House of Commons

Committee of Public Accounts

The operations of HM Customs and Excise in 2001–02

Twenty-first Report of Session 2002–03

HC 398

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Twenty-first Report of Session 2002–03

Report, together with formal minutes and minutes of evidence

Ordered by The House of Commons to be printed 12 May 2003

HC 398
Published on 12 June 2003
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Committee of Public Accounts

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Angela Eagle MP (*Labour, Wallasey*)

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Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/parliamentary_committees/committee_of_public_accounts.cfm. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Leslie Young (Committee Assistant) and Ronnie Jefferson (Secretary).

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1 Introduction

1. Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General to examine the accounts of HM Customs and Excise (Customs) to ascertain:

- that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out; and
- to examine the correctness of sums brought to account; and to report the results to the House of Commons.

2. On the basis of the Comptroller and Auditor General's Report,[1] the Committee took evidence from Customs on five main issues: the controls exercised over the storage and disposal of seized goods; the level of co-operation Customs receive from Imperial Tobacco in combating tobacco smuggling; the collection of revenue from traders; Customs' debt management performance; and the implementation of new money laundering regulations.

2 The storage and disposal of seized goods

3. Customs seize a range of goods, from tobacco and alcohol, to restricted items such as drugs and firearms. The amount of both smuggling and seizures has grown markedly since the mid 1990s. Until 1996 the Queen's Warehouses, operated by Customs' staff, were solely responsible for the storage and disposal of all seized goods. The Queen's Warehouses have continued to hold seized drugs and cash, but the rapid growth in smuggling led Customs to appoint a contractor to transport and store seized tobacco and alcohol. The original contract ran from 1996 until June 2002 when it was replaced by two contracts, one for transport and the other for storage.[2]

The recording and storage of goods

4. When Customs' officers seize goods they are required to enter the details and quantities involved on the computerised stock control system in the Queen's Warehouses. In certain circumstances, because of the risks involved or the limited space available, the Officers estimate the quantity of goods confiscated. After receipt into store the quantity is checked and compared with the seizing Officer's estimate. In the event of a discrepancy the computer record is amended. The system is not secure and staff could amend volumes and values of seized goods inappropriately. Customs acknowledged that there was a risk of theft

1 C&AG's Report, *HM Customs and Excise: Standard Report 2001–02* (Cm 5671)

2 C&AG's Report, paras 7.1, 7.19

or fraud at the point of seizure, but believed that once the goods were in store the risks were reduced because physical security was high.[3]

5. Customs' computer system replaced manual records in the Queen's Warehouses in 1998. Customs saw the introduction of a common, computerised, stock management system as a big advance. But it was not a full stock management system, and could not readily provide information on the total volume and value of items in the stores. Consequently, it was not well suited to the needs of the Warehouses. Furthermore, Customs' system recorded the quantities of cigarettes, or the volume of alcohol, whereas the Warehouse contractor's computer system recorded seized goods by the number of pallets. Data on the two systems could not therefore be readily reconciled.[4]

6. National Audit Office tests identified discrepancies between the Customs' computer records and the quantities of goods in the warehouses. In addition, nearly half the items examined had been held in store for over a year, well beyond the time when they should have been disposed of, and in some cases cash was being held which was no longer required for evidential purposes and which should have been banked. They also found that Customs had carried out only limited stock takes of items held.[5]

7. Customs acknowledged that the standards of record-keeping within the Warehouses had caused concern. In restructuring the Queen's Warehouse operation it had become overwhelmed. In introducing the computer system four years earlier they had not anticipated the growth in their seizures and the increased volumes the Warehouses would have to handle. The system came under intense strain and did not produce adequate management information prior to June 2002, when Customs placed a new storage contract.[6]

The disposal of goods

8. Seized alcohol, tobacco and drugs are disposed of under national agreements. Items such as counterfeit clothes, fuel and vehicles have been disposed of locally. But the Queen's Warehouses did not have written contracts for these disposals. One firm which Customs used frequently was not required to submit invoices for its work and was allowed to offset its costs against the proceeds of sales. Customs accepted that the staff should have known better, and that management of these arrangements had not been sufficiently professional. They assured us that this situation would not recur.[7]

9. In 2001 Customs' Internal Audit Division pointed to evidence that managers had failed to prevent and detect the possible misappropriation and unlawful selling of seized goods and had inadequate audit trails to enable the disposal and proceeds of sale to be verified. They also raised concerns over goods destined for disposal re-entering the market illegally. Customs recognised that this was a possibility, and acknowledged that there had been a couple of cases where goods destined for disposal had found their way back onto the

3 C&AG's Report, para 7.7; Q 17

4 C&AG's Report, paras 7.5–7.6

5 *ibid*, paras 7.8, 7.10–7.11

6 Qq 14, 16, 80

7 C&AG's Report, para 7.18; Qq 20, 137, 139

market. They had found the standards in the Queen's Warehouse organisation to be lower than they should have been, and accepted there had been management failure. But the reconciliation they had undertaken when transferring seized goods from the old contractor to the new during the summer of 2002 had shown that there was no widespread loss of goods. In addition, they were confident that goods were being disposed of properly under new contracts with approved disposal contractors.[8]

10. Customs said that they had needed time to fix the problems through a fundamental reorganisation. They had restructured the network to provide a centralised, fully functional system with fewer but more professionally managed Warehouses. In turn, the Warehouses were supported by a new contractor who could provide better stock management information.[9]

3 Co-operation from Imperial Tobacco in combating cigarette smuggling

11. In 2000–01 one half of all cigarettes smuggled into this country had been manufactured in the UK by the Imperial Tobacco Company and shipped to some rather unlikely export destinations. Customs did not consider that the company had been as cooperative in tackling smuggling as they would have expected, or as the other major tobacco companies. The Committee therefore took evidence from Imperial Tobacco in June 2002. Customs reported that since that hearing their discussions with the Company have been much more constructive and that there had been a step change in the level of cooperation they were receiving. They also reported that one of the Company's brands was no longer the market leader in smuggled cigarettes.[10]

12. Since our hearing in February 2003 Customs have provided a further progress report.[11] Despite improvements in Imperial Tobacco's export policies, they considered it premature to enter into a Memorandum of Understanding with the company until the improvements had been sustained. They undertook to come back to the Committee should they have further issues with Imperial Tobacco or any other company.[12]

8 C&AG's Report, paras 7.2, 7.17; Qq 3, 11, 14, 19

9 Qq 2, 10, 16

10 Q 81

11 Treasury Minute on the 1st to 3rd Reports from the Committee of Public Accounts, Session 2002–03 (Cm 5770)

12 Qq 85, 208–211

4 Collecting the right revenue from traders

13. Over recent years Customs have developed a risk management approach to the collection of revenue. They have drawn up annual business assurance models to target traders who present the highest risk. The models have used several factors to assess risk, such as the complexity of a trader's business, the results of previous visits by Customs' officers and the trader's payment history. Traders have been placed in specific risk groups and staff at regional offices use their detailed local knowledge to select individual traders for examination within each group. Rather than visiting the trader in every case to check that they are paying the correct amount of tax, Customs' staff may gain assurance in other ways, such as by telephone, to aid efficiency and reduce the burden on the trader.[13]

14. When conducting assurance visits Customs have relied on a number of techniques. For traders who routinely provide customers with VAT receipts, Customs' staff have made an assessment of the tax liability by comparing the trader's VAT return for the month with till rolls and other records. Where the trader has rarely given receipts to customers, such as take-away restaurants, Customs have applied other approaches, such as observing the trade conducted by the restaurant over a period as the basis of an assessment of the VAT liability. After producing one or two estimates in this way, Customs have been able to approach other take-away restaurants in the area with assessments of their VAT liability.[14]

15. During 2001–02 Customs identified underpayments of £2.5 billion in VAT and Excise through their assurance work, an increase of 5% on the previous year. Nevertheless, one half of all VAT registered traders in the UK, some 750,000, have not been visited by Customs' staff in the last ten years, and of these traders approximately 500,000 have never had their VAT position assessed in detail. And despite Customs' concentration on high risk traders, they carried out 22% fewer VAT visits to such traders than planned for the year. Similarly, only 77 of all planned Excise visits took place.[15]

16. Customs recognised that in visiting more of the difficult, non compliant, companies they had carried out fewer visits overall, and that they had not been making enough routine contact with traders to give them guidance. Following their internal reorganisation, and the adoption of a VAT strategy, the number of unvisited traders has already started to fall. Customs believed that by March 2005 the number unvisited would be approaching zero.[16]

17. Customs' VAT compliance strategy, published in November 2002, is aimed at tackling fraud across all parts of the VAT system, and aims to achieve overall outcomes rather than focussing on individual outputs. At the same time as producing their strategy the Department published estimates of the possible extent of fraud and evasion across VAT and the other taxes and duties. Customs estimated that in 2001–02 the amount of VAT not

13 C&AG's Report, paras 3.5–3.8

14 Qq 43–45

15 C&AG's Report, paras 3.2, 3.10–3.11, 3.21

16 Qq 33, 131

paid through error, evasion or avoidance was between £7.1 billion and £10.2 billion, with a further £7.1 billion unpaid in taxes and duties payable on alcohol, tobacco and hydrocarbon oils due to error, evasion or legitimate cross-border shopping. Customs have identified two major sorts of VAT fraud: large organised fraud which they believed was in the order of £2 billion; and smaller fraud which was more difficult to distinguish from simple error, negligence and suppression. The Treasury have provided Customs with funds for 900 extra staff to address the issues raised in their Strategy, and expect them to recover £1.4 billion extra VAT by 2005–06 as a result. Customs' own internal target is £2 billion.[17]

5 Customs' debt management performance

18. Traders are responsible for calculating and remitting to Customs the amount of tax they have to pay. Customs collected a total of £105 billion (net) in taxes and duties in 2001–02 in this way. But not all traders complied with their obligations, some paid late and some never paid. Customs' policy has been to take a constructive approach where businesses found themselves in short-term financial difficulties. They make an economic judgement as to whether deferment of tax would allow the trader to survive. But if necessary, they would let the business close in order to secure the tax.[18]

The reasons for increase in debt

19. Customs categorise debt in several different ways, but all categories have increased significantly with debt growing by some 55% during 2001–02.[19] Customs faced some 50% more debtors in that year than three years previously. Traders who in the past had sent in their payments at the same time as their declarations had recently been delaying the payment and gaining 30 days at Customs' expense. The largest increase in debt in 2001–02 was in routine recoverable debt.

20. Over the five years since March 1998 the total amount of debt owed to Customs increased more than threefold. Customs identified several reasons for this increase. They had been seeing record levels of tax liability, and as a consequence, debt to collect. They also had been successful in identifying large fraud-related liabilities following the introduction of their fraud strategies. And finally they had experienced changes in trader behaviour, as more of them challenged their assessments or appealed. These factors, combined, accounted for about one half of the increase in debt over the five year period. Customs mainly attribute the remaining increase to the economic slowdown, which had a direct impact on business and on the level of debt Customs had to manage.[20]

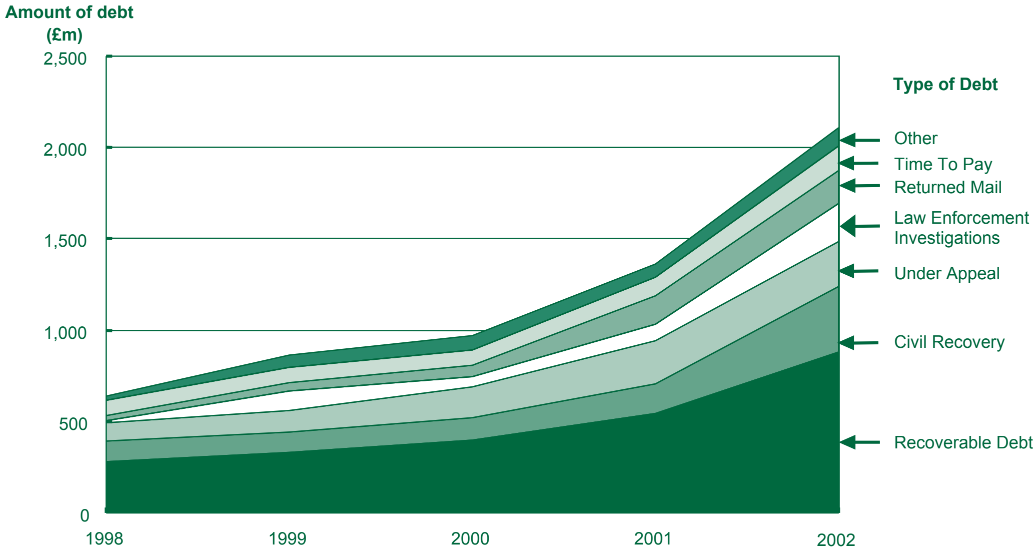
17 C&AG's Report, para 1.9; Qq 50, 87, 157–158

18 Qq 23, 98

19 C&AG's Report, para 6.3

20 Ev 23–24

Figure 1: The increase in Customs' debt since 1998



Source: Customs

21. Customs reorganised their debt management function during 2001–02, reducing the number of debt management units from 29 to 10 and creating a centralised civil recovery unit. The reorganisation sought to improve performance standards and deliver efficiencies. It involved large scale changes in information systems, manpower and accommodation. But IT changes designed to facilitate debt collection were delivered three months late, building refurbishment caused upheaval in the work of one of the largest debt management units, and delays in the recruitment and training of staff at all units affected the programme. The closure of some of the debt management units allowed Customs to achieve a reduction of 101 staff years, but at the cost of a further 128,000 unresolved debt cases at the year end. Customs believed, however, that the reorganisation had improved the effectiveness of debt collection and that they were collecting a higher proportion of debt than before the reorganisation.[21]

22. Customs' public service target for 2001–02 was to restrict debt owing to them to 1.41% of the total amount collected. They did not meet this target, and debt outstanding at the end of that year represented 1.95%. But they expected be very close to the target for the 2002–03 financial year. Customs said that a decrease in the overall debt figure could be a matter for concern, if it meant that they were not doing as much as they could in tackling fraud and collecting tax.[22]

The effect of missing trader fraud on Customs' debt

23. Customs attributed about 30 to 40% of the growth in debt in the year to missing trader fraud. In its simplest form this fraud is perpetuated by traders who sell goods at a VAT inclusive price, but who then disappear before paying over to Customs the VAT they had collected. But it can also be a highly organised type of fraud involving large numbers of buffer and artificial companies. The Department retained the debt on their records until

21 C&AG's Report, paras 6.7, 6.9, 6.15, 6.18; Qq 13, 129

22 C&AG's Report, para 6.1; Qq 199–200

the perpetrator had been caught and prosecuted, or until civil recovery action had been completed. In tackling this type of fraud Customs recently introduced a policy of denying VAT repayments to companies thought to be linked to the fraud. They had reduced repayments to certain industrial sectors to less than half of what it had been six months earlier, a decrease of £50 million to £100 million a month. But Customs recognised that they have to avoid penalising legitimate traders. They had also established specialist teams to recover assets from the directors of the companies involved. They had obtained assets to the value of £2 million by January 2003 and were working on the recovery of a further £47 million in cases before the courts.[23]

6 Implementation of new money laundering regulations

24. Under the Money Laundering Regulations 2001 Customs became the regulatory authority for those money services businesses not already regulated by the Financial Services Authority, namely bureaux de change (including Post Offices), money transmitters and cheque cashiers. The Regulations gave Customs powers to inspect premises in order to gain assurance that the businesses had appropriate controls and procedures to prevent money laundering. Customs were also given the power to impose civil penalties on traders who failed to comply with the Regulations.[24]

25. The Regulations became effective from November 2001, and by 1 June 2002 Customs had been able to process applications from more than 1,000 businesses. They believed that they had registered the vast majority of relevant businesses, and that by having increased access to data held by legitimate bureaux de change they were better able to track the financial flows involved in money laundering. They had encouraged their officers to identify unregistered premises, and the number of criminal prosecutions for money laundering had increased.[25]

26. Since the beginning of 2003 Customs have had powers under the Proceeds of Crime Act to seize any cash they believed to be linked to crime. They had seized some £1 million a week since the Act came into force, and intended to seize other assets, such as houses and yachts. The court process involved in confiscating goods could however be tortuous. Although alive to concerns about data confidentiality, Customs believed that tackling crime would be improved by sharing more data between agencies.[26]

23 C&AG's Report, paras 6.12–6.13; Qq 13, 51, 53, 190

24 C&AG's Report, para 2.13

25 *ibid*, paras 2.15–2.17; Qq 163–164, 168

26 Qq 52, 105, 202–204

Conclusions and recommendations

1. The seizure, storage, and disposal of goods and cash are essential functions of Customs, but carry risks of abuse, theft, and fraud. To mitigate these risks, the Department need rigorous management information based on meticulous record-keeping and stocktaking. Disposal of goods and banking of cash should be without delay, unless explicitly requested by an authorised officer for evidential purposes.

2. Where contractors are used for the storage and disposal of seized goods, their responsibilities should be clearly defined by contract, all transactions should be properly documented, and their records and those of the Department should be on a consistent basis so that they can readily be reconciled.

3. The Committee was able to assist the Customs in pursuing their concerns about the level of co-operation received from Imperial Tobacco in explaining why so much of the Company's product was being smuggled back into the United Kingdom. Customs report improved co-operation, evidenced by the Company's declining share of smuggled cigarettes. The readiness of Customs' Accounting Officer to work constructively with the Committee has produced positive results.

4. Customs have produced some striking estimates of the amount of VAT not paid through error, evasion and avoidance (£7 to £10 billion) and of unpaid taxes and duties on alcohol, tobacco and hydrocarbon oils due to error, evasion or legitimate cross-border shopping (£7 billion) in 2001–02. The Department are right to recognise the scale of the shortfall, and to focus their strategy on improving these outcomes. They should now establish milestones for improvement so that progress can be managed and assessed.

5. In planning visits to traders, Customs should have regard not only to the risk of fraud and evasion, but also to the wider risk of misunderstanding even by compliant traders, and the need for advice and guidance as well as enforcement activity. There is scope to increase revenue yield by visiting a significantly higher proportion of traders.

6. There are a number of reasons for the threefold increase in debt owing to Customs over the past five years, such as increased identification of tax liability, and less favourable economic conditions. The Department now need to show, however, that they can reverse the rising trend, in line with their Public Service Agreement targets.

Formal minutes

Monday 12 May 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Ian Davidson	Mr David Rendel
Mr Frank Field	Mr Gerry Steinberg
Mr Nick Gibb	Jon Trickett
Mr George Osborne	Mr Alan Williams

The Committee deliberated.

Draft Report (The operations of HM Customs and Excise in 2001–02), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 26 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-first Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No 134 (Select Committees (Reports)) be applied to the Report.

[Adjourned till Wednesday 14 May at 3.30 pm

Witnesses

Monday 3 February 2003 *Page*

Mr Richard Broadbent, Mr Mike Norgrove, and **Mr Ray McAfee CB,** HM Customs and Excise Ev 1

List of written evidence

1 HM Customs and Excise Ev 23

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Second Report	Dealing with pollution from ships	HC 119 *(Cm 5770)*
Third Report	Tobacco Smuggling	HC 143 *(Cm 5770)*
Fourth Report	Private Finance Initiative: redevelopment of MOD Main Building	HC 298 *(Cm 5789)*
Fifth Report	The 2001 outbreak of Foot and Mouth Disease	HC 487 *(Cm 5801)*
Sixth Report	Ministry of Defence: Exercise Saif Sareea II	HC 502 *(Cm 5801)*
Seventh Report	Excess Votes 2001–02	HC 503 N/A
Eighth Report	Excess Votes (Northern Ireland) 2001–02	HC 504 N/A
Ninth Report	The Office for National Statistics: outsourcing the 2001 Census	HC 543 *(Cm 5801)*
Tenth Report	Individual Learning Accounts	HC 544
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Fifteenth Report	Opra: tackling the risks to pension scheme members	HC 589
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Seventeenth Report	Helping victims and witnesses: the work of Victim Support	HC 635
Eighteenth Report	Reaping the rewards of agricultural research	HC 414
Nineteenth Report	The PFI contract for the redevelopment of West Middlesex University Hospital	HC 155
Twentieth Report	Better public services through call centres	HC 373
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The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number