Section 7: National Audit Office Standard Report 2003-04

Report by the Comptroller and Auditor General 2003-04

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) 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 sums brought to account; and to report the results to the House of Commons. A detailed breakdown of the gross receipts and repayments for each tax stream is separately reported within the Trust Statement, included at Section 6 in the Customs Annual Report.

2. No system can ensure that all taxpayers and potential taxpayers comply with their obligations. In considering the risks to the assessment, collection and allocation of revenue, I review the way in which Customs 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 2003-04, the National Audit Office examined systems for the assessment, collection and allocation of revenue across a number of Customs' areas of activity. The examination also covered a number of the main information technology systems in place. This report sets out the results of the work carried out in two main areas of Customs activities: the implementation and effectiveness to date of the Hydrocarbon Oils Strategy, and improving compliance in small and medium-sized businesses to close the VAT gap.

The UK Oils Strategy

- Customs have devised and implemented a Strategy to tackle the illegal use of diesel, aimed at reducing the scale of the illicit market to a level of 2% by March 2006. Customs estimated that the scale of the illicit market in 2002 was 6%, costing the Exchequer some £750 million. Latest available data for 2003 revealed that the scale of the illicit market remained constant at 6%, but at an increased cost to the Exchequer of £850 million.
- Customs have developed an innovative approach in their fight against fraud. A scheme has been established that requires dealers in rebated oils to be registered. During the implementation phase of the Strategy, Customs has invested significant resources towards educating traders so that they understand their obligations, and to build a trader database. The registration scheme has in turn provided Customs with access to much greater information to strengthen its intelligence and drive assurance and detection work. From April 2004 onwards, Customs have adopted a tougher approach to the use of sanctions, to ensure compliance of dealers for whom a solely educative approach has not delivered the required results.
- The development of the Strategy represents effective cross-departmental working, and has also seen the development of information sharing with other organisations to improve the quantity and quality of intelligence material. Customs have focused on improving the intelligence processes and networks to deliver more and better quality intelligence to front line officers. However the picture across the UK is far from uniform and some regions could learn much from the good practice identified in this report.
- The Strategy has provided Customs with significant operational challenges in ensuring that proper support, particularly in the IT area, is provided to officers. Customs and industry also need to work together to incentivise greater take up of e-lodgement

for monthly returns amongst the trader population using the Registered Dealers Scheme. This will allow significant savings in administrative and support resources deployed.

- It is difficult to devise a robust performance measurement system to allow the effectiveness of resources deployed to be assessed on a timely basis. Nevertheless, the developments made by Customs appear promising and have created an integrated approach within the department to tackle oils fraud effectively.

Improving compliance in small and medium-sized enterprises

- Customs have implemented a new VAT Compliance Strategy aimed to reduce the VAT gap from 15.8% of what should be collected in 2002-03 to a target of 12% by 2006. Results for 2003-04 show that Customs have made significant progress, with the VAT gap reducing by almost 3% to 12.9%. Although it is too early to report on the effectiveness of the VAT Compliance Strategy, the reduction in the VAT gap, to which the Strategy contributes, appears impressive. Within Regional Business Services, as part of the implementation of the strategy the risk analysis system has been restructured by introducing risk centres to all regions. Initial signs are encouraging, with the move towards a more flexible and varied risk assessment co-ordinated by a national risk management structure.

- Performance measurement systems to evaluate the impact of these changes are still evolving. Customs are able to assess the effect of different elements of the Strategy to varying degrees, and their end of year performance report to Treasury is a step in the right direction that will need to be further enhanced in the future. New measures of performance will continue to evolve as their interventions become more targeted. Customs will continue to evaluate the effect of redeploying and reprioritising resources to address the areas of perceived greatest risk and concern.

- This report focuses on areas where the implementation of the VAT Compliance Strategy can be improved within Regional Business Services. As we note above, it remains too early to report formally on the effectiveness of the Strategy, because of the difficulties in separating out the increase in revenues as a result of assurance and compliance activities, and those caused by other fiscal and economic factors. There are a number of innovative developments which have enhanced the approach to risk taken within Regional Business Services.

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 sums brought to account; and to report the results to the House of Commons. A detailed breakdown of the gross receipts and repayments for each tax stream is separately reported within the Trust Statement, included at Section 6 in the Customs Annual Report.

Audit approach and scope

1.2 In order to review the systems and procedures which Customs have put in place to ensure 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 and other checks carried out by Customs 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 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 2003-04, the National Audit Office's coverage included the following examinations:

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

1.4 This report sets out findings arising from the two main reviews carried out by the National Audit Office during the year to meet my responsibilities under Section 2 of the Exchequer and Audit Departments Act 1921. Further work has also been carried out during the year across other of Customs' activities, the results of which have been reported separately to Customs management.

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 Tackling VAT Fraud (HC 357 2003-04).

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 risk of failure to achieve objectives, or to account properly for public funds. The statements also 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 have strengthened their corporate governance structure, constructed a departmental risk register comprising corporate and operational risks, and adopted a strategic approach to minimising the risks to revenue. This is reflected in the publication of strategies covering VAT

Compliance, Tobacco and Oils as a way of strengthening regulations and procedures to minimise the risk of revenue loss. Customs have procedures to ensure that the risks to the department are regularly reviewed, and that they are the responsibility of the Customs Management Committee, who own, monitor and work to mitigate identified risks.

1.8 The Accounting Officer, in his Statements on Internal Control, acknowledges his responsibility for assessing the effectiveness of the control framework. In reviewing its effectiveness and formulating his statements, he, together with his predecessor, has had regard to three tests: the benefit of any given control in safeguarding public funds; the impact of that control in 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 three significant internal control issues arising in the year. One relates to the ongoing programme to upgrade Customs' Information Systems (IS) infrastructure. Delays in negotiating changes to the contract with the department's main supplier Fujitsu have delayed the timetable for the replacement of legacy systems, and as a result Customs have had to employ short-term solutions to meet operational requirements, pending the full implementation of their e-Business programme. The delay in replacing legacy systems increases their risk of possible failure, although there have not been any major system failures during 2003-04.

1.10 The second control issue disclosed relates to Shipbuilders' Relief, which was abolished with effect from January 2004. Following the abolition, the Department reviewed its estimate of future remaining liabilities under the scheme and liabilities additional to those previously identified amounting to around £110 million were uncovered. The liabilities will be settled over approximately a ten year period. The Accounting Officer's statement gives further details on the circumstances which led to this failure in internal control.

1.11 The statements also disclose expenditure of £167,140 incurred in the year for which there was no Parliamentary authority. Further detail on this matter is provided in my Report on the Resource Account, also included at Section 5 of the Customs Annual Report (HC119 2004).

1.12 I am content that the Accounting Officer's Statements on Internal Control are consistent with the National Audit Office's examination and understanding of HM Customs and Excise.

Review of HM Customs and Excise and the Inland Revenue

1.13 In July 2003 the Chancellor of the Exchequer announced a major review of the organisations dealing with tax policy and administration: HM Customs and Excise, the Inland Revenue and HM Treasury. The review reported in March 2004. It recommended that a new customer-focused tax service should be established, integrating the Inland Revenue and HM Customs and Excise, tasked with improving customer services, reducing compliance costs, improving compliance with tax law and increasing efficiency. HM Treasury will strengthen its responsibility for tax policy, with support from the new department. The report's recommendations were strategic rather than a detailed blueprint for implementation.

1.14 The main recommendations of the report directly relevant to my work were that management should:

- structure the new department as far as possible around customers and functions rather than taxes, so that customer needs can be better met and compliance improved, for example by establishing an integrated large business office, and more specialised service to small businesses;
- develop a better focused Public Service Agreement (PSA) target on customer service and compliance costs, supported by work to develop understanding of compliance costs;
- develop a better focused PSA target on compliance across the tax stream, supported by work to develop understanding of the tax gap and other compliance measures;
- look to identify economies of scale and scope by developing new national services, and reviewing the

local office network, including with other departments; and

- establish a unified information strategy, with strong information governance arrangements and a joint knowledge centre, as part of a re-engineering of business processes.

The report further recommended that:

- The Treasury should have lead responsibility and accountability for tax policy and the new department should lead on policy maintenance; and
- A Framework Document should be published setting out who is accountable to whom and for what, in the new department.

1.15 The report noted that the Departments were currently engaged in significant developments that entailed risks. It acknowledged that integrating the Departments to form the new Department and implementing the recommendations might cause problems for revenue collection in the short term as a result of disrupted priorities; resources focused on change rather than delivery; customer confusion; and poor change management. Organisational changes might cause a reduction in revenues as the effectiveness of compliance activity might be impaired in the short term and there might be a reduction in deterrence. The review report said that vigilance would need to be maintained and that the risks to revenue could be mitigated through good planning and management. Legislation setting up the new Department is expected in 2005.

Conclusions

1.16 I have given an unqualified opinion on Customs' 2003-04 Trust Statement in which taxes and duties are brought to account, and a qualified opinion on the Department's Resource Account in respect of payments made by Customs to a police force. In 2003-04, the Department incurred £167,140 of expenditure which fell outside the ambit of the Department's Request for Resources. By so doing, the Department breached Parliament's control of expenditure and incurred what is termed an "excess", for which further parliamentary authority is required. Further detail is provided in my report on the Resource Account also included at section 5 of the Customs annual report (HC119 2004).

1.17 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'.

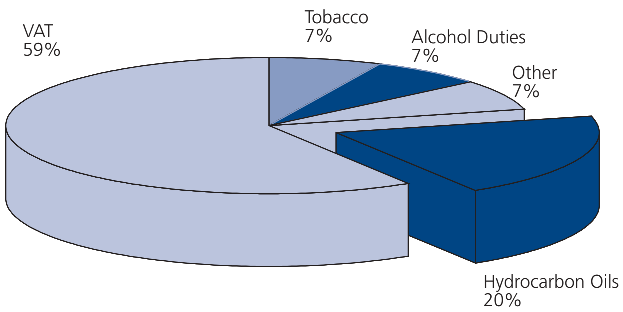
1.18 The Accounting Officer has reported in his Statement on Internal Control how the Customs control framework operates, including controls associated with the collection of revenue, and significant control issues arising from his own review of internal controls. Subject to those issues and in the light of matters outlined in the detail of my report, my work in 2003-04 provides assurance that Customs' regulations and procedures provided an effective check over the assessment, collection and allocation of tax.

Part 2: The UK Oils Strategy

Introduction

2.1 In 2003-04, Customs collected revenues totalling £22.8 billion from hydrocarbon oils duties and taxes, levied on fuels such as petrol and diesel, 20% of the total revenues collected by the department.

Figure 2.1: Net receipts from duties and taxes in 2003-04 by % across tax streams



Source: National Audit Office

2.2 Customs, uniquely in the European Community, have been producing estimates of diesel fraud and now have estimates of revenue loss in Great Britain from 1999, when the revenue loss was £700 million. Further analysis by Customs showed that the size of the illicit market, as a proportion of the total, peaked at the time of the 1999-2000 fuel crisis at about 8%. More recent estimates show a level of fraud which has reduced and now plateaued at about 6% for both 2002 and 2003, resulting in estimated revenue losses of £750 million and £850 million respectively.

Year	1999	2000	2001	2002	2003
Estimated Loss (£ million)	700	1000	950	750	850
Percentage Loss	6	8	7	6	6

Rebated Fuel

2.3 Certain types of hydrocarbon fuels are subject to significantly lower levels of excise duty where they are intended for use in non-road traffic vehicles such as farm tractors, mowing machines or road construction vehicles and use for industrial and domestic heating systems. These lower levels of duty are known as rebates.

2.4 The existence of the duty rebates provides two major risks to revenue through fraud.

- Rebated fuels can be misused following a laundering process or by mixing rebated oils. Rebated fuel can either be treated to remove chemical markers and dyes added to allow its identification, or it can be mixed with duty-paid road fuel or lubrication oils and then sold at full duty prices or just below market rates; and
- Rebated fuel provided for non-road traffic vehicles such as tractors or provided for domestic heating can be diverted for use in vehicles driven on the public highway.

2.5 Misuse of rebated fuel is the simplest fraud, but also the easiest for Customs to detect by looking for the marker dye. Identifying situations where rebated fuels are used in this way can sometimes be complicated by the existence of low-level cross-contamination of fuel oils in deliveries. Fuel tankers typically contain sealed sections, each of which can hold different types of fuel. But the tankers have only one hose, which can result in cross-contamination.

2.6 Fuel laundering is a more complicated process and is harder to detect. Fraudsters "wash" (by adding a laundering agent) or filter oils to remove the colour dyes and chemical markers. This process can often involve the use of acids, which cause environmental damage as well as damaging the engines of vehicles using laundered fuels. Field tests by Customs can detect the presence of a colour dye or chemical marker at very low levels. Below this level Customs can use the services of the Government Chemist who is able to employ more powerful analysis techniques. If a vehicle is stopped for testing, it is extremely unlikely that Customs will fail to detect laundered products if they are present through their chemical testing procedures. However, Customs are currently trialling new technologies to further assist them in the fight against this type of fraud.

The UK Oils Strategy

2.7 The Government announced a UK Oils Strategy in the 2002 Budget. This reflects the increasingly strategic approach taken to tackling fraud across the revenue streams, and is in part a response to the significant level of public and Parliamentary interest in this area. In February 2002, we reported on "The Misuse and

Smuggling of Hydrocarbon Oils". The Committee of Public Accounts considered the issues and made a number of recommendations in its report (HC 649 2001-02). These included the need for improved intelligence and stronger sanctions for the misuse of rebated fuels. The Oils Strategy introduced a scheme requiring distributors of rebated oils to be approved by Customs in order to deal in such fuels. As part of the approval process, reasonable steps are required on the part of the distributor to ensure that sales of rebated fuels are not made to customers where the trader believes that the fuel will be used for illicit purposes.

2.8 The 2002 Spending Review set Customs a Public Service Agreement target to reduce the size of the illicit market for hydrocarbon oils to 2% of the total market in Great Britain by 31 March 2006. Although a target for reducing oils fraud in Northern Ireland was not included within the Public Service Agreement, Customs do have a public commitment to maintain the upward trend in deliveries of legitimate road fuel into Northern Ireland which they established in 2001.

2.9 The Oils Strategy aims to ensure that Customs achieve the target reduction in the size of the illicit market on the mainland. The Strategy combines law enforcement action with better control over the sale and distribution of rebated diesel, kerosene and "tied" oils to target criminal and commercial fraud. This report examines how Customs are addressing the risks to revenue posed by the illegal use of rebated fuel, through the implementation and gradual delivery of the Oils Strategy.

Implementation and aims of the UK Oils Strategy

2.10 In order to meet the targets set out in the Public Service Agreement, the Strategy has two central elements: a control regime making it harder for the fraudster to obtain rebated fuels; and robust law enforcement action for those who still manage to obtain and illicitly use them.

2.11 The Strategy has a control and sanction regime covering the whole of the rebated oils supply chain. Although previously well controlled at the production and end-user stages, this was not as effectively controlled in distribution once oils had passed the duty point at the refinery gate.

2.12 Customs, therefore, implemented a regulatory scheme to control the supply of rebated oils (the Registered Dealers in Controlled Oils (RDCO) Scheme). This requires all distributors of rebated gas oil (red diesel), and marked kerosene (heating oil) to maintain registration within the scheme and to provide returns to Customs giving details of whom they sell rebated or controlled oils to and to take reasonable steps to ensure that their sales of rebated fuels are for legitimate uses. Additional Customs officers have also been deployed to detect illicit fuel use, gather intelligence and investigate those involved in smuggling and fuel laundering.

2.13 Customs also established an Oils Central Co-ordination Team to collect and analyse intelligence on the users and suppliers of rebated fuels. This is used to direct assurance and detection work as far as possible, supported by new technologies, in Regional Business Services and within Road Fuel Testing Units (RFTUs). The targeting of Customs resources to tackle oils fraud has also been supported through a publicity campaign.

Roles and responsibilities

2.14 The effectiveness of the Strategy is dependent on a range of Customs officers in different business streams within the department working together to deliver a shared goal. There are five key areas of Customs activities which have a role to play in delivering the Strategy:

Figure 2.2: Functions and priorities for tackling oils fraud

Function	Priorities
Business Services and Taxes	Carrying out assurance and education visits to Registered Dealers in Controlled Oils, and post detection work to raise duty assessments to recover the revenue.
Law Enforcement Intelligence (including the Oils Central Co-ordination Team)	Providing guidance and support to Law Enforcement and BS&T officers to direct operational activity.
Law Enforcement Detection (specialist)	RFTUs focusing on commercial fraud in the transport sector, supporting investigation activity at laundering plants.
Law Enforcement Detection (multi-functional officers and National Strike Force)	A visible presence to provide deterrence and risk-based checks to produce detections.
Law Enforcement Investigation	Focusing on gangs and illicit supply including fuel laundering plants, and undertaking prosecutions and asset confiscations.

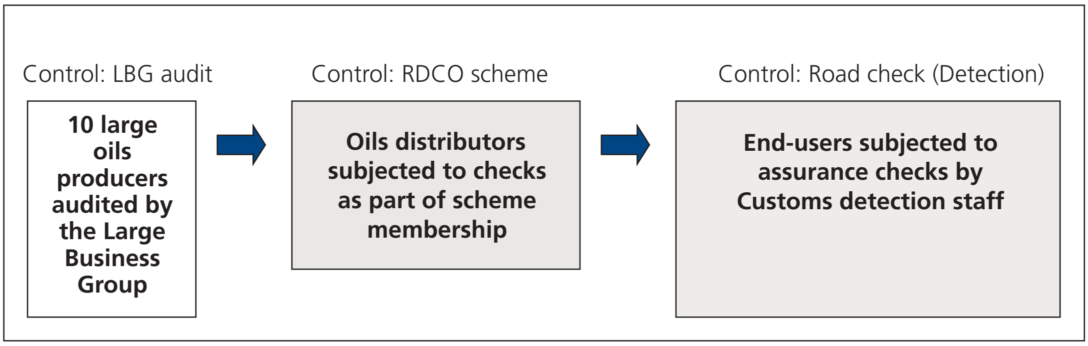
2.15 On the basis of available evidence, we conclude that the Strategy has been implemented effectively within Customs. It has largely broken down the "functional silos" for which we have previously criticised the department. Different operational areas within Customs each have a clear role to play within the Strategy, and the department has worked to facilitate open communication between them.

Registered Dealers in Controlled Oils (RDCO) Scheme

2.16 The cornerstone of the Strategy is the Registered Dealers in Controlled Oils scheme (the Scheme), under which distributors are authorised by Customs to operate. Prior to the implementation of the Strategy, the Department's focus was on illicit supply and use, and involved the detection of illicit fuel and imposing of sanctions. This provided little control over how illicit suppliers and users were sourcing their illegal fuel.

2.17 All distributors of controlled oils are required to register with Customs. There are currently some 4,700 registered dealers and distributors who, under the Scheme, are required to submit monthly returns with customer details for all commercial sales of rebated fuels as well as any domestic sales of more than 3,500 litres per supply, or 10,000 litres per annum. Distributors are also required to take reasonable steps to ensure that the sale of rebated oils is for legitimate use. Customs has the power to impose a range of penalties and sanctions for non-compliance, including, ultimately, to withdraw registration from dealers.

Figure 2.3: How the RDCO scheme fits in to Customs' overall approach



2.18 When distributors apply for admittance to the Scheme, they are subjected to checks with the Mineral Oils Relief Centre (which maintains a database of registered traders) and detailed background checks undertaken by the Central Co-ordination team. During the initial authorisation process, these checks identified around 30 traders attempting to register about which there were concerns, 15 of which were refused registration because of suspicions about the legitimacy of the business. A further 10 traders had extra conditions imposed on their registration approval.

Figure 2.4: Good practice: the registration programme

Customs received an application to register as a dealer in controlled oils from a plant hire business and undertook standard background checks revealing that the trader had no history with Customs and was potentially not a genuine business. Because of these suspicions, assurance staff visited the trader's premises and found the site deserted proving there was no ongoing legal trade which would be entitled to deal in rebated fuels. The trader was subsequently linked to a fuel laundering plant.

2.19 We consider the introduction of a scheme to register dealers to have been an appropriate move to address risks to revenue. Whilst it places some administrative burdens on legitimate traders, it has provided an effective method of regulating traders who previously were largely unsupervised.

Problems in the registration of dealers

2.20 In its Regulatory Impact Assessment, completed prior to the implementation of the Strategy, the department estimated that approximately 1,200 traders would be required to register under the Registered Dealers Scheme. This was a significant under-estimate, with current records showing there to be some 4,700 registered dealers. This was because Customs underestimated the impact of the Scheme in certain areas, for instance the plant hire business, and did not consider the status of other groups such as machinery rings (typically groups of farmers buying rebated fuel in bulk and distributing it between themselves).

2.21 Registered dealers are required to provide Customs with monthly returns on their sales of rebated fuels. Customs store this information on a database they have developed. When Customs started to compile the database of returns from registered dealers, flaws within the system affected the number of returns which could be entered. Initially very large returns of over 100 pages could not be entered onto the system. Although this constituted very few returns (15) the amount of data was significant (40%). This information was analysed but had to be handled manually. Customs have informed us that they have rectified this problem and large returns can now be entered onto the system.

2.22 An additional problem in building and managing the database has been that all large manual returns have to be input in full onto the database in one sitting, resulting in a higher risk of error, because of the lack of a "save" function. Customs told us that they have successfully implemented a technical solution to this in November 2004.

The Role of Intelligence in Delivering the Strategy

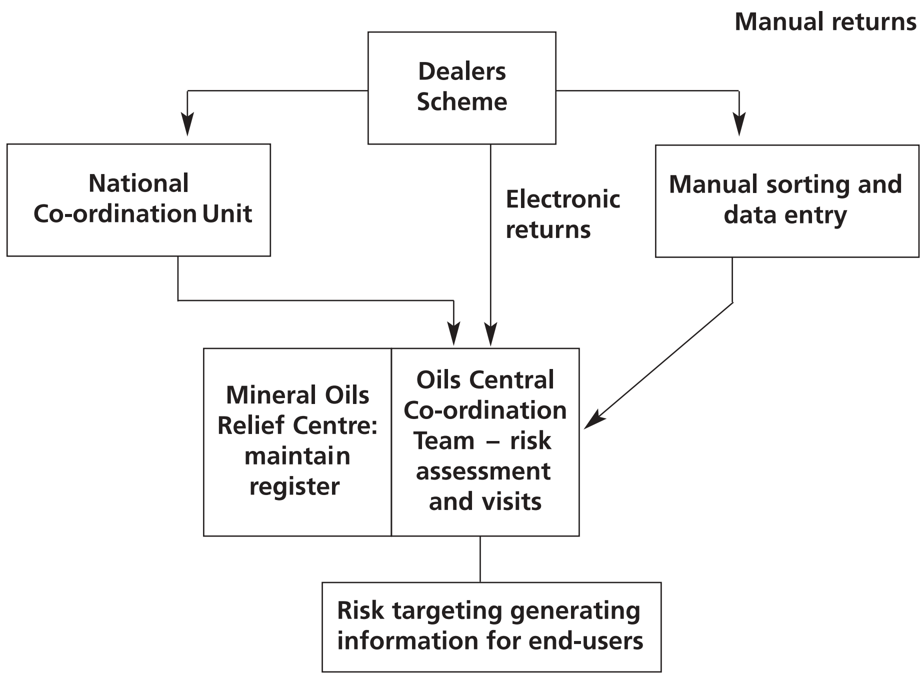
2.23 The registration scheme has provided Customs with significant operational intelligence information to use in targeting potential illicit use of rebated fuels. This information makes it possible for Customs to quickly gain an overall understanding of which traders are buying rebated fuels. Prior to the Strategy, a fraudster may have been able to evade detection by Customs by purchasing small quantities of rebated fuels from a range of different suppliers in order to mask the full scale of illicit use. The monthly returns provided under the registration scheme allow Customs to collate all significant domestic and commercial transactions using a database. This can be interrogated to identify suspicious use through a company name, location or VAT number. For example, in August 2004 the Central Co-ordination Team received intelligence information which resulted in 90 referrals to Law Enforcement Detection officers.

2.24 The existence of the registration scheme has changed the dynamics of oils fraud: the scope for opportunist fraud, taking advantage of the limited controls in the system, has reduced as there are now requirements to provide information which could draw them to the attention of Customs assurance and investigation staff.

2.25 Prior to the implementation of the Strategy, intelligence from oils distributors was gathered when assurance staff visited traders and collected details of

Figure 2.5: Functional Structure of the Oils Strategy

The diagram below shows the information flows from registered dealers, and how this is processed through to influence the activities of assurance staff from the Large Business Group, Regional Business Services and detection staff in the Road Fuels Testing Units.



what they considered to be suspicious transactions. These were then followed through to the final user to see if there was any illicit use.

2.26 Managing the increased levels of information available to Customs provides a very real challenge. Dealers can submit their monthly returns electronically but to date few distributors do so, with less than 5% of monthly returns being submitted in this way. Manual processing of this information uses a lot of staff, with teams dedicated to re-entering data which has been generated from trader systems.

2.27 It is important for Customs to liaise with the trade and find ways of incentivising traders to file monthly returns electronically. The Federation of Petroleum Suppliers, representing a majority of dealers, raised concerns with us over the security of an electronic system, and pointed to cultural differences whereby traders appear to be more comfortable supplying data in hard copy. Our work showed that many traders have systems that allow production of electronic returns; however have yet to use them. Customs and the trade have not yet developed a joint approach to encourage greater take-up of electronic filing.

2.28 The Federation of Petroleum Suppliers considers that it will take time to get the trade to switch over to an electronic filing system. We recommend that Customs and the industry look together at ways to improve the speed of take up, for example by making it mandatory, or by working with selected individual traders to identify the difficulties with the electronic system and to address them.

2.29 We reported more broadly on the Customs e-business programme in November 2003 (HC 1267 2002-03). We identified a number of mechanisms through which greater take up of e-services can be achieved. These include financial incentives, mandating the use of electronic filing, reducing transaction costs for traders through a simplified or quicker process, or through improved information to make electronic filing of returns beneficial and desirable to traders. Customs have informed us that they are currently considering the various incentives to improve the take up of e-returns in this area, following on from findings from their 'Business Needs Survey' which included questions on this issue.

The Central Co-ordination Team

2.30 Customs have established a Central Co-ordination Team to support officers engaged in the delivery of the Strategy, maintain the register of dealers and establish a database of information collated from traders' monthly returns. The team exploits this database to identify either registered dealers where there are indications of non-compliance, or end-users where there is suspicion of illicit use. They then generate referrals, which either indicate to assurance officers which traders should be visited, or direct detection officers to make interventions. Our examination identified that the Central Co-ordination Team provides effective support to other staff engaged on the Strategy, but its effectiveness is limited by IT constraints over the development of its returns database and case handling systems.

2.31 We found that data integrity checks built into the database did not work as expected due to the poor quality of returns received from some registered dealers. A single error on a return would result in the whole return being rejected. This could also explain the poor take up of electronic lodgement. In order to get these returns onto the system, and to allow Customs to target registered dealers with education visits, Customs disabled some of the data integrity checks and allowed returns to be submitted either manually or electronically. Customs aim to overcome these problems with the release of the new RDCO 2 system in tranches, due for full implementation by the summer of 2005.

2.32 The lack of an IT system to manage referrals made by the Central Co-ordination Team to assurance staff and testing units provides further problems for the effective management of intelligence information. The team are currently using spreadsheets to track and manage their work. This severely limits the amount of data that can be stored for management and statistical purposes.

2.33 As the volume of data to be collected and handled increases, the current spreadsheet-based approach, while currently effective, will not be sufficient for the team's needs. Customs are examining for the medium and short term the IT systems they will need to support the team's activity. It is essential that the team have effective IT support so that they are able to maximise the interventions made by front-line staff. Customs have developed a business case for the requirements of the team and are examining ways to deliver its needs. Customs must ensure that IT support made available continues to keep pace with the team's needs, and provides appropriate capacity.

IT support for Excise staff

2.34 Excise Officers, including those visiting registered dealers, do not have an electronic system to record trader information and details of assurance visits undertaken, which the Electronic Folder system provides for their counterparts in the department working on VAT. Many Excise staff are reliant on the Departmental Trade Register as the principal source of trader information; however, this system is not specific to Excise traders, and the information it contains can be unreliable, as it is not updated to reflect the contents of the Electronic Folder system.

2.35 As a result, the Excise side of the business still largely relies on paper files which have to be distributed around the country risking the loss or indeed duplication of information. This also delays the speed with which case information can be shared as officers locate and wait for the arrival of paper files.

2.36 The need for more sophisticated support for Excise reflects the changing nature of risks to revenue. In the past, Excise duties were seen by the department to be easy taxes to collect as the duty point was at the refinery gate, brewer's door or tobacco factory, and there were a small number of major suppliers who accounted for the bulk of duties collected. Since 1992 and membership of the European Community and Single European Market, risks have developed which go beyond this duty point, as product can be sourced from other external suppliers and imported under duty suspension. IT systems to take account of these changing risks have not materialised. Under the Department's e-Programme, Customs are designing systems which are generic and can be applied to excise regimes to provide an equivalent of Electronic Folder for Excise Officers.

Failure to submit returns to Customs

2.37 An integral part of the Scheme is the submission of monthly returns by all dealers. We examined the trader database records for June 2004. We found that 480 traders (10% of the population) had not submitted monthly returns. Customs have worked to reduce the number of missing returns, and this is reflected in a drop in the number of missing returns from 15% for April 2004. Customs have achieved this through a continuation of educational visits to traders in order to ensure high quality and timely returns, and to ensure that most if not all traders are within the Scheme where they can be monitored. Since April 2004, Customs have also adopted a tougher approach to non-compliance with the use of a number of sanctions, including financial penalties.

2.38 We consider it important for Customs to ensure that the largest number possible of dealers are brought into the registration scheme. The potential of the scheme, however, will not be fully realised unless traders are either made compliant and submit accurate and timely returns or, ultimately, de-registered. Since April 2004, Customs have adopted a more robust approach to dealers failing to comply with the Scheme's requirements with additional assurance visits leading to penalties and further conditions attached to their continuing registration where appropriate. Customs will, however, need to constantly review their approach and become more robust still, if their current procedures do not secure the full compliance of dealers.

Feedback to the Central Co-ordination Team

2.39 There are two principal users of the information produced by the team: Law Enforcement (Detection and Investigation) who use the referral system to get additional details on suspicious commercial users and receive referrals based on an interrogation of the database; and assurance staff who receive referrals when they relate to specific suppliers, and details of local bulk traders requiring a higher level of assurance work.

2.40 Testing units and assurance officers have not consistently provided feedback on the usefulness of material generated by the Central Co-ordination Team. We examined a sample of referrals to Road Fuel Testing Units and found that there was a misunderstanding on when feedback was required or when it was useful. Customs have now clarified where feedback is required, and this information can be used to strengthen further the Central Co-ordination Team by making staff aware of the main requirements of end-users of information provided.

2.41 In the great majority of cases no feedback was given. We examined a sample of these cases to determine why. In some cases feedback had been provided but was not recorded on the main referral spreadsheet. In a further sample of cases, we found that assurance staff did not have a record of receiving the referral.

2.42 As a way of improving the quality of feedback, Co-ordination Team staff have been attending regional sift meetings at which traders are identified for visits by Customs Officers to gain a broader understanding of the expectations of end-users. This is a relatively new process, but has been well received by those involved. Management have also been proactive in encouraging more regular and consistent feedback to the team which has generated positive results.

2.43 The team has had a positive effect on post detection work where they examine the historical purchases of a known fraudster to raise assessments. Initial uptake of this service was sporadic, but its success in leading to larger assessments has increased demand.

Figure 2.6: Oils Central Co-ordination Team post-detection work

An officer undertaking research on the RDCO database identified a number of suspicious supplies to a trader from a number of registered suppliers. Further investigation revealed that the trader owed money to Customs, although this information had not been known when a Road Fuel Testing Unit had made a seizure from the trader a few weeks prior. The officer passed the evidence onto assurance staff, resulting in a much larger assessment.

Detection and Prosecution

2.44 For the Strategy to be effective, Customs must make fraud unattractive by making it harder to get hold of rebated fuels for illegal use, increasing the chance that fraudsters will be detected, and through the use of tougher sanctions when they are caught. Detection work is carried out by Road Fuel Testing Units which include Customs Officers trained in chemical testing techniques for detecting illicit fuel. They also provide a visual deterrent for those considering using illicit fuel. Teams identifying the illicit use of rebated fuels can apply a range of sanctions including a £500 fine to recover a confiscated private vehicle, or an assessment for the estimated duty evaded for commercial misuse.

2.45 In implementing the Strategy, Customs have increased by half resources deployed on testing units to 79 officers. Customs also have around 3,500 multi-functional officers available to work across all departmental responsibilities, with an estimated 50 staff years currently targeted to tackling oils fraud in Great Britain. Whilst multi-function staff are not trained to undertake in-depth chemical testing, they are able to detect the use of illicit fuel in all but the most sophisticated laundering cases. These officers provide a visible presence on the roadside and can also gather intelligence.

2.46 The Committee of Public Accounts was previously concerned that staff placed too much reliance on sight tests to detect the presence of the marker dyes in rebated fuels. Customs have responded to this by placing greater importance on sampling and retaining samples for evidence. Officers are now able to send samples for testing by the Government Chemist. There have also been developments in the technology used to detect illicit fuel, with Customs currently trialling a device able to detect illicit fuel in vehicles without the need to draw a sample from the fuel tank.

2.47 Customs informed us that intelligence produced by their Intelligence officers provides the best prospect of securing a detection. Customs management have sought to improve the quantity and quality of intelligence support provided to Law Enforcement Detection officers. This is reflected in a significant increase in the volume of intelligence packages, and the number of hits subsequently generated across 2003-04. For example, 1,724 vehicles were tested as detection staff actioned 1,049 intelligence packages produced in the third quarter of the year, resulting in 143 successful hits.

2.48 Customs have also put in place a framework for officers to establish effective working relationships, and a wide range of networks and techniques to gather intelligence. They identified that other agencies, including the police at the Vehicle Operator and Services Agency, often held a significant amount of information which would be of interest to them. Customs have established this best practice as an important element of an Intelligence officer's work and are working to ensure it becomes the standard working method.

Figure 2.7: Intelligence Performance – Oils – 2003-04

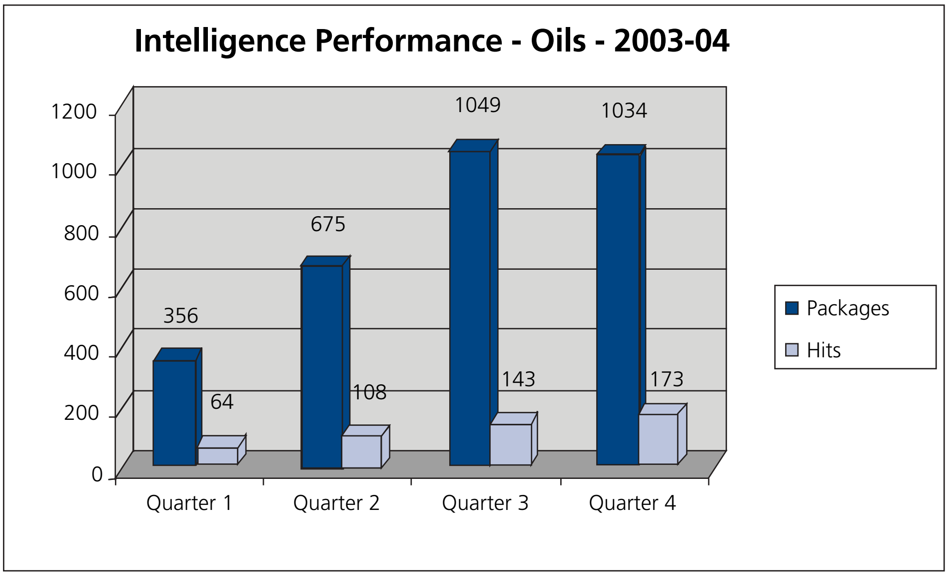


Figure 2.8: Good practice: Scotland

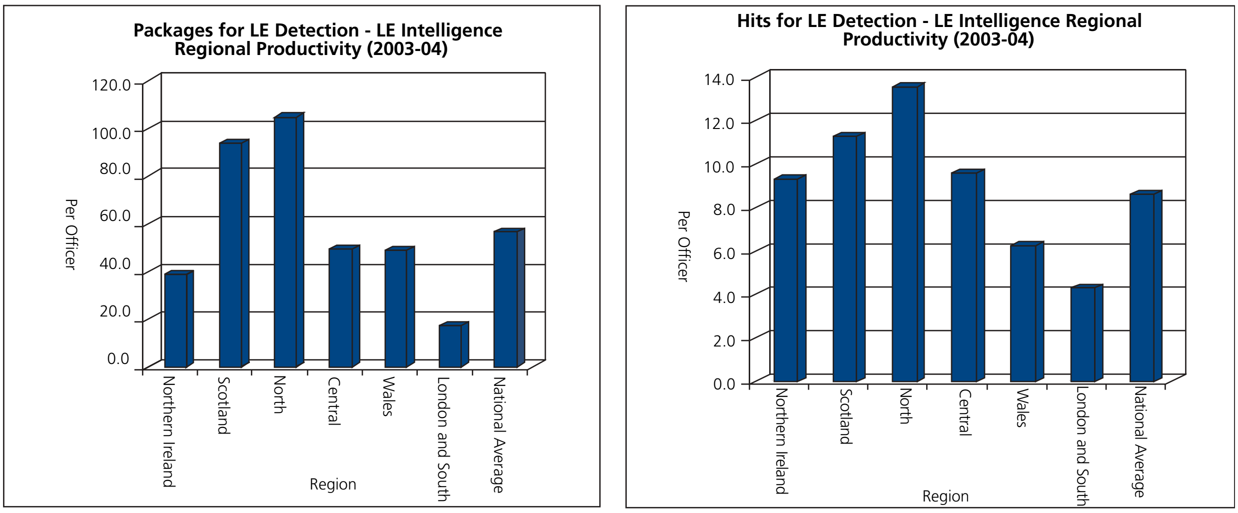
In Scotland relationships have been developed with other agencies such as the Police, Trading Standards and the Vehicle Operator Services Agency. Presentations and leaflets have been given to police on issues such as how to identify laundering plants. This education has lead to an increased amount of intelligence from these other sources.

A large laundering plant was found following a police tip off. In remote areas in particular, police are the main source of intelligence, and increasingly Customs have developed effective partnerships to exploit this intelligence source.

2.49 Customs have worked to improve the support provided by Law Enforcement Intelligence to their Detection colleagues nationally. They have done this through identifying best practice, disseminating it, and ensuring that it becomes the standard to which all staff work. However, performance in different regions does vary. For example, intelligence officers in Northern Region produced almost twice as many packages and hits as the national average. Customs must continue to maximise the support given by Intelligence staff to Detection staff in each region. There will always be an element of differing productivity between regions, the challenge for Customs is to ensure that best practice continues to be identified and used to maximise performance in each. The graphs below show variances in regional productivity in 2003-04.

2.50 Prosecution is a key element of Customs armoury when tackling oils fraud. Customs focus their prosecution activity in those areas where such action will be most effective, in particular when tackling serious criminality. Activities to date under the Oils Strategy have secured 21 convictions in 2003-04 for perpetrators of oils fraud, compared to 11 in 2002-03. Customs have told us they always seek to make use of publicity so that the deterrent effect of every conviction can be maximised.

Figure 2.9: Law Enforcement Intelligence and Detection outputs – regional productivity 2003-04



Source: Customs

Performance Measurement

2.51 The success of the Strategy is assessed on the size of the illicit market. The illicit market figure is estimated using established methodology as detailed in 'Measuring Indirect Tax Fraud'. The "gap" is estimated by calculating the total theoretical consumption of hydrocarbon oils for the UK and deducting the known licit consumption, i.e. deliveries of duty-paid fuel and known cross-border shopping. These estimates are corroborated with evidence from operations on the ground and information from the trade.

2.52 Customs are unique amongst revenue collection bodies in estimating losses attributable to fraud, both in absolute terms and as a percentage of the total market. For oils fraud, the calculation of fraud is performed on a calendar year basis with a time lag of 8 months from the end of the year. Customs are unable to speed up this timetable as the necessary official data is only available annually from the Office for National Statistics and the Department for Trade and Industry. As a result, Customs are unable to gauge accurately the level of the illicit market during and for 8 months after the year in which they are seeking to reduce it through their deployment of resources and the tactics they employ. Customs do, however, assess their impact on the illicit market through a range of other indicators and data sources.

2.53 Customs examine the quantity and quality of activity as a result of the Strategy and compare this to past performance as well as the levels of performance required to meet the 2% target set in the Public Service Agreement. Management information is gathered from a range of sources, including the Operational Planning System which provides information on the amount of resource used for Oils Strategy assurance work but not on their results. This is supplemented by a monthly Oils Strategy Management Information (OSMI) return, detailing the number of visits undertaken by assurance staff and the value of all assessments made.

2.54 Law Enforcement produce management information reports on the numbers of challenges made and detections arising, including variables such as the split between types of vehicles concerned (commercial or private), as well as data on laundering plants discovered and the number of criminal gangs broken up. Performance is monitored by a committee consisting of a number of key managerial heads from within the Department. The committee meets monthly to discuss whether the Strategy is progressing as planned based on regional information.

2.55 Customs rely on a review of the other evidence outlined and trend analysis to see if there are indications that the Strategy is being successful. These can be interpreted by Customs to indicate measures of success along with trade sources showing the level of fuel thefts. We found that the performance measures used are reasonable, although the level of assurance they can provide Customs with about the effectiveness of the Strategy is limited and needs to be compared to actual results when the official data is available.

2.56 The nature of an outcomes-based strategy which focuses on reducing a tax gap means that there will always be a delay in having available the success measure when it can only be measured on an annual basis. This means that Customs cannot use progress in closing the tax gap on an in-year basis to change the strategy they are employing and the resources they deploy. They instead rely on a range of internal and external data to manage performance. As things stand, we recognise the difficulty this presents to Customs, however they should continue to look for ways in which they can measure performance in-year on a timely and accurate basis.

Conclusion

2.57 Customs have developed an innovative approach in their fight against fraud. A scheme has been established that requires dealers in rebated oils to be registered. During the implementation phase of the Strategy Customs has invested significant resources towards educating traders so that they understand their obligations, and to build a trader database. The registration scheme has in turn provided Customs with access to much greater information to strengthen its intelligence and drive assurance and detection work. From April 2004 onwards, Customs have adopted a tougher approach to the use of sanctions, to ensure compliance of dealers for whom a solely educative approach has not delivered the required results.

2.58 The development of the Strategy represents effective cross-departmental working, and has also seen the development of information sharing with other organisations to improve the quantity and quality of intelligence material. Customs have focused on improving the intelligence processes and networks to deliver more and better quality intelligence to front line officers. However the picture across the UK is far from uniform and some regions could learn much from the good practice identified in this report.

2.59 The Strategy has provided Customs with significant operational challenges in ensuring that proper support, particularly in the IT area, is provided to officers. Customs and industry also need to work together to incentivise greater take up of e-lodgement for monthly returns amongst the trader population using the Registered Dealers Scheme. This will allow significant savings in administrative and support resources deployed.

2.60 It is difficult to devise a robust performance measurement system to allow the effectiveness of resources deployed to be assessed on a timely basis. Nevertheless the developments made by Customs appear promising and have created an integrated approach within the department to tackle oils fraud effectively. We have made recommendations to assist in this process.

We recommend that:

- Customs and the trade should work more closely to identify ways of improving take up rates for electronic filing of trader returns by registered dealers, and consider the recommendations we made in our report on e-Services.
- Future system design and implementation should give due regard to facilitating e-filing of returns, and the collection, collation and analysis of trader data. This can, in turn, be used to provide a best practice model for other excise systems within the department.
- Customs examine the current procedures for collecting, collating and monitoring referrals and feedback and put in place a strengthened set of procedures.
- Customs should continue to ensure that they maximise the productivity of each Law Enforcement Intelligence team in the regions by ensuring that best practice in one region is replicated through the country.
- Customs should refine its management information over the lifetime of the Strategy to ensure that the

range of measures it employs to assess its effectiveness continue to provide a realistic indicator of performance.

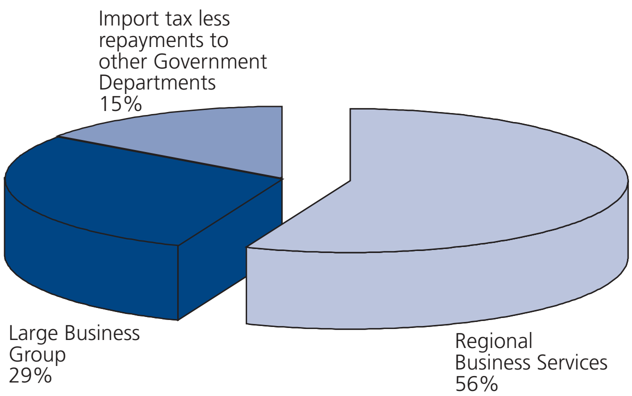
- Customs should liaise with external data providers to examine which data sources can be provided at an earlier stage to allow Customs to better assess progress during the year.

Part 3: Improving compliance in small and medium-sized enterprises

Introduction

3.1 Value Added Tax (VAT) receipts represent the largest amount that HM Customs and Excise collect. In 2003-04 net VAT receipts totalled £69.3 billion, accounting for 59% of Customs' total receipts for 2003-04. Of that £69.3 billion, £38.6 billion, or 56%, was collected by Customs' Regional Business Services department.

Figure 3.1: Net Receipts from VAT 2003-04



Source: National Audit Office

Customs' VAT Compliance Strategy

3.2 In April 2003 Customs launched their VAT Compliance Strategy (VCS). This Strategy was developed in the 2002[1] and 2003[2] Pre-Budget Reports. These established the methodology for estimating VAT losses and suggested areas to target resources to maximise VAT receipts.

3.3 The VAT Compliance Strategy strives to meet the objectives and targets set out in the Department's Public Service Agreement for Spending Review 2002 and the Service Delivery Agreement covering the period April 2003 to March 2006. These require Customs to 'collect the right revenue at the right time' and improve traders' compliance through the closure of the VAT gap (the difference between total VAT due and actual VAT collected) by increasing the VAT yield from 85% to 88%.

3.4 The Strategy concentrates on addressing four areas as a means of closing the VAT gap – tax avoidance, missing trader intra-community (MTIC) fraud, general non-compliance and failure to register. We reported on Customs' overall approach in our report 'Tackling VAT Fraud' (HC 357 2003-04). That report examined Customs' approach to detecting, investigating and preventing VAT fraud. This review focuses further on general non-compliance and the strategies used to tackle it, in particular risk based assurance visits. Compliance is defined by Customs as "encouraging those who are

1 Source: *'Protecting Indirect Tax Revenues – Nov 2002'* and *'Measuring Indirect Tax Losses – Nov 2002'*

2 Source: *'Measuring and Tackling Indirect Tax Losses – Dec 2003'*

complying at present to continue doing so, helping businesses who want to comply but are currently failing to do so, vigorously tackling those who deliberately and consistently fail to comply and ensuring that this activity serves to prevent and deter non-compliance among the wider business population …" The general non-compliance element covers those areas not covered by those elements of the Strategy dealing with tax avoidance, missing trader fraud and failure to register.

3.5 Customs have developed a model which they describe as the compliance continuum. This seeks to capture the behavioural characteristics of all traders, from the compliant to the fraudulent, which determines Customs' response in each of these situations. Over the lifetime of the Strategy Customs aim is to improve and enforce compliance over the range of the continuum.

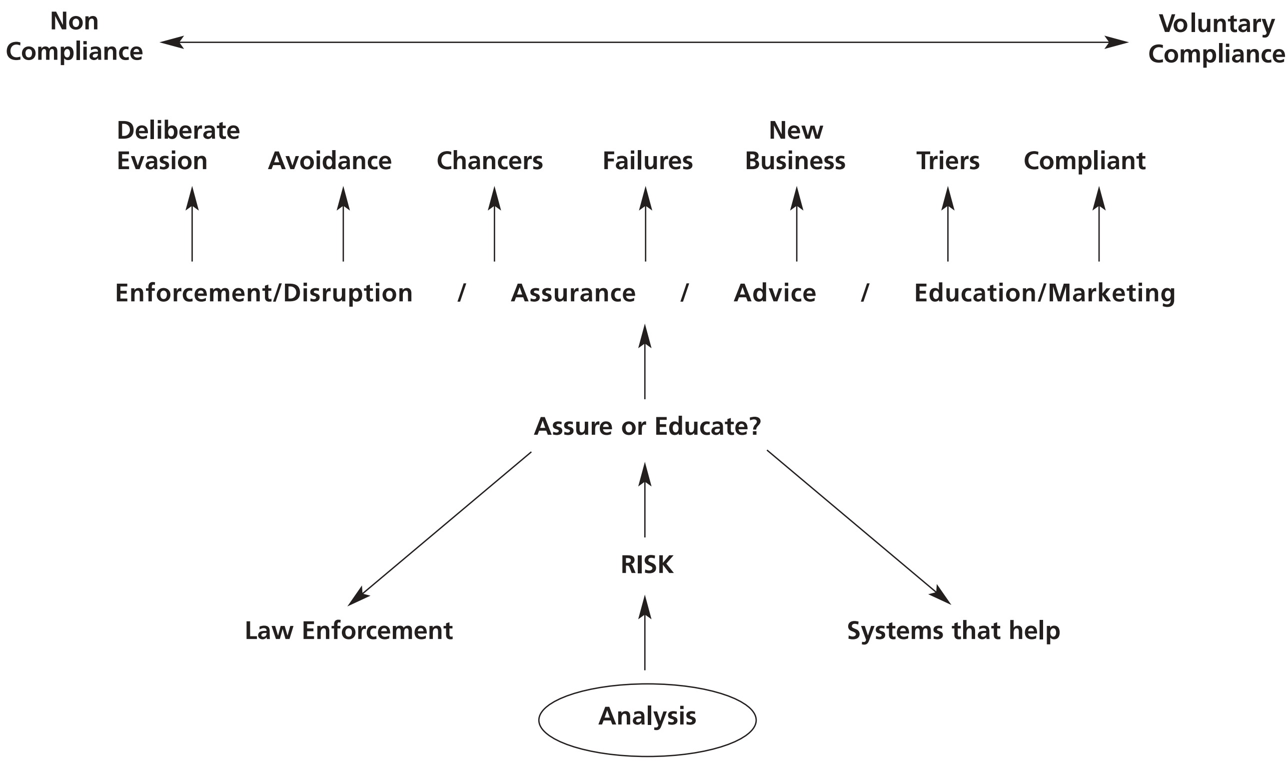
Business Services and Taxes Division

3.6 The Business Services and Taxes (BS&T) division within Customs is responsible for administration, collection and policy relating to VAT, Excise and International Trade services. VAT Operations section within the division is responsible for delivering the VAT Compliance Strategy.

3.7 The Large Business Group collects the taxes and duties for the largest 1,050 revenue traders. We reported upon the work of the group in the 2002-03 Standard Report[3]. Regional Business Services is responsible for the collection of taxes and duties from more than 1.8 million small and medium enterprises. The 1,300 largest traders within this trader population are separately classified as "Trader Group 6" and treated more like large business traders. Under the VAT Compliance Strategy, Customs'

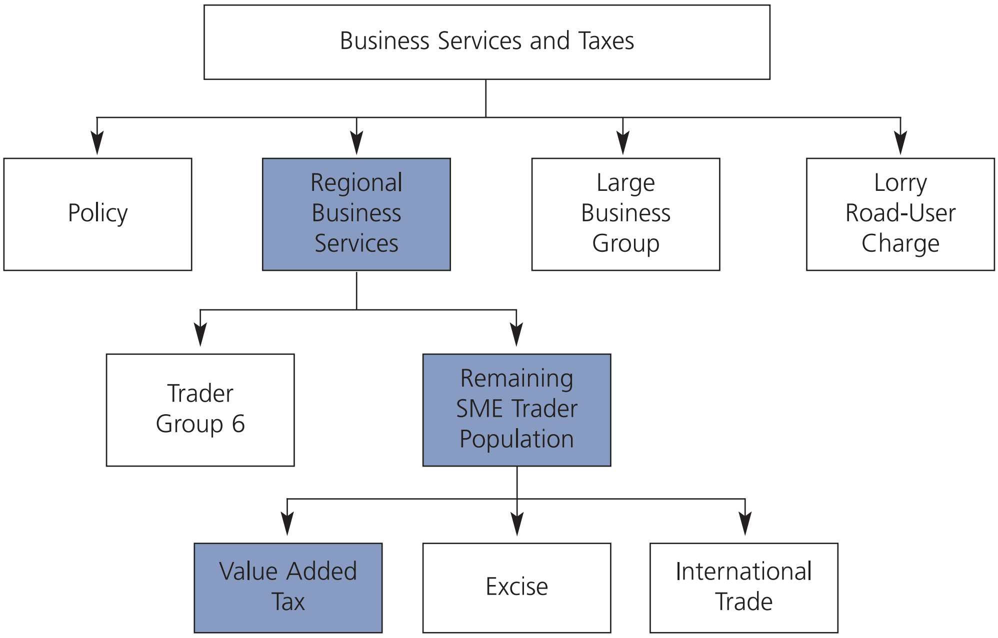
3 *'HM Customs and Excise: Standard Report 2002-03 report by the Comptroller and Auditor General'*

Figure 3.2: The Compliance Continuum



Source: Customs & Excise

Figure 3.3: Customs' revenue collection structure



Source: Customs & Excise

Note: Figure 3.3 does not reflect the role of VAT Operations, a national operational VAT policy division within Business Services and Taxes providing operational policy guidance and undertaking performance monitoring for both Large Business Group and Regional Business Services.

deploy a range of intervention techniques to manage revenue yield and trader compliance, one type being assurance visits by Customs Officers to traders based on a central risk analysis exercise followed by a risk based selection process. For this review we have focused on the strategies used by Regional Business Services to collect VAT from small and medium-sized traders by using assurance visits.

HM Revenue and Customs

3.8 The Government announced in the 2004 Budget the creation of a single integrated tax department. The 2004 spending review set the Public Service Agreements (PSA) for the new department, including the requirement to ensure that by 2007-08, the scale of VAT losses is reduced to 11% of the theoretical liability. The VAT Compliance Strategy will, therefore, continue to be a critical part of the operations of the new department through to 2007-08. Meeting the Public Service Agreement target will depend on the success of the Strategy.

3.9 The Strategy introduced a new strategic approach to reduce VAT losses arising through fraud, avoidance and other forms of non-compliance. It was designed to reverse the trend of an increasing VAT gap by encouraging voluntary compliance in businesses. This was a major change in the way in which Customs deal with businesses, focusing on long-term improvements in compliance, yield and 'aftercare'. The Strategy is designed to:

- create an environment which fosters voluntary compliance and deals robustly with those who choose not to comply;
- optimise revenue collection through robust cash flow management procedures including debt management;
- create an environment in which VAT fraud and avoidance become less economically viable; and

- provide a range of risk based interventions across the business population, aimed at testing and improving voluntary compliance.

There are a range of activities taking place at a regional level to support these aims, and a number of activities which are being undertaken in a new way. Our findings and recommendations are focused on:

- Risk Centres;
- Quality of information; and
- Targets and measuring results.

Risk Centres

Background

3.10 Given that Regional Business Services is responsible for 1.8 million small and medium-sized traders, resources do not allow direct contact with all traders each year, and indeed, visiting all traders every year would form an unacceptable burden on compliant businesses. Risk assessment is, therefore, used to select traders and deploy assurance resources.

3.11 In April 2002, the Director of Regional Business Services commissioned a Risk and Deployment Centre project based in London. The objectives for the project were to review the current system to define risk and deploy resources, in order to develop a new system using the knowledge of internal experts and external data, and to employ a wider range of responses to risks identified. Based on the results of the London project, a blueprint for a new structure of regional "Risk Centres" was developed and implemented.

3.12 The project also developed some guiding principles, with a greater emphasis on project based working to analyse the trader population, the development of procedures to improve the quality and consistency of the process through which traders are selected for assurance visits, and re-iterating the need to coordinate regional activity.

National Implementation

3.13 In July 2003 the project steering group decided that key elements of the project should be introduced across all regions. It delegated responsibility to develop and deliver the Risk Centres to VAT Operations, which in turn devised a change programme to drive forward the main elements of the project.

3.14 Customs assess risk using a range of factors including sector specific knowledge, taking account of issues discovered during assurance visits. This knowledge is being used by Customs to build a National Business Picture to provide an overall picture of risk in the United Kingdom. The development of the National Business Picture marks a significant step forward. It does not, however, currently include a mechanism for routinely comparing the performance of an individual trader to the overall performance of their trade sector, for which staff are reliant on the main VAT system. The Australian Tax Office, for example, in common with Customs identifies risk within small to medium-sized enterprises by looking at the tax performance of the business to see if it is consistent with the level of economic activity or the performance of industry comparators; it has also expanded this analysis work to examine whether payments and debt are consistent with industry benchmarks; and any issues arising during an audit or assurance visit. Customs' ability to develop a similar approach within the National Business Picture is constrained by IT factors. Work to address these limitations is dependent on the full implementation of Customs' e-Business programme.

3.15 Once the full range of risk projects have been developed and implemented throughout Regional Business Services, Customs should have a significantly enhanced ability to view risk in a range of different ways and have an improved flexibility to react accordingly. From our discussions with regional staff we have concluded that the Centres have been embedded effectively throughout the service. Centralisation within each region of key functions (such as the selection of traders for assurance activity, and the booking of assurance visits) is largely underway, and has been positively received, and an evolving national risk structure is also being implemented.

Project initiation and evaluation mechanisms have been developed

3.16 Regional Business Services have developed effective mechanisms for ensuring the delivery of the new project-based methodology to look at risk analysis and the deployment of resources. The processes for generating project ideas, assessing them and gaining approval has been established, and pro-forma Project Initiation Documents introduced.

3.17 Customs provided us with a list of 13 national projects which were underway in June 2004, or had been completed. We reviewed a sample of 7 of these projects, along with a further sample of 13 locally selected projects gathered from our visits to Customs' regions. In looking at the Project Initiation Documents selected, we found that a common standard had been applied for identifying, approving and implementing projects through the regional risk centres. By contrast, however, we found that measures of success are often vague and lack consistent standards, a point which has been recognised by Customs. For example, of the four 'missing returns' Project Initiation Documents we examined, measures of success included such aims as to 'decrease the number of returns outstanding'. Whilst this is a useful aim, it does not set a target level of reduction to be achieved or a timeframe for its completion. Although Customs have attempted to focus on longer term measures of success, these are quite frequently 'softer targets' that require a different evaluation methodology which Customs has yet to fully develop. For instance, Customs has set measures of success including, 'the correction of the (trader) register' and 'the assessment of the role of education' both of which are difficult to quantify or evaluate objectively using any existing performance measures.

3.18 We examined a sample of project evaluation documents and found that they had not been standardised in the same way as initiation documents. They vary in detail and quality. Evaluation criteria are not always consistent with the original implementation criteria. The need for a 'control' population should be included where appropriate in the planning stages of relevant projects in order to assess whether compliance has improved as a result of assurance activity. However, only one of the four 'missing returns' projects we examined included a control population, without which there is no statistical evidence available to support the achievements of targeted projects. It becomes, therefore, more difficult to justify extending the project across a wider trader population. Customs informed us that they are able to construct control populations after the event.

3.19 Evaluation is essential. Where significant time and resources have been deployed on project work the evaluation document should reflect that effort. We found good examples of project evaluation, such as on the project to identify missing trader returns carried out by Central region where the links between project activity and specific risks were explicit. But this was not uniform across all regions, with the lack of specific project targets making the resulting assessments subjective. We welcome the fact that Analysis Division have now been asked to work with project managers to devise an appropriate solution.

New national risk structure

3.20 The VAT Compliance Strategy has led to the development of a new risk management structure within Regional Business Services. The post of National Risk Manager for VAT was created in 2001. In January 2004, VAT Operations appointed a new National Risk Manager responsible for delivering the risk mechanisms to help tackle general non-compliance. The National Risk Manager is a member of the Risk Steering Group and National Risk Forum.

3.21 The Risk Steering Group was formed in May 2004 to ensure a common departmental understanding of risk and the deployment of resources to tackle it. The group includes the directors from Regional Business Services, Policy Group and Large Business Group and also representatives from Law Enforcement, Excise Operations and Customs and International Trade Operations.

3.22 The seven Regional Risk Managers and the National Risk Manager together form the National Risk Forum which was relaunched in the summer of 2003. Its function is to approve, review and evaluate all new risk projects, promulgate national campaigns, and ensure that a consistent standard of risk work is carried out in the regions. Practical operational issues are addressed through the risk technical forum. Our discussions with Regional Risk Managers indicated that the structure is already fulfilling an important role in formalising the approach to reviewing risk and ensuring its consistent treatment across regions.

Central Risk Assessment and Assurance Models

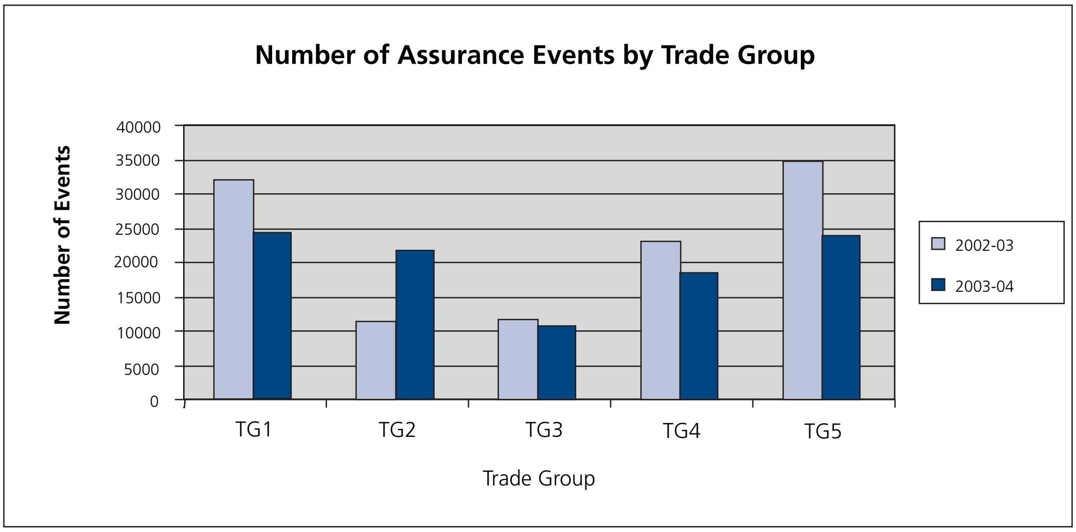
3.23 Customs select traders for an assurance visit based on a mixture of Central Risk Analysis and local risk selection. Central Risk Analysis is performed on all 'live' VAT registered traders using several factors to assess risk such as the complexity of the trader's business, the results of previous visits by Customs' officers and the trader's payment history. The process is then used to divide the Regional Business Services population of traders into six broad categories:

Trader Group 1	New Registrations
Trader Group 2	Low risk
Trader Group 3	Medium risk
Trader Group 4	High risk
Trader Group 5	Exceptional risk
Trader Group 6	Large high risk

3.24 In their Report on the Operation of Customs and Excise in 2001-02, the Committee of Public Accounts concluded that: "In planning visits to traders, Customs should have regard not only to the risk of fraud and evasion, but also to the wider risk of misunderstanding even by compliant traders, and the need for advice and guidance as well as enforcement activity" (HC 398 2002-03). Following this recommendation Customs revised their approach. One of the outcomes of this was to provide regional heads with greater flexibility about how traders are contacted and assured. Although VAT Operations has issued a policy statement providing guidance to regions on 'risk based visiting' we do not consider that this provides sufficient guidance as to how they should use the results of the Central Risk Analysis to prioritise risk within the trader population alongside the work of the Risk Centres. Our visits to Customs' regions revealed that there was a lack of consistency in approach.

3.25 The total number of assurance visits has declined from 119,000 in 2002-03 to 112,000 in 2003-04. There was, though, an increase in overall assurance events which includes telephone contact with traders. Additional resources provided under the 2002 Spending Review have been deployed to examine trader compliance. There has also been a change in the types of traders selected for assurance visits with an increase in training events during the year, and the reallocation of resources to tackling MTIC fraud. The graph below displays a substantial increase in the number of low risk traders being selected and a decrease in the number of exceptional risk traders.

Figure 3.4: Number of assurance events by Trade Group



Source: Customs & Excise

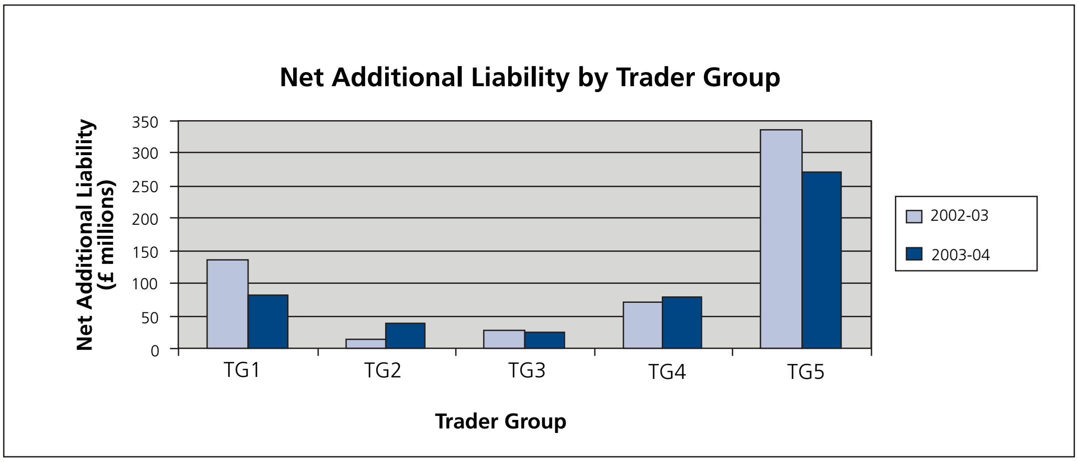
3.26 Customs explained that their rationale for investigating lower risk traders was to identify a number of higher risk traders that are not disclosed by central risk analysis. It is possible that such interventions may lead to reclassifying traders into higher-risk trader groups. However, Customs currently have no data on trader reclassifications resulting from the 2003-04 visit programme, making it difficult for them to explain the effect of this switch. The 2004-05 VAT Functional Plan suggests a re-focusing of resources on to exceptional risk traders. These changes in focus are part of the ongoing programme of improvements to the VAT Compliance Strategy, which is reviewed on a monthly basis by senior management within Business Services and Taxes Division.

3.27 One of the indicators which Customs use to track the effectiveness of its assurance work is the level of Net Additional Liability raised. This is a measure of the assessment raised due to risk based events. Total Net Additional Liability decreased from £696.2 million in 2002-03 to £612.3 million in 2003-04. Within this, the graph below shows the Net Additional Liability raised for Trader Group 2 increased from £14.8 million to £38.4 million, but the Net Additional Liability from Trader Group 5 decreased from £337.2 million to £271.2 million.

3.28 It is likely that the shift in the allocation of resources to lower risk trader categories will have contributed to the changes in Net Additional Liability raised. The usefulness of Net Additional Liability as a measure of the effectiveness of the assurance work is limited; in that Net Additional Liability does not always translate into cash received by the Department (it is, therefore, unsuitable for measuring any closure of the VAT gap).

3.29 Customs have moved, in recent years, to concentrate on a number of new measures as ways of assessing the effectiveness of their work. These other indicators used by Customs to track compliance over the same period have shown improvements. Customs informed us that over the period 92% of VAT payments were received on time, an additional 78,000 VAT returns were received on time and debt as a percentage of

Figure 3.5: Net Additional Liability by Trader Group



Source: Customs & Excise

liability has reduced, exceeding the set target. Crucially, the VAT gap decreased from 15.8% to 12.9%.

3.30 Customs commissioned an internal “Large Business Assurance Review”, which reported in May 2004. One of the major issues identified in the review was the differing levels of assurance activity between Trader Groups 5 and 6. The report noted that Traders in Group 5 (categorised as being of exceptional risk) had an average annual resource allocation of 6 sessions (3 days) each, whilst Trader Group 6 traders (classified as the largest handled by Regional Business Services) received an average of 27 sessions (14 days) per trader. Although regions are encouraged by VAT Operations to deploy resources flexibly and manage them as a pool of time, we did not always find evidence of this in practice. Officers are still not following the guidance consistently, and assurance events that we examined were carried out using the average resource allocations detailed above. The report concluded that more graduated increments in resources used to assure traders might be appropriate. We believe that this complements our review of general assurance activity within the other trader groups by highlighting the need for Customs to manage carefully the assurance work completed on the 'riskiest' traders within the trader population.

Risk research work

3.31 Risk research work supplements general assurance activity within the regions. Up to 20% of the VAT assurance work can be in the form of risk research work, which includes projects which fall into two groups: test drills, which explore prospective new areas of risk, and pilots, which try to find the most appropriate and effective treatment for the risk.

3.32 These projects have allowed Regional Business Services to overcome some of the shortcomings of Central Risk Analysis, particularly its static and backward looking aspects, given that it is based on historic information about known traders. Project work has given the regions the flexibility to develop more cross-cutting views of the trader population as demonstrated in Figure 3.6 below.

Figure 3.6: Good practice:
Growth Industries Project in Wales

The Wales region selected fast growth industries for a project using local media coverage. A previous exercise had highlighted a risk to revenue for fast growth traders as many of these companies run the risk of outgrowing their accounting systems and controls. From this project 30 traders were visited and 15 assessments raised, generating net additional liability of £193,188. The comparatively low level of net additional liability per trader allowed the region to conclude that fast growing businesses did not pose the level of risk that they had previously considered, allowing resources to then be redeployed to target higher risk traders.

Source: Customs & Excise

3.33 The development of project working within the new national risk structure has improved co-ordination between regions. In particular, where campaigns have been effective in one region there is now a mechanism for sharing experience and expertise. There is also evidence that ‘lessons learned’ in one region are considered and applied in others, as happened with assurance work focused on the motor trade. Our work indicates that this has lead to an improved ability to identify and react to emerging threats, and to spread good practice.

Quality of Information

A Minimum Information Requirement has been devised

3.34 Customs have used a system of electronic storage since 2001 for traders’ records. This stores all work papers, correspondence, telephone contact and audit event reports. The system has made the retrieval of trader information easier compared to the paper records used previously. It has also set mandatory reporting requirements which have helped in ensuring consistency of the quality of documentation across Regional Business Services.

3.35 The Central Risk Analysis and the National Business Picture both rely on underlying trader and trade sector data, which, if incorrect, will impact adversely on the quality of the risk assessment. Customs is aware of the need for high quality information and have made a considerable effort to help staff understand the need for minimum information standards. Customs has launched a campaign to improve the quality of information, mainly through a national initiative which has established a Minimum Information Requirement, specifying what must be recorded on the Departmental Trader Register for each trader.

3.36 In May 2004 we examined a sample of 60 traders' electronic folders to ensure all the requirements were completed, and compared the information on the electronic folder with the compliance management team questionnaire and/or the departmental trader register. Whilst the basic trader information was available in all cases, there were inconsistencies in the level of reporting of assurance activity recorded in electronic folder. Customs anticipate that the quality of reporting will improve as awareness of the minimum information requirement increases. For 11 traders of the 60 selected there was no information in the electronic folder relating to the assurance event. Of the remaining 49, 30 recorded consistent information in both the trader register and the questionnaire, however in 14 cases the register showed a difference in reported trader turnover, although VAT Operations have explained that this data is available from the VAT 1 forms submitted by traders at registration; and that this data field is static and does not influence risk assessment. The remaining 5 cases contained differences between the recorded trader class and business type.

3.37 Revised national guidance has been prepared to cover the conduct and documentation of assurance visits. This was distributed to the regions in May and June 2004, showing what should be recorded in the electronic folder. The guidance requires a risk profile to be completed, all sections of the audit report to be completed, and the completion of the electronic folder summary screens. From our testing we found six out of 60 risk events did not have a completed audit report and six out of the 60 events had completed the mandatory fields with dash (-). The standard of the documentation on the electronic folder needs to be consistent between the regions. The production of this "Quality Visit Guidance" is a good step in ensuring consistency; however management assurance of the electronic folder is Customs' main tool to ensure consistency.

3.38 In October 2004, staff in VAT Operations reviewed the audit sample and found that in 10 of the 11 electronic folder cases where we had found no visit report filed, they were able to locate visit reports which had been filed incorrectly. The results of two of the 60 risk events were not recorded correctly. VAT Operations has consequently issued guidance to staff reiterating the need for the electronic folder to be completed correctly.

Figure 3.7: Good practice: London Region

In the London region VAT business managers use electronic folder to produce a report showing the numbers of traders' records reviewed by staff over a given period of time. This enables them to ensure that the required checks and reviews are taking place.

3.39 As a result of our work on the 2001-02 Standard Report, we became concerned that traders not yet subjected to a risk assessment had previously accounted for almost 20% of the trader population. We were concerned that this would run a risk of undermining the central risk analysis and the subsequent selection of traders for assurance activity. Customs recognised that this posed a serious problem, and as a result in 2003-04 launched an initiative to improve the quality and consistency of trader information held. This took the form of an exercise to contact all newly registered traders, allocated to Trader Group 1 pending a risk assessment. Contact with these traders has been used to update the minimum information requirements. The collection of detailed trader information has been used to carry out risk assessments which has seen a reduction in the number of traders held in Trader Group 1 for more than 12 months from 355,000 in March 2003 to 138,000 in March 2004. This represents a very positive development, and Customs believe they are now on track to completely remove the backlog of trader risk assessments by the end of 2004-05.

Selection of traders

3.40 For a trader to be selected for an assurance event they have to be 'sifted'. 'Sifting' is the process of an officer reviewing trader's information from many sources to determine the risk of non-compliance. Where a risk is identified a 'sift form' is completed and attached to the electronic folder.

3.41 During our review of sift forms, we noted that in some cases only the traders' name and registration number were completed. In 10 of the 60 trader samples we selected where the trader was selected for an assurance event because of a sift, no sift form was attached to the electronic folder. The sift form should explain the reason for the assessment and should provide the assurance officer with information for planning the assurance event. In these cases this was not available. VAT Operations have suggested that these cases may have been sifted because they relate to exceptional risk traders.

3.42 The link between assurance staff and risk teams is one area where there is a potential breakdown in the flow of risk information. Whilst the results of trader visits and other interventions are recorded electronically, informal feedback arising from assurance events is not routinely communicated back to risk teams to inform future and ongoing risk assessments. It is therefore important that feedback between assurance staff and sift teams is robust.

3.43 To address this, some regions stated that they have a rotation policy between assurance staff and sift staff. Having experienced assurance officers in the sift team provides operational experience about what is useful when completing an assurance event. This also gives the assurance officer an understanding of the sift process and an idea of the methods used to sift the traders. This knowledge may help in the development of projects and targeted sift ideas.

Targets and Results

The VAT Gap

3.44 Customs have a target to reduce VAT losses to 12% of VAT Liability by 2006. Losses are calculated based on yearly figures prepared by the Office of National Statistics; therefore, Customs are only able to measure their progress against this measure once a year. The Customs Annual Report disclosed that the gap at the end of 2002-03 was 15.8% reducing to 12.9% in 2003-04. Customs' performance during the year is a significant achievement, and considerable progress has been made towards achieving the Public Service Agreement target by 2005-06.

3.45 The Spending Review 2002 provided additional resources for the implementation of the VAT Strategy to help achieve specific monetary increases required in revenue from tackling missing trader fraud, tax avoidance, general non-compliance and failure to register. The increases required from improvements in general compliance are shown in figure 3.8. For the VAT Strategy to achieve its aim the projected increases in yield must be reached.

Figure 3.8: Projected increases in yield (£m)

	2002-03	2003-04	2004-05	2005-06	Total
General Non-compliance	–	35	185	390	610

Source: Customs & Excise

3.46 To date Customs has been unable to link directly all of their activities to combat general non-compliance to increased VAT receipts. To assess performance during the year, Customs have converted the percentage-based VAT gap target into a monetary target based on net VAT receipts. To calculate this target a number of assumptions have to be made, and as a consequence there is a risk that, should these assumptions prove inaccurate, achievement of the monetary target may not result in the ultimate closure of the VAT gap as required. Customs currently have been partially successful in putting in place a suitable mechanism for readily identifying what VAT receipts have been collected as a result of strengthened assurance and compliance work, and what is due to economic or fiscal factors outwith Customs control. Customs have reported this to Treasury in their annual performance report. Customs have also devised an ongoing programme to allow them to test the effects of the wide range of available intervention activities under the VAT Compliance Strategy as a way of validating the assumptions that have to be made when measuring performance. We welcome Customs' ongoing efforts to further refine performance measures in this area.

3.47 Each year Customs compares final monetary outturn to actual percentage yield. This exercise allows Customs to determine whether its monetary targets are sufficiently high so as to close the VAT gap if they are achieved. Performance in 2003-04 suggests that these mechanisms do provide Customs with an adequate means of monitoring their performance, and deploying resources to achieve the levels of progress required to meet the target set by the VAT Compliance Strategy. If Customs could develop a means of dividing the net receipts between their different activities then the relative success of each activity could be more easily assessed and resources could be allocated based on these results.

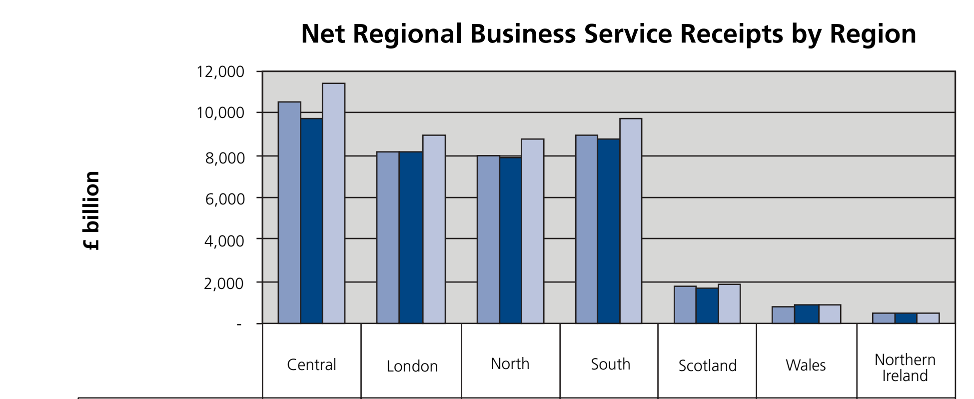
3.48 In order to monitor the performance of Regional Business Services specifically, an element of the overall departmental VAT receipts target is attributable to it. VAT Operations have in turn set targets for the individual regions based on the service's total net receipts target. It can be seen from the graph below that five of the seven regions have achieved the target set by VAT Operations from 2003-04. Wales and Northern Ireland, the two smallest regions did not achieve their targets; however, Regional Business Services as a whole exceeded its target by more than £1 billion.

3.49 As the Strategy reaches the halfway point, Customs' activities and interventions continue to evolve, and targets and methods of measurement are being developed accordingly. Although they have been able to measure some of their activity from the beginning of the Strategy, Customs continue to develop new procedures to improve knowledge, information and performance measurement. Some of the measurement ideas being developed may be very useful tools in the future. Whilst ideally it would have been more useful had such procedures and tools been available from the outset of the Strategy, the fact remains that in international terms Customs is unique in attempting to measure the loss of revenue against total theoretical VAT receipts.

Measuring Compliance

3.50 Measuring ongoing trader compliance is a crucial aspect of evaluating the success of the Strategy. For the first year of the VAT Strategy, national measurement techniques were not developed to facilitate this pending the receipt of reliable data from the Office for National Statistics. Customs have since identified this gap and are developing a measurement of compliance which will be accessible to all project managers.

Figure 3.9: Net Regional Business Service receipts by region



	Central	London	North	South	Scotland	Wales	Northern Ireland
Net Receipts	10,490	8,188	7,981	8,922	1,738	798	491
Target 2003-04	9,711	8,175	7,835	8,767	1,676	907	509
Target 2004-05	11,455	8,943	8,715	9,744	1,897	873	535

Source: Customs & Excise

3.51 For individual projects, regions can currently request information from Analysis Division which could help them to measure the level of compliance of traders. Additional resources have been provided by VAT Operations to support this programme, although staff in the regions including two regional risk managers, a sift team leader, and project managers expressed concerns to us that responding on a timely basis to the volume of requests made has provided Analysis Division with a major challenge. VAT Operations set up a system in summer 2003 to manage the analytical needs of the regions and regulate the demands placed on Analysis Division.

3.52 VAT Operations and Analysis Division are currently developing a 'Volumetrics Template' which will provide Customs with the capability to assess the level of filing, declaration, debt and payment compliance for a group of traders as a way of monitoring compliance effectively. It will also provide a measure of the number of changes to the trader register as a result of assurance and compliance activity. The intention is for this to provide a capability for the department to analyse targeted sifts and projects and evaluate compliance and compliance trends. This will shorten the time lag between requesting the information and receiving it and will also enable comparisons between projects and sifts in a region and between regions.

3.53 The department conduct a Compliance Testing Programme each year aimed at providing a picture of the compliance of the whole VAT population. The programme randomly selects traders from the whole population for an assurance visit, at which point Customs completes a questionnaire for each trader and compares the results with those gained in prior years. VAT Operations considers each year how this compliance resource/reporting structure can be used to support the objectives of the VAT strategy and current Public Service Agreement target.

Conclusions

3.54 Customs have implemented a new VAT Compliance Strategy aimed to reduce the VAT gap from 15.8% of what should be collected in 2002-03 to a target of 12% by 2006. Results for 2003-04 show that Customs have made significant progress, with the VAT gap reducing by almost 3% to 12.9%. Although it is too early to report on the effectiveness of the VAT Compliance Strategy, the reduction in the VAT gap, to which the Strategy contributes, appears impressive. Within Regional Business Services, as part of the implementation of the strategy the risk analysis system has been restructured by introducing risk centres to all regions. Initial signs are encouraging, with the move towards a more flexible and varied risk assessment co-ordinated by a national risk management structure.

3.55 The work undertaken by staff within Regional Business Services is dependent on risk analysis, which, in turn is dependent on the quality of the underlying trader and trade sector data. The development of the Minimum Information Standard is, therefore, to be welcomed and it is important that it lifts the quality of documentation throughout the Service.

3.56 Performance measurement systems to evaluate the impact of these changes are still evolving. Customs are able to assess the effect of different elements of the Strategy to varying degrees, and their end of year performance report to Treasury is a step in the right direction that will need to be further enhanced in the future. New measures of performance will continue to evolve as their interventions become more targeted. Customs will continue to evaluate the effect of redeploying and reprioritising resources to address the areas of perceived greatest risk and concern.

3.57 The implementation of the VAT Compliance Strategy shows many areas of encouragement. This report focuses on those areas where the implementation of the Strategy can be further enhanced within Regional Business Services. As we note above, it remains too early for us to formally report on the effectiveness of the Strategy, especially because of the difficulties in separating out the increase in revenues as a result of assurance and compliance activities during the year, and those caused by other fiscal and economic factors. There are a number of promising and innovative developments which have strongly enhanced the approach to risk taken within Regional Business Services. We have made recommendations to assist in this process.

We recommend that:

- All regions adopt the national standards for the targeting and delivery of assurance work which have been implemented centrally by VAT Operations. This should include the provision of consistent regional work programmes, showing priority work in each region.
- Customs should put the developing National Business Picture on a robust IT footing to expand its functionality and use to staff, for instance by allowing trade sector data to be compared to individual traders' data. Customs have told us that this will take place as the e-business programme is delivered and IT systems are enhanced.
- Customs ensure a consistent evaluation process for projects using measures of success that will provide useful information and focus on outcomes not simply outputs. We support recent initiatives to involve Analysis Division in project evaluation methodology, and in the preparation of draft project guidance.
- The role of Central Risk Analysis is more clearly defined, showing how it fits into the overall risk assessment process which is used by regions to deploy resources. Greater risk based assurance work in lower risk areas may be defensible, as many of these traders have not been visited for several years.
- Business Service and Taxes manage carefully the assurance of the 'riskiest' traders within the trader population, given the significant differences in resourcing levels provided to traders in each group.
- VAT Business Managers should use electronic folder reports to ensure that assurance managers are regularly reviewing the quality of the documentation.
- Customs further develop measures to assess individual projects and sifts to provide a picture of the success of the general non-compliance activities. We accept that such evaluation is inherently difficult, but believe that a broad range of lower level measures can be used to present an indicator of progress against targets. For example, the speed and accuracy of trader returns or the number of voluntary disclosures made by traders.
- Customs should develop further, with a view to implementation, the use of a 'volumetrics template' to provide a capability to assess the impact of projects on compliance.