Tax Research

Accountancy Briefing

The benefits of country-by-country reporting

What is country-by-country reporting?

Country-by-country reporting is a new and innovative form of accounting. It is intended to be a part of the financial reporting of quoted multinational corporations, to be included in their annual published financial statements. It would be backed by an International Financial Reporting Standards, which would require the backing of the International Accounting Standards Board if it were to be introduced[i].

A briefing sheet is available on country-by-country reporting. It is recommended that the reader read that briefing before this one if they are not familiar with this issue[ii]. The full rationale for country-by-country reporting is explained in a publication by Richard Murphy, the director of Tax Research UK entitled 'Country-by-Country Reporting: Holding multinational corporations to account wherever they are'[iii].

Tax Research, and the Task Force on Financial Integrity and Economic Development[iv] of which it is a member, and many other organisations concerned with development issues[v] support the creation of country-by-country reporting for multinational corporations.

The problems in existing accounting that country-by-country reporting will tackle

The disclosures made by multinational corporations in their published annual audited financial statements is very largely governed by non-statutory, self regulated requirements laid down by bodies established by and largely run by the accounting and auditing professions (the International Accounting Standards Board in much of the world and the equivalent Federal Accounting Standards Board in the USA) and by the requirements of the stock exchanges on which the equity of such entities is traded.

The organisations calling for country-by-country reporting have identified two key weaknesses in these reports. The first is that they are published on a group consolidated basis. This is, of course, of benefit to the equity holders in the corporation. No one denies that. No one calling for country-by-country reporting argues that consolidated group financial statements should not be supplied to the members of such entities. There are, however, weaknesses in group consolidated financial statements, some of which are:

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1. They represent an accounting fiction – no entity actually exists that undertakes all the transactions that the accounts report – those transactions are a selection of the transactions undertaken by an amalgam of a great many other organisations;

2. They ignore all intra-group trades which at a local level may be highly material and which are, for tax purposes, very often the most sensitive transactions undertaken by the companies in the group;

3. They do not locate trades in a place because their reporting is not geographic;

4. They do not identify the assets and liabilities located in a place;

5. They do not reveal the structure of the trading group;

6. They do not supply many users – including many considered suppliers of capital by the International Accounting Standards Board, such as trade creditors and employees – with information about the particular entity they are engaged with[vi];

7. They cannot properly represent tax due because tax is not paid on a group basis but at the level of the individual corporate entity.

It is readily apparent as a result that such accounts cannot meet the needs of all suppliers of capital to a multinational corporation, let alone meet the needs of the many other users of financial statements who are not suppliers of capital.

These deficiencies are not overcome by current reporting standards relating to segment reporting. These are International Financial Reporting Standard 8 in countries where IASB standards apply and SFAS 131 in the USA. For all practical purposes these standards are the same. These standards requires that if the reporting entity is a multinational corporation it need only differentiate trading geographically by reporting trade in its head office location separately from trade in all other locations, and then only if that split is material. No other geographic data need be supplied: other segment data to be supplied to users of the financial statements must use the same break-down as is used for supplying data to senior management for their decision making purposes. This may be geographic data, of course, but need not be so if, for example, the data is analysed by business category when the multinational corporation undertakes diverse trades.

This type of business sector analysis may well suit the multinational corporation; again this is not disputed. It does not however suit the needs of many users of accounting data whose need is to assess geographic risk relating to the place in which the entity is trading and in which the user of information is located.

What is argued by those supporting country-by-country reporting is that:

1. The lack of mandatory geographic data destroys comparability in reporting;

2. The lack of specific jurisdiction data means that many local users of the financial statements of multinational corporations have no locally specific data on which to base their decisions, placing them at a competitive disadvantage;

3. Those wishing to hold corporation and governments to account for the management of the settlement and use of taxation revenue streams do not have the information they need in group consolidated financial statements of multinational corporations to let them do this and, in addition, the accounts of local subsidiary entities are no substitute for group data when:

    a. Those subsidiaries are often not identified;

    b. Their accounts are frequently not available on public record.

Finally, those arguing for country-by-country reporting contend that significant macroeconomic data crucial for managing the international economy is not available for that purpose as a result of the absence of country-by-country reporting. For example:

1. Data on the precise value of intra-group trading is absent, although the OECD now appear to estimate that it amounts to 70% of total world trade;

2. Data on the location of worldwide profits is hard to secure;

3. Data on where multinational corporations declare and pay their tax is largely unknown;

4. Data on employment patterns within multinational corporations is largely unknown;

5. Data on where multinational corporations locate their assets and liabilities is largely unknown;

6. The location of financing flows within multinational corporations is little known about.

As is noted below, country-by-country reporting can provide this data, and more besides.

The information disclosure required by country-by-country reporting

Country by country reporting as currently proposed would require disclosure of the following information by each multinational corporation in its annual financial statements:

1. The name of each country or jurisdiction in which it operates;
2. The names of all its companies trading in each country or jurisdiction in which it operates;
3. What its financial performance is in every country or jurisdiction in which it operates, without exception, including:
    - It 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 or jurisdiction 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 or jurisdiction;
6. Details of its gross and net assets in total for each country or jurisdiction in which operates.

Tax information would need to be analysed by country or jurisdiction in more depth requiring disclosure of the following for each country or jurisdiction 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 or jurisdiction 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 or jurisdiction 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 a full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between the categories of reporting required in the Extractive Industries Transparency Initiative[4] would be required.

The benefits that country-by-country reporting data would provide

The data that country-by-country reporting would supply would meet the following information needs, all of which are illustrative and not intended to be complete indication of the benefits arising:

Data disclosed	Information need met
1. The name of each country or jurisdiction in which a multinational corporation operates;	• Discloses geographic spread of the multinational corporation • Advises host communities of the presence of the multinational corporation in their jurisdiction • Indicates presence in locations likely to be subject to geo-political risk • Indicates exposure to local regulatory and tax regimes.
2. The names of all its companies trading in each country or jurisdiction in which it operates;	• Identifies completely and accurately the full groups structure of a multinational corporation, a feat rarely possible at present • Lets a multinational corporation be properly identified in the host communities that facilitate its activities • Allows those engaging with a multinational

	corporation locally to identify ultimate responsibility for the entity with which they are trading • Ends the corporate culture of secrecy about activities in many jurisdictions, whether they are secrecy jurisdictions or not • Means a multinational corporation is accountable for all its actions – a pre-condition of corporate social responsibility.
3. Sales, both third party and with other group companies. Sales information will also require additional analysis. If sales to 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	• The extent and direction of sales flows by multinational corporations will be documented • The full extent of intra-group sales will be understood for the first time • The use of tax havens / secrecy jurisdictions as locations for the routing of intra-group transactions will be properly understood • The splitting of sales from the location in which a service is received from the jurisdictions from which they are billed will be capable of identification, an issue of particular significance in services where limited data on sales flows is currently available • The relocation of sales for tax purposes will be identifiable • The risk inherent in internal supply chains will become apparent
4. Purchases, split between third parties and intra-group transactions	• This data is requested to complement that on sales: when the sales of a multinational corporation from a jurisdiction are largely matched by intra-group purchases it is likely the jurisdiction is being used for re-invoicing purposes and transfer mispricing may be taking place: a cause of concern to almost all tax authorities • The extent of outsourcing in source jurisdictions likely to be at the start of supply chains can be identified, especially when compared to labour data (see below) • The vulnerability of supply chains can be identified

	• By comparing intra-group purchases and intra-group sales likely intra-group supply chains can be established • Sourcing from locations with high geo-political risk should be identifiable
5. Labour costs and employee numbers	• The organisation of labour by jurisdiction within multinational corporations can be identified • Unusual incidence of value added in proportion to labour cost can be identified • The likelihood of outsourcing can be identified • Average reward per employee by jurisdiction can be calculated • Trends in labour relationships over time can be monitored
6. Financing costs split between those paid to third parties and to other group members	• Financial flows indicate where financial assets and liabilities are located within and beyond multinational corporations: disclosure of income and payments, especially on an intra-group basis will indicate the extent to which profits are relocated through the use of debt that creates internal and external financial risk within the multinational corporation

7. Pre-tax profit;	• Pre-tax profit is, without exception, the principle starting point for determining:
	  o The location of retained reserves
	  o The ability to finance activity without recourse to third parties
	  o The likelihood of ongoing financial stability of the entity
	  o The potential for making payment of taxation liability on income arising
	• Pre-tax profits located in many countries where there is considerable corporate secrecy are currently wholly unascertainable
	• The presence of significant profit in locations where most purchases and / or sales are intra-group might indicate artificial relocation of profits
	• The absence of profits in locations where it

	would be expected there should be considerable value added e.g. in source locations for extractive industry supply chains, might indicate transfer pricing issues • Persistent losses in a jurisdiction might indicate the misallocation of resources by a multinational corporation, as might strongly differing profit rates between jurisdictions • Significant profits arising in politically sensitive jurisdictions might indicate vulnerable future earnings • Significant earnings in tax havens / secrecy jurisdictions might indicate high tax risk or unsustainably low tax charges indicating a likely change in future after tax earnings ratios • Significant profits arising outside a parent company location where corporate taxation is assessed on a remittance basis might indicate limited access to funds for dividend distribution purposes
8. The tax charge for the year split between current and deferred tax;	• The extent to which a tax charge is expected to arise when compared to headline tax rates indicates the effectiveness of a tax regime in capturing income for tax assessment purposes • The degree to which corporate tax liabilities can be deferred indicates the existence of incentive allowances out of alignment with economic costs incurred, and indicates future potential reversal and erratic cash flows • The ratio of tax paid to profitability across jurisdictions is at present unknown: country-by-country reporting would provide it and indicate the extent and nature of cross border tax planning and international tax arbitrage • If a declared tax rate appears aberrant it may indicate unsustainability
9. The actual tax payments made to the government of the country or jurisdiction in the period;	• It is not accruals made for tax that allow governments to meet their obligations – it is cash in its bank accounts that allows it to

	do that: cash paid is the ultimate proof of tax settled. This data is currently entirely unavailable and as such the contribution of multinational corporations to individual national economies is very hard to assess • It is cash that is the subject to corruption: it is cash for which governments have to be held to account. This data is vital for that purpose • Cash settlements of less than liabilities declared in earlier years suggest the presence of undetected tax planning or corruption. In either case the effectiveness of the tax regime of the jurisdiction is in question.
10. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period	• This data is required to undertake an overall tax reconciliation for a jurisdiction: tax due at the beginning of the period plus the current tax charge for the period less tax paid should equal the closing liability. If it does not there is indication of irregularity in accounting or in the statement of taxes due, in either case worthy of investigation • The failure of a jurisdiction to collect tax owing to it is indicated by this data: if tax outstanding relates to more than one year prime facie there is a tax collection problem within the jurisdiction or the entity is declaring liabilities in its accounts that are inconsistent with those declared to tax. In either case problems are indicated
11. Deferred taxation liabilities for the country or jurisdiction at the start and close of each accounting period.	• Deferred taxation indicates any of these things: o Excessive allowances offered by he jurisdiction o The existence of significant tax avoidance o A non-alignment of taxation with underlying economic reality • In each case there is cause for concern
12. Details of the cost and net book value of its physical fixed assets located in each country or jurisdiction and	• Without indication of the capital dedicated by a multinational corporation to a jurisdiction it is not possible to calculate:

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13. Details of its gross and net assets in total for each country or jurisdiction in which operates.	○ Rate of return on capital employed in the jurisdiction and to compare these ○ To determine whether capital invested justifies the level of profit reported ○ To determine whether capital assets are being appropriately allocated to support labour productivity, or not ○ To determine where assets and liabilities are likely to be within a group and whether they are as a consequence available a) to shareholders and b) to creditors
14. A full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between the categories of reporting required in the Extractive Industries Transparency Initiative if the multinational corporation is engaged in extractive industry activities	• Required for all the reasons noted by the Extractive Industries Transparency Initiative

As noted: these benefits from the data noted are indicative and should not be considered complete.

In combination it is suggested that this data would contribute to the benefits users of the financial statements of multinational corporations would secure from the transparency created by country-by-country reporting.

In summary, 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;
- Opens 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 and in the process contribute to constraining corruption on the part of some recipient governments;

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- 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.

It is for these reasons that the data it can supply is requested by those campaigning for its introduction.

[i] For more information on the International Accounting Standards Board and International Financial Reporting Standards see http://www.iasb.org/Home.htm and http://www.iasplus.com/standard/standard.htm

[ii] The briefing sheet is available at http://www.taxresearch.org.uk/Documents/CBC.pdf

[iii] Available here: http://www.financialtaskforce.org/2009/06/17/country-by-country-reporting-holding-multinational-corporations-to-account-wherever-they-are/

[iv] See http://www.financialtaskforce.org/ 15-2-10

[v] For example, Tax Justice Network, Global Financial Integrity, Christian Aid, Action Aid, Global Witness, Publish What You Pay, Revenue Watch, Oxfam in many countries, EuroDad, and many more.

[vi] For more information see the Tax Research Briefing on The Users of Accounts - http://www.taxresearch.org.uk/Documents/Accountsusers.pdf

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