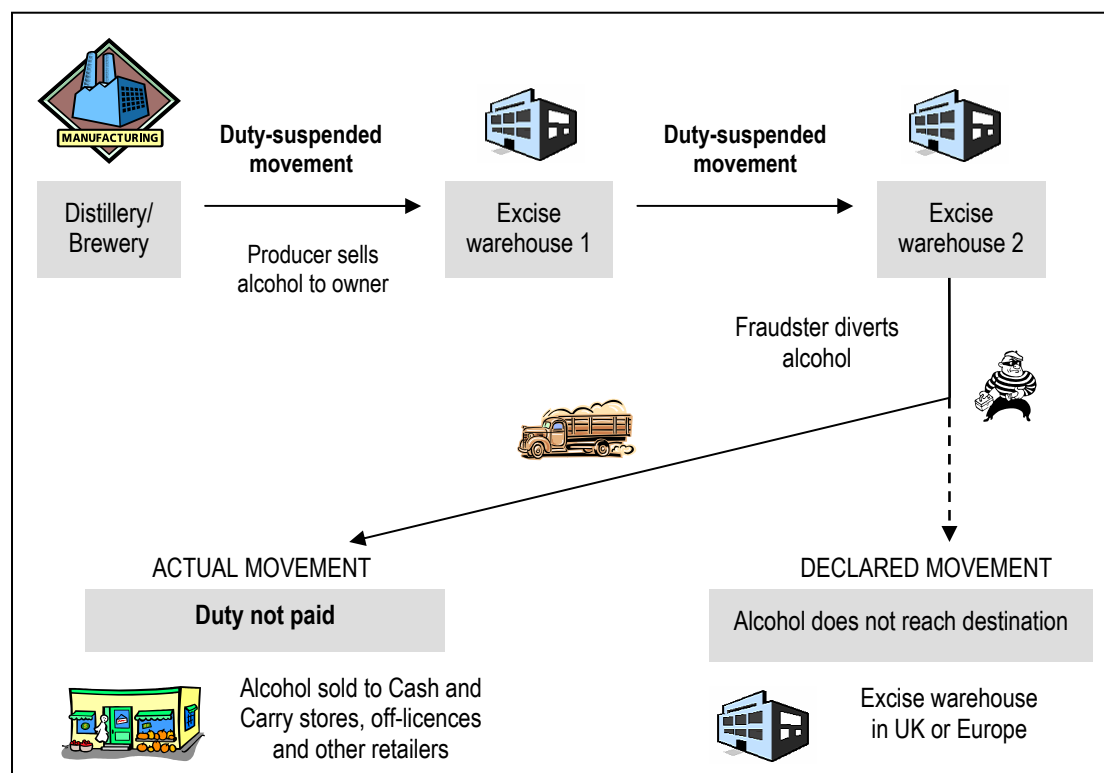
**Figure 3.3: Types of excise diversion alcohol fraud**

<p>There are three main types of excise diversion fraud:</p> <p><b>Inward excise diversion:</b> fraud involving duty suspended goods from the EU diverted onto the UK home market without payment of UK duty.</p> <p><b>Outward excise diversion:</b> fraud involving duty suspended goods ostensibly for export which are diverted onto the UK home market without the payment of UK duty.</p> <p><b>Inland excise diversion:</b> fraud involving duty suspended goods moving within the UK which are diverted directly onto the UK market without payment of UK duty.</p>
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*Source: Customs and National Audit Office*

3.9 Figure 3.4 shows the mechanics of excise diversion fraud. It is very hard for Customs to identify where the fraud takes place due to the complicated nature of the fraud. One or more of the owners of the goods, warehouse owners or operators, employees, hauliers or transporters may be complicit in the fraud and the loss of the goods may not be evident for several weeks as Customs are required to allow traders a set period to declare alcohol movements in accordance with provisions in EU legislation. To further complicate matters, one or more of the warehouses involved could be in different EU member states.

**Figure 3.4: The basic principles behind excise diversion fraud**



Source: Customs and National Audit Office

3.10 As well as diversion, revenue is also at risk from other types of fraud, and smuggling. Fraudsters seek to mask their activities under the pretext that they are legitimate importations under the Registered Excise Dealers and Shippers (REDS) or Occasional Importers Schemes. REDS allows alcohol products to be imported into the UK with duty payment deferred to the 15<sup>th</sup> of the following month. Under the Occasional Importers Scheme the importer pays a deposit to cover duty prior to the importation. Fraudsters can abuse both of these schemes by running duplicate loads under the same paperwork. The goods are as described on the paperwork which is used to disguise their true status.

3.11 Spirits diversion fraud can also involve counterfeit product. Illicit spirits produced overseas and diverted into the UK have resulted in some recent, highly publicised alcohol poisoning incidents. There is also some illicit production within the UK but, with the exception of one recent detection, this is thought by Customs to be small scale.

3.12 Freight smuggling is the other means by which fraudsters illegally bring excise goods into the UK, though this type of smuggling is rarer than alcohol diversion. Smuggling involves the deliberate mis-describing of goods as something completely different or concealing goods among other products. The documentation of the consignment will make no reference to excise goods at all.

## **Customs' response to alcohol fraud**

3.13 Customs latest strategic measures for combating alcohol fraud are set out in the Pre-Budget Report published in December 2003. This will complement the alcohol operational tactical plan (Operational Plan) which was put in place at the beginning of 2003-04. This process is similar to the development of the Tobacco Smuggling Strategy in 2000.

### **Tactical response – the Operational Plan**

3.14 Customs have been developing and implementing an Operational Plan to provide a platform for the Strategy. The Operational Plan aims to reduce losses attributable to alcohol fraud by:

- Identifying and quantifying the incidence of fraud and other non-compliance within the excise holding and movement system;
- Taking action to stop the fraud and other non-compliance by using the full range of available sanctions; and
- Informing on-going development of the Strategy by identifying any system, procedural or legislative shortcomings that need to be addressed.

### **Strategic response – the Alcohol Strategy**

3.15 The Strategy represents a shift of emphasis within Customs from operational considerations to a longer term approach. Its key feature will be the implementation of tax stamps for spirits in 2006, unless an equally effective anti-fraud measure is put forward by the trade. Tax stamps will provide a clearly visible indicator on a bottle that UK duty has been paid. Customs anticipate that tax stamps will have the effect of dramatically limiting the volume of spirits moving under duty suspension, thus preventing its diversion, and they will allow the public, retailers and Customs officers to quickly and easily identify illicit, non-duty paid product. The Strategy will aim to further reduce opportunities for fraud by implementing other regulatory measures to tighten other vulnerable areas of the alcohol supply chain.

3.16 In the lead up to the 2002 Budget, Customs consulted with the industry on the introduction of tax stamps for spirits. The industry lobbied against this plan due to the likely cost of compliance. The government opted not to implement tax stamps as the compliance costs were not considered proportionate to the estimated benefit in reducing fraud at that point in time.

3.17 The development of the Strategy has involved a further consultation with the industry (via a consultation document), to explore alternative means to reduce opportunities for alcohol fraud. Responses to the consultation suggested that the main alternative proposals (for radically reducing sales and movements of duty-suspended goods) would not deliver a significant anti-fraud benefit. In the light of this, and the latest evidence of a rising trend in spirits fraud, the Government concluded that tax stamps will be implemented for spirits from 2006 unless an equally effective alternative is put forward by the industry. In order to maintain a downward pressure on fraud in the interim, and to enhance its work to tackle beer and wine frauds,

Customs will also implement during 2004 a number of regulatory changes from those that were subject to consultation:

- notification of cash transactions and advance payments;
- extension of the existing pilot scheme of 'real-time' notification to Customs of intra-EU movements of alcohol in duty suspension;
- changes to the Warehousekeepers and Owners of Warehoused Goods Regulations (1999); and
- a scheme for recognising transporters of duty-suspended alcohol.

#### **Difficulties in measuring alcohol fraud**

3.18 A key element of the Strategy will be establishing the level of revenue loss and the size of the illicit market. Only by establishing reliable estimated levels of fraud will Customs be able to assess the effect of their work in this area. Reliable estimates are also crucial in assisting Customs' efforts more generally to devote scarce resources towards areas of highest risk in terms of fraud and revenue loss.

3.19 Estimates for spirits fraud have been provided by Customs' Analysis Division since 1999-2000 using a process called 'gap analysis'. This takes the total UK consumption figures for spirits, and subtracts the legitimate UK alcohol market to arrive at a figure for the illicit market. To estimate total UK consumption, Customs have been using data on average household consumption compiled from a number of national food and expenditure surveys. Estimates for revenues lost due to wine and beer fraud represent cross-channel smuggling only, with data collected through the cross-channel survey.

**Figure 3.5: Estimates of revenue lost through alcohol smuggling and fraud**

	<b>Spirits (£m)</b>	<b>Beer (£m)</b>	<b>Wine (£m)</b>
2000-01	450	250	50
2001-02	600	<50	<50

*Source: Customs Annual Report and Accounts 2002-03.*

*Figures rounded to nearest £50 million*

3.20 Customs face difficulties in obtaining accurate figures for total UK consumption. People tend to under-report their consumption of alcohol when surveyed. Customs attempt to adjust for this effect by indexing from a point in the past where they believe there was negligible smuggling. This method produces a figure for the illicit share in spirits. Spirits producers have expressed their views to Customs on the accuracy of fraud estimates. Some spirits producers believe that estimates of spirit fraud exaggerate the problem because of concerns over the reliability of what is the only source for consumption data. The alcohol trade is however unable to offer a better alternative methodology.

3.21 Gap analysis does not however produce an estimate for beer or wine fraud – applying the technique in fact produces a ‘negative’ gap, partly as a result of under-reporting of consumption levels. The lack of fraud estimates for beer, other than for cross-channel smuggling, makes it difficult to calculate the likely overall revenue loss to the Exchequer. Recent Customs successes in tackling and reducing the levels of cross-channel smuggling increase the risk that beer fraud may be displaced elsewhere. In terms of litres of product, the volume of illicit beer finding its way onto the UK market is larger than the volume (litres) of illicit spirits, but given the fact that beer is a much more voluminous product than spirits (the UK beer market is some 20 times larger than the spirits market, in volume terms), this is likely to be indicative of nothing more than that. Customs Analysis Division currently concludes that both the size of the UK illicit beer market and revenue losses are likely to be relatively small (in comparison to spirits). In contrast to the response from spirits producers, beer producers have commented that the current fraud figures, which only report cross channel smuggling, underestimate the level of fraud. This point is acknowledged by Customs alongside the previously published figures.

3.22 With the continuing development of the Strategy, Customs need realistic and robust fraud estimates to monitor their progress and see how effective they can be with the resources available. To address this issue Customs Analysis Division continues to investigate alternative methodologies for estimating the level of beer and wine fraud, but an early, more accurate solution is not anticipated. The resultant estimate may not necessarily be an exact figure but a range representing Customs’ best approximation of the current fraud situation. The National Audit Office acknowledges the difficulties faced by Customs in identifying robust and reliable data sources at a reasonable cost, and welcomes the steps taken by Customs to date.

### **Producing a robust framework for delivering the Alcohol Strategy**

3.23 There are a number of operational teams working within Law Enforcement and Business Services and Taxes to combat alcohol fraud. A key challenge for Customs will be to implement the proposed strategic framework, bringing together the numerous teams working to combat alcohol fraud under co-ordinated leadership. Those teams operate within Regional Business Services, Large Business Group, Intelligence, Detection and Investigation. Effective communication across the Department will therefore be key to the successful delivery of the Strategy.

#### **Communication is key to the Strategy’s success**

3.24 Effective communication is crucial to the successful operation of the Strategy and Operational Plan. The National Audit Office review found that Customs was at its most effective when different teams co-ordinated their approach to fraudulent traders, for instance through joint visits to traders and retailers; and when intelligence was shared between Law Enforcement and Business Services and Taxes staff. The Fulcrum Initiative [see Figure 3.9] provides an excellent example of such cross-departmental co-ordination which is effective in breaking down traditional operational silos. On the other hand, in three of the 36 cases which we reviewed, ineffective communications between different areas of Customs hindered the



successful investigation and prosecution of fraudsters [two of the three examples are included in Figure 3.6]. Conflicting interests between different internal groups can reduce the effectiveness of anti-fraud initiatives where joint working would be appropriate.

**Figure 3.6: Examples of ineffective communication disclosed to the National Audit Office**

- Detection staff did not notify Investigation staff of their intention to visit a suspect site, and Investigation only in fact received notification that they had arrested the owner of an illegal distillery. As a result, resources were not available to secure the site overnight and consequently, the distillery was left to be dismantled, removing key evidence.
- Different teams were alerted to a fraud by separate contacts. On the same day, teams from Regional Business Services and Detection both visited the site. The Regional Business Services team arrived first, and found 330 cases of whisky. These had been removed by people on the site by the time the Detection team arrived later in the morning, and paperwork relating to the illicit alcohol had allegedly been destroyed.

*Source: Customs and National Audit Office*

### **Holding and movement of alcohol**

3.25 Regional Business Services within the Business Services and Taxes Division of Customs, and the Law Enforcement Policy Group view the highest risk area within the alcohol supply chain as being the holding and movement of duty-suspended alcohol. Teams within Regional Business Services are key to maintaining the integrity of both the system for holding alcohol in duty suspension and the system for regulating its movement. The National Audit Office review of this area of Regional Business Services work identified the following improvements in procedures which had been put in place within the system for holding duty suspended alcohol:

- In the past, Holding and Movement officers visited a new excise warehouse after it had been operating for eight months to review documentation kept on the movement of alcohol in and out of the warehouse. However, some warehouses were being set up to evade duty with an apparently legitimate front. To counter this, Customs now require a visit to be made by specialised Holding and Movement teams in the first two months to monitor warehouse activity;
- The Regional Excise Assurance and Compliance Teams (REACT) have been set up to improve compliance across the whole alcohol supply chain. REACT are co-ordinating activity across regional boundaries and with other business areas within Customs to identify and address high risk activity. REACT's flexible assurance capability is nationally co-ordinated through delivery of exercises targeting current and emerging risks in the supply chain. Although it is too early to evaluate its impact, this is a positive initiative; and
- Specialist assurance teams, combining Serious Non Compliance and Holding and Movement officers are carrying out VAT-based audits of

retailers to try to identify smuggled or diverted alcohol being sold. This co-operative approach appears to be having a worthwhile effect in the retail sector. In the 2002-03 financial year one of the joint Assurance, Compliance, and Holding and Movement Teams reviewed by the National Audit Office made 183 seizures of alcohol from about 300 visits to alcohol-based traders.

### **Customs promote closer working with alcohol producers**

3.26 Large Business Group have appointed National Business Managers who act as a central contact point within Customs for each trader [see Part 2 for further details]. This relationship is particularly useful in co-opting assistance from the trade in fighting alcohol fraud.

3.27 Following the 2002 Budget, when the Government decided not to implement tax stamps at that time, the spirits producers agreed to work closely with Customs to fight fraud, out of which developed the Joint Spirits Fraud Task Force. The group has made some progress - the industry has, amongst other measures, given Customs test kits to help detect counterfeit product and information on product labelling to aid identification.

3.28 Memoranda of Understanding between Customs and UK spirits producers (members of the two main trade associations, the Scotch Whisky Association and the Gin and Vodka Association), negotiated through the Joint Spirits Fraud Task Force, have already been agreed. It remains to be seen whether, or to what extent, the trade will consent to implementing the Memoranda in the light of the announcement to introduce tax stamps.

### **Detection of alcohol fraud: new initiatives**

3.29 Customs Frontier and Inland Detection Officers aim to detect a range of illicit activities, including illicit alcohol movements. Frontier Detection is made up of teams of anti-smuggling staff around the country, who work at "pinch-points" such as ports. Frontier staff aim to detect full lorry loads of alcohol. Bulk interceptions are one of the most effective and efficient means of disrupting the supply of illicit alcohol. Inland Detection teams work to intercept diverted loads that are already in the UK, but once the load has been broken, detection becomes much more difficult and resource intensive.

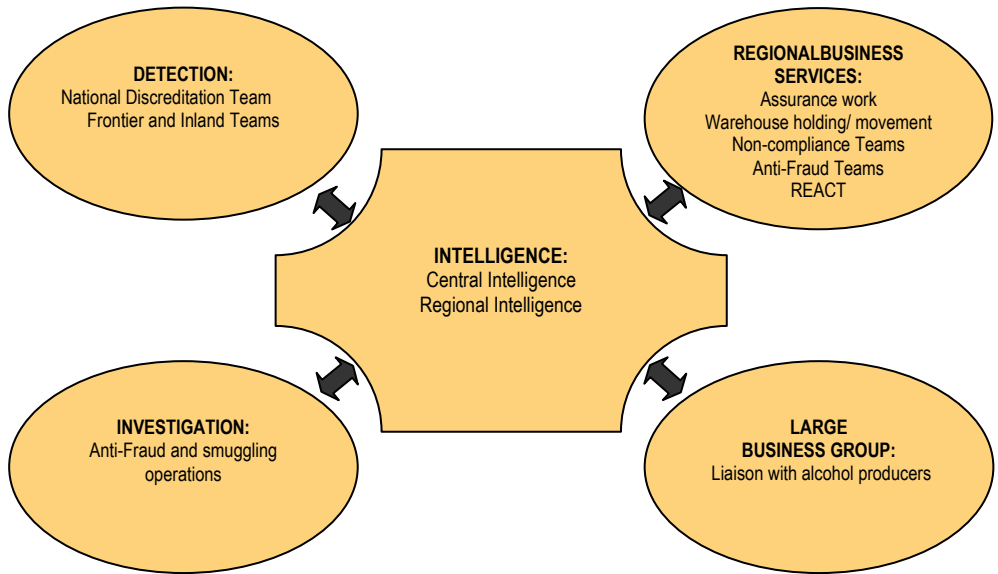
3.30 The National Discreditation Team was established in April 2002 to support Frontier Detection staff by undertaking discreditation work. They conduct further enquiries into the legitimacy of detained inbound and outbound excise loads. Approximately 80 per cent of their work relates to alcohol. The 'discreditation' process involves a checklist of factors based on intelligence and the economic viability of an importation. If the National Discreditation Team is not satisfied about the veracity of the movement, the detained goods will be seized. The National Discreditation Team have been successful in targeting inward diversion fraud, and helping to prevent hundreds of thousands of litres of alcohol reaching the UK illicit

market. In the three months to 31 March 2003 the team were involved in 210 successful interceptions of illicit goods with a duty value of some £7.5 million.

**Intelligence plays a pivotal role**

3.31 The Intelligence service responds to requests from both Law Enforcement and Business Services and Taxes within Customs for information about illicit activity. Intelligence resources to tackle alcohol fraud are split approximately 60:40 between these two areas respectively. Intelligence fulfils a central role within Customs' communications network [see Figure 3.7]. Intelligence also co-operates with EU partners, other government bodies and external organisations.

**Figure 3.7: Intelligence is Customs' central network for gathering and disseminating information**



Source: Customs and National Audit Office

3.32 The role of Intelligence is central to the effectiveness of anti-fraud work. Intelligence has contributed to most operations undertaken by Investigation. A recent example of good quality intelligence led directly to a successful operation and major disruption of diversion fraud activities by organised criminal gangs. However, communication difficulties sometimes leave other areas within Customs expecting greater levels of intelligence input than is provided. This creates an expectation gap.

3.33 This could be addressed through better dissemination of the results of the Intelligence requirement exercise, which is used by Intelligence to allocate resources to client projects. This exercise involves engagement with Intelligence customers to determine the requirements for each of the strategies, including alcohol. The aim of this process is to specify precisely what Intelligence are contracted to deliver during the year. The Director of Intelligence then allocates his resources in accordance with overall departmental and client priorities. However, the outcome of this exercise is not effectively disseminated to stakeholders outside of Intelligence. This can leave them unable to see how the work undertaken by Intelligence addresses their requirements and how and why resources have been prioritised in support of certain areas of activity.

3.34 The National Audit Office sought to establish what performance management systems exist in Intelligence, in order to gain a more objective view of the group's contribution to tackling alcohol fraud. Intelligence also has a system, INTELOPS, which measures intelligence activity, and a separate, manual system which records information specific to each strategy. They also conduct evaluation interviews to assess whether customers are satisfied with the service provided. However, there was little performance data available that Intelligence could use to demonstrate the level or quality of service they achieve in this area. The National

Audit Office recognises the difficulties involved for Intelligence in assessing their performance or the quality of their impacts. However, performance monitoring could be improved by setting operational milestones and targets, and linking them to the Department's wider targets and objectives. By doing so, Intelligence can show how their activities have contributed to seizures of illicit property, prosecutions and also helped to meet the targets as set out in Customs' Public Service Agreement. There is, however, currently no Public Service Agreement target for alcohol.

3.35 Customs may wish to consider in the context of our work on alcohol fraud, ways in which performance measurement systems in Intelligence can be strengthened to provide an objective means of assessing the performance of the division in tackling specific threats or issues.

### **Investigations' role in tackling alcohol fraud**

3.36 Some alcohol fraud cases are passed onto Investigation teams from Regional Business Services, Intelligence and Detection. Investigation operations are carried out to disrupt the major suppliers of illicit alcohol, by stopping fraud as early as possible and preventing it re-occurring, all aimed at reducing revenue losses.

3.37 The National Audit Office reviewed a sample of 36 alcohol fraud investigation case files from 2001 onwards. In many cases, these operations led to the successful prosecution of the fraudsters. The purpose of the review was to identify the strengths in Customs' systems which enabled the fraud to be detected and pursued, as well as the weaknesses which had facilitated the fraud or hampered action against it. To gain an understanding of each operation, the National Audit Office interviewed the responsible investigation officer and case officer, and reviewed files held on each operation.

#### **Investigation has a good standard of case management**

3.38 The frauds concerned in each of the 36 cases showed varying levels of sophistication and resulted in differing scales of revenue loss. The standard of case management was generally good in all the offices visited. It was clear from the cases reviewed that, when provided with good quality intelligence, case officers made considerable efforts to achieve a successful prosecution. The officers were able to give clear, detailed accounts of their operations. Case papers were logically laid out and comprehensive.

3.39 Case progression was sometimes hampered by communication problems with other parts of the Department; this was noted in five of the cases reviewed. In some instances, progress was also hampered by a lack of staff training in specialist areas. For example, progress on three of the cases reviewed had been hampered because officers had been unclear about the correct form in which to present their evidence. In one case, a prosecution was abandoned because the quality and relevance of officers' witness statements were unacceptable.

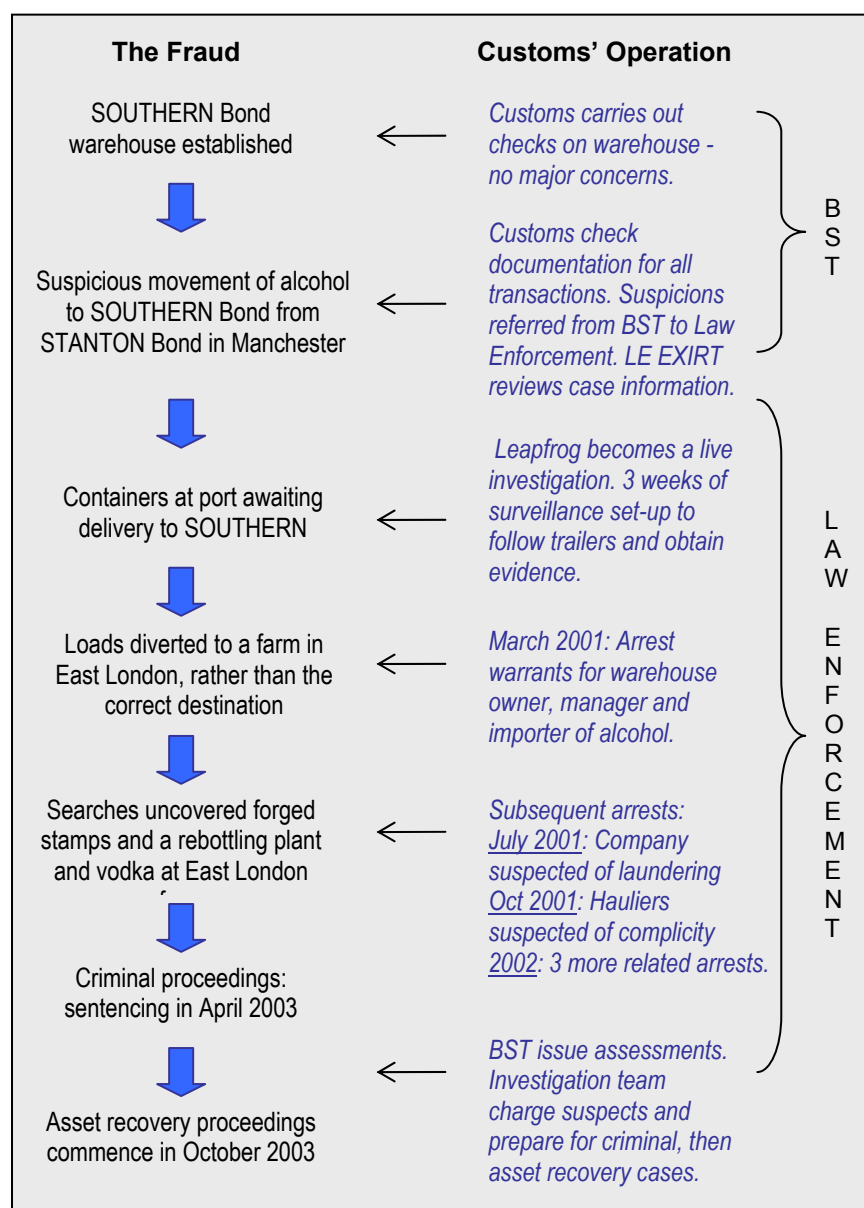
3.40 An encouraging development is the willingness of the legitimate trade and members of the public to co-operate with Customs by reporting suspicious activity.

Co-operation with other customs authorities, particularly within the EU, was necessary in many of the cases. This generally worked well, although there were instances where information was slow to arrive, or was not provided at all.

### Notable successes in combating large-scale fraud

3.41 Customs has had recent notable successes in its efforts to combat large-scale alcohol frauds. Operation 'Leapfrog', which resulted in convictions in April 2003, was undertaken against a diversion fraud centred on an excise warehouse in Southampton [see Figure 3.8]. The goods passed through the warehouse in duty suspension, with documentation showing that they were destined for other excise warehouses. In fact, all the spirits were diverted elsewhere. As at March 2001, estimated losses to the Exchequer stood at £500,000.

**Figure 3.8: Case study of Operation 'Leapfrog'**



Source: Customs

3.42 Operation 'Leapfrog' is a good example of co-operation between the different arms of Customs. The initial referral to Investigation came from Business Services and Taxes based on assurance work. The operation also shows how the duty suspension system depends on trader honesty and can be open to abuse. After raiding the warehouse, officers found stamps which had been used to forge notifications and approvals from Customs and the other warehouses. Their investigation established that the apparent customer for the spirits was a fictitious business, set up purely to disguise the fraud.

3.43 The wider-ranging Fulcrum Initiative shows the effectiveness of pan-departmental working to combat alcohol fraud [see Figure 3.9]. The Initiative began in March 2002, and involved Investigation, Civil Asset Recovery Teams and Business Services and Taxes, as well as liaison with overseas customs authorities.

**Figure 3.9: Case study of the Fulcrum Initiative**

#### **The 3-Legged Stool**

The Fulcrum Initiative was made up of a series of investigations against suspected cases of serious alcohol fraud. The Initiative was characterised by close co-operation throughout the Department. The aim was to break down departmental 'silos' and enable closer working between the divisions - Fulcrum was a ground-breaking initiative in this regard.

The term "3-legged stool" was coined to describe the simultaneous use of a range of Customs' powers to contain systematic abuse of the duty-suspension regime. The three legs of the stool were:

- *Criminal investigations carried out by Investigation which lead to prosecution;*
- *Civil proceedings launched by the Civil Asset Recovery Team to secure outstanding debts owed to Customs; and*
- *Regulatory action carried out by the Holding and Movement teams within Business Services and Taxes, including the revocation of warehouse approvals.*

The combination of these three actions meant that Customs could maximise their effect on the fraudsters and those complicit in the holding, transport or sale of non-duty paid goods. Running criminal and civil proceedings in parallel is only occasionally appropriate, and may only take place where there is a 'chinese wall' between the two processes to ensure that there is no suggestion that Customs are using coercive powers to justify civil action. However, the Fulcrum Initiative provides valuable lessons as to how departmental co-operation and communication can be enhanced.

Source: Customs

#### **Fraudsters take advantage of a system designed to facilitate trade**

3.44 The duty suspended arrangements for alcohol products introduced with the Single Market, combined with comparatively high UK duty rates, mean that the system has operated under constant threat from diversion since its inception. Most of the cases reviewed by the National Audit Office involved abuse by fraudsters of measures conceived to facilitate the legitimate movement of alcohol in duty suspension across the EU.

3.45 Customs officers need a better understanding of where they can apply the comprehensive range of discretionary powers and sanctions available to the Department and determine which are the most suitable to apply. The National Audit Office was informed of instances where discretionary measures might have proved more effective against transporters involved in excise diversion fraud, instead of prosecutions, which by their nature are more complex and carry greater risk of failure. We were pleased to note, however, that new and comprehensive guidance for officers in this area is currently under preparation.

3.46 Customs officers with whom we met recognised that their work in combating fraud in this area could be made more effective through better availability of more 'real time' information on alcohol movements (e.g. required notification of the arrival of expected inward goods or proof of export for outward movements). Customs have been exploring the scope for developments in this area in formulating the Strategy. Potential improvements to the documentation accompanying alcohol consignments and the regulations concerned are, however, strictly bound by European legislation.

3.47 The preferred tactics of fraudsters tend to correlate to changes in Customs' anti-fraud activity. Significant seizures by Detection have displaced inward diversion fraud into other areas. The risk of fraud being displaced from inward diversion into other areas means that Customs need to establish and understand the risks posed by all potential traffic modes and types in their approach to tackling alcohol fraud. Work carried out by Customs has identified some weaknesses in certain of these modes and Customs are in the process of tightening their ability to target alcohol fraud using those modes.

## Conclusions

3.48 Customs have made good progress in developing a tactical response to alcohol fraud, which should underpin their enhanced Strategy.

3.49 Our work on alcohol fraud has also thrown light on areas where there is potential for better internal communications to achieve more joined-up working across the Department. The lessons learned in respect of alcohol may be useful for Customs to apply to the way in which the Intelligence function works together with its internal clients. Improvements have been implemented, but more needs to be achieved.

## Recommendations

3.50 National Audit Office recommendations based on work undertaken are:

- In view of the difficulties in obtaining reliable data to allow the construction of robust estimates for beer fraud, other than in respect of cross-channel smuggling, we encourage Customs to continue their work to further enhance their methods of assessing levels of fraud.



- Our review of a sample of anti-alcohol fraud operations found some instances (though not prevalent) where ineffective communications had hindered the successful investigation and prosecution on cases. Equally, we noted examples of good practice. Effective cross departmental communications will be crucial to ensuring the effectiveness of the department's efforts in this area, bringing the numerous anti-fraud initiatives in the alcohol sector under co-ordinated and strategic leadership. We encourage Customs to develop and implement a strategy for cross-departmental communication and working in this area.
- In April 2001, Customs introduced an Intelligence Requirements Process, which involves engagement with customers to determine the requirements for each of the strategies, including alcohol. The aim of this process is to specify precisely what Intelligence are contracted to deliver. It is underpinned by a raft of Intelligence Steering Groups. Our work on alcohol fraud has demonstrated that this process falls short of achieving that aim. In particular, there is no explicit process whereby the intelligence products are translated into deployment decisions and resource allocations. We note that Customs are considering adoption of the National Intelligence Model as a means of addressing this weakness and we recommend that they do so urgently to ensure that:
  - ~ their clients' requirements are fully specified;
  - ~ their contribution in meeting those requirements is recognised and recorded;
  - ~ expectations about delivery are clarified with end users; and
  - ~ there is formal feedback on major projects.

This recommendation is grounded in our work in the area of alcohol fraud. Customs should assess whether our observations have relevance more broadly to the activities of Intelligence across the Department.

- Customs regard the Intelligence Requirements Process as the front end of their performance management process. They also have a system, INTEL OPS, which measures intelligence activity, and a separate, manual system which records information specific to each strategy. They also conduct evaluation interviews to assess whether customers are satisfied with the service provided. However, our work on alcohol fraud has demonstrated that these systems do not allow Intelligence to have an overview of its performance, and therefore overall effectiveness. We therefore recommend that they develop, not only for alcohol, but for all strategies where appropriate, a more comprehensive performance measurement/ management system which allows the contribution made by Intelligence towards tackling fraud to be monitored, assessed and controlled.