

Country-by-Country Reporting:



Holding multinational corporations to account wherever they are



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account wherever they are**

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June 2009**

The Task Force on Financial Integrity and Economic Development is a unique global coalition of civil society organizations and more than 50 governments working together to address inequalities in the financial system that penalize billions of people. Launched by Global Financial Integrity in January 2009, the Task Force advocates for greatly improved transparency and accountability in the global financial system.

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Task Force Membership

Coordinating Committee

Global Financial Integrity* – www.gfip.org

Christian Aid - www.christianaid.org.uk

Global Witness – www.globalwitness.org

Tax Justice Network – www.taxjustice.net

Transparency International – www.transparency.org

Secretariat of the Leading Group on Innovative Financing for Development representing the following governments:

Algeria	Germany	Nicaragua
Bangladesh	Great Britain	Niger
Belgium	Guatemala	Nigeria
Benin	Guinea	Poland
Brazil	Haiti	Romania
Burkina Faso	India	Sao Tome and Principe
Cambodia	Italy	Saudi Arabia
Cameroon	Japan	Senegal
Cape Verde	Jordan	Sierra Leone
Central African Republic	Lebanon	South Africa
Chile	Liberia	South Korea
Congo	Luxembourg	Spain
Cote d'Ivoire	Madagascar	Togo
Cyprus	Mali	Uruguay
Djibouti	Mauritania	
Ethiopia	Mauritius	<i>Observer Countries:</i>
European Commission	Mexico	Austria
Finland	Morocco	China
France	Mozambique	Egypt
Gabon	Namibia	



Partnership Panel

Government of Norway
Government of Germany
Government of France
Government of Spain
Government of Chile
Government of Denmark
Ministry of Foreign Affairs of the Netherlands
Ford Foundation

*Global Financial Integrity is the convening organization in the Task Force



Foreword

Tax avoidance is a global problem. It involves the abusive exploitation of gaps and loopholes in domestic and international tax law that allow multinational companies (MNCs) to shift profits from country to country, often to or via tax havens, with the intention of reducing the tax they pay on some or all of their profits. Tax avoidance on such a large scale is facilitated by a lack of transparency in the way MNCs report and publish their accounts. Making MNC accounts more transparent would help tackle tax avoidance at very low cost.

At present most MNCs publish segmented information that breaks their trade down along product or division lines. However, MNCs are not required to publish geographic data, and there is no requirement to do so on a country-by-country basis. Despite publishing their accounts as if they are unified entities, MNCs are not taxed in this way. Each member company of the group is taxed individually. This makes it difficult to establish an overview of what is happening within a group of companies for tax purposes.

Tax avoidance is facilitated by tax haven structures created to shroud business activity in secrecy. It is often impossible for tax authorities to obtain information or assistance from the government of a tax haven, and companies are not usually under any obligation to disclose what they are doing outside the country that is making the enquiry. Given this opacity, even proving the existence of a tax avoidance scheme can be difficult.

The European Parliament has already urged the International Accounting Standards Board to move beyond voluntary guidelines and support the development of an appropriate accounting standard requiring country-by-country reporting by extractive companies. While this measure is a sound first step, it is not far-reaching enough: It is time to require that all multinational corporations report sales, profits, and taxes paid in their audited annual reports and tax returns for each jurisdiction where they are established.

This reporting, country-by-country reporting (CbC), would provide information to a wide range of stakeholder groups which will strengthen efforts to monitor corrupt practices, corporate governance, tax payments, and world trade flows. CbC would benefit investors by revealing which corporations operate in politically unstable regimes, tax havens, war zones, and other sensitive areas. CbC would also enable citizens of developing nations to determine who owns the companies that are trading in their countries, what tax is being paid, and whether that appears reasonable in relation to the tax rates in the country in question.



In this context, we are honoured to publish the work of Richard Murphy, perhaps the foremost expert in the world on country-by-country reporting. The work done by Richard in recent years and the recent campaigns by the Tax Justice Network and Christian Aid (both Task Force members) have been invaluable in advancing the cause for country-by-country reporting.

Raymond W. Baker

Director, Task Force on Financial Integrity & Economic Development

Director, Global Financial Integrity

June 2009



Summary

Country-by-country reporting is a new system of accounting for multinational corporations.

Accountancy has a reputation for being dull. This reform is anything but dull. It is about asking every multinational company to account for where it is, what it is called in each place it works and to report what its financial performance is in that place.

Amazingly, this information is not required and not available at present. As a result it is simply impossible to tell what some of the biggest companies in the world do in many of the places in which they operate. Those places include tax havens. But they also include developing countries, and many other places where secrecy is considered more important than protecting those people who trade with multinational corporations from potential abuse.

There's nothing wrong with secrecy: sometimes it is essential. However, the world's largest corporations do not need it. Their size makes them relatively invulnerable to competition. That same size makes it possible for a lot to happen within their accounts that can be, even inadvertently, swept under the metaphorical carpet and yet be of great significance to the places in which they trade. For example, if you live in the smallest jurisdiction in the world – the Pitcairn Islands¹ – the fact that anyone is present is of interest, and significant. You may well be dependent upon what they do. The same is true of a great many other countries. The relationship between a great many places, the people who live in them, and the multinational corporations that work there is critical to their well being. That is just one reason why country-by-country reporting is important.

There is another reason as well: multinational corporations are some of the biggest taxpayers in the world. There is also some fairly strong evidence that they are good at avoiding tax, especially when it comes to working in developing countries². They are also regular users of tax havens³. This may not be coincidence. What is beyond doubt is that the developing countries (where very few of them currently pay tax) desperately need the tax revenues that companies avoid paying in these places.

It is our belief that country-by-country reporting would be of considerable benefit to developing countries by letting the tax authorities, civil society and other regulatory agencies in those places see just what multinational corporations located there actually do, how their trade is undertaken, and

¹ http://en.wikipedia.org/wiki/Pitcairn_Islands accessed 15-5-09

² <http://www.christianaid.org.uk/images/deathandtaxes.pdf> accessed 15-5-09

³ <http://www.taxresearch.org.uk/Blog/2009/03/21/where-on-earth-are-you/> accessed 15-5-09



what profits and taxes they declare. They could then, using the data that country-by-country reporting would require to be reported for every single country in which a multinational corporation operates, compare the trading performance of that company in their own jurisdiction with what it is doing elsewhere. If, using techniques we demonstrate in this report, it is then apparent that the country in question is not collecting its fair share of taxes paid on the overall profit of the multinational corporation when it is treated as a whole, then the country in question would have powerful evidence available to it to challenge its local tax arrangements.

The results of country-by-country reporting will ensure that corporations pay their fair-share of taxes within each country that they operate – generally ensuring that more tax is paid in developing countries. This would improve the well being of all people in those states, reduce their aid dependency, enhance the strength of their democracies and improve the quality of their lives. We can think of no other measure that could release as many resources for their benefit or deliver an impact of such significance for their well-being as this single change in the rules of accounting for multinational corporations.

There are numerous benefits for other users of the accounts of multinational corporations from the transparency created by country-by-country reporting. Country-by-country reporting would:

- Provide a stakeholder view of accounting
- Create reporting of results by country, without exception, which has previously been unknown
- Provide a new view of corporate structures
- Impart a new understanding of what the business of a corporation is, and where it is
- Open up a new perspective on world trade because intra-group transactions would be reported for the first time in multinational company accounts
- Give a new view of world labour markets
- Create an entirely new tool for geo-political risk profiling of companies
- Permit better appraisal of corporate contributions to the governments that host their activities
- Provide better awareness of the true extent of tax haven activity
- Allow measurement of tax lost through tax planning by corporations through the relocation of profit
- Provide a better understanding of the physical resource allocation of the corporate world.

That is information that has the power to create real change for the benefit of all who live in our world. That is why, dull as it might seem, we believe that this accounting reform is really very important indeed: important enough to get passionate about.



What would country-by-country reporting do?

Country by country reporting would require disclosure of the following information by each Multinational Corporation (MNC) in its annual financial statements:

1. The name of each country in which it operates;
2. The names of all its companies trading in each country in which it operates;
3. What its financial performance is in every country in which it operates, without exception, including:
 - Its sales, both third party and with other group companies;
 - Purchases, split between third parties and intra-group transactions;
 - Labour costs and employee numbers;
 - Financing costs split between those paid to third parties and to other group members;
 - Its pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which operates.

Tax information would need to be analysed by country in more depth requiring disclosure of the following for each country in which the corporation operates:

1. The tax charge for the year split between current and deferred tax;
2. The actual tax payments made to the government of the country in the period;
3. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period;
4. Deferred taxation liabilities for the country at the start and close of each accounting period.

Sales information will also require additional analysis. If sales too any state are more than 10% different from the figure from any state then data should be declared on both bases so that there is clear understanding of both the source and destination of the sales a multinational group makes.

In addition, if the company operated within the extractive industries we would also expect to see a full breakdown of all those benefits paid to the government of each country in which a multinational



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corporation operates broken down between the categories of reporting required in the Extractive Industries Transparency Initiative⁴.

⁴ <http://eitransparency.org/> accessed 13-5-09



Why we need country-by-country reporting

Country-by-country reporting is a system of accounting that is only of relevance to multinational corporations – companies that operate in more than one country.

It is usually also only of relevance to companies that operate as groups: those are companies that structure their businesses through a number of companies all of which are wholly, or mainly, owned by one holding or parent company which is then in turn owned by independent shareholders. Many of these subsidiary companies will be located in different countries to manage the trade of the group in those different locations.

There are currently two accounting problems when multinational corporations are structured as groups. Firstly, the requirement for them to report on their activities on a geographical basis is very limited indeed. Compulsorily they have only to report the split in their activities between the activity in the parent company location and all other locations combined, and many now do little more than that so it is very difficult to work out what they do, where.

Secondly, when a group of companies are under common ownership a particular form of accounting is adopted. This is called consolidated accounting. Accounts of this sort are prepared by the parent company of a group for issue to its shareholders. The consolidated accounts effectively show the trading of the group as a whole, and the assets and liabilities and cash flows of the group as a whole. They do this by making an assumption that the entity is just one company even though this is not, of course, the case in legal fact. This is achieved by eliminating from view all the trades between group companies within the consolidated accounts. This is, of course, possible because they should net out with each other. What is left for presentation to the shareholders is a set of accounts showing what the trade of the group would have been if there were only one company in it, even though there are groups with more than 3,000 companies under common control.

We stress there is nothing wrong with these approaches to accounting. We are most certainly not asking that they be changed. They have been developed to meet the needs of shareholders in particular who want to know what ‘their’ directors are doing with the assets they have invested in ‘their’ company. We highlight the word ‘their’ for good reason though: implicit in this form of accounting is the assumption that multinational corporations only exist for the benefit of their shareholders in their role as providers of capital. This is undoubtedly an important reason for their existence, but the whole corporate responsibility agenda which has been so actively promoted in the



last decade or so clearly suggests that companies have many more duties besides those that they owe to their shareholders, and in many countries this broader responsibility is now reflected in the law⁵.

These other people to whom the company has a duty might include employees, suppliers and customers, governments, tax authorities, regulatory agencies, civil society, trade unions and the ordinary citizens of the places that provide the company with opportunity to trade for profit. In combination these people and agencies provide the company with its 'licence to operate' and are also owed a duty of care by it, which is often reflected in local law covering a wide variety of issues for trade regulation, employment law, environmental requirements, health and safety, tax law and much more besides.

For these organisations the range of issues on which they need information is much broader than the rate of return on the capital which the company employs. The United Nations Conference on Trade and Development in their 2008 report entitled "Guidance on Corporate Responsibility Indicators in Annual Reports"⁶ noted 16 categories of information that these groups might need, including (notably) total revenues by country, the value of imports vs. exports by country, total new investments by country, total local purchasing by country, employment data by country, payments to government by country and the number of convictions for violations of corruption related laws or regulations and amount of fines paid/payable.

Country-by-country reporting is designed to address many of these needs by supplementing the reporting already available with data produced for each and every country in which a multinational corporation operates. In doing so it adds a stakeholder perspective to corporate reporting which at the same time considerably enhances the quality of the data on risk that is available to shareholders, which in and of itself more than justifies its adoption.

This report explains why we need country-by-country reporting, what it is, who it affects, what it will deliver and what it will look like. It provides a cost/benefit analysis, shows that it can be delivered quite quickly if the right political will were to exist, and demonstrates that the benefit could include a reform in international taxation which would deliver considerably increased taxation revenues to developing countries.

⁵ For example, see section 172 of the UK Companies Act 2006 which says that the directors of a UK company have a duty to promote the success of a company whilst having regard "the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, and the desirability of the company maintaining a reputation for high standards of business conduct.

⁶ http://www.unctad.org/en/docs/iteteb20076_en.pdf accessed 15-8-08



Why we think country-by-country reporting is important

Country-by-country reporting (CbC) is important for the following reasons:

1. **Transparency matters.** In many countries a corporation does not have to put its accounts on public record. That means that what an MNC does in that country is not a matter of public record. That matters. What MNCs do has enormous implications for the wellbeing of the world. CbC overcomes this problem. It puts all MNC activity 'on the record'. Many investors appreciate this.
2. **Corporate social responsibility (CSR) matters.** CSR is about the relationship between a company and its host community. But this does require that the host community knows the company is there. CbC reporting provides that information.
3. **Accountability matters.** A company cannot be accountable unless it can be identified. This means that the names an MNC uses locally must be on public record. Too often they are not. CbC reporting names local subsidiaries.
4. **Trade matters.** 60% of world trade is intra-group. In other words it takes place across national boundaries but between companies under common ownership or control. Existing MNC accounts completely eliminate all of this trade from public view. CbC shows it all. This is vital if trade relationships are to be understood, and made fair.
5. **People matter.** MNC accounts include statements on the number of employees a company has and their aggregate remuneration. CbC would require this statement for every country in which an MNC operates. This would provide invaluable information on labour conditions.
6. **Tax matters.** MNCs have more opportunity than any other group in a society to plan their tax affairs. They can seek to shift their profits from state to state to find the lowest overall bill. CbC discloses the profits that companies record in each country in which they operate and the taxes that they pay on them. This means they can be held accountable for what they do and don't pay. It's estimated that if this problem were tackled enough tax could be collected to pay for the Millennium Development Goals.



7. **Corruption matters.** The Extractive Industries are dominated by MNCs. The Extractive Industries Transparency Initiative seeks to hold those companies to account for the tax payments they make, and to hold the governments that receive those payments to account for what they do with them. Many MNCs resist disclosure of information on what they pay because of competitive pressure, contractual obligations and local political opposition. CbC would overcome these objections, significantly enhancing transparency in this sector, and help cut corruption.
8. **Development matters.** Developing countries lack revenue to finance public goods and services. Aid helps alleviate this problem but creates a dependency, aid harms the democratic accountability of developing country governments because they aren't accountable to their electorates for what they spend, and aid can itself directly contribute to corruption. Local declaration of economic activity by MNCs with the resulting accountability for taxes paid could break this cycle and help create fully independent, accountable governments capable of raising their own taxation revenues.
9. **Governance matters.** Many of the major corporate scandals of recent times have involved extensive use of offshore subsidiary companies. These are becomingly increasingly common throughout the MNC world, but it is recognised that the problem of managing them creates severe governance issues for MNCs. This problem results in increased risk for shareholders and others who need to understand the risk inherent in an MNC's activity.
10. **Where you are matters.** Some countries are politically unstable. If a company trades there shareholders should know. Some are politically unacceptable. If an MNC trades there civil society wants to know. Some countries are subject to sanction. Trading there is illegal. Where you are matters. CbC holds a company to account for where it is.



What country-by-country reporting would deliver

For shareholders

For shareholders country-by-country reporting would:

- Provide a perspective which is not currently available of the geo-political risk inherent within the companies in which they have invested.
- Let them appraise the governance risks a corporation takes. Almost all major corporate failures in recent times have been associated with intra-group trading, complex group structures and tax haven activity. All of this is disclosed by country-by-country reporting, and as such it would provide a new perspective on governance risk;
- Allow appraisal of the vulnerability inherent in a corporations internal supply chains since these will be reported for the first time under country-by-country reporting. For example, if a supply chain was critically dependent upon a politically unstable state it would be very important that the shareholders are aware of this fact, and that they are able to quantify it. Country-by-country reporting would permit this;
- Allow appraisal of the sustainability of the tax charge within the accounts of the company. At present this is very difficult to do since it is not disclosed where the tax is actually either due or paid. If it became apparent that the tax rate the company was reporting was dependent upon tax haven / secrecy jurisdiction activity then investors might presume that the rate was not sustainable. This has a significant impact on perceptions of share valuation because these are often linked to the ratio of after tax earnings per share to the share price (the so called price / earnings or P /E ratio). Availability of this data is, therefore, important for investors.

For stakeholders

- Country-by-country reporting would provide better information than is currently available on the identity and location of a corporation's subsidiary companies in a particular country. In many countries that information is simply not available at present. As such for the first time in many cases local stakeholders would know the real identity of the companies with which they are engaging;



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- Country-by-country reporting will identify a corporation's direct contribution (in the form of tax payment) to a country's national interest, a task which is presently almost impossible in most places.
- The tax disclosure that country-by-country reporting requires is intended – in combination with the other data that is made available – to indicate the level of tax compliance that the corporation offers in each country in which it operates. Existing accounts do not achieve this objective. This identification might be done, for example, by comparing the locally reported level of profit with the reported level of current tax due, thereby allowing the calculation of the effective current local tax rate. If the effective tax rate is much lower than the local published tax rate it becomes fairly obvious that some form of tax planning is going on. Disclosure of this information allows stakeholders within a country to raise questions of the company regarding its local taxation activities.
- The information disclosed by country-by-country reporting on both local sales and country based employment costs is also important in connection with tax. Both activities are likely to result in tax payments to a government; both VAT and taxes due by staff are examples of this. Knowledge of this information facilitates the assessment of the total value of payments a company should be making to a government in a particular period. This information also indicates the total economic contribution the company is making to its host society. Many companies stress the significance of such payments as part of their corporate social responsibility reporting: disclosing this data will let them do so with increased validity while letting local civil society hold them accountable for such payments.
- In those locations where a multinational corporation is engaged in the extractive industries, the disclosure of data to be used in the local Extractive Industries Transparency Initiative will ensure that this information is in the public domain for each company, that contractual objections to publishing this data are overcome as a result of international regulatory requirement, and that the EITI process is enhanced as a result. The Extractive Industries Transparency Initiative process has been enormously valuable in promoting the interaction between civil society and governments in many locations, with a resulting increase in the transparency of government accounting for the resources over which it has control. Country-by-country reporting would enhance this process.

For employees

Employees in all locations in which the multinational corporation operates will be able to use the data country-by-country reporting provides to:

- Assess whether the company is a good employer in all locations in which it operates since data on employee numbers and total pay will have to be published under country-by-country reporting, allowing the comparison of average pay rates by location;
- Use objective data when pursuing negotiations on local pay and conditions;
- In addition, those seeking to monitor the abuse of labour conditions in multinational corporations, which has become a matter of considerable significance in sectors such as the clothing industry, will have access to considerably more data than ever before that can be



used to hold multinational corporations accountable for activities undertaken within their supply chains.

For local suppliers and customers

- It is presently very difficult, and very often impossible, to determine what assets a multinational corporation has committed to a country. This measure provides an assessment of the risk local suppliers take in providing it with credit. If that commitment is low then this places a burden of risk on local small businesses that are at risk of not being paid if the local subsidiary of the multinational corporation is allowed to fail. This risk will be reduced if country-by-country reporting is introduced. As such, the survival rate of local businesses will be increased by country-by-country reporting. Additionally local business' cost of capital will be reduced as the risk they face will be lowered by the implementation of country-by-country reporting.
- Local customers of the subsidiaries of multinational corporations also face risk when trading with these companies. These risks might include non-delivery of goods paid for in advance, the risk that guarantee or service obligations might not be fulfilled if local capital is too low with resulting high risk of business failure on the part of the multinational corporation's subsidiary, or the risk that the local multinational corporation's subsidiary may not have the resources to meet an individual or group claim for compensation if the goods or services do not work, or cause harm. Such risks are real: Bhopal is an obvious example. Country-by-country reporting will facilitate the assessment of this risk.

For economists and regulators

- The OECD has estimated that at least 60% of world trade is undertaken on an intra-group basis. None of this trade is currently reflected in the published accounts of multinational corporations. As such it is incredibly hard to collect reliable data upon it at either a corporate, country or international level. Country-by-country reporting will assist collection of this data. As such it is very likely that world trade will be better regulated, the international economy will be better understood and economic management will be improved for the benefit of all who live in the world.

For tax authorities

Country-by-country reporting offers useful additional information to tax authorities seeking to appropriately tax multinational corporations. There is a particular problem in doing so. Almost without exception groups of companies are not taxed anywhere in the world. The individual companies that make up the group are taxed instead. This gives problems however, especially when those companies under common control are located in different jurisdictions with differing tax rules and rates. In such situations it is easy to see that there is considerable benefit to a group of companies arranging that all its profits be recorded in a location where tax rates are low or tax allowances against profit are high whilst at the same time minimising any profits declared in



countries with high tax rates or limited tax reliefs. It can arrange to do this by ensuring the trades that take place between group companies are artificially set to achieve this outcome. The volume of such trades (noted in the preceding section) makes this easy to do.

This issue has been known about for a long time. Pressure to remove double taxation of profits earned within multinational corporations because the profit might be earned in one location and then be taxed again when remitted to another arose soon after the end of the First World War. Those who designed the system to end this double taxation wanted, at the same time, to ensure that they also stopped double *non*-taxation; in other words, profits not being taxed anywhere. Two systems were identified to do this. The first was unitary taxation, which taxes groups of companies as if they are single entities (rather as their accounts still do). This is discussed later in this report, but was not the system adopted in the inter-war years. Instead a system of individual company based taxation was adopted, but with the prices to be charged between companies under common control within a multinational corporation to be regulated by the process that is called 'arms-length transfer pricing'.

Arms-length transfer pricing requires that two companies under common control because they are both owned by the same multinational corporation sell any goods or services they supply to each other at market prices i.e. at the price that two independent companies would negotiate for the supply of the same goods or services.

In principle this should achieve the desired outcome of fairly distributing the profit earned within a group of companies on an appropriate basis to ensure that the right amount is taxed in each company and in each location that it trades, or so those who negotiated these issues in the 1920s and 1930s thought. The world has, however, become considerably more complicated since then, as have the number of multinational corporations and the complexity of the trades they undertake. In addition, whilst in the inter-war years international trade in services was very limited. In contrast today the trade in services is almost certainly more commonplace than the trade in goods.

This gives rise to multitudinous issues that together make the issue of arms-length transfer pricing the most complex issue in international taxation and, consequently, the issue that is most open to abuse. Amongst the problems are:

- Setting transfer prices for goods or services for which there is no open market. For example, there is no open market price for a half finished automobile engine that is shipped across international boundaries during the course of its manufacture because assembly occurs in two different plants in two different countries. How is a price allocated in that case?
- How are services priced when it is common that the price paid for them depends upon the perception of their value, not any intrinsic worth?
- How is the value of a patent or copyright determined when it is sold across international boundaries and what are reasonable royalty and copyright charges that might be charged for their exploitation, especially if the assets are only ever available to companies within the multinational corporation and never to third parties?



International tax departments in the world's tax authorities tackle these issues on a daily basis. They face two major problems when doing so:

1. Working out which multinational corporations to challenge on transfer pricing issues when they only have limited resources available to them;
2. Deciding where, if at all, it is most likely that abuse is taking place within a multinational corporation so that the correct subsidiary companies have their accounts challenged.

Country-by-country reporting does not answer these questions. What it does do is provide data that the tax departments in question can use to assess the likely risk that exists within the accounts of a multinational corporation. They can do this by:

- a. Assessing the likelihood of risk within the group structure;
- b. Reviewing the overall allocation of profits to countries within the group to see if there is indication of systemic bias towards low tax jurisdictions;
- c. Assessing whether the volume and flows of intra-group trading disclosed by country-by-country reporting suggest that this outcome is achieved as a result of mispricing of that trade;
- d. Using that information to assess where that abuse is most likely to occur so that an appropriate challenge can be raised.

To use an example: if a multinational corporation locates all its patents in a tax haven / secrecy jurisdiction location, pays considerable intra-group fees for their use so that the entire income of the subsidiary in that place is reported in its country-by-country accounts to arise on an intra-group basis, it has no apparent third party costs there of any significance, and it has only one employee then it has a very high tax rate in proportion to sales on which little or no tax is paid. This would raise an obvious 'red-flag' warning within that data, thereby alerting tax authorities that they might wish to investigate payments to this location. Of course, not all arrangements would be so simple to spot, and this is why the inter-action between country-by-country data and unitary taxation is noted below. Nevertheless the important point is made here that the mere existence of country-by-country reporting is likely to have two effects. The first is that companies will substantially reduce the volume of potentially embarrassing/incriminating transactions they undertake – a significant deterrent effect that will make country-by-country reporting worth implementing in its own right. Second, the speed, accuracy and effectiveness of tax enquiries will increase considerably, thus reducing the cost of tax abuse. The likely outcome of both effects is that tax compliance will increase. Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

Summary

For all these reasons country-by-country data will provide information that will significantly increase the value of reported accounting data for shareholders, other providers of capital to a company, employees, suppliers, customers, stakeholders in civil society, trade unions, trade organisations, tax



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authorities and regulatory agencies. The value of corporate reporting will be enormously increased as a result. We firmly believe that the benefits for society at large, and for business itself, will be considerable.



What will country-by-country reporting look like?

It is important to understand what country by country reports will look like.

The first thing to note is that this reporting will form part of the annual audited reporting of the multinational corporations to which it will apply. It will not be required for any other reports such as interim statements.

Second, we are aware that for some companies which work in many countries the amount of data that country by country reporting would require to be disclosed is significant. We have seen a list of members of a group of companies that extends to more than 100 printed pages, disclosure of which was, however required by law⁷. This might be exceptional, but we have no desire to see more printed paper than is strictly necessary. Since all companies likely to be affected by country-by-country reporting will also be required to place their audited annual reports on their web sites and there is a marked trend towards all financial data being published in this form, we think it entirely appropriate that country-by-country data be exclusively reported electronically.

Third, whilst the first two requirements of country by country reporting, namely that all subsidiary companies that make up a multinational corporation and the countries in which they operate be disclosed, can be fulfilled by the publication of simple lists, production of which should impose almost no cost at all on the multinational companies effected, we accept that this will not be true of country-by-country financial reports.

These country-by-country reports will look like individual profit and loss accounts for each of the countries in which a multinational corporation has an operation. It is stressed that the data is not required for each subsidiary in each country: that would be too voluminous to report. It might also be misleading. For many of the reasons noted above, data is required for countries as a whole, not for individual companies within countries. This is particularly true with regard to transfer pricing issues. As such the profit and loss account, supporting notes, and limited balance sheet data to be published for jurisdiction would comprise consolidated data for the country in question.

There would be a cost to assembling this data: we accept that it is not of relevance for any other purposes. However, we would add that comments we have received from some major corporations

⁷ BP plc annual return for 2008 as filed with the UK Registrar of Companies.



suggest this should not be a difficult process. Firstly, attribution of profits to countries already has to take place for tax purposes. This is a reason why many corporations already use different subsidiaries to undertake their trades in different countries. For those that do not follow this practice the process of subdividing results by country will already take place for tax purposes. Second, there are no technical innovations in this process. Under existing financial reporting standards the reporting of geographically delineated data is permitted; indeed in theory country-by-country reporting is already possible, it is just not required. Many multinational corporations do publish geographic data, most often on a continental basis, and for that reason will already have procedures and system in base to allocate data on this basis. All that country by country reporting will require is a little more granularity in that process, and slightly more categorisation of data within the accounting system of the organisation as a whole. This should present very few challenges to major companies, all of which have sophisticated accounting systems.

An example may best show how this will work. For these purposes assume that company A, located in country A, which has a corporation tax rate of 30%, has two subsidiary companies. The first is company B, which is in a tax haven with a corporation tax rate of 0% and the second is company C, which is in a developing country with a tax rate of 35%.

Company A and Company C only make sales to genuine third-party customers. They do not trade directly with each other. Company B only makes sales to company A and company C; It makes sales to no third-party customers because its only activity is to own the intellectual property that is used exclusively by companies A and C. That intellectual property was created by company A and was transferred to company B some time ago. Company B has only to maintain a lawyer and a small team of administrators to generate the income that it earns. In contrast, companies A and C employ staff to undertake tasks in order to supply the services that their customers want.

The pattern of trading for a year looks like this:



Country by country reporting

		Company A \$'m	Company B \$'m	Company C \$'m	Eliminated \$'m	Consolidated Group \$'m
Turnover	Third party	400	0	100		500
	Intragroup		80		-80	0
	Total	<u>400</u>	<u>80</u>	<u>100</u>		<u>500</u>
Purchases	Third party	150	0	30		180
	Intragroup	65	0	15	-80	0
	Total	<u>215</u>	<u>0</u>	<u>45</u>		<u>180</u>
Employee: Cost		135	1	42		178
	Number	<u>3000</u>	<u>10</u>	<u>2800</u>		<u>5810</u>
Profit before tax		<u>50</u>	<u>79</u>	<u>13</u>		<u>142</u>
Tax	Current	11	0	1		12
	Deferred	4	0	3	24	31
	Total	<u>15</u>	<u>0</u>	<u>4</u>		<u>43</u>
Profit after tax		<u>35</u>	<u>79</u>	<u>9</u>		<u>99</u>
Apparent tax rate		<u>30%</u>	<u>0%</u>	<u>31%</u>		<u>30%</u>
Fixed assets		<u>200</u>	<u>5</u>	<u>150</u>		<u>355</u>

Companies A, B and C are all in separate countries so each has to prepare individual and separate sets of accounts in order to record all the transactions that they undertake. These are shown in the separate columns under their company names, above. As is apparent, company A pays company B \$65 million dollars a year for the use of its intellectual property and company C makes a payment of \$15 million for the same entitlement. It is stressed that these figures are probably high; the exaggeration is, however, necessary to highlight what happens.

Company A also makes genuine third-party purchases and has a significant employment cost in respect of some 3,000 people. Company B employs 2,800 people, but it will be noted at a somewhat lower cost per head. This is normal for operations located in developing countries.

All of the companies make a profit before tax. In combination the group makes a healthy \$142 million profit before tax on a turnover of \$500 million.

Company B is the most profitable in the group but has no tax liability.

Company A enjoys what appears to be a reasonable profit rate and declares a total tax liability at 30%, which is the exact expected rate due in its country. Of this liability, however, \$4 million is deferred tax: it will not be due until a subsequent period. This may be because of additional allowances due to it in respect of expenditure on capital equipment in the period in excess of the



equivalent depreciation charge included in the accounts as a measure of the wearing out of those assets in use during the period.

Company C also declares a tax liability, but at a rate slightly lower than the notional rate for the country in which operates. There is nothing very surprising about this. Recent research has shown that most quoted companies in the UK declared tax liabilities that are slightly below the notional corporation tax rate and that they actually pay tax, on average, at a rate at least 8% lower than that notional rate⁸. Of company C's tax liability, 75% is deferred. This is commonplace in developing countries where tax allowances on capital expenditure tend to be very generous.

It is important to note that in all likelihood the accounts of company B and the accounts of company C will not be available on any public record for inspection. So long as company A prepares group accounts on a consolidated basis, in most countries it will not have to make available the accounts of company B and company C. The group result will be sufficient to satisfy its disclosure requirement.

The group result arising from these individual company accounts is reflected in the right-hand column. It will be noted that the intra-group sales and purchases are eliminated when the consolidation is prepared. Group accounts only include transactions with third parties, and current assets and liabilities owed by and owing to third parties. As a result the only actual transactions undertaken by company B that are reflected in the group accounts are the payments to its staff amounting to less than \$1 million. The curious will note that these employees are on average the best remunerated within the whole group.

In this first table it will be noted that although the intra-group transactions with company B are eliminated from view when the consolidation takes place, a provision for the tax that might be due on the profit transferred to the tax haven has been included in the consolidated accounts. This provision is \$24 million, being tax at 30% on the \$80 million profit earned in Company B. There are two reasons for making this provision. The first might be that the payments to company B might be challenged by the tax authorities in countries A or C, and a tax liability might arise as a result. It is assumed that the average rate of that liability would be 30%. Alternatively, it is assumed that the tax saving created by use of company B is only temporary and that if and when the profits of that company are transferred to company A for onward payment to its shareholders, a tax liability will arise in that country at 30%. This will require deferred tax to be provided now on the liability that is expected to arise in the future.

Neither assumption need be true, of course. If the tax saving that the operation of company B has created passes the scrutiny of the relevant tax inspectors in countries A and C, then there will be no need to provide deferred tax for fear of the arrangement being challenged: this will not happen. In addition, if the company is satisfied that it does not need to bring the reserves in company B back to country A for onward distribution to its shareholders, there is no reason for it to provide deferred tax on the potential cost of that distribution. In that case a very different set of accounts is presented as a result of there being a very different tax charge:

⁸ Murphy, R. *The Missing Billions*. TUC, London. 2008.



Country by country reporting

		Company A \$'m	Company B \$'m	Company C \$'m	Eliminated \$'m	Consolidated Group \$'m
Turnover	Third party	400	0	100		500
	Intragroup		80		-80	0
	Total	<u>400</u>	<u>80</u>	<u>100</u>		<u>500</u>
Purchases	Third party	150	0	30		180
	Intragroup	65	0	15	-80	0
	Total	<u>215</u>	<u>0</u>	<u>45</u>		<u>180</u>
Employees: Cost		135	1	42		178
	Number	<u>3000</u>	<u>10</u>	<u>2800</u>		<u>5810</u>
Profit before tax		<u>50</u>	<u>79</u>	<u>13</u>		<u>142</u>
Tax	Current	11	0	1		12
	Deferred	4	0	3		7
	Total	<u>15</u>	<u>0</u>	<u>4</u>		<u>19</u>
Profit after tax		<u>35</u>	<u>79</u>	<u>9</u>		<u>123</u>
Apparent tax rate		<u>30%</u>	<u>0%</u>	<u>31%</u>		<u>13%</u>
Fixed assets		<u>200</u>	<u>5</u>	<u>150</u>		<u>355</u>

The only difference between the two tables is in the taxation charged in the consolidated group result. In the second table the taxation liabilities of the individual companies are simply added together. The current tax liability of the group is now shown to be just 8.5%. When deferred taxation is taken into account the liability appears to rise to 13%. Of course, this is substantially lower than the potential tax rate due in country A - where company A is located.

Two tax arrangements made this second table more likely. The first is that a “dividend exemption arrangement” is in operation in country A. When a dividend exemption arrangement is in operation, income paid by way of dividend from a subsidiary company to a parent company is not subject to tax in the country in which the parent company is located upon its receipt. As a result – in this case if the \$79 million of retained profits in company B was paid by way of dividend to company A and if a dividend exemption was in operation – no further tax would be due in country A. However, if there was no dividend exemption in operation, the dividend would be taxed at 30% upon receipt in country A and the deferred tax provision noted in the first example would be appropriate. It is very obvious as a result why multinational corporations are in favour of the dividend exemption basis of taxation.

The second reason why the profits of company B may not be taxed is that country A, in which company A is located, either does not have a foreign company taxation regime or has only a weakly controlled one. Controlled foreign company taxation regimes were created in the 1980s to tackle the



issue that this example highlights, namely the transfer of profits, particularly from passive sources of income such as royalties and copyright fees paid to tax havens. They work by simply deeming the tax haven subsidiaries to be resident in the country where the parent company is; in this case country A. The income of the tax haven subsidiary is then taxed as if it arose in the parent company location, even though it technically did not. These arrangements were effective for a while, but have increasingly come under fire, particularly in the European Union. The arrangements now apply to much narrower ranges of income and only apply in particular circumstances, which most companies are able to avoid. When weakly controlled foreign company regimes are coupled with dividend exemption arrangements the opportunity for companies to locate profits in tax havens increases significantly.

What the example does make clear is that – although the company has gone to considerable efforts to secure a tax saving – there would be very few clues in the consolidated accounts published in the second version as to why the tax rate paid by company A was much lower than the expected tax rate of 30%. The reason for the benefit, which the company secured from its tax haven operation, would be almost entirely hidden from view.

This is because, using the second example as the basis for demonstration, under consolidated accounting the disclosure would be as follows:

Country by country reporting		Consolidated Group \$'m
Turnover		500
Purchases		180
Employees		<u>178</u>
Profit before tax		<u><u>142</u></u>
Tax	Current	12
	Deferred	<u>7</u>
	Total	<u><u>19</u></u>
Profit after tax		<u><u>123</u></u>

Whereas under country-by-country reporting this data would be published (excluding all balance sheet and cash flow related information, which would be additional to that information noted here):



Country by country reporting

		Country A \$'m	Country B \$'m	Country C \$'m	Consolidated Group \$'m
Turnover	Third party	400	0	100	500
	Intragroup		80		0
	Total	<u>400</u>	<u>80</u>	<u>100</u>	<u>500</u>
Purchases	Third party	150	0	30	180
	Intragroup	65	0	15	0
	Total	<u>215</u>	<u>0</u>	<u>45</u>	<u>180</u>
Employees	Cost	135	1	42	178
	Number	<u>3000</u>	<u>10</u>	<u>2800</u>	<u>5810</u>
Profit before tax		<u>50</u>	<u>79</u>	<u>13</u>	<u>142</u>
Tax	Current	11	0	1	12
	Deferred	4	0	3	7
	Total	<u>15</u>	<u>0</u>	<u>4</u>	<u>19</u>
Profit after tax		<u>35</u>	<u>79</u>	<u>9</u>	<u>123</u>

In this way, the quantity and quality of data that country-by-country reporting would disclose becomes readily apparent.

It is also stressed in making this observation that even when a country does have controlled foreign company rules of the type noted above, the abuse must be noticed in order for the rule to apply. This is not always easy. Country-by-country reporting would change this, as is clear from the above example. When data for each country is published with the total of their transactions reconciling to the group consolidated accounts, and with the transactions within the group becoming transparent, it will be much easier to identify controlled foreign company abuse. As such, it will be much easier to tackle this abuse when it occurs – abuse which seems to be epitomized by company B in this example. That company is, after all, an entity with almost no real economic substance, trading purely on an intra-group basis with almost no staff or assets, and yet is easily the most profitable company in the group. Yet, at the same time, the company has no tax liability.

This example might appear far-fetched, but may not be as unusual as it looks. In December 2005 The Sunday Post in Ireland reported that⁹:

The Irish subsidiary of a giant US tech company earned a pre-tax profit of almost \$5million (€4.2 million) for every Irish employee on its books last year.

⁹ <http://archives.tcm.ie/businesspost/2005/12/25/story10601.asp>



Country-by-Country Reporting

The Sunday Business Post has learned that NCR Global Solutions, which employs just 31 people in Ireland, reported pre-tax profits of \$152 million on turnover of \$1.1 billion.

The accounts also reveal that the Irish company's after-tax profits amounted to \$131 million. That is equivalent to almost half the worldwide profits of NCR, which employs 28,000 globally. NCR reported group profits of \$285 million last year.

It is apparent that tax planning of this sort really does happen. The Sunday Post clearly had little doubt that the extraordinary profit rate of the Irish employees had as much to do with Ireland's very low corporation tax rate as it did with their apparent exceptional productivity.



What will country-by-country reporting cost us?

This question is often asked and the completely honest answer is ‘no one yet knows’. There are a number of good reasons. For example, as noted already, some companies will already have geographic reporting systems in place; others will not. Some will have simple group structures and a limited number of local subsidiaries to consolidate as a result; others will have a great many. Costs cannot therefore be predicted without having individual data to appraise.

This said, the proposal that the required data produced by country-by-country reporting only be published on the internet is one clear indication of an attempt to mitigate costs of its production whilst ensuring that all the benefits are obtained. A second cost mitigation is restricting the requirement that country-by-country data be produced to the most significant multinational corporations - there is no intention to impose country-by-country reporting unnecessarily. Presently, the most significant multinational corporations are those listed on a stock exchange. Although, as there are some very large private companies too, it would be necessary to establish a probable size-consideration for private companies so that the largest private companies would be covered by these requirements as well. This would greatly benefit the tax authorities in their endeavours.

Taking the above into account, we have made some enquiries as to potential costs of this exercise. One major company suggested that there would be very little additional accounting cost for them in producing data of this sort. Another suggested that it would require some reorganisation of their accounting systems, and that would have an inevitable setup cost, but that once routines were established producing the data would not be difficult.

What became clear from discussion was not that the accounting in question would impose any significant additional burdens, but that the auditors of these companies might have to undertake significant additional work to ensure that the country-by-country information was fairly stated. This is because at present many auditors do not even visit all countries where the companies that they audit have operations. They presume that many of the smaller subsidiaries of these groups can simply be ignored because they are unlikely to have any significant impact on the overall consolidated results of the group on which the audit report is issued. If, however, country-by-country reporting required that country-by-country data would have to be audited, each country would then become significant in its own right, meaning that audit costs would increase.



Country-by-Country Reporting

One major audit firm suggested that the cost of auditing a major multinational company might increase by at least twenty five per cent as a consequence of country-by-country reporting.

Institutional investors who became aware of the audit approach of the firm in question as a consequence of this discussion were, however, of the opinion that this cost would be more than justified by the reduced risk to shareholders that would result from the requirement for auditors to attend the premises of a company in each and every location in which it operated.



Summarising the benefits of country-by-country reporting

Some of the benefits of country-by-country reporting are:

1. For management of the company

- a. Better management of data within the organisation
- b. Increased accountability within the organisation
- c. Enhanced governance as a consequence
- d. Better data for decision making and resource allocation purposes
- e. Better risk management data

2. For shareholders

- a. Increased profitability as a result of better management performance for the reasons noted above
- b. Reduced risk
- c. Greater stability of earnings

3. For stakeholders

- a. Improved data on what the company does, where it does it, and who it does it with
- b. The ability to hold the company to account
- c. The chance to decide that this is an organisation civil society wants to applaud
- d. Better data on trade for those concerned with trade, environmental, resource and human justice

4. For employees

- a. Better data in advance of working for a company
- b. Better data to assist employment negotiations with a company
- c. Comparable data to assess whether a company is consistent in its dealings with its employees
- d. Data to prevent abuse

5. Suppliers and customers

- a. Reduced risk from trading with a multinational corporation because local data on its operations will be available

6. Tax authorities

- a. Better data to determine whether multinational corporations are tax compliant where tax compliance means seeking to pay the right amount of tax (but no more) in the right place at the right time. Right means that the economic substance of the



transaction undertaken coincides with the place and form in which it is reported for taxation purposes.

7. *Other regulators and agencies*

- a. Data to assess who does what and where - data which is currently almost impossible to obtain. The consequence of this being better and more focussed regulation produced at a lower cost.



Beating tax avoidance

In the longer term, there is another potential benefit to country-by-country reporting. The existing structure used for taxing multinational corporations, described already, where each company within a multinational group is assessed to tax individually, with trade between them being supposedly regulated by the arms length pricing rule, is for all practical purposes time expired. There is almost universal agreement between the tax authorities of large states, multinational corporations, and their tax advisers that transfer pricing is now the single biggest issue of concern in international tax. In August 2008 KPMG published a review of current transfer pricing practice¹⁰ and suggested that tax authorities around the world have established “red flags” that draw attention to potential transfer pricing abuses. These include:

- Unusually high profits or losses in a group company,
- Corporate restructurings involving closures or reductions in operations,
- Significant inter-company management fees, perhaps of the type paid to company B in the example noted above,
- Dealings with a group company in a tax haven, and
- Location in a low cost country.

All of these would be highlighted by country-by-country reporting. It is readily apparent as a result that country by country reporting would considerably improve the quality of information that tax authorities would have available to them upon which to base their decisions as to cases to investigate. In this manner, the reporting will significantly increase the effectiveness of tax authorities’ operations and increase the chance that they will actually collect tax currently underpaid.

There is, however, an alternative tax system available which might also use country-by-country reporting and which could achieve the desired outcome of the existing tax system more expeditiously, at lower cost, and with greater efficiency. It is called unitary taxation. This system of taxing overcomes the inherent conflict between the way in which groups of companies report their

¹⁰ A Meeting of Minds - Resolving Transfer Pricing Controversies
<http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Resolving-transfer-pricing.aspx>



accounting data and the way in which they are taxed. Whilst accounting encourages a group view and ignores the individual companies that make up the entity, presently tax is only ever charged on the individual entities. This makes group accounts, in a sense, meaningless for tax purposes. This is why country-by-country reporting will always at present provide a better and more objective view of a group's tax liability than can ever be presented in the group consolidated accounts.

The same country-by-country data also allows any user of the accounts to determine if the group's profits and tax liability appear to have been reasonably apportioned. This can be done by applying what are, in effect, unitary taxation apportionment formulas to the country-by-country data that a company would be required to publish if this system of accounting were to be adopted.

Under the rules of unitary taxation, which are widely used to allocate profits between companies operating in different states within the USA and have therefore been extensively tried and tested, the total group profit is allocated to a location on the basis of a formula. It should be noted that the European Commission is already seriously exploring the use of a unitary basis of tax apportionment in the EU, although this proposal has been subject to significant objection, not least from the United Kingdom and Ireland¹¹.

The classic apportionment formula used in unitary taxation is called the Massachusetts apportionment and it allocates profit on the basis of a formula that gives equal weighting to third-party sales, employees, and physical fixed assets in a location. One of the reasons for requiring employee and fixed asset information to be disclosed under country by country reporting is to ensure that this calculation can be undertaken. The purpose of doing so is to ensure that the profit allocation between states looks reasonable.

Taking the example already used, and using two different bases for allocating employment, one being based upon employment cost and the other being based upon headcount, the relevant apportionment ratios are shown at the foot of the following table:

¹¹ See

http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm
for more information



Country by country reporting

	Company A \$'m	Company B \$'m	Company C \$'m	Eliminated \$'m	Consolidated Group \$'m
Turnover	400	0	100		500
Third party					
Intragroup		80		-80	0
Total	<u>400</u>	<u>80</u>	<u>100</u>		<u>500</u>
Purchases	150	0	30		180
Third party					
Intragroup	65	0	15	-80	0
Total	<u>215</u>	<u>0</u>	<u>45</u>		<u>180</u>
Employees: Cost	135	1	42		178
Number	<u>3000</u>	<u>10</u>	<u>2800</u>		<u>5810</u>
Profit before tax	<u>50</u>	<u>79</u>	<u>13</u>		<u>142</u>
Tax	11	0	1		12
Current					
Deferred	4	0	3	24	31
Total	<u>15</u>	<u>0</u>	<u>4</u>		<u>43</u>
Profit after tax	<u>35</u>	<u>79</u>	<u>9</u>		<u>99</u>
Apparent tax rate	<u>30%</u>	<u>0%</u>	<u>31%</u>		<u>30%</u>
Fixed assets	<u>200</u>	<u>5</u>	<u>150</u>		<u>355</u>
Third party sales weighting	<u>80%</u>	<u>0%</u>	<u>20%</u>		<u>100%</u>
Employee number weighting	<u>52%</u>	<u>0%</u>	<u>48%</u>		<u>100%</u>
Employee cost weighting	<u>76%</u>	<u>1%</u>	<u>24%</u>		<u>100%</u>
Fixed asset weighting	<u>56%</u>	<u>1%</u>	<u>42%</u>		<u>100%</u>

If these weightings are in turn weighted equally (as the Massachusetts formula does), then the following calculations can be made:



Country-by-Country Reporting

Weighting for unitary allocation on a 33.3%: 33.3%: 33.3% basis:	Company A	Company B	Company C	Eliminated	Consolidated Group
Third party sales weighting	<u>26.7%</u>	<u>0.0%</u>	<u>6.7%</u>		<u>33.3%</u>
Employee number weighting	<u>17.2%</u>	<u>0.1%</u>	<u>16.1%</u>		<u>33.3%</u>
Employee cost weighting	<u>25.3%</u>	<u>0.2%</u>	<u>7.9%</u>		<u>33.3%</u>
Fixed asset weighting	<u>18.8%</u>	<u>0.5%</u>	<u>14.1%</u>		<u>33.3%</u>
Allocation if employee numbers count:	<u>62.7%</u>	<u>0.5%</u>	<u>36.8%</u>		<u>100.0%</u>
Allocation if employee cost counts:	<u>70.7%</u>	<u>0.7%</u>	<u>28.6%</u>		<u>100.0%</u>
Allocation if employee cost and numbers are weighted 50 : 50	<u>66.7%</u>	<u>0.6%</u>	<u>32.7%</u>		<u>100.0%</u>
Allocation on legal entity basis	<u>35.2%</u>	<u>55.6%</u>	<u>9.2%</u>		<u>100.0%</u>

If employee numbers are counted, then the allocation weights the third-party sales ratio, the employee number ratio, and the fixed asset ratio equally. The allocation of employee cost counts does the same, except it considers employee cost and not employee numbers. A third option is included where employee numbers and cost are both included and the one third share allocated to employees is itself weighted half to cost and half to numbers.

It is important to note that while disputes about appropriate formulas for allocation purposes are one of the problems within unitary taxation, this is not the point here. This organization is not recommending the adoption of unitary taxation, although it recognises its attractions. The point about undertaking a unitary formula allocation on any one of the bases used if country-by-country data were available (and maybe all of them, because the time expended would be small) is to check whether the allocation results that arise as a consequence are broadly consistent with those which arise on a legal entity basis where transfer pricing methods have been used. As the last line shows, in this example this is not the case, and whilst the numbers may be exaggerated in the example, a similar calculation for NCR in 2004 might have resulted in the formation of a very similar view.

It is stressed that this is an example of the potential use of country-by-country data. Like all good accounting information, it does not provide answers in itself but is the data which can be used by others to calculate answers to questions they wish to pose. For this reason, it is important that any disclosure regime includes sufficient accounting information that the credibility of one number can be verified by comparison with a variable with which it would be reasonable to expect a correlation.



This is the basis on which all good accounting analysis takes place. An incomplete or partial version of country-by-country reporting would not achieve this objective.



The counter arguments to country-by-country reporting

It has to be noted that not everyone is yet convinced of the merits of country-by-country reporting. In May 2009 UK based publication Accountancy Age reported¹² that Barry Marshall, UK head of tax at PricewaterhouseCoopers, said

We have a common interest to improve corporate reporting of tax information. However, we do not believe the introduction of the kind of country-based reporting proposed by this campaign would meet this ambition

It is therefore important to note and respond to the potential counter arguments to country-by-country reporting. We think these might be as follows:

1. It will destroy company's competitive advantages and so harm markets;
2. It will be hard to put in place, or to make work properly;
3. Companies do not have or could not calculate the necessary data;
4. It will not decrease tax avoidance / evasion because firms will use other devices;
5. Developing countries do not have enough people or qualified people, to look at country-by-country based accounts and therefore will not increase their tax revenues as a result;
6. Even with country-by-country reporting, how to determine the "right" level of transfer pricing is far from obvious, especially on intangibles, meaning that this will not settle the issue;
7. Consolidated accounts are based on information provided by subsidiary companies but additional entries are made during the consolidation process, so it will not be possible to reconcile country-by-country reporting with the published accounts;

¹² <http://www.accountancyage.com/accountancyage/news/2241789/postcard-plea-big-four>
accessed 14-5-09



8. Each country already requires that all companies submit their accounts for taxation purposes and so no additional information will be secured by those authorities as a result of country by country reporting but a huge flow of information will be published that will be difficult to interpret;
9. It will be difficult to audit country by country information;
10. In some countries this information is already available, even for subsidiaries located elsewhere;
11. The volume of information required to be disclosed will destroy too many trees.

No doubt there are other arguments as well, but dealing with these issues, and with only one point each having to suffice, our answers are as follows:

1. The great advantage of country-by-country reporting being introduced as an International Financial Reporting Standard is that these standards are, by definition, international and already apply in more than 100 countries. In addition, the USA now allows their use by quoted companies. This will still leave some exceptions, the most obvious being China, but in practice even the largest Chinese companies are quite often governed by these disclosure rules. This is because they list their shares on stock exchanges where compliance with International Financial Reporting Standards is a requirement for share trading. As such we are moving towards an era when there will be an almost uniform requirement for information disclosure. Thus, there will be no disadvantage to any one particular country from the adoption of country-by-country reporting.
2. The complexity of country-by-country reporting is not under estimated: it is a real issue. However, as a matter of fact many corporations are already reporting on a country-by-country basis. This is a requirement even under International Financial Reporting Standard 8 and it was obligatory under its predecessor, International Accounting Standard 14. As such, companies are already accustomed to making geographic disclosures in their accounts, and have the ability to do so. The mechanisms to handle the technical issues already exist. As a result, increasing the granularity of disclosure by requiring this for all countries in which the company operates will not create additional technical problems. If it is already possible to identify information for accounting purposes on a selective country basis, then there are absolutely no technical reasons why this cannot be done for all countries.
3. Companies must already have information on their activities in each and every country in which they operate¹³. This is because they either have separate subsidiaries for each country in which

¹³ It should be noted that some companies dispute this: they say that they organise their internal reporting on the basis of product lines and not on a geographic basis. This may be true, but even if that is their basis of internal commercial reporting they still have to re-sort that data on a country basis for taxation reporting purposes. As such, the claim that they do not have information on a geographic basis appears very difficult to believe, unless they are suggesting they do not comply with the requirement that they report their profit on an appropriate basis to all taxation authorities who have interests in their affairs.



they operate or they have, for taxation purposes, what are called “permanent establishments” in those places. Permanent establishments are self accounting entities for taxation purposes even if they are not separate legal liability corporations. As such, they have their own books and records and are required to make their own returns of profit and loss to the individual taxation authorities of the countries in which they operate. As a result, companies have the necessary information to make declarations at a country level. In addition, they already have to certify that it is correct for taxation purposes, meaning that some degree of auditing or verification will have already taken place with that data.

4. It would be wholly unreasonable to think that a single change in accounting disclosure could stop tax avoidance or tax evasion. It will not. However, transfer pricing abuse is considered one of the most important issues in tax avoidance, both by taxation authorities around the world and by tax advisers and their multinational client companies. It is also of enormous concern to developing countries and those who advise them. Indeed it costs developing countries more in revenue loss than the entire international aid budget¹⁴.

It is not suggested that country-by-country reporting is a panacea that will solve all ills. There can be no doubt that some companies will seek to allocate profits in ways that appear plausible and acceptable, but will actually be hiding tax avoidance when doing so. However, we do not abandon laws against murder because human beings do not seem to have stopped killing each other as a result of having them. We keep those laws because they are a deterrent, a mechanism for identifying those who continue to abuse and a means of imposing sanctions when the standards expected by society have not been adhered to. There seems no difference with regard to the creation of a country-by-country reporting standard: just because we know that some people will not comply, or will continue to abuse does not mean that the standard is not in itself desirable, nor does it mean it will not create an effective mechanism for identifying abuse or assisting the imposition of sanction on those who perpetrate it. As a result, the standard remains desirable even if it can never be wholly effective.

It is also incredibly important to note that tax abuse is one of many issues that country-by-country reporting is expected to address. It also has benefit to those concerned with trade issues, labour issues, corruption, corporate social responsibility, the management of geopolitical risk in an investment context among others. Consequently, to suggest that it is not needed because it cannot solve all taxation problems is to argue from a perspective that ignores its other benefits.

5. The argument that developing countries do not have enough people or enough qualified people to look at country-by-country based accounts thereby implying that country-by-country reporting will not help increase their tax revenues is deeply patronising, probably wrong, and regardless is able to be remedied through the provision of technical assistance and resources that are required by developing countries. Such assistance would allow these countries to create the necessary capacity within their taxation authorities to tackle transfer pricing abuse.

¹⁴ See ‘Death and Taxes’ Christian Aid 2008



Moreover, as country-by-country reporting will reduce the cost of tackling transfer pricing abuse, it would actually aid (not hinder) the efforts of tax authorities in developing countries benefit by reducing the scale of the support that they require. As such, this argument does not withstand scrutiny.

6. Indubitably, country-by-country reporting alone will not completely solve the problem of how to create “correct” transfer prices. It would be completely unrealistic to expect it to do so. However, it is also important to note that in practice transfer prices are frequently negotiated to achieve a fair apportionment of profit - thus producing a result that in the end is little different from formula unitary apportionment – a fact that is not always acknowledged.

In that case whilst country-by-country reporting does not say what the “correct” transfer price should be, it does provide some clear indication of whether that objective has been achieved. In so doing, country-by-country reporting will be an incredibly important tool for a variety of groups: whether for the companies themselves, who can use it to defend their position; for tax authorities, who can use it to inexpensively undertake initial audits of transfer pricing; or for civil society, who want to know who do and who do not appear to be abusing the rules.

There is a further return for investors who want to appraise the risk they might face from any particular investment as a result of a company’s compliance or non-compliance with regulation. No investor will ever have access to an individual company’s transfer pricing information: country-by-country data provides a good proxy measure of likely compliance both in this, and other tax areas. As a proxy measure of tax risk, the reporting data will be invaluable.

7. It is true that adjustments are made to the individual subsidiary company accounts when consolidated financial statements are prepared. This is demonstrated in the numeric example given above. This fact is, however, assumed to be a matter of interest, and not a matter that should be disguised or go undisclosed. If the consolidated accounts do not reflect the transactions actually undertaken by a group of companies, it would seem to be important that the shareholders be aware of this fact. Consequently, this should not be a reason for suppressing the information.

It is also important to note that since at least 60% of world trade is undertaken on an intra-group basis but not one dollar, pound, yen or euro of this is currently reported in the group consolidated accounts of the world's multinational corporations, there is presently a substantial amount of missing accounting information. This missing information – which will be provided by country-by-country reporting – is important for the management of the world economy. In the process of reconciling individual country-by-country statements with group consolidated accounts, intra-group trade will become visible. Therefore the disclosure of this information would benefit all people by increasing the effective management of worldwide trade.

This reconciliation statement is not considered to be a weakness within country-by-country reporting: it is considered to be perhaps the most important piece of information that the reporting would make available. For example: if many of the banks that required national



government support during the autumn of 2008 had reported their affairs on a country-by-country basis, then those governments would have had a better basis to appraise the inherent risk within each company's structure – potentially averting the ensuing credit crisis thereby saving a substantial amount of public money.

8. Of course, it is true that most countries do already require companies operating within their domain to submit their accounts to the local tax authority. However, there are notable exceptions to this rule. For example, in both Jersey and the Cayman Islands there is no tax on corporate profits and therefore no company is required to submit a tax return. Moreover, since corporations are not required to report in jurisdictions like Jersey and the Cayman Islands, the governments of those places do not automatically have access to the accounting information of corporations that are located there. Consequently, nobody else is able to obtain that information either. Therefore, if a local company located where corporation tax is payable trades with a related group company located in a place like Jersey or the Cayman Islands, and if the group of companies is not willing to provide the accounts of its subsidiaries in those tax havens, it is nearly impossible for a taxation authority wishing to enquire about transfer prices to secure information about the tax haven side of the transaction. .

To therefore argue that country-by-country reporting does not provide additional information to local tax authorities is wrong. Country-by-country reporting may be the only realistic and cost effective way in which they can obtain information on trade with certain locations where accounts do not need to be put on public record.

9. As a matter of fact, auditors have for many years reported upon country specific data included in the accounts of multinational corporations because this information has been disclosed under the requirements of International Accounting Standard 14. This standard was always geographically based – a feature that is still partly true of its replacement standard, International Financial Reporting Standard 8. As a result, it cannot be said that country-by-country information cannot be audited.

That said, it is undoubtedly true that country-by-country reporting will make the audit of some multinational companies more complex and more expensive, as has already been noted above.

10. It is accepted that some countries require more information to be available about the subsidiaries of multinational corporations registered in their domain than do others. For example, France appears to require that the accounts of subsidiary corporations of French corporations be available for inspection on public record in France; in this respect it is almost alone in the world. Both the UK and USA, in different ways, expect their multinational corporations to place on public record the names and registered locations of the subsidiaries that they own, but neither requires that their accounts be available for inspection. If a company is incorporated in a location such as the Isle of Man – a phenomenon that is becoming increasingly more common with companies registered on the UK's AIM stock market – no such requirement exists. Ireland also has a lax approach regarding the disclosure of information and is becoming an attractive location for the registration of holding companies.



It is precisely because of this variable access to information that a universal standard for disclosure is required. It appears perverse to argue that just because some countries have better practices than others, those who take advantage of this in order to hide information should benefit as a result.

11. It is true that country-by-country information could be of significant volume. However, this is no reason to not publish it.

First of all, many corporations already send summarised financial statements to a majority of their private shareholders. These summary statements would not be required to include country-by-country data; instead it would be available on request.

Second, the accounts of almost all multinational companies are now available online, and this is undoubtedly the most common way in which stakeholders access this information. Paper need not be printed as a result.

Third, because of the recognition of this general fact, new standards for the provision of corporate accounting data online are being created and should be in operation within a year or two. The data will then be available to a universal standard that will allow it to be downloaded and manipulated in spreadsheets and other programs. Thus making calculations of the sort noted above (to determine unitary apportionment ratios) would be a relatively easy task that would no longer require any transcription.

Put simply, the accounting profession has recognised that the complexity of global companies requires substantial information to be published. Some accounts are already 400 pages long. This is necessary to provide users with all of the data that they require to assess information and interrogate it as they wish. If anything, this volume of data provides additional incentive for the provision of country-by-country reporting, and not the opposite, as country-by-country reporting cuts a path through the complexity to provide local data to those for whom this data is a concern.

As previously noted, there will be other counter arguments to country-by-country reporting. In practice, the primary anticipated objections to country-by-country reporting are either political or commercial. For example, secrecy jurisdictions (tax havens) and the commercial organisations, such as multinational accountants, that are located within them may not wish information on activity located in these places to be made easily accessible – a likely result of country-by-country reporting. In addition, companies may not wish to have their corporate structures, their use of particular locations, details of their commercial operations, or their profits arising in some locations to be put on public record, and they may therefore object to country-by-country reporting. However, this has always been the case with any suggested accounting reform. Reforms occur despite the objections of those who will have to comply with them, never because the producers of such information demand that they be allowed to publish it.



How likely is it that country-by-country reporting will be introduced soon?

Country-by-country reporting is a relatively new concept. Something called ‘segment reporting’ has been a well established part of multinational corporation accounting under the rules of consolidated accounting for many years, and, until recently, it usually required some form of geographic reporting (although not on a country-by-country basis). The ideas that are included in country-by-country reporting were first proposed in a paper¹⁵ written by Richard Murphy and published by the Association for Accountancy and Business Affairs in the UK in January 2003. Entitled ‘Reporting Turnover and Tax by Location,’ it proposed that an International Financial Reporting Standard on what has now been called country-by-country reporting be created by the International Accounting Standards Board for use by all multinational corporations which have to comply with its regulations.

The International Accounting Standards Board is a privately funded body based in London, which is heavily influenced by the Big 4 firms of chartered accountants¹⁶, and which has been given extraordinary powers to create accounting regulations which have the effective power of law in more than 100 countries in the world since 2005. It largely came about because the European Union needed an agency to establish common accounting rules for quoted companies in all EU states and opted to use the standards created by the little known International Accounting Standards Committee for this purpose. As a consequence, it evolved into the Board but still remains quite independent of all government control.

Although published originally by the Association for Accountancy and Business Affairs and then adopted as one of the very early campaigns of the then new Tax Justice Network (TJN), the campaign for country-by-country reporting was first taken up by the Publish What You Pay (PWYP) coalition, an organization which was campaigning for greater transparency in the extractive industries. As a result, PWYP helped create the Extractive Industries Transparency Initiative¹⁷.

PWYP and TJN led joint campaigns on this issue seeking to influence the International Accounting Standards Board standards on both extractive industries (IFRS 6) and, more generally, on segment

¹⁵ <http://visar.csustan.edu/aaba/ProposedAccstd.pdf> accessed 15-5-09

¹⁶ PricewaterhouseCoopers, KPMG, Deloitte and Ernst & Young

¹⁷ See <http://www.publishwhatyoupay.org/en/about/advocacy/accounting-standards-regulations> and http://www.globalwitness.org/media_library_detail.php/141/en/extracting_transparency



reporting (IFRS 8) so that the latter would include country-by-country reporting¹⁸. These campaigns achieved high profile, receiving receive coverage in the Financial Times¹⁹ and other newspapers in September 2006. As a result, pressure grew on the European Union, and in November 2007 the European Parliament voted in favour of a resolution for a new international accounting standard which required oil, gas and mining companies to report critical information on a country-by-country basis²⁰.

This was a major success for the campaign, and support has continued to grow steadily since that time. There remains the ‘narrow ask’ for country-by-country reporting for the extractive industries, which Publish What You Pay continues to lead. They are actively supported in this work by NGOs such as Save the Children and CAFOD (Catholic Aid for Overseas Development). The ‘broader ask’ for country-by-country reporting for all countries has been lead by the Tax Justice Network and now has active support from Oxfam, Christian Aid, Action Aid a many other NGOs in the UK and Europe along with increasing support from within the USA. The reason for these organizations’ support is that they believe that if multinational corporations paid the tax that is expected of them in developing countries, but which they currently avoid, then the aid dependence of many of these states would be dramatically reduced, their standards of governance would be significantly increased, and the transparency the standard would create would reduce the risk of corruption.

Increasing awareness is raising public demand for accounting reform that includes country-by-country reporting. For example, the issue was widely referred to in a debate²¹ on tax avoidance and evasion in the UK House of Commons in May 2009.

The prospect of success is, however, largely dependent upon the agreement of the International Accounting Standards Board to change. As is noted above, the European Parliament has demanded that change of the Board, and has some power to do so. Pressure from this source will remain crucial if change is to happen. Pressure from local legislatures is also important: in principle, any state could introduce country-by-country reporting for companies registered in its own domain if it so wished.

However, the problem with progress is that the International Accounting Standards Board is financed by and dominated by the very bodies most resistant to change, namely the Big 4 firms of accountants and the multinational corporations who would be required to report quite differently – and much more transparently – under country-by-country reporting. This does, of course, highlight considerable problems in the governance structures surrounding the creation of International Financial Reporting Standards. These problems were, in part, recognised at the G20 meeting in London in April 2009, and the International Accounting Standards Board is therefore slowly responding to demands for reform of its governance procedures.

¹⁸ See <http://www.taxresearch.org.uk/Documents/IAS14Final.pdf> accessed 15-5-09

¹⁹ <http://www.ft.com/cms/s/0/bbbb0046-498f-11db-84da-0000779e2340.html> accessed 15-5-09

²⁰ <http://www.publishwhatyoupay.org/sites/pwypdev.gn.apc.org/files/EP%20resolution%20accounting%20standards%20141107.pdf> accessed 15-5-09

²¹ <http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090506/halltext/90506h0009.htm> accessed 15-5-09



That said, the International Accounting Standards Board (right?) is not showing any real sign of awareness of the need for multinational corporations to account for their actions to civil society. During 2008 the International Accounting Standards Board and its US equivalent – the Federal Accounting Standards Board – consulted on what it refers to as its ‘conceptual framework’. In this they suggest²² that, “[t]he objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Capital providers are the primary users of financial reporting.” In so saying they also note that, “[i]nformation that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers.”

These attitudes have been challenged by civil society organisations and others who have made submissions to the International Accounting Standards Board on this process, but it appears that little that has been said has persuaded the Board of the limitations inherent in their stated opinion. This obviously has consequence for the country-by-country reporting campaign: if the International Accounting Standards Board does not accept that the primary users whose needs country-by-country reporting is meant to meet are of relevance as users of accounts, then there are clear obstacles to progress in negotiation. However, it is also easy to demonstrate that the benefits of country-by-country reporting extend to shareholders and other providers of capital, as has been noted in this report. The fact that the European Parliament has been persuaded of its merits also helps: a powerful ally is supporting the campaign. If all tax authorities that might benefit from country-by-country reporting were to lend their support to the campaign for it, there is little doubt that the campaign would be over. This may yet be the best chance there is for change.

Realistically, the campaign for country-by-country reporting requires three things to succeed. The first is better informed information as to what the merits of the proposal are. What you are reading is part of that process. Second, this needs to inform dialogue with the accounting profession. This process is under way. Thirdly support for a broader range of potential users is required. Some investors have already shown that support. Support is now needed from a broader range of users, tax authorities, developing countries, and others who might benefit from country-by-country reporting from an increased range of countries.

Even without such broad support, the International Accounting Standards Board is duty bound by the resolution of the European Parliament noted above to report by 2011 on its progress towards introducing country-by-country reporting for the extractive industries. Dialogue, lead by Publish What You Pay, is taking place with the International Accounting Standards Board on this issue in 2009 and it is expected that a proposed revision of International Financial Reporting Standard 6 on accounting for the Extractive Industries might include this requirement. If so, a first and most important step on the path to general country-by-country reporting will have been taken.

²² http://www.fasb.org/draft/ed_conceptual_framework_for_fin_reporting.pdf accessed 15-5-09



Progress to full country-by-country reporting will still take time. In broad terms it takes at least three years to produce an International Financial Reporting Standard because of the consulting processes used by the International Accounting Standards Board. In addition, once a standard is set it often takes a year or two before it becomes operative, largely to ensure that companies have the time to change their systems and produce the necessary data.

That said few changes that could deliver so much for the benefit of so many – in developing countries in particular and for the enhancement of transparency within business in general – could be achieved in a shorter time scale. As such, encouragement should be taken from this fact.

The reality is that as people around the world realise that the increased taxation demands arising from the current credit crisis and world recession will fall unevenly unless multinational corporations are held to account for their actions, the demand for country-by-country reporting will increase assuming that people become aware of what it has to offer. We believe that country-by-country reporting can deliver on its promise; we believe that it is technically viable; we believe it will impose few costs on business compared to the benefits it can deliver to society at large and to developing countries in particular. We believe that business will be more robust if it uses this reporting, and that all who invest in multinational corporations will benefit as a consequence. That is why we are campaigning for country-by-country reporting. That is why we believe country-by-country reporting will happen.



About the author

Richard Murphy (50) is a chartered accountant.

A graduate in Economics and Accountancy from Southampton University he was articled to Peat Marwick Mitchell & Co in London. He specialised in tax before setting up his own firm in 1985. In 1989 this became Murphy Deeks Nolan, Chartered and Certified Accountants of which he was senior partner until he and his partners sold the then 800 client firm in 2000.

In parallel with his practice career Richard has been chairman, chief executive or finance director of more than ten SMEs.

Richard has written widely on taxation and accounting, including for the Observer. He has appeared in BBC radio and television documentaries on taxation issues.

Since 2000 Richard has been increasingly involved in taxation policy issues. He is a founder of the Tax Justice Network and director of Tax Research LLP which undertakes work on taxation policy for a wide range of clients including governments, government agencies, commercial organisations, aid agencies and pressure groups in the UK and abroad.

Richard is a visiting fellow at the Centre for Global Political Economy at the University of Sussex and an External Research Fellow at the Tax Research Institute, University of Nottingham.

He was included in Accountancy Age's "Financial Power List for 2006" as one of the 50 most influential names to look out for in 2006. He was promoted on publication of the 2007 list and in 2009 was placed at number 25.

More information on Richard's work can be found on the Tax Research LLP web site: <http://www.taxresearch.org.uk/>



