Internal Audit Report

Key Financial Systems – VAT

29 January 2024

CS2305

Overall Assessment	Reasonable Assurance

Contents

This Internal Audit review is conducted for the City of Edinburgh Council under the auspices of the 2023/24 internal audit plan approved by the Governance, Risk and Best Value Committee in March 2023. The review is designed to help the City of Edinburgh Council assess and refine its internal control environment. It is not designed or intended to be suitable for any other purpose and should not be relied upon for any other purpose. The City of Edinburgh Council accepts no responsibility for any such reliance and disclaims all liability in relation thereto.

The internal audit work and reporting has been performed in line with the requirements of the Public Sector Internal Audit Standards (PSIAS) and as a result is not designed or intended to comply with any other auditing standards.

Although there are specific recommendations included in this report to strengthen internal control, it is management's responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the City of Edinburgh Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and elected members as appropriate.

Executive Summary

Overall opinion and summary of findings

There is a generally sound system of governance, risk management and control in place for managing VAT processes within the Council. The following issues and areas for improvement were identified, which if not addressed may put at risk the achievement of objectives:

- the VAT manual requires updating to ensure alignment to current VAT requirements, systems and organisation structures
- issues identified in processing Financial Insurance invoices should be rectified and processes implemented to prevent re-occurrence
- simple guidance to support services to process Output VAT accurately and handover arrangements to ensure continuity of operations should be considered
- Input VAT procedures should be updated to reflect current operations and systems.

Areas of good practice

- controls developed by the Corporate Finance teams are well-designed, with comprehensive procedure notes available.
- the Corporate Finance team approves the VAT returns for submission to HMRC, controls are in place to address concerns and maintain data accuracy
- system procedure notes and comprehensive training is in place for the new Oracle R12 system
- there is extensive knowledge and experience within Banking and Payment Services to enable them to determine and contest the VAT codes, and with controls to reject invoices if services fail to comply with HMRC's VAT requirements
- all paid and received invoices are retained for filing purposes for more than six years as per HMRC requirements.

Audit Assessment

Audit Area	Control Design	Control Operation	Findings	Priority Rating
1. Oversight, governance, and performance monitoring	🟠	🟠	Finding 1 – VAT manual and guidance updates	Medium Priority
	🟠	🔴	Finding 2 – Financial Insurance (FI) Invoices	Medium Priority
2. Capturing Input/Output VAT	🟠	🟠	Finding 3 – Guidance materials and handover arrangements	Medium Priority
	🟢	🟠	Finding 4 - Input VAT procedures	Low Priority
3. Processing of VAT return	🟢	🟢	Finding 5 - Recording exceptions / issues	Advisory

See Appendix 1 for Control Assessment and Assurance Definitions

Internal Audit Report: CS2305 Key Financial Systems – VAT

Background and scope

The [Value Added Tax Act 1994](#) is a UK tax law concerning taxation of goods and services that fall within the scope of Value Added Tax (VAT). VAT applies to most transactions in which the Council is involved, whether purchasing (Input VAT) or supplying goods and services (Output VAT). The difference between the input and output VAT is either paid to or reclaimed from HMRC. The total net recovery from HMRC for the Council in 22/23 was £105.6 million.

The Council's [Financial Regulations](#) and [Finance Rules](#) set out the roles and responsibilities concerning VAT. Due to making both taxable and exempt supplies and incurring input VAT on both kinds of supply, the Council is 'partly exempt' for the purposes of VAT. This requires a calculation to determine how much input tax can be recovered. If HMRC partial exemption thresholds are exceeded for VAT recovery, then the entire amount of VAT reclaimed on exempt activity must be repaid.

It is therefore imperative that VAT is correctly charged on the supply of goods and services and that VAT details are accurately recorded for all purchases to allow the accurate preparation of the VAT return and for thresholds to be monitored. If transactions are treated incorrectly or returns are delayed, then penalties could be applicable.

The Corporate Accounts Team is responsible for preparing and submitting the monthly return to HMRC and is the key point of contact for VAT queries for officers. The Council's VAT registration includes the administration of VAT for several other related organisations, including the Lothian Valuation Joint Board, Trust Funds, Lothian Pension Fund, and SEStran.

Scope

The objective of this review was to assess the adequacy of design and operating effectiveness of the key controls established to ensure the accurate processing and recording of VAT transactions, as well as management of the Council's VAT calculations and returns.

Risks and Business Plan Outcomes

The review also provided assurance in relation to the following Corporate Leadership Team (CLT) risks:

- Financial and Budget Management
- Regulatory and Legislative Compliance
- Service Delivery

[Business Plan Outcomes:](#)

The Council has the capacity, skills, and resources to deliver our priorities efficiently, effectively and at lower cost.

Limitations of Scope

The process for reclaiming Input VAT on purchases made via Purchase Cards was excluded from scope, as a [review of purchase cards](#) was completed in November 2022

Reporting Date

Testing was undertaken between October 2023 to December 2023

Our audit work concluded on 18 December 2023, and our findings and opinion are based on the conclusion of our work as at that date.

Findings and Management Action Plan

Finding 1 – VAT manual and guidance updates

Finding Rating	Medium Priority

The Council's Financial Regulations set out the overarching responsibility for identifying and accounting for input and output tax, while the Finance Rules provide further detail on the roles, responsibilities, and the broad approach to VAT across the Council. Operationally, these documents are supported by the VAT Manual, which is available on the Orb and has been prepared by the Corporate Finance team to assist services in properly treating VAT on the invoices received (Input VAT) and the charges services make (Output VAT).

Our testing confirmed that the Corporate Finance Team issues guidance documents to relevant Heads of Service and Budget Holders, outlining changes to VAT legislation when they occur, and the action services should take to correctly treat specific transactions for example: Domestic Reverse Charging for Building and Construction Services and Property VAT. It was noted that this guidance is not reflected in the published VAT Manual, which has not been updated since 2019. Officers have advised the VAT manual is currently under review.

We also noted that key changes in VAT legislation and their impacts have not been captured in the published manual, including changes to the Single Market rules and Making Tax Digital. Officers advised that some of these changes have limited impact on processing of VAT for Council officers.

It is also noted that the VAT manual requires updating to reflect the current organisational structure of the Council including directorates/divisional titles and current systems (including R12 and Apex), and no version control table or date of next revision noted within the document.

Risks

- **Service Delivery:** outdated policies, procedures, and guidance could lead to inconsistent practices and errors. As a result, we may also have ineffective training and onboarding of new staff, and a lack of succession/contingency planning.

- **Regulatory and Legislative Compliance:** out of date guidance documents up to date could lead to non-compliance with relevant VAT legislation. This could result in penalties, fines, or other sanctions by HMRC.

Recommendations and Management Action Plan: VAT manual and capturing VAT changes

Ref.	Recommendation	Agreed Management Action	Action Owner	Lead Officers	Timeframe
1.1	Review of the VAT Manual should be completed as soon as possible, with consideration of the issues raised to ensure it is up to date, complete,	Updated manual, taking account of all audit points raised will be published on the Orb as soon as possible.	Service Director Finance and Procurement	Principal Accountant Corporate Accounts	31/03/2024

Internal Audit Report: CS2305 Key Financial Systems – VAT

				Senior Accountant Corporate Accounts	
1.2	A process should be implemented to ensure emerging changes in VAT legislation, systems, and organisational structures are reflected in the VAT Manual, so that it remains current going forward. The VAT Manual should also be subject to routine review (e.g. annually) to ensure it is up to date and accurate. Changes to the document should be summarised in a version/change control table at the front of the document with reference to the appropriate section to allow officers to easily see recent changes. In addition, consideration should be given to further developing the Orb VAT page to make available guidance provided to services throughout the year on relevant changes accessible in one place for reference when required.	The VAT Manual will be reviewed at least annually and updated as appropriate taking into account the issues raised by the audit recommendation. A version control table will be added to the manual, highlighting the timing and outcome of these reviews, with any resulting changes summarised. The VAT page on the Orb will be updated with significant guidance changes highlighted in conjunction with updating the VAT manual.	Service Director Finance and Procurement	Principal Accountant Corporate Accounts Senior Accountant – Corporate Accounts	31/03/2024 At least annual review of content of manual and Orb page content

Finding 2 – Financial Insurance (FI) Invoices

Finding Rating	Medium Priority

Internal Audit completed an audit of Key Financial Systems - Debtors in December 2023 which highlighted an issue raised in September 2022, where a VAT calculation error was identified by Finance which has affected invoices issued under the debt type Financial Insurance (FI), which relates to insurance charged to commercial tenants.

This issue has been investigated by Finance and, at the time of completion of the VAT audit, it had been determined that around 400 invoices have been affected, with a total financial value of circa £35,000 having been overpaid by tenants in relation to VAT and circa £8,000 having been underpaid by tenants in relation to VAT, as per regulations, this covers four years of invoices from January 2020.

Officers advised the issue was highlighted due to a change in personnel in the Insurance Team which led to a query of the VAT rules, resulting in a recognition that some customers had historically been billed VAT in error while others were not billed VAT when they should have been. It is understood there were written procedures/handover notes to support this work, however the information provided was not in line with regulatory and legislative compliance.

Findings in relation to the specific error volumes and value have been raised in the Debtors audit report and are not raised here to avoid duplication. However, a recommendation in relation to procedures and handover processes is raised in this audit at Finding 3.

Risks

- **Financial and Budget Management –** inaccurate invoicing may prevent maximum VAT being recovered.
- **Regulatory and Legislative Compliance** – invoices raised may not be compliant with relevant VAT requirements.

Finding 3 – Guidance materials and handover arrangements

Finding Rating	Medium Priority

Training and guidance materials support an effective internal control environment. Whilst there is the overarching VAT Manual available, and there is guidance available on the Orb and e-learning for the new debt management system (Apex) which is used for creating invoices, discussions with officers in services who process invoices highlighted that clearer guidance to enable understanding of specific VAT treatments would be beneficial.

The Corporate Accounts Finance team carry out VAT checks on invoices on over £5,000 which do not have VAT included, therefore errors below this threshold may go undetected. It is recognised that due to the volume of lower-level transactions a full review is not feasible, however adequate guidance and support should be available. Management advice that details are provided in the manual and supporting guidance and Finance can be contacted for support as needed.

In addition, there is a need for services to ensure there are adequate handover notes and training within teams to ensure continuity in operations when there is a change of personnel and prevent services from choosing incorrect VAT codes when billing customers.

Risks

- **Financial and Budget Management -** lack of clear guidance resulting in errors leading to inaccuracies in VAT recovery
- **Regulatory and Legislative Compliance** – invoices raised may not be compliant with relevant VAT requirements.

Recommendations and Management Action Plan: Guidance, training and handover arrangements

Ref.	Recommendation	Agreed Management Action	Action Owner	Lead Officers	Timeframe
3.1	Following update of the VAT manual and supporting procedures as set out in this report, communications should be issued to officers in services who are responsible for processing Output VAT to request they review the updated VAT Manual, supporting procedures and guidance and to complete any relevant systems training. In addition, the communication should remind services to ensure that adequate contingency, handover, and training arrangements are in place to ensure that VAT continues to be processed accurately when there is a change in personnel or absence of a key individual.	Agreed. Communications will request officers review the updated manual procedures and guidance, and that they ensure that they have completed any relevant system training. Communications will also remind services of their responsibilities to ensure there are adequate contingency and handover arrangements in place to maintain processing of Output VAT as required.	Service Director Finance and Procurement	Principal Accountant Corporate Accounts Senior Accountant Corporate Accounts	31/03/2024

Finding 4 – Input VAT procedures

Finding Rating	Low Priority

Fieldwork included a review of relevant in-house procedures including the VAT Return procedure prepared by Corporate Finance and the Accounts Payable Manual prepared by Banking and Payment Services.

It was noted that the VAT Return procedure was last updated in December 2023, and includes comprehensive operational information and guidance for officers on the VAT Return. It was noted however, that the document did not include a version control table or owner which supports officers understanding recent changes and who to contact if there are any queries.

The Accounts Payable Manual was last updated in 2011, however it is recognised the Council has been progressing the upgrade of the Oracle Financial System (v11 to R12) since 2018, which was recently completed in October 2023. The Banking and Payment team has prepared updated guidance for R12 and Mi invoicing which they advise will be incorporated into the updated Accounts Payable Manual.

Risks

- **Service Delivery:** outdated policies, procedures, and guidance could lead to inconsistent practices and errors. As a result, we may also have ineffective training and onboarding of new staff, and a lack of succession/contingency planning.

- **Regulatory and Legislative Compliance:** out of date guidance documents up to date could lead to non-compliance with relevant VAT legislation. This could result in penalties, fines, or other sanctions by HMRC.

Recommendations and Management Action Plan: Input VAT procedures

Ref.	Recommendation	Agreed Management Action	Action Owner	Lead Officers	Timeframe
4.1	The Accounts Payable manual sections for input VAT should be updated to bring together the relevant processes for MI invoicing and Oracle R12. Once updated the document should be circulated to relevant officers. The procedure document should also include version/change control, date of update and an annual review/sense check should be undertaken annually to ensure it remains up to date and accurate.	Agreed. The relevant sections of the Accounts Payable manual will be updated and communicated to relevant officers within Banking & Payment Services. The document will include version control and be subject to annual review/sense check to ensure it remains up to date.	Service Director – Customer and Digital Services	Head of Customer Services Transactions Team manager – Banking and Payment Services	31/03/2024

4.2	The VAT Return procedure document should be updated to include version/change control, date of update and owner and an annual review/sense check should be undertaken annually to ensure it remains up to date and accurate. Once updated, the document should be circulated to relevant officers.	The VAT Return procedure will be updated to include a version control table and other details recommended, which will be circulated to relevant officers	Service Director Finance and Procurement	Principal Accountant - Corporate Accounts Senior Accountant - Corporate Accounts	31/03/2024

Finding 5 – Recording exceptions / issues

Finding Rating	Advisory

During audit fieldwork, we reviewed controls in place for recording and monitoring exceptions or issues identified from processing the Council's VAT return. Officers advised that historically the number of exceptions or issues identified is of low volume, therefore no exceptions log is currently in place for either Banking and Payment Services or the Corporate Finance team.

Banking and Payment Services have advised that the new R12 system will operate differently and there will be system-based control which includes a rejection process for incorrect invoices, and exception log to track rejections will be of use.

Appendix 1 – Control Assessment and Assurance Definitions

Control Assessment Rating		Control Design Adequacy	Control Operation Effectiveness
Well managed	🟢	Well-structured design efficiently achieves fit-for purpose control objectives	Controls consistently applied and operating at optimum level of effectiveness.
Generally Satisfactory	🟢	Sound design achieves control objectives	Controls consistently applied
Some Improvement Opportunity	🟠	Design is generally sound, with some opportunity to introduce control improvements	Conformance generally sound, with some opportunity to enhance level of conformance
Major Improvement Opportunity	🔴	Design is not optimum and may put control objectives at risk	Non-conformance may put control objectives at risk
Control Not Tested	**N/A**	Not applicable for control design assessments	Control not tested, either due to ineffective design or due to design only audit

Overall Assurance Ratings	
Substantial Assurance	A sound system of governance, risk management and control exists, with internal controls operating effectively and being consistently applied to support the achievement of objectives in the area audited.
Reasonable Assurance	There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified which may put at risk the achievement of objectives in the area audited.
Limited Assurance	Significant gaps, weaknesses or non-compliance were identified. Improvement is required to the system of governance, risk management and control to effectively manage risks to the achievement of objectives in the area audited.
No Assurance	Immediate action is required to address fundamental gaps, weaknesses or non-compliance identified. The system of governance, risk management and control is inadequate to effectively manage risks to the achievement of objectives in the area audited.

Finding Priority Ratings	
Advisory	A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.
Low Priority	An issue that results in a small impact to the achievement of objectives in the area audited.
Medium Priority	An issue that results in a moderate impact to the achievement of objectives in the area audited.
High Priority	An issue that results in a severe impact to the achievement of objectives in the area audited.
Critical Priority	An issue that results in a critical impact to the achievement of objectives in the area audited. The issue needs to be resolved as a matter of urgency.