Comptroller and Auditor General's Standard Report on the Accounts of HM Customs and Excise 2004-05

Issued under Section 2 of the Exchequer and Audit Departments Act 1921
as amended by the Government Resources and Accounts Act 2000

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EXECUTIVE SUMMARY

1 Section 2 of the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000, requires me to examine the accounts of HM Customs and Excise (Customs) on behalf of the House of Commons to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue. I am also required by that Act 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, along with my audit certificate, is separately reported within the Trust Statement account, included in the Department's Annual Accounts.

2 This report describes a number of significant developments on the management of VAT debt and the strategy implemented by Customs to tackle tobacco fraud. The results of my work not detailed in this report and suggestions of further improvements in controls have been notified to the department in management letters. In 2002 the Committee of Public Accounts examined the Department's progress in implementing the tobacco strategy and made a number of recommendations. The Department responded positively to these and Customs went on to agree a Memorandum of Understanding with Imperial Tobacco resulting in more effective co-operation.

3 Since April 2005, the functions of Customs have been transferred into a new tax department, Her Majesty's Revenue and Customs (HMRC). All of my recommendations and conclusions are intended to assist the new Department to achieve their objectives, and remain relevant for the new organisation. The work that the NAO has carried out focuses on the Department's efforts to manage VAT debt, and references to 'the Department' prior to April 2005 are references to HM Customs and Excise which was responsible for the collection and management of VAT prior to the creation of HMRC. The structures and procedures referred to prior to April 2005 are, therefore, structures that were in place within Customs and Excise.

The Tobacco Strategy

4 Tobacco Duty Fraud has been the source of annual revenue losses estimated to exceed £2.5 billion since the late 1990s. The strategic response developed by HM Revenue and Customs (HMRC) to combat this fraud was set out in their March 2000 publication Tackling Tobacco Smuggling. The aim of the strategy was first to slow the growth in, and then to cut the level of tobacco fraud.

5 Over the lifetime of the strategy, the market share for illicit cigarettes has fallen from an estimated 21 per cent in 2000-01 to a projected 15 per cent in 2004-05. HMRC are therefore on course to meet their Public Service Agreement (PSA) commitment to reduce the size of the illicit market for cigarettes to 17 per cent by the end of March 2006. Revenue losses from all forms of tobacco fraud have fallen from an estimated £3.4 billion in 2000-01 to £2.6 billion in 2003-04.

6 Estimated reductions in the level of cigarette fraud were most pronounced in the first two years of the strategy, and have been consolidated in subsequent years. In order to fulfill the new PSA commitment of a 13 per cent illicit market share by the end of March 2008, HMRC are considering ways to refocus the strategy to reflect the constantly changing nature of fraud.

7 The Department's success in reducing the illicit market share for cigarettes has resulted in organised criminal gangs becoming ever more sophisticated in their methods. It has also led to displacement from genuine UK brands towards counterfeit tobacco products. A report by the House of Commons Treasury Sub Committee (TSC) earlier this year also noted the 'extraordinarily high' level of smuggling of hand rolling tobacco and called for 'urgent action' to be taken.

8 HMRC need to ensure that the resources deployed to deal with tobacco fraud continue to be appropriate to achieve ever more challenging targets. Resource decisions should take account of the full range of indicators available given the timing and uncertainties of the annual fraud estimates.

9 The Department need to enhance the current fraud estimates to reflect total risks to tobacco revenue. Work to establish a PSA-type target to reduce fraud relating to hand rolling tobacco will help to address this.

10 HMRC have established an effective model for ensuring cooperation across traditional work streams to reduce the level of tobacco fraud. The Department is constantly seeking ways to improve delivery, including a significant reorganisation of the tobacco intelligence teams during 2004-05. Implementation of the conclusions of the Department's review of the deployment of overseas intelligence staff will provide assurance that that network is appropriately resourced and properly located to address all relevant risks.

11 HMRC should continue their review of the adequacy of current operational targets below the top level PSA in order to optimise efforts to disrupt criminal gangs and ensure that senior management has a clear view of current progress towards reducing the level of fraud.

12 The work HMRC has undertaken with the tobacco manufacturers has successfully restricted the availability to smugglers of genuine UK tobacco products. HMRC are looking to enhance their relationship with the tobacco manufacturers to ensure greater control of legitimate supply chains and introduce further measures to address the problem of counterfeit product.

13 HMRC also recognise that it is time to review the existing Memorandum of Understanding with major cigarette manufacturers to ensure that the current arrangements represent the best interests of taxpayers. HMRC should also look to formalise its cooperation with Philip Morris International in the context of the recent agreement between that company and the European Union, perhaps through the agreement of a memoranda of understanding.

VAT Debt Management

14 HMRC are responsible for the collection of gross VAT receipts of more than £125 billion each year. As part of my 2001-02 Standard report on Customs, I noted a rapid rise in debt levels and weaknesses in IT systems which resulted in poor management information and impaired performance. The Committee of Public Accounts recommended that Customs improve their IT systems handling debt management and take action to reverse the rising trend in debt levels.

15 Debt management makes an important contribution to the delivery of the Department's Public Service Agreement (PSA) target to reduce VAT losses to no more than 12 per cent by March 2006. In responding to this challenge, the Department have significantly improved their collection rates for recoverable debt, and steadily reduced the level of outstanding debt available for collection. The report examines how the Department's arrangements for managing VAT debt have developed.

16 The use of legacy IT systems continues to provide major problems for HMRC. Many of the legacy systems on which the Department relies were due for replacement or upgrade as part of Customs' e-Business solution. However, ongoing work to make improvements to legacy systems had to undergo continual re-evaluation and prioritisation.

17 In May 2002, key systems failed to reconcile by £300 million. This meant that £300 million of outstanding debt was not passed to debt management units for monitoring or collection. Since then the unreconciled difference has grown, and by March 2005 stood at approximately £900 million. The Department have established that most of this balance represents debt not likely to be immediately recoverable as it relates to fraud cases under investigation, and assessments made by the Department against which traders have appealed. Of the total £900 million, about £35 million of this accrued debt should have been pursued and, although the Department are now taking action in respect of this debt, delays in starting recovery action may make collection more difficult.

18 HMRC have taken positive action to reduce the levels of outstanding recoverable debt. Structures, systems and training have been re-engineered, aimed at ensuring national consistency based on best practice, with a focus on risk and compliance management. This has been supplemented by high quality, commercial style training.

19 In 2004-05 HM Treasury provided funding for 150 additional debt management staff. This led to a major re-organisation, supported by an upgrade to the debt management case handling system allowing the Department to reorganise and focus of specific areas of debt. In return for this investment, the debt management business had a target to collect an additional £185 million of receipts in 2004-05. This target was exceeded with an additional £299 million being collected by March 2005, an increase of 13.5 per cent from the previous year. These measures have also translated into improvements in some aspects of debt management performance. Debt that is classified as immediately recoverable stands at its lowest level for 3 years.

20 The Department did, though, fail to meet some of its internal targets associated with debt management. March 2005 VAT arrears represented 2.32 per cent of the total VAT liability figure against a target of 2.06 per cent. VAT debt at 31 March 2005 was £2.56 billion, up by 24 per cent from £2.06 billion by March 2002. Management review in the Department showed that this was largely due to increasing amounts of debt being identified as owing from Missing Trader Intra-Community fraud cases, as part of the Department's strategy to tackle fraud, and because of an increase in the proportion of traders appealing against departmental assessments.

21 HMRC is currently restructuring the debt management and banking business. The new Department remains committed to collecting taxes efficiently and in a cost effective manner.

CHAPTER ONE
Audit approach and scope

1 In order to review the Department's systems and procedures to ensure an effective check on the assessment, collection and allocation of revenue, the National Audit Office undertake:

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

2 Information technology is essential for the administration of taxes and duties. The Department's information systems hold data on all traders, process information, and produce a range of outputs designed to assist the trader and the Department 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 2004-05, the National Audit Office's coverage included the following examinations:

- Customs and Excise Core Accounting System (CECAS);
- General Computing Controls;
- VAT Systems;
- Customs Handling of import-Export Freight (CHIEF);
- Duty Deferment;
- Law Enforcement IT Systems; and
- Tobacco Systems.

3 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 Gambling Duties (HC 188 2004-05) and Stopping Illegal Imports of Animal Products into Great Britain (HC 365 2004-05).

Statement on Internal Control

4 Each Accounting Officer is required to make a Statement on Internal Control covering all operations and financial systems. The Department produces a statement, covering both the Resource Accounts covering administration costs, and the Trust Statement, covering taxes and duties brought to account. The statement reports that the Department's 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 statement also explains that a balance has to be struck between empowerment to achieve objectives, and controls to safeguard and account for public funds.

5 In previous years I have reported how Customs has updated its 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 leakage or loss. Procedures were also implemented to ensure that the risks to the Department are regularly reviewed, and that they are the responsibility of the Customs management team, who own, monitor and work to mitigate identified risks.

6 The transfer of functions from HM Customs and the Inland Revenue to HMRC has major implications for the control framework, and for the Statement of the Accounting Officer. In his Statements on Internal Control he acknowledges his responsibility for assessing the effectiveness of the control framework. In reviewing its effectiveness and formulating his statements, he has had regard to three tests: the benefit of any given control in safeguarding public funds; the impact of that control in achieving objectives; and its cost. He has therefore considered whether any given control is reducing risk while allowing the Department to achieve its core objectives, and whether the cost associated with the controls is commensurate with the risk.

7 The Statement made by the Accounting Officer highlight weaknesses in the systems of internal control employed by the Department, and report progress in addressing those weaknesses identified in earlier years. The Department have now implemented systems to allow for the effective management of shipbuilders' relief claims. In past years the Department has also noted the risks associated with the potential failures of legacy IT systems. Further work has been completed to enhance controls and schedule the replacement of systems. There were no major system failures during 2004-05.

8 In 2004-05 the Accounting Officer has also reported on reputational risks faced by the Department, following the loss of a number of high-profile court cases. To address these weaknesses the Department are implementing a major training programme for staff, and monitoring of Law Enforcement activity has now been brought within the remit of Her Majesty's Inspector of Constabularies and the Independent Police Complaints Commission. An independent prosecution office has also been established accountable to the Attorney General.

9 I am content that the Accounting Officer's Statements on internal Control are consistent with the National Audit Office's knowledge of Customs and Excise.

HM Revenue and Customs

10 In July 2003, the Chancellor of the Exchequer announced a major review of the organisations dealing with tax policy and administration. The review led by Gus O'Donnell reported in March 2004 and recommended that a new Department should be created. HM Revenue and Customs (HMRC) were established in April 2005 by the Commissioners for Revenue and Customs Act which brought together most of the functions of the Inland Revenue and HM Customs and Excise.

11 Good governance is vital for any organisation, particularly one as complex and wide ranging as HMRC. A group of Commissioners has statutory responsibility and authority for running the new organisation. They have created a departmental Board, including several non-Executive Directors, responsible for strategic oversight and providing advice. They are also supported by a number of Committees, of which the Executive Committee, chaired by the Chairman of HMRC, is responsible for strategy and driving performance across the business. Other top-level groups include an Operating Committee and an Audit Committee comprised of and chaired by Non-Executives. Core management processes include an annual planning and performance management cycle, with an important feature being a quarterly Chairman's review of each of HMRC's 36 business units.

12 Efficient and effective Information Technology (IT) is essential to the administration of taxes. In October 2004, the Department made a new Board-level post of Chief Information Officer. The departmental integration offered the opportunity of improving the service IT provided. The Chief Information Officer's unit has taken a more active role in identifying and pursuing business opportunities, with a more customer-focused approach. In bringing the IT together, the Department is undertaking an ongoing programme of health checks of the IT systems during the first half of 2005 and the National Audit Office will monitor the resulting changes.

13 Integration offers the new Department the opportunity to adopt a more effective approach to taxpayer compliance across all tax streams. The Department reviewed the implications of the integration for its compliance strategy and the tax gap.

14 There are also risks involved in the integration of two large departments including risks that existing priorities could be disrupted. The Department set up a Change Management Centre to oversee the changes, provide information and make recommendations on risks posed by the Department's capacity to deal with the number of planned changes. The new Department is responsible for a number of the Government's nominated "mission critical" projects and they need to remain focused on them.

Efficiency Savings

15 The 2004 Spending Review required HMRC to achieve staff reductions and annual efficiency savings of £507 million by 2007-08, out of an annual budget of about £4.6 billion. The Department had 98,370 Full time Equivalent (FTE) staff in post at 1 April 2004 and planned to reduce this by a net 12,500 FTE posts by 1 April 2008.

16 By July 2005, the Department had identified how the forecast savings would be achieved through:

- Investment in Information and Communication Technology;
- Reform of back office functions;
- Savings in procurement of goods and services; and
- Improvements in productive time.

17 A significant challenge for the Department was to establish effective governance and monitoring arrangements to ensure the savings do not adversely affect service provision or the new IT systems underpinning intended efficiency gains. The Department established an Efficiency Programme Board to manage these risks and meet targets. The Office of Government Commerce concluded that achieving the Departments' efficiency savings posed a very high challenge.

Conclusions

18 I have given unqualified opinions on Customs' 2004-05 Resource Accounts and their Trust Statement on which taxes and duties are brought to account.

19 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'.

20 The Accounting Officer has reported in his Statement on internal Control how the Department's 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 2004-05 provides assurance that Customs' regulations and procedures provided an effective check over the assessment, collection and allocation of tax.

CHAPTER TWO
The Tobacco Strategy

Introduction

Scope of the report

1 In examining HMRC's Tobacco Strategy, the National Audit Office's (NAO) main objective was to evaluate the success of the strategy and to understand how it has evolved to meet changing circumstances. The NAO reviewed the effectiveness of HMRC's systems and procedures in place to address the risks to revenue, taking account of the Department's need to fulfil its other obligations including the strengthening of frontier protection against threats to the security, social and economic integrity of the United Kingdom.

2 We interviewed a number of groups and individuals including HMRC officers, representatives of the legitimate tobacco trade and Action on Smoking and Health (ASH).

Overview of the 'Tackling Tobacco Smuggling Strategy'

3 Smuggling of tobacco products into the UK has been the cause of significant revenue losses for many years. The Chancellor's Pre-Budget Report 2004 stated that,

"Tobacco smuggling undermines the Government's health objectives, involves serious and widespread criminality, and costs over £2.5bn a year in lost tax revenue".

4 The Department's latest estimates show that the UK lost approximately £1.9 billion as a result of cigarette fraud and smuggling in 2003-04 and £0.8 billion relating to Hand-Rolling Tobacco. These figures include duty and VAT. HMRC currently estimate actual tobacco duty receipts for 2005-06 will reach £8.4 billion.

5 In March 2000, Customs and HM Treasury jointly published a strategy document, Tackling Tobacco Smuggling. This set out an analysis of the problem as the government then saw it and contained a series of proposals to reduce the level of fraud. The programme of work involved £209 million of additional funding, covered the three financial years from 2000-01 to 2002-03. The strategy aimed to provide around 1,000 extra staff in support of law enforcement activity and a network of x-ray scanners to be deployed at UK ports. Additional measures included the introduction of 'UK Duty Paid' fiscal marks for UK manufactured tobacco products and stronger penalties for smuggling offences.

6 Along with the new strategy, the Department for the first time produced an estimation of the tax gap arising from tobacco fraud. The Department compares, on an annual basis, total tobacco consumed in the UK with actual UK duty paid cigarettes sold. An adjustment is made to reflect legitimate intra EU cross-border and duty-free imports. This is used to estimate the size of the residual 'illicit' market share. Latest estimates of the scale of the tax gap are published annually alongside the Pre-Budget Report.

7 The publication of a 'tax gap' estimate allows the Department to measure progress against targets on an annual basis. HMRC have been able to review progress and refocus the measures to tackle tobacco smuggling based on the results achieved to date.

8 Reducing the level of tobacco fraud is one of the Department's specific departmental PSA commitments. Under PSA objective 1 for 2003-04 to 2005-06, HMRC are required to reduce the illicit market share for tobacco to 17 per cent by 31 March 2006. The Department's updated PSA 1 Objective amends this to 13 per cent by 2007-08.

Previous NAO and Parliamentary Scrutiny

9 In April and June 2002, the Committee of Public Accounts examined:

- the success of the strategy in tackling tobacco smuggling;
- co-operation between Customs and the tobacco manufacturers;
- the sanctions being used as a deterrent to smuggling; and,
- the use of x-ray scanners to detect illicit tobacco.

10 The Committee concluded that:

- there were concerns about the level of co-operation from Imperial Tobacco;
- HMRC and Imperial Tobacco should work towards signing a Memorandum of Understanding;
- HMRC should consider applying penalties and sanctions to lower level smugglers as a deterrent;
- HMRC should ensure its publicity campaigns were effective; and,
- more scanners were needed to provide additional coverage for the network of maritime ports.

11 The Government's responses to the Committee's reports on tobacco smuggling[1] were positive. Subsequent to the Committee's hearing with the Chief Executive of Imperial Tobacco, and further discussions between Customs and Imperial Tobacco which ensued, seizures of the company's cigarettes fell significantly. Customs went on to agree a Memorandum of Understanding with Imperial Tobacco, resulting in more effective co-operation with the UK's largest manufacturer of cigarettes.

12 The main achievement of the Memorandum is that it allows the Department to work with Imperial Tobacco, in highlighting exports of cigarettes to markets, where the supplies were being diverted by smugglers rather than satisfying local demand. Customs are satisfied that, as a result of this greater co-operation, Imperial's exports no longer show these patterns (see paragraphs 75-78).

1 Responses to the Third and Twenty First Reports of the Committee 2002-03

13 In May 2002 the House of Commons Scottish Affairs Committee published a report on Customs' Services in Scotland which considered the issue of tobacco smuggling in a Scottish context. The Committee expressed the view that the predominantly intelligence-led approach adopted by the Department in recent years had led to a reduction in the preventative or deterrent impact of regular Customs presence at strategic points. The government responded by arguing that flexible intelligence led deployments were the most efficient and effective way of dealing with smuggling risks, but conceded that:

"Customs recognises the importance of maintaining public support and confidence in all aspects of its work. The Department's deployments therefore take account of the need to produce a visible anti-smuggling presence as a means of deterring potential smugglers and as an avenue for local people to support the Department's law enforcement work. The Department recognises that this has been an area of concern and is taking additional steps to respond to these concerns."

14 The Government agreed that additional resources for frontier controls were necessary and pledged an additional £2 million for 2002-03 and further funding for the next three years to enable the Department to enhance its anti-smuggling effort at the frontier[2].

15 In March 2005 the House of Commons Treasury Sub Committee reported on Excise Duty Fraud. With regard to tobacco fraud, the Committee concluded that:

- the strategy has had some success in reducing the smuggling of cigarettes there was 'still a long way to go';
- by contrast the size of the illicit market for hand rolling tobacco was, 'a matter of very serious concern', and 'effective action was now urgently required';
- HMRC should consider the benefits of the recent agreement signed by Philip Morris and the EU and review the existing Memoranda of Understanding (MoU) with tobacco manufacturers; and
- HMRC should enter into an agreement with Philip Morris.

Detailed Findings

16 Our detailed findings are set out in the following four sections:

- Has the Tobacco Strategy Succeeded?
- Operational Delivery of the Tobacco Strategy
- The Effect of Changing Threats on the Strategy
- Relations with the Tobacco Manufacturers

Has the Tobacco Strategy Succeeded?

Measuring the success of the Strategy

17 Tackling Tobacco Smuggling introduced a single key measure to monitor progress, namely the extent to which the market penetration of illicit tobacco declines. In addition, further indicators of success were identified and reported. These have subsequently been supplemented by the PSA target for reducing the illicit market share. The table below sets out the results to date against these initial targets. In reviewing the overall achievement of HMRC in the period from 2000 to 2005 the changing nature of tobacco fraud needs to be considered. As a result of the Department's actions, organised smuggling gangs have adopted increasingly sophisticated methods. There has also been a change in the type of product being smuggled, with a growing threat from counterfeit cigarettes. The environment in which HMRC operates has also changed, particularly in relation to intra-EU smuggling as a result of high profile legal challenges.

18 These measures have proved successful in first halting the previously rapid growth of cigarette smuggling, and then reducing its level. The section on Illicit Market Share below demonstrates that this success appears to have been consolidated in the period to March 2005.

19 Performance against lower level measures has been less consistent and suggests that the strategy needs to be updated to reflect the nature of current threats to revenue. HMRC are aware of this need and are taking action to identify improvements to the strategy.

2 Scottish Affairs Committee, Second Special Report, November 2002, Appendix: Memorandum by John Healey MP (paragraph 16).

Key Measure	**Were HMRC successful?**
Slow the growth in smuggling in the next financial year, and put smuggling into decline in the third year.	Yes - the illicit market share grew more slowly to 20% in 2001-02 and subsequently decreased to an estimated 15% (+/- 2%) by the end of 2003-04. HMRC believe that without any action the illicit market could have grown to over 35% in the same period.
Additional Data Sources	**Were HMRC successful?**
Customs/ HMRC expect to raise the number of cigarettes they seize to over 2 billion in 2000-01, 3.5 billion in 2001-02 and to 5 billion in 2002-03.	No - Customs exceeded their seizures target in 2000-01 but fell significantly behind in the following two years. In 2002-03 outturn was 1.9bn, a shortfall of 3.1bn . Seizures were 1.8 billion for 2003-04. Specific targets for seizures no longer exist as HMRC now use a range of other measures which contribute to the 'outcome' target of reducing illicit market share.
They aim to reduce the revenue loss from… [Cross-Channel]… smuggling by 10% a year.	Not Known - Customs estimated that they had reduced the level of cross-channel smuggling by 72% in 2000-01, and a further 23% in 2001-02. However the survey work carried out in support of these estimates was discontinued in 2003 and no disaggregated data is available for subsequent years.
….through their enhanced investigative effort, Customs plan to break or disrupt at least 50 tobacco smuggling gangs next year, 55 the year thereafter and 75 in 2002-03.	Yes - HMRC exceeded the target of 180 gangs over the three year period, successfully disrupting 190 criminal gangs in the period (see paragraph 38).
For the first time Customs/ HMRC will also introduce financial targets against tobacco smuggling involving asset seizures (benefit determined by the courts) of £15 million, £16.5 million and £18 million over the next three financial years.	Yes - these figures are published annually in the Pre-Budget Report. The total outturn for these three years exceeded the target by £153m.
The strategy would generate an estimated £2.25bn over the three years from 'higher tobacco duty revenue and consequential VAT'; a total of £3bn extra revenue including indirect benefits.	Yes - figures published in 2003 suggested an outturn against this indicator for tobacco duty only of c. £3bn for the period to 31 March 2003. The Department also reported in the 2005 Spring Report that (unaudited) revenues totalling £5.8bn have been protected over the life of the strategy.
Under the 'getting tougher' policy more vehicles would be seized.	Yes Prior to the launch of the strategy vehicle seizures stood at around 5,200 per annum. This increased to 10,219 in 2000-01 and 11,064 in the following year. However there has been a sharp reduction in subsequent years to the total of 6,848 recorded for 2003-04.
Targets would be set for confiscations of criminal financial assets.	Yes Targets were set.
The relative size of the UK Duty Paid market would increase in relation to the Non UK Duty Paid (NUKDP) market and net receipts would increase.	Yes -for cigarettes the UKDP proportion increased from 73% of total consumption in 2000-01 to 76% in 2003-04. For hand rolling tobacco the implied UKDP share shows a marginal increase from 27% in 2000-01 to 29% in 2003-04. Total tobacco excise revenues increased in this period from £7.6bn in 2000-01 to £8bn in 2003-04.
Pressure on illicit supplies would lead to an increase in street prices.	No - the strategy estimated that the street price for a carton of 200 cigarettes was about £25, c. £2.50 for a pack of 20 against an average legitimate price of £4.20. The street price for illicit product does not appear to have risen as a result of the strategy although HMRC argue that this is the result of the changing dynamics of the licit market with lower priced brands having become more popular and profit margins being cut for illicit.

Illicit Market Share

20 The calculation of the fraud estimates relies on official survey data which is produced annually. HMRC report progress against PSA targets each year in the Pre-Budget Report. An analysis is published of the illicit market share for both cigarettes and hand rolling tobacco but there are, as yet, no targets to reduce the level of hand rolling tobacco fraud. In addition to the periodic PSA targets HMRC have interim objectives which set out the expected maximum cigarette related tax gap at the end of each year. The following results have been published (the results are accurate within a tolerance of +/- 2%):

PSA target and outturn data for the illicit market

Year	PSA Target (%)	Outturn (%)
2000-01	21	21
2001-02	22	20
2002-03	21	15
2003-04	20	15
2004-05	18	-
2005-06	17	-
2006-07	13	-
2007-08	13	-

Source: HM Revenue and Customs

21 The official estimate of illicit market share for the year 2004-05 has not yet been published, although HMRC have said, in their 2005 Spring Report that, "We expect, at least, to match our performance of 2003-04, when we reduced the illicit market share to 15 per cent."

22 In Measuring and Tackling Indirect Tax Losses – 2004 HMRC recognised that, "the scale of illicit activity is inherently uncertain", but argued that the methodologies used represented the "most up-to-date" estimates currently available. Figures for outturn illicit market share in 2002-3 were also revised downwards from 18 per cent to 15 per cent between publication of the PBR in 2003 and 2004.

23 In interpreting the outturn figures above it is important to consider these uncertainties. However, HMRC can undoubtedly take credit for a significant reduction in the overall level of cigarette fraud as a result of the new strategic approach adopted in 2000, and appears to have achieved its PSA target two years early.

24 If the final fraud figures for 2004-5 were to show an illicit market share for cigarettes of 15 per cent, however, this could suggest that the current approach has reached the limit of its effectiveness in continuing to reduce the level of fraud. HMRC believe that consolidating early gains is a significant achievement because of the fluid and constantly changing nature of the threat.

25 The PSA target, against which performance is measured, is based around the level of smuggling for cigarettes. HMRC are able to produce separate estimates for the scale of the illicit market for both cigarettes and hand rolling tobacco. A combined estimate for the illicit market share for all tobacco products would be useful in identifying the totality of fraud, and the overall trend in the illicit market.

26 There has been a shift in resources away from tobacco during 2004-05 towards other high risk revenue streams and high profile PSA targets. HMRC believe that this redeployment illustrated strategic flexibility and was the proper response to the 'basket of risks' faced by the department as a whole. HMRC also consider that resources deployed to deal with tobacco fraud will inevitably reduce as the illicit market share and estimated revenue losses decrease.

27 HMRC should consider all relevant indicators when deploying available resources. For tobacco this should include the range of measures reported to the Tobacco Strategy Group (see paragraph 47) on a quarterly basis. A continuing redeployment of resources away from tobacco may undermine achievement of further reductions in illicit market share.

28 The major UK tobacco manufacturers commission independent surveys to assess the size of the Non UK Duty Paid market. These are derived from a variety of methods including Pack Swap surveys (where a smoker will exchange the pack of cigarettes they are currently using for a brand new one) and discarded pack collections. The trade's estimates produce a total for Non UK Duty Paid and rely on HMRC estimates for duty free and cross-channel shopping to produce an illicit market share.

29 Each methodology for estimating illicit market share has shortcomings. The companies we spoke to agreed that Pack Swaps tend to under-report the size of the illicit market. There are a number of reasons for this including the locations where the surveys are conducted and the number of refusals by smokers. Discarded pack collections supply useful additional information but tend to be completed at major social and sporting events to ensure a large volume of packs for analysis. This introduces a further bias into the estimates.

30 The manufacturers believe that the size of the Non UK Duty Paid (NUKDP) market in the UK is 3-4 per cent higher than HMRC estimates. However, the manufacturers do not base their overall assessment on the unadjusted results from the survey, instead forming a consensus view which includes a subjective assessment based on their understanding of the market. As a result, their assessment is somewhat higher than the Department's. The manufacturers argue that they have a better commercial understanding of the tobacco market than HMRC. For their part the Department remain confident in the robustness of their own fraud estimates.

31 The manufacturers also contend that the high level fraud estimates produced by Customs disguise underlying trends in the source of illicit tobacco. They argue that HMRC seizure data tends to overstate the amount of counterfeit product, and that a greater proportion of the UK market is supplied from EU sources than HMRC believes. They argue that this could have a significant impact on the strategic response to the problem of smuggling.

32 Based on their detailed analysis of data from cigarette seizures, HMRC reported in 2004 that 54 per cent of cigarettes seized were counterfeit. They considered that this indicated a significant new threat. HMRC also estimate the number of cigarettes which they believe have been successfully smuggled each year. In the 2004 'Counterfeit cigarettes' handbook the Department estimated that counterfeit cigarettes represented around a quarter of the smuggled market. Discarded Pack collection survey results produced by the Tobacco Manufacturers Association in June 2005 imply a total counterfeit penetration in the UK market of 2-3 per cent.

33 In their submission to the Treasury Sub Committee investigation on Excise Fraud, the Tobacco Manufacturers' Association argued that intra-EU smuggling or 'bootlegging' is more significant than HMRC believe. They claimed that estimates based on seizures overstate the extra-EU origin of illicit tobacco products.

34 These disparities reflect the different perspectives of the competing methodologies. The seizure data which HMRC publishes as part of its fraud estimates tends to profile the product targeted at the UK. Trade estimates tend to under-report the illicit market, but also provide important information about the product which has evaded frontier detection.

35 HMRC make use of the results of the various surveys commissioned by the trade when assessing tobacco trends. The tobacco manufacturers are keen to develop a more consistent analysis of the total NUKDP market and its constituent parts. HMRC would benefit from seeking to reconcile departmental fraud estimates with the analyses produced by the trade.

36 The current PSA target does not reflect the totality of the market for illicit tobacco products. The problem of Hand-Rolling Tobacco in particular has increased in significance. According to the most recently published fraud figures this amounted to just under one third of the total £2.6 billion estimated annual revenue loss. We consider that any new strategic approach to deal with this problem will require a PSA type fraud target.

Seizures

37 A considerable proportion of the resources deployed by the Department at the start of the Tobacco Strategy were intended to facilitate detection and seizures of smuggled cigarettes. The resources included the purchase and deployment of a network of x-ray scanners to be based at UK ports. Seizure levels were also thought to represent an important measure of the success of the strategy. Seizure statistics on their own, though, can be difficult to interpret, and do not give an indication on their own of either increasing or decreasing fraud.

38 Thus over the same period that HMRC met their target to reduce illicit market share, they did not meet their seizure targets. This corresponded to a fall in the number of cigarettes which HMRC estimate were 'successfully smuggled' from 16 billion in 2000-01 to 10.4 billion in 2003-04. Over that period HMRC believed it had continued to successfully intercept a broadly consistent proportion (around 14.75 per cent) of smuggled cigarettes.

39 The level of seizures of hand rolling tobacco has declined from 472 tonnes in 2000-01 to 185 tonnes in 2003-04. HMRC can point to a declining illicit market share for cigarettes, but there are growing revenue losses in the hand rolling tobacco area. HMRC needs to take action to identify ways to increase hand rolling tobacco seizures. The Department has announced work to address this.

Disruption and Dismantling of Smuggling Gangs

40 HMRC achieved its targets for disruptions of organised criminal gangs in the first three years of the strategy. But the Department have fallen behind internal targets in subsequent years. The following targets and outturn have been recorded:

Criminal gangs disrupted

Year	Target	Outturn	Difference
2000-01	50	43	-7
2001-02	55	60	+5
2002-03	75	87	+12
2003-04	87	69	-18
2004-05	87	66	-21

Source: HM Revenue and Customs

The Seizure and Confiscation of Criminal Assets

41 The level of criminal assets that the Courts have authorised HMRC to seize in each year of the strategy have risen from £10.7 million in 2000-01 to £181.25 million in 2003-04. HMRC sets annual targets for confiscation orders for financial assets. The actual level of assets physically seized by the Department in 2003-04 was £9.45 million. Seizure of criminal finances is increasingly supported by inter-agency co-operation with bodies such as the Assets Recovery Agency (ARA) and the Concerted Inter-agency Criminal Finances Action Group (CICFA). HMRC are aware of the need to maximise financial seizures against serious crime groups through the innovative use of confiscation and civil recovery options and improving the financial awareness and expertise of Law Enforcement Officers.

42 To assist the Department to further strengthen and enhance the skills base of law enforcement staff, a formal review of the skills type and mix required to underpin this aspect of the strategy should be carried out. In addition, the gains already made will need to be safeguarded as the Department continues to reorganise in readiness for the launch of the Serious Organised Crime Agency, due in April 2006.

Additional Revenue and the UK Duty Paid Market

43 Total annual revenue losses have decreased from an estimated £3.4 billion in 2000-01 to £2.6 billion in 2003-04. In recent years, some of the reductions in cigarette losses have been offset by an increase in smuggling of hand-rolling tobacco. In the 2005 Spring Departmental Report HMRC reported that the strategy had 'protected' £5.8 billion of revenue.

44 Many factors influence the overall level of receipts including consumption, tax rates, the level of cross-border shopping and the size of the illicit market. In the Pre-Budget Report 2004 HMRC estimated tobacco revenue receipts for 2004-05 to be £8.1 billion, on total consumption of 71billion licit and illicit cigarettes. This equalled outturn for 2003-04. The projection for 2005-06 is £8.4 billion.

45 HMRC achieved just over £3 billion of additional revenue during the first three years of the strategy. Most was attributable to successfully tackling fraud and smuggling, with an additional £760 million of revenue due to a lower than projected illicit market share resulting in higher revenue receipts from legitimate sales.

Operational Delivery of the Tobacco Strategy

Background

46 Responsibility for implementing the strategy lies predominantly within the Law Enforcement sections in HMRC's Operations Division. Staff in other areas of the Department who carry out trader inspections to protect revenues also have a role in providing an assurance function for the legitimate trade. The Department have set up a coordinating body called the Tobacco Strategy Group (TSG). This model, designed to co-ordinate traditional work streams, has subsequently been deployed in support of other strategies as a result of the perceived success in dealing with tobacco fraud.

The Tobacco Strategy Group (TSG)

47 The TSG does not make detailed decisions about resource deployments, but is a forum, meeting at six-weekly intervals, where such decisions can be discussed and challenged. The TSG also provides an important forum for discussing the results of operational activity, and for reviewing key assumptions underpinning the strategy as a whole. Where frontline teams believe they have identified a significant new risk they can bring it to TSG for consideration. The TSG also formally approves the annual programme of work for the tobacco intelligence teams.

Intelligence

48 Correctly managing intelligence is vital if assurance work is to be properly targeted against the huge volumes of traffic at the major points of entry into the UK. Tobacco Intelligence was significantly reorganised during 2004-05. The reorganisation included the appointment of a National Commodity Coordinator (NCC) to oversee tobacco intelligence work. The NCC also attends meetings of the TSG.

49 We examined a large variety of tobacco intelligence material. We noted that recommendations made to improve intelligence gathering were circulated to appropriate staff who were given an opportunity to respond. A review of the risks from maritime container traffic for example included a series of recommendations to enhance the Department's performance against this threat. The relevant operational staff at a UK container port prepared a full response and an indication of timescales for delivery of enhancements.

50 As part of the reorganisation of the Intelligence function one team has taken on responsibility for collating and disseminating information provided by the network of overseas Fiscal Liaison Officers (FLOs). FLOs provide intelligence and international liaison across a number of different activities. FLOs are now seen as increasingly important in the effort to identify shipments of illicit tobacco and the organised criminal gangs behind them. HMRC are in the process of reviewing the allocated resources for this programme to ensure that it is adequate to provide effective intelligence from a number of major overseas locations. The complement of FLOs for one key location is in the process of being increased as a result.

Detection

51 HMRC have used information gathered by law enforcement staff to build up a national picture of detection risk, and to evaluate the effectiveness of their approach to tackling fraud and smuggling. The seizure statistics are the most direct measure of the success of the Detection function and the focus of its activities. Detection staff are based around UK points of entry, predominantly at the maritime ports. Data show major fluctuations in seizure levels at various locations.

52 HMRC have recognised the need for an overall assessment of the relative risks and threats posed at UK points of entry. Such an assessment would inform key decisions on resource deployments – including both manpower and technology.

53 The Department have developed innovative methods within Detection to tackle revenue risks from fraud and smuggling. These include a maritime pre-selection hub, the establishment of dedicated profiling teams, and the deployment of the National Strike Force. This is supplemented by the Department's National and Regional Deployment Centres.

54 HMRC's profiling and targeting teams are responsible for identifying potential shipments of illicit tobacco goods from ship manifests. This information is then used to direct the efforts of intervention staff. The processes used to profile incoming container are largely manual, relying on the skill and experience of the individual profiler. There is scope for greater automation through the use of a dedicated software package. Although the system which is currently used does have some of this capacity, a more automated package to collect and manage all relevant data would allow greater coverage of incoming traffic. Information which may also be of use in profiling traders is available on the Department's Electronic Folder System used by VAT staff to record trader data, which is not accessible by staff working on Excise.

55 The Department are working to make improvements through better and more efficient use of technology, including expanding access to trader data through the development of an e-frontiers system to support the implementation of the Frontiers Strategy.

Investigation

56 Investigation staff are responsible for identifying the supply chains and criminal gangs associated with tobacco smuggling. Their effectiveness is measured through an assessment of the number of major tobacco smuggling organisations disrupted/dismantled, and the value of tobacco related criminal assets confiscated.

57 HMRC's performance in these areas peaked in 2002-03, since when HMRC have failed to meet their disruption targets. Law Enforcement Officers regard the most important indicator of the success of the tobacco strategy as the falling illicit market share for cigarettes.

58 Investigation officers use a baseline of seizure volume and potential revenue loss as one trigger for becoming involved in particular cases. Other factors are considered, such as frequency and pattern of seizures, with the aim of targeting larger scale smuggling operations.

59 Organised criminal gangs have grown in sophistication and are often based outside the UK. Those parts of the smuggling chain which operate within the UK may not be fundamental to the organisation, and that successful seizures may not translate into a 'dismantling' of the gang behind the operation. Dealing with the trans-national nature of these groups requires complex and increasing levels of cooperation with overseas law enforcement agencies.

Resources Deployed

60 The tobacco strategy's original proposals set out in detail the intended deployments of additional resources including:

- Up to 520 additional staff at high risk border and inland locations, with 170 dedicated to tourist lanes;
- 95 additional intelligence staff, including overseas Fiscal Liaison Officers;
- Up to 310 more Investigation Staff based around the UK;
- An additional 30 staff in the Solicitor's Office.

61 The Department made no commitments beyond the original three year strategic horizon, and stressed that the numbers were 'indicative' with some flexibility in the deployment of additional staff. In practice it has proved difficult to identify how many additional staff were actually assigned to tobacco work, and in which parts of the Department they were employed. This is due, in part, to the ongoing reorganisation of the Department, and the development of 'multi-functional' law enforcement officers.

62 In 2004-05 there was a clear shift of resources from tackling tobacco fraud to tackling the risks posed by class A drugs. Analysis provided to the Tobacco Strategy Group for March 2005 showed that 1,726 Law Enforcement staff years were deployed on tobacco against a complement of 2,108.

Scanners

63 To improve cigarette detection rates at major UK ports, £44 million of the original £209 million of total funding was allocated for the purchase of mobile scanners. The poor performance of the scanners when first deployed was a cause of concern for the Committee of Public Accounts. The Department have since addressed these operational concerns.

64 The Committee also recommended, that the scanner network, used for a range of revenue protection and anti-smuggling work, be increased. In 2003, the Department acquired two further machines. In 2004 the Department carried out a major review of the use and deployment of scanners, the results of which will help to determine their use in the tobacco strategy going forward.

The Effect of Changing Threats on the Strategy

Evolution of the Strategy

65 The illicit market for tobacco has not been static since the launch of the strategy in 2000. HMRC's work has undoubtedly been a major factor in the displacement of criminal activity from the smuggling of genuine UK brand cigarettes towards other contraband. As the illicit market has changed so has the strategy, although rather than 're-launching' a revised strategy, there has been a process of incremental review and evolution.

Internal Reviews of the Tobacco Strategy

66 Internal departmental papers record two formal assessments of the tobacco strategy to date:

- In September 2003 the Department prepared a paper setting out the achievements of the first three years and emerging issues. This reflected the perceived change from smuggled genuine product to counterfeit and also identified intelligence gaps which HMRC needed to address. Tangible results from this review include the reorganisation of tobacco intelligence, an increase in resources devoted to air passenger smuggling, the establishment of a freight selection hub and a reinvigorated publicity campaign.
- The Department undertook a further review in November 2004 under the auspices of the TSG. This was against the background of the new PSA target to further reduce the illicit market share for cigarettes to 13 per cent by the end of March 2008.

67 As a result of these reviews, HMRC have refocused resources to provide intensified detection activity at UK airports, a more systematic approach to maritime freight targeting, and a major publicity campaign against counterfeit cigarettes.

68 It is too early to report on whether the available resources will allow HMRC to meet the new, more challenging PSA target for reducing the size of the illicit market.

Hand Rolling Tobacco

69 Smuggling of Hand Rolling Tobacco (HRT) has been a problem since at least the mid 1990s. It was discussed in the original Tobacco Strategy document published in 2000. According to the most recently published fraud figures, smuggled hand rolling tobacco has grown in significance relative to other forms of tobacco fraud. The Department have already made a public commitment in the 2004 Pre Budget Report to take action to reduce the level of hand rolling tobacco fraud, with a more detailed package of proposals expected in the autumn of 2005.

70 The dynamics of the illicit market in hand rolling tobacco are different from that of smuggled cigarettes in a number of important ways. This includes the fact that smuggled hand rolling tobacco appears to originate within the EU, is dominated by one brand, is usually genuine rather than counterfeit and is believed to be smuggled through cross channel and air passenger routes.

71 The department have been considering their response to this growing threat for some time. Tobacco Strategy Group minutes show that a strategic response was suggested as early as December 2003. Work has since been undertaken to identify the resourcing implications of any departmental response. HMRC will need to consider how this can be done without damaging current work targeting cigarette fraud and smuggling. HMRC should also introduce a quarterly intelligence analysis of hand rolling tobacco seizures in order to provide routine and up-to-date analysis on the trends in this market. This is already being done for cigarettes.

Counterfeit

72 HMRC and the tobacco manufacturing companies have cooperated closely on publicity campaigns to highlight the dangers associated with counterfeit cigarettes. In late 2004 HMRC launched its most high profile campaign to date and produced a booklet called Counterfeit Cigarettes to publicise the problem of counterfeit and the help given by trade bodies.

73 There are ongoing difficulties in estimating accurately the scale of the counterfeit market. The Department's estimates for counterfeit seizures could be improved. Currently only counterfeit from seizures of greater than 500,000 are included in the published figures. Including the results of all counterfeit seizures would improve the quality of published estimates.

74 HMRC also publish breakdowns of the most seized UK brands in each year. HMRC should also consider publishing the brands which are most likely to be counterfeit and therefore, likely to contain higher levels of toxins that are more harmful to health. This would help publicity campaigns by identifying those brands which are most at risk.

Relations with the Tobacco Manufacturers

Background

75 When the Committee of Public Accounts previously examined the issue of tobacco fraud the Committee identified the conduct of the legitimate tobacco trade as an area for concern, made specific criticisms about the export policies of individual companies and noted an apparent reluctance to cooperate with the Department.

76 The Committee called the Chief Executive of Imperial Tobacco as a witness, because of their concerns that Imperial were not co-operating with the Department to tackle smuggling, particularly by stemming exports to markets where the supplies were being diverted by smugglers. Following the hearing, Imperial and the Department agreed a Memorandum of Understanding to target this, resulting in a significant reduction in seizures of Imperial's cigarettes, and an end to the pattern of exports to markets from where the brands were being diverted rather than satisfying domestic demand.

Managing the Relationship with UK Tobacco Manufacturers

77 HMRC's development of Memoranda of Understanding with three of the major UK tobacco manufacturers represents a significant development since the PAC hearing in 2002. The Department regards the signing of these agreements as emblematic of a more cooperative relationship and of willingness by the trade to fully engage with the problem of tobacco smuggling. The results to date provide evidence that the approach has been an effective one. The memoranda provide a framework for cooperation on a range of issues relating to tobacco fraud. HMRC have devoted considerable time and resources to enhancing and improving the dialogue between the Department and the legitimate trade.

78 HMRC have taken measures to enhance their contacts with the companies whose brands have traditionally been most at risk from smuggling. Regular meetings and other ad hoc contacts provide both sides with opportunities to raise issues of concern and identify new trends or sources of illicit tobacco products.

79 A problem for the Department in managing its relations with the legitimate trade has been in the handling of sensitive human intelligence. The trade have often felt that HMRC has been too limited in the feedback it gives on the outcome of tips and information about suspect loads or sales of tobacco. Concerted efforts to explain the legal constraints and complexities involved during 2004-05 has resulted in a clearer understanding by the manufacturers of the constraints under which the Department must operate.

80 HMRC also communicate regularly with the Tobacco Manufacturers Association (TMA), which is the main trade body representing manufacturers and retailers in this sector. This allows the Department to communicate with a broader cross-section of those involved with the trade. Where HMRC feel it is necessary they work on a more ad-hoc basis with companies with a smaller market presence in the UK.

Allegations of a proposed amnesty with tobacco manufacturers

81 In February 2005, the Sunday Times published allegations that in 1999-2000 the Department had instructed a major accountancy firm to approach the UK's largest tobacco producers, and discuss a proposal whereby the producers would agree to pay VAT and excise duty allegedly lost to the Exchequer as a result of cigarette smuggling, in return for an amnesty from prosecution. These allegations were denied by the Department.

82 In response, the Chairman asked for an investigation to be carried out by a member of the Inland Revenue Board independent of the operational areas affected.

83 As this was not a tax investigation, the Department had to rely on the goodwill of the tobacco industry and their advisers in gathering evidence for the report.

84 The resultant report concluded that:

- Discussions were held between the Department and the firm about how tobacco companies could be encouraged to prevent the smuggling of their products;
- All of the available evidence suggested that the idea of an amnesty as described in the Sunday Times was a marketing initiative of the firm although it seems that the word "amnesty" was first used by a Customs official. One of the then employees of the accountancy firm suggested Customs saw the 'amnesty scenario' as a strategic initiative but there is no independent evidence to support this;
- There was no evidence that Customs were willing to offer immunity from prosecution in return for payment of substantial duties; and
- There was no evidence that Customs were acting in any way as agents for HM Treasury, or that HM Treasury played any role at all in discussions between the parties concerned in late 1999 and early 2000.

85 The National Audit Office examined the report, along with supporting documentation. The evidence gathered by the Department supports the conclusions drawn in the report; namely that the Department did not propose or sanction an amnesty. The Department's approach was instead to work to engage with tobacco manufacturers to prevent smuggling.

86 Nevertheless, the National Audit Office considered there to be some weaknesses which emerged as a result of the investigation, which the Department needs to address:

- The Department was unable to produce records of meetings held with the advisers of tobacco manufacturers. The investigation carried out by the Department had been reliant on recreating records through interview, and obtaining copies of records retained by tobacco manufacturers, the Tobacco Manufacturers' Association and other third parties.

- The Department's investigation was delayed because one officer, currently on secondment overseas, had difficulty in recalling, without access to records, details of meetings at which he was present which were key to the allegations made by the Sunday Times. The Department should ensure that notes of key meetings are made and retained to provide a chain of evidence to demonstrate how decisions are taken.
- The Department found that one official involved was at least a close acquaintance and possibly a personal friend of one of the employees of the accountancy firm developing the amnesty proposal. The official should have disclosed that to his managers and the Department should now consider the adequacy of its guidance on potential conflicts of interest.

Philip Morris Agreement

87 Another major development since the previous PAC report has been the agreement between the European Union and Philip Morris International to cooperate in combating the smuggling of non-duty paid Philip Morris product into the EU. This agreement was associated with the resolution of a legal dispute and included significant monetary payments by PMI to Member States involved in the litigation. The UK Government is not a signatory to the agreement, nor is it a beneficiary of any payments from PMI.

88 The main components of the agreement include:

- compliance protocols;
- customer oversight provisions;
- product tracking and tracing provisions; and
- monetary contribution, including penalty payments.

89 Some stakeholders have argued that the Philip Morris agreement represents a 'gold standard' against which other similar agreements need to be measured. The penalty payments which must be made if a certain quantity of contraband Philip Morris tobacco is seized are seen as a particular step forward. The establishment of a track and trace database[3], (whereby particular movements of tobacco products can be traced via an on-line system to show where the consignment was produced and where it was being delivered to) with 24 hour access is also seen to be an improvement on current arrangements.

90 An anti-smoking group told us that they believed the agreement enhanced the relationship between tax authorities and legitimate traders. Whilst they concede that the current MoUs appear to have been effective in reducing seizures of genuine UK brands, they continue to push for a legally enforceable agreement.

TSC concluded that,

We are concerned to note…that Customs have not sought a similar agreement with Philip Morris. Whether it would be better for the UK to sign the EU agreement or to seek a separate memorandum of understanding with Philip Morris depends upon the arrangements that can be negotiated with the company. But doing nothing is unacceptable.

91 HMRC estimated that the revenue benefits from penalty payments, had the UK signed the agreement with Philip Morris would be less than £1 million for the 2003-04 financial year. In their evidence to the Treasury Committee HMRC stated that that they worked, "… with Philip Morris in much the same way as we work with each of the UK manufacturers. We seek to track and trace their product in the same way as we seek to with UK manufacturers and we meet with Philip Morris on a regular basis." Philip Morris confirmed that they currently cooperate with HMRC, including sharing a seizure database, identifying suspect container loads, training and other information sharing exercises.

92 Philip Morris believe that the 'track and trace' arrangements for 'master cases' of cigarettes[4] in their EU agreement are superior to those in place in the current memoranda of understanding. However other manufacturers consider that current arrangements are not inferior, allowing a similar 'track and trace' to the first customer and intended destination market for individual packs of cigarettes rather than just for 'master cases'. The one apparent advantage of the Philip Morris agreement is the existence of a database with 24 hour access for law enforcement agencies. However the agreement only relates to product originating from outside the EU, whereas under the memoranda HMRC can ask manufacturers for information about all shipments of genuine UK product.

3 See paragraphs 87-88.
4 A master case contains 10,000 cigarettes.

93 Tracking and tracing tobacco consignments is not without its limitations. 'First customer' information is provided in all cases (i.e. the system records the intended customer, but not any subsequent customers that the consignment is shipped on to, either as a whole, or broken down into smaller consignments). The nature of intra-EU hub and spoke distribution chains means that any track and trace arrangements are more useful for product being imported into or exported from the EU. In some cases UK manufacturers export to their own subsidiaries within the EU for onward sales and distribution. This means that the information about the first customer would be of limited value to HMRC.

94 This highlights an area in which the current memoranda could be improved. HMRC would benefit from having information about the first sale outside a group of companies in addition to the original transfer to the inter-group subsidiary. HMRC needs to address the issue of overseas production of UK sensitive brands, and the provision for track and trace for this product. Not all UK sensitive brands produced overseas currently contain track and trace pack markings. This is something which HMRC may wish to see in future.

95 The Philip Morris agreement has only been in operation for a little over one year, and the European Union has not published details of the benefits or penalty payments which have resulted from it. A representative of OLAF reported that during the first year of the agreement the EU was 'more than satisfied' with the level of cooperation it had established with Philip Morris, although without data on the level of penalty payments made, and the effect of the agreement on fraud and smuggling, it is too early to comment further on the effectiveness of the agreement.

Memoranda of Understanding

96 HMRC have recognised the need to review the current Memoranda of Understanding. These agreements were developed in an iterative process between April 2002 and June 2003 and vary considerably in the detail and commitments they contain. Some of the manufacturers with whom we spoke felt that there should not be a standard 'one size fits all' document. They believe that HMRC requires different levels of cooperation from different companies depending on factors such as market presence and vulnerability of their brands to smuggling.

97 There would be significant benefits to the department in standardising the document and ensuring that the most effective clauses are included in all versions. These include specific commitments to discuss and provide information about new export markets and customers. The current review of the adequacy of the memoranda will assist the Department to achieve this.

Oversight of the Supply Chains and Export Markets

98 Some aspects of the relationships between the tobacco manufacturers and HMRC predate the existence of memoranda. This includes the system of 'yellow' and 'red' cards through which the Department can provide warnings to companies about potentially problematic customers. This system requires the manufacturers to take measures to ensure that their exports are going to legitimate and responsible customers. The ultimate sanction is for the company to cease trading with that company.

99 It is not currently the case that a customer who is red carded by HMRC would automatically be 'blacklisted'. HMRC are not, however, aware of any cases where a red-carded customer has been able to trade with other UK manufacturers, and do not consider there is any legal basis for blacklisting distributors unless they have been convicted of an offence.

100 Manufacturers believe that HMRC could improve the quality of information it supplied on seizures. When the Department track and trace illicit product they provide seizure data on excel spreadsheets to the tobacco companies rather than in a consistent data format. This limits significantly the amount of analysis which can be done on the data to identify patterns. The Department have pointed out, in response, that they are limited by law as to the extent of the information they may disclose.

101 The information provided by HMRC to manufacturers will include quantity seized, type of brands and some samples for analysis; however there is no breakdown of the quantity of each brand within the seizure. For instance, one manufacturer has its own software which it is prepared, at a cost, to share and develop with HMRC. Use of such a product would allow HMRC to generate reports very quickly identifying the intended customer, destination and brands.

102 In addition, the Department could also expand its analysis work through the use of specialist consultants with knowledge of the global tobacco markets. In one such case, consultants Euromonitor (a European trade analysis resource) produce a detailed analysis of trade movements and brand penetration which may assist the Department in further enhancing its understanding of areas of greatest risk.

Conclusion

103 The Department have made significant progress in dealing with the problem of illicit cigarettes, although more recently the size of the illicit market has plateaued rather than continued to reduce. The strategy has evolved over time to reflect the changing nature of organised crime and smuggling in this sector. A strong commitment exists within the Department to tackle the problem, and clear lines of responsibility exist to ensure delivery. The Department will need to ensure that the level of resources deployed to tackle tobacco fraud continues to be appropriate to the level of risk, and will also allow the Department to make further progress on reducing the size of the illicit market.

104 The relationship between HMRC and the legitimate tobacco manufacturers has improved considerably since the Committee of Public Accounts last considered this issue in 2002. This has delivered benefits, with a continuing reduction in the quantity of genuine UK brand cigarettes being seized by Customs Officers. There is scope for even closer cooperation, particularly in relation to published estimates of the level of fraud. HMRC will also need to consider the implications of the Philip Morris Agreement with the EU.

105 The displacement of tobacco fraud into counterfeit cigarettes and hand rolling tobacco also poses new challenges for the department. HMRC are renewing their strategy to face these challenges, but believe that this must be accompanied by specific targets and a clear idea of the level of resources which will be needed to respond to them.

Recommendations

The National Audit Office recommends that HMRC should:

- consider the benefits of producing and publishing an aggregate revenue based fraud estimate to include all forms of illicit tobacco products (cigarettes, hand rolling tobacco cigars and other products). This would be in addition to the current separate figures for cigarettes and hand rolling tobacco.
- work with the legitimate trade to include within their fraud estimates a more consistent analysis of the component parts of the non-UK duty paid sector below the high level fraud estimates. This would allow HMRC to identify quickly new trends and react accordingly.
- establish a PSA type target to reduce the illicit market share for Hand Rolling Tobacco. This should be consistent with the method developed to deal with cigarettes.
- take immediate action to increase the level of hand rolling tobacco seizures through targeted disruption activity.
- seek ways to further enhance their profiling of maritime traffic by investigating the potential for greater automation and exploitation of IT capacity, as well as through providing staff access to data stored on the Department's Electronic Folder system.
- embed analysis of hand rolling tobacco seizure information into routine seizure intelligence/ analytical reports as they already do for cigarettes.
- publish more precise estimates of the likely penetration of counterfeit product by including data from all seizures made where samples are taken, rather than simply those of more than 500,000.
- publish a breakdown of the brands most affected by counterfeit each year in order to publicise the nature of this market and better warn smokers of the associated risks and dangers.
- consider an additional clause in the current memoranda of understanding which commits the manufacturers to providing information on UK brand sensitive exports outside company groups, as well as intra-group transfers and sales.
- review the procedures in place for oversight of the overseas production of UK brands by the major tobacco manufacturing companies.
- look at ways to improve the analysis of seizure data provided to tobacco manufacturers, and used by the Department to target their own work.

CHAPTER THREE

VAT Debt Management

Introduction

1 One of the early changes, arising from the creation of HMRC, was the decision to merge the debt management and banking functions of the two predecessor departments with effect from February 2005.

2 The most significant Customs tax stream in 2004-05 was Value Added Tax (VAT), with £126 billion of gross receipts, accounting for 72 per cent of total indirect tax receipts for the year. Traders have a legal obligation to calculate the amount of VAT they are due to pay and then to remit the sum to the Department by the due date. Most businesses pay their VAT on time but a number fall into arrears because they are unable or unwilling to pay. As at March 2005, the Department reported that overdue VAT they were owed amounted to £2.554 billion.

3 The overall aims of HMRC's debt management activities are to reduce debt outstanding, to maximise revenue collected and to encourage greater future voluntary compliance amongst the whole customer population. Traders who fail to pay established liabilities will be notified in writing when payment is overdue. VAT debt cases which remain unpaid are dealt with by one of the Department's 10 core or four national debt management units. The Department may not be able to collect this because it is owed by traders who cannot be contacted, or because it is under negotiation because the trader disputes the debt and payment would cause financial hardship, or is being paid off in agreed instalments, or is the subject of criminal investigation. Recovery action on these cases (of suspended debt) is "suspended" until the issue involved is resolved allowing the suspension to be lifted.

4 In the case of recoverable debt, HMRC contacts the trader to arrange settlement of the current debt at the earliest opportunity, and to discuss how the trader can be assisted to avoid incurring debts in the future. Action on the current debt can include negotiating time to pay for the amount owed or arranging for bailiffs to seize goods to recover the amount owed. Where it is not possible to recover the debt using these options the Department can seek bankruptcy in the case of a sole trader or partnership, or seek the winding up of a limited company where circumstances permit. Where a debt cannot be recovered, the Department may consider writing it off. In the year ended 31 March 2005, Customs wrote off £835 million of VAT debt in total.

2001-02 Standard Report

5 Debt rose rapidly in the five-year period to 31 March 2002 due to a number of factors. These included a rising tax yield, success in tackling certain types of fraud, and an increase in the proportion of traders challenging assessments of VAT due made by the Department.

6 In June 2003, the Committee of Public Accounts recommended that the Department should look to demonstrate that after a number of years of increasing debt balances, it could reduce outstanding debt.

7 Since 2003, the Department have taken steps to improve debt management. Changes introduced are linked to the VAT Compliance Strategy launched by Customs in April 2003. The Department introduced the National Business Model[5] to promote consistency in the business, with a focus on risk and compliance. This was supported by an extensive, commercial style training programme, to provide caseworkers with essential debt management skills. To measure performance, the Department set an internal target for 2004-05 to restrict VAT arrears to no more than 2.06 per cent of a rolling 12 month VAT liability figure. In 2004-05, as part of a special initiative, HM Treasury provided additional resources which led to a major re-organisation of the debt management business, supported by an upgrade to the IT case handling system.

Debt Management Organisation

8 The management of VAT debt was split between the following areas:

- The Debt Management Functional Management Team, with 9 staff responsible for strategic oversight of national debt management operations including civil recovery, development of policy and working practices, national performance monitoring, training and guidance.
- 10 core and 4 national debt management units, responsible for the recovery of debts. There are also specialist teams dealing with specific aspects of debt management including insolvency, asset recovery and the collection of non-VAT debt. The debt management business handles an average of 47,000 new VAT debt cases worth a total of £375 million each month.

5 See paragraphs 20-23.

9 Until February 2005, debt management formed part of the Business Services and Taxes division in Customs. Since then work has been ongoing to create a single Debt Management and Banking business function responsible for all incoming cash flow including overdue payments and returns on all tax streams. This business unit is, in turn, part of HMRC's Operations business area responsible for customer service, tax and benefit compliance and frontier protection in HM Revenue and Customs. **Figure 1** below sets out the reorganised structure of the Debt Management and Banking Business introduced in August 2005.

1 New HMRC Debt Management and Banking Structure

Banking Operations	People & Planning	Debt Management
Deputy Director	Director (Reports to the Executive Committee through Director General Corporate) Services)	Deputy Director
Process & Strategy	Performance Development	Business Design

Source: HM Revenue and Customs

Scope of Our Review

10 This part of my report focuses on:

- The level of reported debt;
- Action taken by the Department in recent years to improve debt management;
- The operation of the debt management business; and
- The Department's reported debt management performance.

Level of Reported Debt

11 The Department's management of VAT debt is supported by two key IT systems; the VAT Mainframe and the Departmental Trader Register. The VAT Mainframe system is a central record of information on all VAT registered traders, and is updated with details of new transactions with traders on a daily basis. The Departmental Trader Register is the VAT debt management case handling system. It is updated three times a month with information from the VAT Mainframe, including the notification of new debt. It is used by the Debt Management Units as the basis of their contact with traders for debt recovery action.

12 The VAT Mainframe and Departmental Trader Register are old, large and complex systems. An interrogation of the two systems by the National Audit Office in July 2002 identified approximately £300 million of debt recorded on the VAT Mainframe that could not be traced to the Departmental Trader Register system.

13 In March 2005, the discrepancy had increased to approximately £1.3 billion. Of the £1.3 billion difference identified, the Department identified £400 million as attributable to timing differences since the VAT Mainframe is updated daily, but the Departmental Trader Register case handling system (though it is used and updated by case workers with case specific information daily) is only updated from the Mainframe three times a month. Approximately £900 million represented debt that should have been downloaded onto the Departmental Trader Register, but had not been because of inhibitors on the VAT Mainframe which prevented the download of certain types of debt.

14 In 2004-05, after a feasibility review, the Department took action to reconcile the two systems. This exercise involved an interrogation of the VAT Mainframe and Departmental Trader Register at a single point in time, in order to identify, on a trader by trader basis, all the differences that existed between the two systems and the reason for each one. The exercise was undertaken using data for 16 May 2005, when there were 200,000 traders with debt balances which differed between the two systems. The Department will use the results of the May 2005 reconciliation as the basis for arranging for the removal of all non-essential inhibitors by 31 March 2006. This will ensure that debt is correctly downloaded to the Departmental Trader Register in future.

15 In advance of the results of the May 2005 exercise, the debt management Functional Management Team undertook a separate exercise analysing the high value differences between trader balances on the two systems. As a result arrangements were made to manually add a number of high value debts totalling around £700 million onto the Departmental Trader Register in June and July 2005.

16 Debt on the VAT Mainframe which is not notified to the debt management business cannot be actively managed by properly trained debt management staff using the appropriate systems. Most of the inhibited debt relates to missing traders and cases under appeal, although a more detailed explanation and a breakdown of the additional amounts of suspended debt by type will not be available until the Department have completed their review.

17 Early analysis of the data led HMRC to estimate that £35 million of the accrued debt blocked on the VAT Mainframe is currently recoverable. Even when the inhibitors for the recoverable debts are removed, however, in some circumstances the chances of collecting the amounts may be substantially diminished because of their age.

18 A number of high profile and ongoing legal cases have caused the variance to increase markedly. In addition, reconciliation work has been delayed by resourcing difficulties and because decisions were ongoing about changes to IT systems needed to support the business more effectively in a period of significant organisational change.

Developments in the National Debt Management Business

19 Customs carried out an internal review of their debt management activities in September 2002. The review concluded that improvements could be achieved from a better application of current systems. It recommended action in the short term to improve management information and performance measures, update policy, training and assurance and to ensure a greater focus on key risk areas. The review also recognised that a long term step change, supported by enhanced IT systems, would be needed to secure significant improvements in performance.

The National Business Model

20 In May 2003, the Department implemented a revised framework for the business called the National Business Model, setting standards for the debt management business. It was developed by a team of representatives from the debt management units and the central Functional Management Team. The aim was to provide a basis for improvements in the business, consistent with the VAT Compliance Strategy and without significant system change. The objectives identified for the debt management business were 'to categorise and identify debtor behaviour and to devise strategies for':

- Improving revenue flow
- Minimising write-off
- Improving compliance
- Removing persistent non-compliant businesses from the trading population
- Promoting timely payment; and
- Providing help and support to vulnerable but viable businesses.

21 The Department placed greater emphasis on dealing with the debtor rather than the debt and identifying underlying causes for late or non-payment. The new approach involved dividing debtors into two groups:

- First time and occasional defaulters, who would normally be contacted by telephone, not only to obtain payment of the outstanding debt but also to identify the key reasons for the debt arising. This allows the Department to offer targeted advice, education and support, to improve compliance in future.
- Persistent defaulters, where trader information already held would be used to inform and target activity so that prompt action can be taken in order to protect against future revenue loss.

22 The approach recognised that early action on new debt was essential to improve recovery and reduce write off. The National Business Model stipulated that the performance of individual debt management units should be measured against the following national standards:

- To achieve a positive outcome for 100 per cent of recoverable debts within 3 months for first time and occasional defaulters
- To achieve a positive outcome for 100 per cent of recoverable debts within 6 months in the case of persistent defaulters
- To review time to pay and other suspended debt on a timely basis to ensure prompt and appropriate recovery action is taken.

23 The National Business Model also proposed a preferred structure for the Debt Management Units. This recommended setting up centralised teams to deal with certain key areas of suspended debt and missing trader fraud debt, freeing other staff to concentrate on the clearance of new recoverable debt. The Department continued to support the National Business Model by issuing good practice guidance on debt management for first time and occasional defaulters, and persistent defaulters.

The Operation of the Debt Management Business

Trends in Suspended Debt

24 **Figure 2** includes analysis by type of suspended debt, and shows the amounts outstanding at March 2002 and March 2005 and the increase or decrease in the intervening three year period. These figures do not include the 'inhibited' debt held within the VAT Mainframe computer system and not passed to the debt management business.

25 The only category of suspended debt where there has been a reduction is that relating to time to pay, an area of activity fully controlled by the debt management business. This has seen a drop of £49 million (35 per cent) in the 3 years to March 2005. This category of debt now stands at its lowest level since 1998.

2 Analysis of debt

Type of debt	March 2002 (£m)	March 2005 (£m)	+/- (£m)	Definition
Suspended Debt				
Law Enforcement investigation	216	792	576	Debt assessed where a trader is under Customs investigation.
Under Appeal	243	426	183	A disputed liability where a trader has appealed to an independent VAT Tribunal or protective assessments pending legal action.
Missing Trader	178	204	26	Debt owed by traders who cannot be traced by the Department.
Disputed liability	51	60	9	A disputed liability where no appeal is in progress.
Time-To-Pay	141	92	- 49	An agreement between Customs and the trader to receive money in instalments
Other	-7	67	74	New suspended debt categories
Total Suspended	822	1,641	819	
Recoverable	1,240	913	-327	Debt available for recovery action, including by legal process in the Civil Courts.
Total Debt	**2,062**	**2,554**	**492**	

Source: HM Revenue and Customs

26 The substantial part of the overall increase in suspended debt is attributable to debt resulting from law enforcement investigations, which has risen by £576 million in the three year period to March 2005. The majority of this is due to the Department's efforts to identify and tackle Missing Trader Intra-Community fraud (MTIC) debt. The nature of this fraud means that these balances remain recognised as debt while the criminal investigations continue. Debt suspended because an officer's assessment of VAT due from a trader is under internal reconsideration or appeal to an independent VAT Tribunal has also increased significantly. Cases may not be concluded in some instances until the Courts have ruled in favour of HMRC or the trader.

27 An example of this has arisen from HMRC's efforts to require a number of businesses to register their card handling companies for VAT. Pending the completion of legal action, the Department have issued protective assessments to the businesses which will be enforced if the litigation is successful. In the meantime the amounts are recorded as suspended debt. The litigation may take several years to go through the Courts. In the meantime the reported level of debt is expected to rise significantly.

28 HMRC see these increases as, in large part, the natural consequence of addressing MTIC fraud and VAT avoidance activities. As such, they consider that the increases should be taken as a sign that the Department is successfully tackling serious non-compliance. Unlike recoverable debt, HMRC recognise that a significant proportion of suspended debt will not be recoverable for some time, possibly even several of years. A significant proportion may ultimately need to be written off. We agree with the Department's view.

29 As part of an ongoing departmental review process, in the last few years the debt management business has taken various actions to improve arrangements to control suspended debt. This included a review in 2004 of the "hardship" policy for officers' assessments under appeal. This found that the policy for suspension of debt where an officer's assessment is under appeal to a tribunal was not always being correctly applied.

30 Once that assessment is issued, the law requires that the VAT must be paid before the appeal is heard, unless payment of the amount would cause genuine hardship to the trader. In some instances, debts under appeal had remained suspended, where hardship had not been explicitly applied for by the trader. As a result guidance on the matter was revised. Arrangements were introduced to provide for central monitoring of assessments suspended due to hardship. This action is a contributory factor in the fall in this category of debt during 2004-05. The March 2005 figure of £322 million represents a drop of 14 per cent from the figure of £375 million recorded as at March 2004.

31 Although recommended by the National Business Model, some debt management units did not have a central team responsible for monitoring suspended debt. Responsibility for monitoring cases was assigned to individual caseworkers, who often had problems identifying and then making contact with the Law Enforcement officers responsible for suspended debt cases. There were also variations in the timescales for reviewing progress on suspended debt cases, from one month up to 21 months in one case, with an average time of 5 months.

32 Since May 2004, the Large Debt Unit, which managed debts worth more than £100,000, has assumed responsibility for much of the suspended debt, since the cases tend to be high value. The Large Debt Unit is developing arrangements to improve communication with law enforcement officers in relation to suspended debt. The status of suspended debt cases will be reviewed and updated as necessary at specified periods based on the predicted timescale for developments on the law enforcement operation the debt relates to. Responsibility within law enforcement for the initial raising of suspended debt and then its monitoring will also be centralised.

Write Off of Debt

33 It is a key principle of the Department's National Business Model that early action on new recoverable debt is essential to improve recovery rates and reduce write off. Once a recoverable debt is more than 6 months old the chances of collecting the debt diminish rapidly in certain circumstances.

34 Different considerations apply in the case of suspended debt where cases can remain unenforceable for several years due to law enforcement action or appeals. The nature of much of this debt is such that there is a greater probability that when the debt ultimately is deemed recoverable it will be written off. Regardless of the type of debt, it is important that appropriate and justified write off action is taken on a timely basis to prevent total debt from being overstated. This is especially important now that the Department's Trust Statement account, which discloses total tax revenues, is prepared on an accruals basis. As a result the Department is required to disclose the level of debtors at the year end. Debt management currently advise on any provisions for doubtful debts for inclusion in the accounts.

35 Three years ago the NAO recommended that Customs should speed up the write off of debt deemed irrecoverable. Since then the Department have taken action aimed at improving arrangements. In 2003, the procedures for the handling of aged debt relating to traders who are missing or deregistered were revised to encourage timely write off of these cases where there is little or no prospect of recovery. Periodically since then, there have been drives to write off debt deemed irrecoverable. We noted one such exercise towards the end of 2004-05. Additionally the Department commissioned a review in 2004 which considered delays in the write off process.

36 The level of write offs has nonetheless fallen significantly in recent years. The graph in **Figure 3** shows the value of VAT debt written off for each of the financial years since 2001-02. This shows that amounts written off almost doubled in the 2002-03 financial year to a figure of £1,714 million (105,196 cases) but since then has fallen significantly to £835 million (46,096 cases) in 2004-05.

37 The major reduction in 2004-05 in the level of write off cases could indicate that irrecoverable debt is not being written off on a timely basis and, therefore, debt may be overstated. There were problems preparing cases for write off because the required evidence was not readily available, either because of the age of the debt or the fact that the information was not held by the debt management unit. This meant that the average age of debt put forward for write off action for the sample we examined was 33 months.

3 Trends in write off cases by number and value since 2001-02

Figure 3(a) – By value

Value (£ millions) of VAT Write offs reported

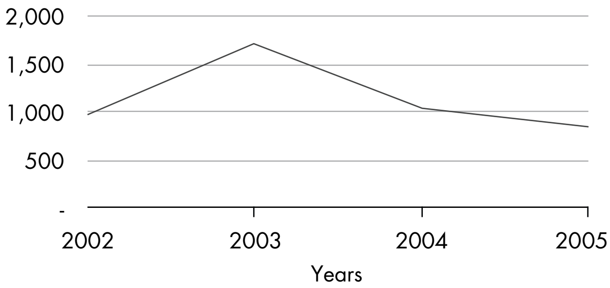
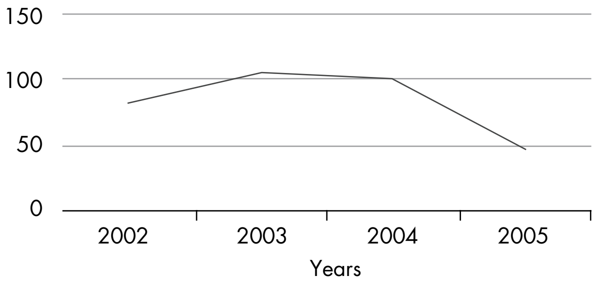


Figure 3(b) – By number

Number of Cases Written off (000's)



Source: HM Revenue and Customs

38 Departmental guidance specifies the delegated authority levels for writing off debt, depending on value. The process for authorisation of proposals can be lengthy, particularly for high value debts which go through several stages of review before submission to senior management. Even then, there was sometimes a reluctance to write off amounts when officers considered that a debt may have been inappropriately managed in the past.

39 For the sample of debts written off in 2004-05 examined by the NAO, on average it took 5 months for a write off case to be processed and often longer if the debt is high value. The process for the write off of debt is expected to speed up under the new structure for the debt management. Additionally, the Department is in the process of developing new departmental write off guidance.

40 The focus for caseworkers to take early action on new debt to maximise the prospects of recovery may also have contributed to a reluctance to write off debt. Success here, as demonstrated by the additional £299 million banked in 2004-05, may have been at the expense of clearing debt appropriate for write off. The Department's Large Debt Unit has recently undertaken a major exercise to establish the status of all high value suspended debt cases. Although the results of this exercise are not yet available, the Unit expects that a significant number of debts will be written off.

The National Business Model

41 The National Business Model was developed by Customs to provide a consistent way for Customs to manage debt across the range of debt management units. It resulted in a number of positive developments as a result. These include:

- The issue by the Functional Management Team of a management assurance programme to test the quality and accuracy of work done by caseworkers for use by the debt management units, to check that resources are being directed to risk areas, and to highlight any additional training needs;
- The requirement for debt management units to submit quarterly reports to the Functional Management Team reporting on performance against national standards, the results of management assurance activity and problem areas for example on staffing or IT;
- Periodic site visits made by staff from the Functional Management Team to the regional sites to follow up on issues identified in the quarterly reports
- Periodic meetings of key individuals from the business to discuss issues affecting the national business
- The use of staff from the debt management units in the Functional Management Team or on specific projects associated with the national business.

42 The Department's debt management units still need to address some inconsistencies over the application of the National Business Model. For example, although the Model proposes specialised teams to deal with suspended debt and deregistered traders, these did not operate in many units. These inconsistencies also affected the application of a national programme of management assurance which was inconsistently applied and evidenced in the regions. Many units no longer adopted the management assurance programme. The result of this was to increase the risk that quality thresholds for management assurance would not be met, and therefore, that resources would not be properly targeted to maximise recovery rates. The Department are currently carrying out an internal review into management assurance which will report in the Autumn of 2005.

Management Information

43 Any effective debt management business needs reliable, detailed and up-to-date management information to allow the business to manage individual debts efficiently, to allocate staff resources in response to risk and workloads, and to assess the effectiveness of various debt management actions. It also enables performance to be monitored over time against appropriate targets and indicators.

44 In 2004-05, the Department had arrangements in place for monitoring and reporting of debt management performance against internal targets. Progress against the target, to restrict VAT arrears to no more than 2.06 per cent of total VAT liability, was reported on in the Department's monthly Management Accounts. In the case of the 4 national targets, details of performance were reported to management in the VAT business in the monthly "VAT Business Performance Pack" (VAT pack). Unlike with the Management Accounts, there was no commentary to accompany the performance data. The data for these reports was compiled by the Functional Management Team based on information extracted from the Departmental Trader Register.

45 In addition to reporting the position for the national business as a whole, during 2004-05 the "VAT Business Performance Pack" included details of performance against national targets for each of the 10 core and four national debt management units. The information in the Packs is an important tool for regional and functional management with responsibility for debt management. It allows them to monitor outturn against targets for the debt management units in their region. It also provides an overview of the comparative performance of the different debt management units.

46 The 2004-05 VAT Pack performance data for the individual management contained a number of deficiencies:

- Performance for the 4 national debt management units was reported against standard targets, those being debt cleared as a percentage of debt advised and debt paid as a percentage of collectable debt advised. Although these targets had been assigned to the 10 core debt management units dealing with the routine processing of new debt; they were inappropriate for the national teams given the specialist nature of their work in chasing up older debts relating, for instance to fraud cases. No alternative performance data for the national teams was included in the VAT Packs, although lower level data was available, though not included;
- Data on individual unit performance was based on flawed information. The management information system in place could not support the revised business structure introduced in May 2004. For much of the year, this system continued to generate information on the basis of debt being handled by 10 rather than 14 debt management units. Functional Management Team efforts to manually adjust data generated by the IT system to reflect the impact of transfers of debt from the regional debt management units to the national teams proved unsuccessful. Aggregate national data was, however, accurate; and
- Understanding of the performance data, which was presented in graphs or tables, would have been enhanced if it had been accompanied by a narrative to explain what the data meant and to provide the appropriate context. For example the linkage to the related targets was not clear; there was no commentary about whether the recorded performance was satisfactory and if not, how this would be addressed. The Department used this information as the basis for regular monthly VAT performance meetings. At these meetings performance data was analysed, and points needing clarification discussed.

47 Most debt management units had their own arrangements in place to generate more reliable local management information on performance against targets. The quality of monitoring arrangements varied significantly. Most of the new national teams had particular problems in generating reliable information of performance against their targets. As a result individual units developed separate procedures as required.

48 The quality of information from the Departmental Trader Register improved in the latter part of the year and it is expected that the system will produce reliable information in future once the upgrade is completed later in 2005. This will be of key importance, not only to monitor departmental performance, but to be able to assess the effectiveness of different types of enforcement action against debtors. This sort of analysis is not currently possible and is crucial to a risk and compliance based approach to debt management.

Staffing and resources

49 In 2004-05 HM Treasury provided an extra 150 staff for the Customs debt management business for a two year period under a "Spend to Raise" initiative to deliver an additional £185m of revenue for each of the two years. The majority of the additional staff were deployed in 4 new specialist National Units from April 2004, covering Large Debts, Missing Trader cases and two covering Aged Debts dealing with cases more than six months old. These new national units took casework from the core regional units. The balance of additional staff resources were assigned to the 10 regional debt management units and the legal recovery units, providing an increase in resources overall to permit the quicker clearance of new debt.

50 In 2004 the Department also approved an upgrade to Departmental Trader Register. The key improvements to be introduced by the upgrade were:

- providing system access to the 150 new debt management staff;
- supporting the four new National Units; providing more accurate and enhanced management information;
- providing the Civil Recovery Unit with the reporting and monitoring tools necessary to support it's specialist work; and
- to allow additional debts to be downloaded from the VAT Mainframe to Departmental Trader Register.

In view of the short timescale and the limited specialist IT resources available to perform the work, the upgrade was performed in 3 phases. The first phase was delivered in May 2004 to address priority issues. HMRC will deliver the final phase of the enhancement in September 2005. This release will:

- introduce corrections to the missing and deregistered trader debts from the mainframe to the Departmental Trader Register;
- introduce a case tracking system; and
- make improvements to management information systems.

51 The additional staff resources funded by HM Treasury increased the total staff complement to 1,095 for the 2004-05 financial year. At the start of the financial year, however, taking account of the working time lost due to training requirements, the debt management business was operating at only 77 per cent of the allocated number of staff. The position improved as the year progressed so that by March 2005 the business had 916 assigned staff on debt management activities, which was 84 per cent of the optimum staff complement.

52 The debt management units were given relatively short notice of the additional 150 staff that the business would have for the 2004-05 financial year; as a result some of the extra staff were not in post at the start of the year. The business tends to see a relatively high turnover of staff, particularly in the caseworker grade, because the skills acquired and training received on debt management work are readily transferable elsewhere in the Department so staff can easily move, often on promotion.

53 In 2004-05, staffing of the debt management units was a regional responsibility, not the debt management Functional Management Team. As a result, during 2004-05 some debt management units were unable to recruit staff even though they were below complement because of a freeze on recruitment due to surplus staff deployed on other tasks elsewhere in the region. The impact of this varied depending on the region; however some debt management units were particularly badly affected. For example, the number of caseworkers at the largest debt management unit was 20 per cent below complement for 6 months of the year. Looking to the future this kind of problem should not arise, because in HMRC debt management will be organised on a functional rather than a regional basis.

54 Staff responsible for VAT debt management can expect to see an increased workload during 2005-06 following the upgrade to the Departmental Trade Register and the results of the reconciliation exercise with the VAT Mainframe which will result in the notification of additional debt. The challenge will be to deal with this at a time when reductions in staffing are required to deliver agreed efficiency savings. Work is currently underway within the Department to identify the structure and staffing levels required.

Training and guidance

55 Recent years have seen the development and implementation of a comprehensive and structured training programme for debt management staff to ensure that they have the required knowledge and skills to deliver a professional debt management service. Key elements of this have included:

- The delivery of telephone pursuit training from a commercial market leader in the technique, introduced in 2003 which involved a five day training programme delivered to over 600 staff;
- A new course on financial and commercial awareness specific to debt management, designed to equip caseworkers with the necessary skills to become effective debt managers – the first of its kind in the Department;
- Each debt management site has a training manager responsible for supporting local trainees and assisting the Functional Management Team in the development and delivery of the national training programme;
- Guided learning units on debt management and related topics, designed to complement the formal training;
- In 2005-06 the VAT debt management area introduced an accreditation programme for debt management training; and
- In 2004 a management mentoring programme was delivered by a commercial training organisation at one of the debt management sites. Following very positive results it is intended to apply the lessons learnt in other debt management units in 2006.

56 Departmental guidance forms the backbone of the information available to debt management staff. Although those relevant to debt management had been updated in February 2005, aspects were out of date, including reference to legislation. The coverage given to some aspects was too brief given the importance and complexity of the subject, for example the guidance on suspended debt and write off. In order to address the latter point, a number of debt management units had developed their own local guidance on write offs.

57 Within the debt management business, there are a number of 'guided learning units' (training modules that can be used by staff new to the business), intended to complement the formal training programme. These have been developed by staff from the debt management business. The Department have not promptly updated the documents to reflect the impact of organisational change, leading to some confusion about the respective responsibilities of debt management units and new national teams. This also led to the inappropriate transfer of some cases from regional debt management units to the national teams responsible for missing trader and civil recovery work.

58 Although the Department addressed this specific point through the issue of new guidance towards the end of 2004-05, a number of the guided learning units are still out of date. For example the one on "introduction to the Debt Management Unit" was last updated in 2001.

59 There are disparities between the guided learning units with regard to the way they are written and their technical content. The document on suspended debt in particular was too simplistic given the nature of the subject. However, a number of the learning units were clear, comprehensive and well set out. These included the ones in specialised national units dealing with "Missing Traders" and "Civil Recovery Case Referrals".

Debt Management Performance

60 There are a number of factors relevant to assessing the Department's performance in managing debt:

- The Department's targets and results,
- Trends in reported debt levels over time;
- The impact of wider economic factors; and
- Overall picture on debt management performance.

The Department's Targets and Results

61 The Department's main objective is to reduce the VAT gap to less than 12 per cent by March 2006. To measure the progress of the VAT Compliance Strategy in delivering this, the Department have developed a number of top-level indicators. In 2004-05 the target for debt management was to restrict VAT arrears to no more than 2.06 per cent of a rolling 12 month VAT liability figure. The table below shows that the Department failed to meet this target in 2004-05 and, overall, in 3 of the 4 most recent financial years. With the exception of an improvement in 2003-04, the level of debt relative to the overall VAT liability is on an upward trend: see **Figure 4** below.

4 Performance against high level targets – monthly arrears as a percentage of liability

Year	Target	Outturn	Result
2004-05	2.06 per cent	2.32 per cent	Missed
2003-04	2.20 per cent	2.09 per cent	Achieved
2002-03	1.57 per cent	2.23 per cent	Missed
2001-02	1.41 per cent	1.95 per cent	Missed

Source: HM Revenue and Customs

62 The Department consider that this target is not an accurate absolute measure of overall performance for the debt management business. It is not solely a debt management measure as the level of VAT liability declared is outside the control of the debt management function. The level of monthly arrears, and therefore the percentage of debt relative to total VAT liability, is increasing due to the impact of measures taken elsewhere within HMRC as part of the VAT Compliance Strategy, for example through the identification of debt attributable to Missing Trader Intra-Community fraud. At the same time, however, recoverable debt has fallen, and cash receipts have increased.

63 The top level target is supported by four underlying national targets for the VAT debt management business; those for 2004-05 were set out in a Delivery Agreement for Customs' Regional Business Service division. The outturn against the 2004-05 targets is recorded in **Figure 5**, and shows that two of the four national targets were achieved, and two were not.

5 2004-05 performance against national targets

National Targets	Target	Outturn	Result
Debt cleared as a per cent of debt advised	101 per cent	100 per cent[6]	Missed
Reduce recoverable debt	£790m	£918m[7]	Missed
Debt paid as a per cent of collectable debt advised	72 per cent	78 per cent	Exceeded
"Spend to Raise" target for additional cash in the bank	£185m	£299m	Exceeded

Source: HM Revenue and Customs

64 The longer an amount is outstanding, the more difficult it becomes to collect. Targets 1 and 2 were, therefore, designed to provide the Department with a means of measuring the clearance rate for debt. Target 1 on debt clearance was missed, albeit by a small margin. Whilst the department has succeeded in reducing the level of recoverable debt outstanding, levels of suspended debt have increased. This debt is not immediately available for collection and clearance, contributing to the failure to meet the target.

6 Actual outturn 100.2 per cent.
7 See paragraph 65.

65 Performance in clearing recoverable debt has improved. However, as suspended debt accounts for a larger and larger proportion of total debt the Department will find it difficult to meet the target by increasing the collection rate for recoverable debt alone. It may, therefore, be appropriate to identify an alternative target to use so that the performance of the Department in managing the debt it is able to directly control can be assessed. Part of the reason for the failure to meet Target 2 on reducing the level of recoverable debt was that there was an unexpected increase of £72 million in debt, relating to recoverable debt not advised to the debt management business until late (March 2005) in the financial year.

66 Although targets 1 and 2 were missed, the 2004-05 position represented an improvement from the previous year. In particular, the level of recoverable debt as at March 2005 of £913 million represented a drop of nearly 9 per cent from the March 2004 figure of £1,001 million, and was 26 per cent below the March 2002 figure of £1,240 million.

67 The fact that targets 3 and 4 were met is a reflection of the fact that the debt management business was successful in translating debt advised into cash in the bank in 2004-05. The outturn of 78 per cent debt paid as a percentage of debt advised recorded under the third target is up from 68 per cent recorded in 2003-04. The provision of an extra 150 staff from April 2004 was specifically linked to delivery of the extra cash recorded as delivered under Target 4. In fact, money banked by Customs in 2004-05 as a result of debt management action was £2,417 million. This was £299 million more than that banked in 2003-04, representing an increase of 12 per cent in one year.

68 Compliance management is now a key aspect of debt management, an upgrade to the Departmental Trader Register planned for late 2005 should allow collection of management information which will allow the effect of compliance management work on debt to be assessed.

The Impact of Wider Economic Factors

69 When the NAO reported on VAT debt management 3 years ago, the then Chairman of Customs stated that the recent significant increases in VAT debt level should be interpreted in the context of wider economic factors which were beyond the control of Customs. For this review of debt management, and with the assistance of specialist consultants, we therefore identified the relevant external factors, estimated the contribution that these may have made to VAT debt levels and then sought to "correct" the reported levels of VAT debt accordingly.

70 The key step in the analysis is to estimate the contribution of external factors on the levels of VAT debt. To do this, we have used data on the levels of debt owing to local authorities in relation to national non-domestic rates. Business rates and VAT debt both relate to amounts owed by businesses to public bodies, both relate to the non-payment of liabilities that are incurred in the course of running a business and which can not be written off unless business operations cease. Therefore, we considered it reasonable to expect that both types of debt would be affected by similar external economic factors.

71 The role of economic growth and the number of new cases of company insolvency were considered as external factors as part of the analysis. Between 1998 and 2004 annual real growth varied around 2.5 per cent. The number of new cases of company insolvency in England and Wales remained relatively stable at around 5,000 cases each year. Analysis could only be performed on data up to March 2004 because the local authority data for later periods was not available.

72 The analysis excluded the effect of MTIC fraud on debt management performance, since the debt is unique to VAT and results from positive anti-fraud measures taken by the Department. Similar considerations apply to debt suspended pending the outcome of law enforcement investigations. Once debt has been adjusted for these, the level of VAT debt fell by 4 per cent from £1,849 million as at March 2002 to £1,767 million as at March 2005.

73 The ratio of VAT debt (excluding MTIC and law enforcement investigations) to receipts fell by 17 per cent between March 2002 and March 2004. Although this is welcome progress, the reduction in the ratio of debt to receipts came at a time of economic growth, and where business insolvency rates were comparatively low.

74 In the case of the performance of Local Authorities, after making an allowance for targeted debt management activities, the debt to receipts ratio fell by an estimated 19 per cent. If improvement was attributable to the performance of the wider economy, it may also imply that the Department's performance was aided by a positive economic climate.

Conclusion

75 In creating a single debt management and banking unit incorporating both Customs and Revenue debt management staff, HMRC is effectively forming the largest debt collection agency in the United Kingdom. Since the NAO last reported on the performance of debt management in Customs in 2001-02, the Department have successfully 'turned the tide' in respect of the collection of recoverable debt, where an additional £299 million was banked in 2004-05.

76 Overall debt, though, has continued to increase. This is primarily as a result of additional liabilities identified through the Department's compliance and anti-fraud activities that are not available for immediate recovery. Suspended debt, therefore, continues to be a challenge, even more so following the download of an extra £900 million of debt from the VAT Mainframe.

77 At present, debt management for VAT, the third largest tax stream for the new Department and accounting for almost 20 per cent of total gross receipts, continues to rely on legacy IT systems. We found that certain debt data had not been transferred from the VAT mainframe system to the Departmental Trader Register (the debt management case handling system) associated with the accounting for and the management of debt.

78 The Departments' own reconciliation work, indicates that the amount of un-notified debt as at March 2005, setting aside timing differences, was in the region of £900 million, £865 million of which was suspended. The Department have work in progress to address the issue by reconciling the VAT Mainframe and the Departmental Trader Register.

79 The reorganisation of the debt management business, and the creation of specialised national units to address particular types of debt has increased the Department's skills base and their capacity to process debt more quickly than before realising more cash. This has been supplemented by high quality, commercial style training.

80 The changes that the Department have initiated are still to bed in fully. For instance, the benefits that should have been delivered from the implementation of the National Business Model have yet to be fully realised. There continue to be inconsistencies between the ways in which individual debt management units process cases and check the quality of work done by staff. However, as the changes introduced bed in further the enhanced systems will help the Department to deliver performance improvements.

81 Looking to the future, HMRC will need to ensure that the redesigned debt management business operates an efficient, effective service, supported by appropriate technology. Obviously this will need to be considered in the context of the overall IT requirements for HMRC.

Recommendations

The National Audit Office recommends that:

- As long as the Department continues to use the existing systems the VAT Mainframe and the Departmental Trader Register should be reconciled on an on-going basis to ensure that all differences between the debtor balances in the two systems are valid. We understand from the Department that improved management information arising from the upgrade of the Departmental Trader Register may reduce the work required in future.
- The Department are removing inhibitors blocking the download of debt from the VAT Mainframe to the Departmental Trader Register. In future, the Department should ensure that, unless essential, nothing inhibits the notification of debt to the debt management business.
- The debt management business should urgently press ahead with their work already underway to enhance procedures for the monitoring of suspended debt. We consider that the arrangements being developed by the Large Debt Unit to improve liaison with Law Enforcement could be used as the basis for revised arrangements in other debt management units. We would expect enhanced procedures:
  - to clarify responsibilities, so that individuals are named as liaison points for suspended debt in Law Enforcement and debt management units;
  - to ensure efficient arrangements for the timely monitoring of cases;
  - to provide robust management information, including that necessary for performance measurement; and
  - to be supported by appropriate guidance and training.
- The debt management business should speed up the process for the write off once debt is deemed irrecoverable. This should include setting deadlines to escalate cases for senior management consideration if the debt management unit is unable to progress the case within a given timescale.
- The Department should ensure, in restructuring its debt management business, that a consistent standard of management assurance checking is applied across different locations.
- Performance reporting against targets for debt management units should be supported by readily available, reliable management information.
- In developing a new business structure for debt management in HMRC, the Department needs to consider carefully those areas where staff resources can be reduced whilst maintaining effective performance.
- HMRC should review their departmental guidance and the Guided Learning Units relevant to VAT debt management to ensure that references to legislation, policy, procedures and structures are up to date. The department should also update and enhance the guidance on suspended debt and write offs.
- Any departmental VAT debt management targets set should take due account of factors outside the control of the debt management business. In view of the specific issues associated with the management of suspended debt, which accounted for 64 per cent of total debt as at 31 March 2005, consideration should be given to measuring performance here under a separate set of targets to those used for recoverable debt.
- Once the Departmental Trader Register upgrade is complete, the Department should set targets to help assess the impact on debt management activities of work designed to deliver improvements in the future compliance of traders.
- The Department should compare their performance with appropriate public sector organisations in both the United Kingdom and internationally, as well as commercial debt collection agencies. The aim should be to review performance against that achieved by other debt recovery bodies to determine relative performance and compare collection practices.