Do they add up?

A review of the quality of tax information in the accounts of the FTSE 50

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Note: An explanation of technical terms used in this report can be found in 'Mind the Tax Gap' available from www.thetaxgap.com

Publishing Information

Published by
The Tax Gap Limited
150 Beresford Road
Ely Cambridgeshire
CB6 3WD

T: 01353 645041
E: info@thetaxgap.com
W: www.thetaxgap.com and www.taxjustice.net

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Thanks

A publication of this sort cannot be produced without the help and assistance of a great many people.

Richard Murphy of Tax Research LLP was the primary researcher of this work on behalf of The Tax Gap Limited.

John Christensen of the Tax Justice Network offered help, support, encouragement and advice during the production of this report. Mike Lewis provided much help in copy editing.

Numerous people within many development and commercial organisations have also offered help and support during the course of this project. They are too numerous to mention individually.

Any errors and omissions that remain within this report are the sole responsibility of The Tax Gap Limited.

Important note

No comment, data or other information in this report suggests that any company to which it refers, or any officer of any such company or any auditor to those companies has in any way acted illegally. The Tax Gaps to which this report refers are all presumed to arise because of the use of legal tax avoidance methods.

Key Findings

'Mind the Tax Gap'

In January 2006 we published 'Mind the Tax Gap', the first statistically rigorous attempt to measure the size of the UK's 'Corporation Tax Gap': the difference between the expected rates of tax that UK companies should pay and the tax that those companies have actually paid. This was done by examining the published accounts of the UK's 50 largest companies over 5 years from 2000 to 2004.

'Mind the Tax Gap' shows that there is an increasing 'expectation gap' in the corporation tax paid by the UK's 50 largest companies:

1) These 50 companies have paid an average of 5.7% less corporation tax than expected from 2000 to 2004;

2) This expectation gap increased from 4.2% in 2000 to 7.6% in 2004;

3) Over 5 years, these companies have thus paid £20 billion less tax on their profits than expected rates would suggest appropriate;

'Mind the Tax Gap' can be downloaded from
http://www.taxjustice.net/cms/front_content.php?idcat=8&lang=1&client=1

Testing the reliability of the data

While undertaking work on 'Mind the Tax Gap' it was obviously important to establish the reliability of the data we were using. Audited accounts should be reliable. We wanted to see if there was evidence to support that conclusion.

We designed two tests to check this. Both, we stress, use nothing but the data within the accounts themselves. The first test monitored the 'prior year adjustments' that companies are required to disclose each year with regard to the current taxation charges they have declared in previous years: these are a statement of the changes made to those declared tax liabilities since the accounts were issued. It seemed obvious that the lower the rate of these adjustments the more reliable we could believe the underlying data within the accounts to be.

The second test was equally straightforward. We simply checked to see if the accounts for each company for each year added up. The addition test was a simple one. We took the corporation tax declared to be due at the start of the year, added to that the current tax charge for the year, and subtracted the tax paid. It is reasonable to expect that the resulting answer should be the tax due at the end of the year. In fact, this was almost never the case.

So significant were our findings that we have issued this separate report on our finding.

Results – prior year adjustments

The first test revealed surprising results. The absolute value of prior year adjustments with regard to current taxation for the sample companies in aggregate were as follows:

Table 1

Absolute value of prior year adjustments

	2000	2001	2002	2003	2004	Total
	£m	£m	£m	£m	£m	£m
Total	333	927	1,426	1,411	1,758	5,854
Number of companies reporting an adjustment	26	31	42	41	43	
Average adjustment	13	30	34	34	41	32

The table makes clear that:

1. the number of companies reporting a prior year adjustment increased over the period until it became normal to do so, with over 80% of the sample reporting adjustments in each year from 2002 onward;
2. the absolute value of prior year adjustments increased dramatically over the period;
3. the average value of prior year adjustments increased significantly.

As the report also shows, by the most conservative of our estimates (which excluded those companies with very high adjustments and those four companies who report no adjustments), the average adjustment rate was 3% on 2000. It was 10.7% in 2004 and averaged over 7% throughout the period.

Auditors normally think a mis-statement of 5% is significant within a set of accounts. On this basis, on average the declared current tax liabilities of the companies subject to this survey were materially wrong from 2001 onwards.

Results by auditor

We also tested to see if the adjustment rate varied significantly depending upon which auditor a company used.

On average, and again excluding exceptional cases, we found that they did. The average restatement by auditor was:

Table 2

Firm	No. of companies	Adjustment rate
PricewaterhouseCoopers	22	6.7%
KPMG	13	7.3%
Deloittes	3	11.5%
Ernst & Young	2	8.0%
Total	40	

Deloittes sample base was low since five of the eight companies they audited within the FTSE 50 were eliminated from these results either for having an exceptionally high adjustment rate or for not reporting any adjustments at all. The average adjustment rate is above the 5% rule of thumb for materiality in the case of all of the firms surveyed.

Results – do they add up?

In simple summary it has to be concluded that the accounts of the FTSE 50 do not add up when it comes to disclosure of tax information:

- In just five sets of accounts (2.1%) does the tax account balance without seeking reconciliation from other sources (BAA manage this three times, Marks & Spencer once and Associated British Foods once).
- In only 36 out of 238 sets of accounts (15%) is the difference less than £10 million.
- In 149 sets of accounts (62.6% of the sample) the difference is more than 5% of the current tax charge.

Explanations can be offered, but none can explain what is happening with any certainty or confidence.

Is this outcome inevitable?

As was the case with 'Mind the Tax Gap' the sample results were compared with those of the Co-operative Bank. The Co-operative Bank had average prior year adjustments of 1.2% of its current tax charge. Its tax equation added up in 2 out of five years. In the three years when it did not the difference was £0.1 million, the smallest unit of measure used in its accounts. This suggests the differences were due to rounding.

Conclusions

The findings of this report are worrying. They suggest that there must be real doubt about the reliability of the tax data disclosed in the financial statements of the largest companies in the UK.

More than 80% of tax charges disclosed have to be restated the following year. The average restatement exceeded 10% in 2004 when, as a rule of thumb a misstatement of 5% is considered significant with regard to any figure in a set of accounts.

No auditor commented upon the prior year adjustments within the accounts on which they reported even though all issued reports on accounts that appear to include material adjustments. The absence of such comment raises questions about whether auditors are as alert to these issues as they should be.

At least 62% of the accounts in question cannot be shown to add up, with the apparent difference exceeding 5% of the current tax charge. The result is that in the period surveyed £6.2 billion of current tax charges included in profit and loss accounts do not appear to have resulted in tax being paid.

These figures require further explanation from the companies involved, since the data they publish cannot provide those explanations. Only improved accounting disclosure can overcome this deficiency. This issue needs to be addressed by all the companies covered by this survey. As long as differences as large as those shown here continue, there must be real doubt as to the accuracy of their tax reporting.

Valuation

Overall, our testing of prior year adjustments shows that £4.5 billion of tax expected to be paid during the survey period was not settled. Of this sum £1.6 billion arose in 2004. In addition, testing the arithmetic accuracy of the accounts suggests a further £6.2 billion of tax reported to be due was not paid, of which £3.6 billion arose in 2004. It is important to note that these figures do not relate to the same issues.

'Mind the Tax Gap' suggested that the Corporation Tax Expectation Gap in 2004 for the companies surveyed was £7.7 billion. To this should be added the £5.2 billion identified in this report for 2004. This makes the Tax Gap for these 50 companies in that year a total of £12.9 billion: some 37% of their declared liabilities of £34.5 billion in that year.

How reliable are these numbers?

'Mind the Tax Gap'

In January 2006 we published 'Mind the Tax Gap', the first statistically rigorous attempt to measure the size of the UK's 'Corporation Tax Gap': the difference between the expected rates of tax that UK companies should pay and the tax that those companies have actually paid. It does this by examining the published accounts of the UK's 50 largest companies over 5 years from 2000 to 2004.

'Mind the Tax Gap' shows that there was an increasing Expectation Gap in the amount of corporation tax paid by the UK's 50 largest companies:

1) These 50 companies have paid an average of 5.7% less corporation tax than expected rates from 2000 to 2004;

2) This 'Expectation Gap' increased from 4.2% in 2000 to 7.6% in 2004;

3) Over 5 years, these companies have thus paid £20 billion less tax on their profits than expected rates would suggest appropriate;

4) In 2004-5 alone this estimated 'Expectation Gap' constituted around £4.6 billion in lost tax revenue from these 50 companies (calculating that 60% of the tax was due in the UK);

5) Extrapolating across all UK companies, the likely total UK 'Expectation Gap' may be as much as £9.2 billion a year: about 28% of corporation tax receipts in 2004-05. This lost corporation tax revenue is larger than the equivalent 'VAT Gap' (estimated by HM Revenue & Customs at around 16% in 2002);

6) While the UK's VAT Gap appears to be decreasing, its Corporation Gap is increasing.

'Mind the Tax Gap' can be downloaded from
http://www.taxjustice.net/cms/front_content.php?idcat=8&lang=1&client=1

How reliable was the data?

Producing 'Mind the Tax Gap' involved the collection of an enormous amount of data from the accounts of the 50 companies surveyed. Details of the companies involved can be found in Appendix 1 to this report. One of the obvious questions we asked was: 'how reliable is the data we have collected'

Two methods of testing

We created two methods of testing tax reporting in the financial statements of the companies we surveyed. Both only used data disclosed in the accounts themselves.

Method 1 Assessing prior year tax adjustments

The tax charge in a set of UK accounts is unique in being the only number where an adjustment found to be necessary to a prior year's disclosure must be corrected in a subsequent period. As a result companies have to disclose their prior year adjustments with regard to tax. Based upon the experience of the research team as practising accountants, it was expected that these adjustments would be:

1. modest in amount;
2. likely to be of neutral impact over time i.e. positive and negative adjustments would likely be of broadly equal value;
3. of persistently low value over time.

This expectation was based on the following assumptions:

a. companies, and their auditors would wish these figures to be as accurate as possible;
b. any adjustments would not reflect "after the event" tax planning but would instead reflect the replacement of reasonable estimates made in the course of preparing figures for disclosure in the accounts, with the actual figures presented to tax authorities;
c. the quality of those estimates would be of a persistently high level and the rate of adjustment would therefore be consistent over time.

Method 2 Do the accounts add up?

The second method is simple: to determine whether the accounts add up. Any accountant will agree that if one knows the opening tax liability in a set of accounts, the tax due for the current period (having allowed for prior year adjustments), and the actual amount of tax paid, then if you add the tax due onto the opening balance, and subtract the tax paid, the resulting figure should be the tax due at the end of the period. We even asked FTSE tax directors if they thought this would be true. They agreed it should be the case. So we tested this using the data we had collected.

This report concerns the findings from these two tests of reliability.

Method 1: Assessing Prior Year Tax Adjustments

Why prior year tax adjustments arise

There are good reasons why prior year tax adjustments occur:

1) The provision for tax included in a set of accounts can rarely be prepared until the audit of the company involved is almost complete. There is then something of a rush to complete work on calculation of the estimated tax charge. This rush can mean that some data is not analysed in as much detail as might be required before tax returns are submitted.

2) This rush might also mean that some opportunities for tax planning are overlooked and only come to light when more detailed work is undertaken after the audit is signed off and before tax returns are submitted - usually several months later.

As a result prior year adjustments are, to some extent, an inevitable part of the tax accountant's life.

What we expected prior year adjustments to be

Based upon the experience of the research team as practising accountants it was expected that these adjustments would be:

1. modest in amount;
2. likely to be of neutral impact over time i.e. positive and negative adjustments would be likely to be of broadly equal value;
3. of persistent low value over time.

This expectation was based on the following assumptions:

a. companies, and their auditors would wish these figures to be as accurate as possible;
b. any adjustments would not reflect "after the event" tax planning but would instead reflect the removal of reasonable estimates made in the course of preparing figures for disclosure in the accounts;
c. the quality of those estimates would be of a persistently high level and the rate of adjustment would therefore be consistent over time.

Current and deferred tax prior year adjustments

Prior year adjustments can relate to current tax charges and deferred tax charges. For the purposes of this review only those relating to current tax charges have been considered.

This is because deferred taxation charges are highly subjective and the assumptions on which they are based can quite reasonably change from year to year e.g. because of changes in law, taxation rates or trading prospects. As such prior year adjustments in deferred taxation charges are to be expected.

Prior year adjustments with regard to current taxation are substantially more objective, because:

1) The law regarding the tax liability applying to the accounts should, in most cases, have been known at the time the charge was prepared;
2) The profit on which the tax should be due has been finalised when the tax figure is calculated;
3) The tax rate which should apply to those profits is known.

Any adjustments are therefore much more likely to reflect:

1) Haste in preparation;
2) Insufficient attention to accuracy;
3) Amendment arising as a result of tax planning whose validity had yet to be

proven at the time that the financial statements were approved;
4) Policy decisions with regard to disclosure to be made.

Current taxation charge disclosure is also appropriate for review because the Expectation Gap which was the primary focus of 'Mind the Tax Gap' is a current taxation issue.

Which prior year tax adjustment?

In company accounts, prior year tax adjustments with regard to the current tax charge can be noted in two places. The first is within the note to the accounts which explains the profit and loss account charge for the period. This is the logical location for such information.

Not all companies that have prior year adjustments to their current taxation charges report them in the note to their profit and loss account. Some instead report them only as part of their reconciliation of the current year tax charge. GlaxoSmithKline is an example of a company that adopts this second option.

If there is a change to the current year tax charge in the profit and loss account as a result of a prior year adjustment which has been declared in the note to the profit and loss account it would always be logical for it to also be disclosed in the current year tax reconciliation. This does not always follow, somewhat to our surprise. Lloyds TSB Group is an example of a company where this is not done.

We would assume that if a disclosure of an adjustment is to be made in both the note to the profit and loss account and the tax reconciliation then the figures disclosed should be the same. They are, for example consistently the same from 2002 onwards in the case of Royal Bank of Scotland and AstraZenecca. They are never the same throughout that period in the case of HSBC, with additional inconsistency as to which is greater or smaller in that case.

Because of these inconsistencies in presentation we have:

1) Sought to identify current taxation prior year adjustments wherever they might be reported;
2) Assumed that the largest reported adjustment in a period is the correct one, for the purposes of this report, if two figures are offered.

We believe substantial improvement in the presentation of this data is needed in the case of some FTSE 50 companies. We would suggest that the data should always be in the notes to the profit and loss account, and that the data should always be consistent with that in the tax reconciliation, or else a note should be provided to explain the difference.

Aggregate findings

The absolute value of prior year adjustments with regard to current taxation for the sample companies as a whole (with positive and negative figures therefore all being treated as having positive value) were as follows:

Table 3

Absolute value of prior year adjustments

	2000	2001	2002	2003	2004	Total
	£m	£m	£m	£m	£m	£m
Total	333	927	1,426	1,411	1,758	5,854
Number of companies reporting an adjustment	26	31	42	41	43	
Average adjustment	13	30	34	34	41	32

The table makes clear that:

1. the number of companies reporting a prior year adjustment increased over the period until it became normal to do so, with over 80% of the sample reporting adjustments in each year from 2002 onward. Less than 60% did in 2000;
2. the absolute value of prior year adjustments increased over the period;
3. the average value of prior year adjustments increased over the period.

Positive and negative adjustments

As is noted above, this data assumes all prior year adjustments have a positive value. Prior year tax adjustments with regard to current taxation liabilities can in fact be either negative or positive. In other words, the tax liability of a prior year can be increased or decreased on subsequent review. For the purposes of the analysis in this report all adjustments have been considered to have a positive value i.e. they are not netted out one against another.

This approach is statistically valid. A set of accounts is meant to provide a true and fair view by itself and not as part of a series of reports. An adjustment, whether positive or negative, is therefore a restatement of a prior year whatever its value and as such they can be aggregated.

It is however also interesting to note that:

1) there were 183 prior year adjustments noted in the 238 sets of accounts covered by this survey (77%).
2) 44 adjustments were positive i.e. an increase to liabilities (24%)
3) 139 adjustments were negative (a reduction in prior stated liabilities) (76%).
4) In absolute value the positive adjustments amounted to £656 million.
5) In absolute value of the negative adjustments amounted to £5,198 million, a sum 7.9 times bigger than the positive adjustments.

Just four companies (BP. Anglo American, WPP and Carnival) did not disclose prior year adjustments at any time in the period. Carnival (and its predecessor company) had very small tax charges throughout the period covered by the survey, suggesting that any prior year adjustments that did arise in its case could not have been material to an understanding of its accounts. No explanation for non-disclosure can be offered in the other cases mentioned.

If these four companies, who may have decided that disclosure of prior year items was not a material issue, are excluded from consideration, the remaining companies declared prior year adjustments in 84% of their accounts. In short:

1. the need to declare material prior year adjustments is commonplace in the accounts of the companies surveyed;
2. the predominant trend in prior year adjustments is to reduce charges previously declared to be due.

Reasons why adjustments may be negative

We cannot explain definitively why the majority of prior year adjustments in number and value are to reduce previously stated liabilities. Possible explanations might be:

1. Excessive caution by the companies when calculating their tax provisions;
2. The companies undertook tax planning with a reasonable degree of uncertainty attached to it, which subsequently secured approval from the relevant tax authorities.

No doubt others could be suggested, but the trend is so significant that the following companies made a prior year adjustment to reduce previously declared liabilities in every one of the five years under review:

- Lloyds Tsb
- Tesco
- Unilever
- Prudential
- Cadbury Schweppes
- Scottish & Southern Energy
- Reuters Group
- Compass

Findings – individual companies

We sought to compare data on prior year adjustments (whatever their value) with a company's current tax charge for the year (i.e. its profit and loss account charge excluding corporation tax). These are directly comparable items. The following table resulted:

Table 4

Percentage of prior year adjustment to current tax charge

	2000	2001	2002	2003	2004	Average
	%	%	%	%	%	%
Scottish Power	0.0%	79.5%	418.5%	28.3%	6.3%	106.5%
Compass	7.7%	2.7%	428.6%	68.2%	16.3%	104.7%
Reuters Group	18.2%	1.9%	21.6%	131.0%	102.5%	55.0%
Reed Elsevier	0.0%	0.0%	204.1%	61.8%	0.0%	53.2%
British Sky Bcast. Group	118.2%	0.0%	0.0%	0.0%	6.7%	31.2%
ITV	0.0%	0.0%	0.0%	0.0%	37.8%	18.9%
Cadbury Schweppes	1.0%	5.9%	9.9%	17.6%	59.6%	18.8%
BAE Systems	6.6%	1.1%	60.0%	3.0%	8.2%	15.8%
Centrica	8.8%	38.8%	8.2%	2.0%	16.7%	14.9%
Tesco	15.6%	14.8%	8.6%	17.0%	14.9%	14.2%
Scottish & Southern Energy	10.7%	15.3%	19.2%	12.5%	10.6%	13.7%
BT	0.4%	50.6%	1.9%	11.3%	0.0%	12.8%
Unilever	1.9%	5.1%	14.0%	17.4%	24.8%	12.6%

Vodafone Group	0.0%	4.6%	49.5%	0.4%	6.6%	12.2%
BG	11.8%	5.6%	23.2%	9.6%	8.5%	11.7%
Aviva	4.0%	0.4%	0.6%	5.7%	44.8%	11.1%
Allied Domecq	0.0%	9.2%	16.0%	7.8%	16.9%	10.0%
Kingfisher	5.4%	1.1%	2.3%	5.5%	35.5%	10.0%
National Grid Transco	0.0%	0.0%	0.0%	0.0%	19.8%	9.9%
O2	0.0%	0.0%	18.2%	0.0%	7.7%	8.6%
Legal & General	0.6%	19.0%	0.0%	20.5%	0.0%	8.0%
BAA	0.0%	0.0%	4.1%	19.8%	15.3%	7.9%
Prudential	3.1%	15.0%	3.4%	7.4%	5.1%	6.8%
Diageo	0.3%	5.6%	1.2%	4.5%	16.1%	5.5%
Land Securities	4.6%	0.9%	0.2%	20.2%	1.7%	5.5%
Xstrata	0.0%	0.0%	12.4%	1.5%	0.8%	4.9%
British American Tobacco	1.4%	0.0%	5.3%	5.9%	10.9%	4.7%
AstraZeneca	0.0%	0.0%	5.0%	2.8%	14.5%	4.5%
Standard Chartered	0.0%	0.0%	9.1%	12.1%	0.5%	4.3%
Old Mutual	11.8%	3.7%	0.8%	4.2%	0.4%	4.2%
BHP Billiton	0.0%	0.6%	3.0%	12.1%	1.0%	4.2%
HSBC	0.0%	0.0%	5.1%	7.3%	6.3%	3.7%
Lloyds Tsb Group	0.2%	3.5%	0.3%	9.6%	5.0%	3.7%
Wolseley	1.3%	2.8%	9.3%	3.6%	1.5%	3.7%
Marks & Spencer	1.7%	4.3%	2.2%	8.3%	1.7%	3.6%
Royal Bank of Scotland Group	0.0%	1.2%	1.2%	5.7%	9.8%	3.6%
Reckitt Benckiser	0.0%	0.0%	7.0%	0.0%	8.3%	3.1%
Imperial Tobacco	4.1%	3.0%	0.6%	5.1%	2.5%	3.1%
Rio Tinto	0.0%	4.3%	2.2%	4.7%	0.8%	2.4%
GUS	5.4%	1.2%	0.4%	1.8%	2.1%	2.2%
HBOS	0.0%	0.0%	2.2%	1.4%	4.9%	2.1%
GlaxoSmithKline	0.0%	0.0%	4.6%	2.8%	2.9%	2.1%
The Shell Transport & Trading Co.	0.8%	2.9%	3.2%	1.8%	0.3%	1.8%
Barclays Bank	1.3%	2.8%	0.9%	0.8%	2.2%	1.6%
Associated British Foods	0.0%	0.0%	1.9%	4.2%	1.6%	1.5%
SABMiller	0.0%	4.2%	0.5%	0.3%	0.2%	1.0%
BP	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Anglo American	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
WPP	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Carnival	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Number with prior year adjustment	**26**	**31**	**42**	**41**	**43**	
Average adjustment (1)	**9.5%**	**10.0%**	**33.1%**	**13.8%**	**13.0%**	**15.9%**
Total number in sample	**44**	**46**	**48**	**50**	**50**	
Average adjustment (2)	**5.6%**	**6.8%**	**29.0%**	**11.3%**	**11.2%**	**12.8%**
% of population with an adjustment	**59.1%**	**67.4%**	**87.5%**	**82.0%**	**86.0%**	**76.4%**

Average adjustment (1) divides the aggregate percentage prior year adjustments by the number of companies reporting such adjustments. Average adjustment (2) does the same but divides by the total number of companies in the sample.

Average adjustment (1) shows a surprising adjustment rate of 15.9% and adjustment (2) a slightly lower but still large adjustment rate of 12.8%.

It is, however, accepted that these statistics are distorted by the companies at each end of the adjustment scale. At the top of the range a large prior year adjustment in relation to a relatively low current year tax charge may distort the impression given. At the bottom of the table, and as is noted above, it is possible that some at least of the companies showing no prior year adjustments chose not to report them.

It is therefore reasonable to exclude the top 5 and bottom 5 companies from aggregate data. If this is done the following aggregate data is produced:

Table 5

Percentage of prior year adjustment to current tax charge EXCLUDING exceptional top and bottom 5

	2000	2001	2002	2003	2004	Average
Number with prior year adjustment	23	27	38	39	37	
Average adjustment (1)	4.5%	8.3%	8.4%	7.1%	11.6%	7.9%
Total number in sample	34	36	38	40	40	
Average adjustment (2)	3.0%	6.2%	8.4%	6.9%	10.7%	7.0%
% of population with an adjustment	67.6%	75.0%	100.0%	97.5%	92.5%	86.5%

Clearly the distortions of the earlier table are removed, but the trend in both average adjustments remains marked. From what might be considered immaterial levels in 2000, prior year adjustments to current tax charges have increased markedly in percentage terms, both with regard to the number of companies making them and with regard to their relative value.

Materiality

It seems reasonable to conclude that the adjustment rate disclosed is material. In auditing the term 'material' is used to identify the significance of an item. In general, an item is material if its misstatement would lead to a different opinion being formed upon the accounts, and an adjustment relating to an individual item is material if misstatement by that amount would change opinion on the sum declared. This is, of course, a subjective measure but in general auditors work to a rule of thumb that a 5% mis-statement is likely to be material and is therefore a cause of concern. In all but one year, on average (and whichever adjustment level is used) this statistic is substantially exceeded by the reported adjustment rate on the current tax charge declared in the accounts of the 50 largest UK companies. It is an adjustment rate that does not inspire confidence in the reliability of the data that they disclose.

Who audits these accounts?

Those accounts were audited by just 5 firms (4 after the demise of Arthur Andersen). In 2004 the audits of these companies was split between the firms as follows:

Table 6	
Firm	**No. of audits 2004**
PricewaterhouseCoopers	26
KPMG	13
Deloittes	8
Ernst & Young	3
Total	50

As an additional exercise the second, aggregate, result noted above for the 40 mid range companies found in the first sample was tested to see if the prior year adjustment rate varied significantly between different firms of auditors. It did. For these 40 companies the prior year adjustment rate was noted by auditor, with the rate for each auditor then being aggregated as follows:

Table 7		
Firm	**No. of companies**	**Adjustment rate**
PricewaterhouseCoopers	22	6.7%
KPMG	13	7.3%
Deloittes	3	11.5%
Ernst & Young	2	8.0%
Total	40	

It should be noted that 5 of the top and bottom companies eliminated were audited by Deloittes & Touche. Elimination of these companies for the results significantly reduced the absolute prior year adjustment rate, but all firms have an average adjustment rate in excess of a normal acceptable materiality rate of 5%.Deloittes more than doubles that on average.

Implications of this finding

The purpose of this review was to assess whether the declared figures for tax in the accounts of the companies in question were reliable, or not. The answer appears to be that they may be materially inaccurate in many cases, with liabilities being consistently overstated, followed by reversal of the provision in subsequent years.

The reality is that if these net reversals had been recognised in the earlier year to which they related, the average tax rates of the companies might have been restated by relatively little in 2000. But by 2004 the effective tax rates might (having allowed for positive and negative adjustments) have reduced the declared average tax rates by over 1% in aggregate, and by substantially bigger individual margins in many cases, so adding to the Tax Gap, and to its marked increase over this period. In that sense these restatements are misleading because they:

1. distort taxation declared;
2. make it appear that companies owe more than they actually pay;
3. give a misleading view of the Tax Gap.

Valuation

During the survey period the total current tax bill declared by the reviewed companies amounted to £132 billion. The overall restatement rate (ignoring the net off of positive and negative values) suggests that this liability might have been misstated by £9 billion. However, if the net negative restatement rate is considered £4.5 billion of liability that was declared to be due was not subsequently paid, contributing to the Tax Gap by that amount. In 2004 the net reduction in liability reported by prior year adjustments was £1.6 billion.

Method 2: Do the accounts add up?

The accounting logic

Accounting is a logical subject. Certain rules can, therefore, be expected to apply to accounting disclosure. If they do not then it is reasonable to ask why that is the case. One such simple arithmetical rule is that if the opening balance of corporation tax due has the current tax charge added to it, and the amount of tax actually paid in the year is then taken off the resulting figure, then the balance remaining should be the tax due at the end of the year. This equation can be expressed like this:

Current tax reconciliation	£
Tax due at start of year	V
Add current tax charge including any prior year adjustment	W
	X
Less tax paid in the year	(Y)
Tax due at end of the year	Z

The figure (Y) is shown in brackets since it is a deduction.

In principle each of these numbers should be available from the accounts of UK quoted companies, although the declaration of corporation tax liabilities as a figure distinct from other taxation liabilities is done as a matter of good practice at present, not because it is required by law or current UK accounting standards. This defect will be remedied in 2005 when International Financial Reporting Standards will apply to all the companies covered by this survey. International Accounting Standard 12 requires such separate disclosure. At present the following companies do not appear to follow this approach to best practice:

Anglo American
BG
Reckitt Benckiser (in 2001 alone)
Centrica
Reed Elsevier *
Land Securities
Allied Domecq *
ITV *

In those cases marked * disclosure is ambiguous: it is not possible to determine whether the tax liability declared upon the balance sheet is just for corporation tax or includes sales, payroll and other taxes as well.

Disclosure of tax paid is a requirement of cash flow accounting and is therefore available for all companies. A few split the payment between UK tax and overseas tax, but that is not necessary for this exercise.

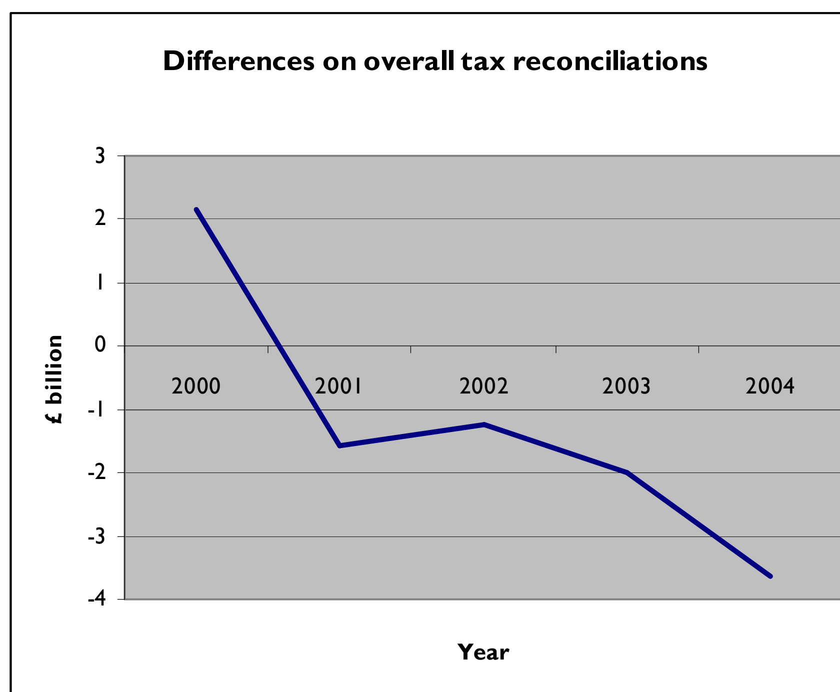
As part of the research undertaken for this paper the logical rule noted above has been presented to a large number of accountants, including tax directors of some of the companies subject to this review. None noted a flaw in the logic.

The findings

In practice the logic that has been tested does not work. Based on aggregate data the overall tax reconciliations for the period are as follows:

Table 8 Overall cash tax reconciliation	2000	2001	2002	2003	2004
	£ mil	£ mil	£ mil	£ mil	£ mil
Tax liability brought forward	14,154	18,528	18,160	19,287	20,751
Current tax charge	24,670	24,082	21,491	27,252	34,558
Total potential liability	38,823	42,611	39,650	46,539	55,309
Tax paid	22,456	23,033	19,161	23,801	27,507
Calculated liability due	16,367	19,722	20,516	22,738	27,802
Declared tax due carried forward	18,528	18,160	19,287	20,751	24,174
Difference (Positive = overpaid)	2,161	-1,563	-1,229	-1,987	-3,628

The differences arising are so dramatic that they are worth demonstrating graphically:



In 2000 too much tax was apparently paid. Since then in every year, and with an increasing tendency, tax has been underpaid.

It is noteworthy that the issue is not an isolated problem:

- In just five sets of accounts (2.1%) does the equation balance without seeking reconciliation from these other sources (BAA manage the feat three times, Marks & Spencer once and Associated British Foods once).
- In only 36 out of 238 sets of accounts (15%) is the difference less than £10 million.
- In 149 sets of accounts (62.6% of the sample) the difference is more than 5% of the current tax charge.

Possible explanations

It should be said that there are possible reconciling items. These include tax charges recorded in the Statement of Total Recognised Gains and Losses. Over the five year period, however, these amount to just £322 million. Net tax charges included in exceptional items have an almost equal and opposite effect. In other words, these two factors, which are the only location where tax charges should be recorded if not in the profit and loss account, cannot explain even a small part of the difference.

Another possible explanation is that the missing payments were in fact made by associated companies whose share of profits and tax are included in the accounts of these groups. But that cannot explain the positive charge in 2000, giving rise to doubt as to the validity of this explanation. Nor does it explain the fact that many companies have both positive and negative variances fluctuating (but rarely cancelling out) between years.

The other possibility is that foreign exchange re-translation may explain non payment, but the scale of the missing payments suggests that if that were the case, disclosure would be needed, firstly because the resulting gain or loss would not be tax allowable since it relates to a non tax-deductible provision, and secondly because it is material to the understanding of the tax charge in itself.

Conclusions

Whichever of these explanations might be true, or if there is another cause, they all contribute to an underlying concern that adjustments can be made to declared tax liabilities which are not passing through the taxation charge within the profit and loss account. This creates doubt about the accuracy of the declarations made, and uncertainty as to the amount of tax actually paid.

During this period over £6.2 billion of current tax charges included in profit and loss accounts of the UK's fifty largest companies appear not to have been paid. This is over 5% of the total tax paid and is, therefore material to an understanding of tax within these companies.

Only improved accounting disclosure can overcome this deficiency in the accounts of these companies, and this has to be a key issue all the companies covered by this survey need to address.

Valuation

The addition differences noted suggest that substantially less tax was paid than declared liabilities in profit and loss accounts would suggest due. The difference is £6.2 billion over the survey period, with £3.6 billion arising in 2004.

Does it have to be this way – comparisons with the Co-operative Bank

Prior year adjustments

When preparing 'Mind the Tax Gap' a very limited benchmarking exercise was undertaken by comparing the results of the survey group with the results of the Co-operative Bank, a company which seeks to be managed on ethical grounds. A similar comparison has been undertaken with regard to the issues raised in this report.

The findings – prior year adjustments

The Co-operative Bank did have prior year adjustments to its current tax charge in four of the five years surveyed. Three were negative. One was positive. Their absolute values did not exceed £1.1 million, the average being £0.4 million. The percentage average was 1.2%. This pattern was well within the range of expected outcomes for this adjustment when this research began, and is entirely acceptable. No adjustment the Co-operative Bank made in any year can be considered material.

The findings – do they add up?

The Co-operative Bank's tax equation balanced in 2 of the five years. This is a feat beaten by only one FTSE 50 company.

In the three years when the equation did not balance it was out by just £0.1 million, the lowest reporting unit used by the Co-operative Bank. Two of these figures were negative, one positive. The average error over the five year period was therefore zero. It is highly likely that the differences noted are rounding errors. These happen when figures are restated to their nearest decimal point. If the equation we tested was not checked by the bank such rounding errors at the level shown may be disclosed without indicating underlying cause for concern.

Appendix 1 - The companies included in this report

The data used

Unless noted otherwise, the data used to prepare this report relate solely to the fifty companies with the largest market values listed on the London Stock Exchange on Easter Sunday (March 27) 2005.

The data collection process is described in fuller detail in Appendix 4.

The companies

The companies in question, their market values on the day in question and their reported turnovers (sales), pre-tax profits and shareholder's funds or capital employed as declared in their 2004 financial statements are as follows:

Table 9

Background information on the companies reviewed

		Market Capitalisation	Turnover 2004	Pre-tax Profit 2004	Shareholder funds 2004
		£ million	£ million	£ million	£ million
BP	1	117,740	155,617	13,235	41,847
HSBC	2	94,470	27,616	9,612	47,288
Vodafone Group	3	92,550	33,559	-5,047	111,924
GlaxoSmithKline	4	71,920	20,359	6,119	5,925
Royal Bank of Scotland Group	5	52,940	22,754	6,917	31,865
The Shell Transport & Trading Co.	6	45,950	144,770	17,679	46,171
Barclays Bank	7	35,560	13,945	4,603	17,417
AstraZeneca	8	34,820	11,697	2,776	7,871
HBOS	9	31,930	10,227	4,592	20,535
Lloyds Tsb Group	10	26,610	9,567	3,493	9,977
Tesco	11	24,430	30,814	1,600	7,945
Diageo	12	22,670	8,891	1,969	3,692
British American Tobacco	13	19,950	10,764	1,886	5,416
Anglo American	14	18,750	13,610	2,534	13,647
Rio Tinto	15	18,270	6,193	1,963	6,870
BT	16	17,510	18,519	1,948	3,094
BHP Billiton	17	17,500	12,494	2,466	7,664
National Grid Transco	18	15,310	9,033	1,362	1,213
Unilever	19	15,020	27,252	1,926	3,754
Aviva	20	14,460	29,798	1,488	9,244
BG	21	14,410	4,082	1,544	4,590
Standard Chartered	22	12,280	2,930	1,178	4,605
Reckitt Benckiser	23	12,190	3,871	770	1,676
Prudential	24	11,900	16,355	650	4,281
Cadbury Schweppes	25	10,900	6,738	642	3,088
British Sky Bcast. Group	26	10,770	3,656	480	90

Imperial Tobacco	27	10,220	3,032	688	136
O2	28	10,100	5,694	95	10,091
GUS	29	9,140	7,548	692	3,007
SABMiller	30	9,140	6,205	759	3,813
BAE Systems	31	9,400	9,095	-232	4,738
Centrica	32	8,350	18,303	1,708	2,571
Scottish Power	33	7,760	5,797	792	4,752
Scottish & Southern Energy	34	7,660	5,124	607	1,728
Legal & General	35	7,660	10,911	646	3,376
WPP	36	7,640	19,598	457	3,966
Reed Elsevier	37	6,970	4,906	562	2,267
Kingfisher	38	6,900	8,799	427	4,407
Wolseley	39	6,500	10,128	559	1,902
BAA	40	6,340	1,970	539	5,018
Carnival	41	6,210	2,130	300	2,466
Xstrata	42	6,180	3,325	747	4,378
Land Securities	43	6,130	1,481	373	6,039
Associated British Foods	44	5,980	5,165	494	3,496
Allied Domecq	45	5,930	3,229	479	590
Reuters Group	46	5,890	2,885	437	612
Marks & Spencer	47	5,680	8,302	782	2,454
Compass	48	5,420	11,772	370	2,482
ITV	49	5,300	2,053	207	3,418
Old Mutual	50	5,230	3,629	873	4,772
Total		1,032,540	816,191	101,747	504,167
Average		**20,651**	**16,324**	**2,035**	**10,083**