Country-by-Country Reporting

Shining Light onto Financial Statements

Prepared by Richard Murphy On Behalf Of TJN International Secretariat

tax justice network

Contents

This report was written by Richard Murphy of Tax Research LLP on behalf of Tax Justice Network International Secretariat. Enquiries should be directed to info@taxjustice.net or richard.murphy@taxresearch.org.uk

Introduction and summary

This report is a full response to the questions posed by the European Commission in public consultation on country-by-country reporting by multinational companies, published in October 2010[i]. The submission elaborates the summary responses posted on line to the European Commission and is an integral part of the overall submission.

In summary the submission argues that:

- Country-by-country reporting is financial reporting data;
- Country-by-country reporting data is essential information likely to have significant impact on economic decision making by investors and other users of financial statements;
- As such country-by-country reporting requirements should be included in International Financial Reporting Standards, or failing that in the European Union Seventh Directive on Financial Reporting;
- This information is material without exception for the users of financial statements located in the jurisdictions in which multinational corporations trade (as indicated by their having a taxation permanent establishment in that location) and as such must be published for all such jurisdictions, with the sole exception being that some trading data may be omitted when immaterial to the jurisdiction in question.
- Most country-by-country reporting data should be audited but this should not impose significant additional cost on multinational corporations, all of whom must already have all the necessary data if they are to fulfil their legal obligation to maintain adequate internal control systems capable of determining their assets and liabilities at any point in time.
- Country-by-country reporting data would substantially enhance taxation governance within multinational corporations, jurisdictions and internationally;
- There are significant benefits to full country-by-country reporting for the extractive industries and that this requirement complements and does not in any way undermine the disclosures required by recent US legislation and the Extractive Industries Transparency Initiative.
- Whilst country-by-country reporting by all multinational corporations would be invaluable, greatest benefit is secured from this disclosure by what are defined as 'very large' corporations and some other quoted companies.
- That all these users need country-by-country reporting data because this data;
  - Adds essential information for the effective operation of capital markets to that available in existing financial statements.
  - Emphasises the duty of directors to exercise sound governance over the assets of which they have stewardship, including the decisions they make as to where to invest those assets and to undertake trade.
  - Ensures that all users of accounts receive the information that they require to appraise the performance of the reporting entity.
  - Provides essential information required by users of accounts which is not made available by existing International Financial Reporting Standards.

- Provides that information, if delivered consistently across Europe, on as basis that ensures that comparison can be made between reporting entities, which is a key attribute essential to successful interpretation of financial data.
- Will increase the well-being of the people of Europe as a consequence of the enhanced return likely be made when directors of multinational corporations are held accountable for locating corporate investment in those places where their use is likely to be most advantageous.

1. Would it be useful to have common EU rules on the disclosure of financial information on a country-by-country basis?

Issues addressed in this section:

- Why the EU has accounting rules
- What those rules do not disclose
- Who the users of accounts of accounts are
- What information users of accounts need
- Why country-by-country reporting meets those needs

Summary

In this section it is argued that:

- The EU has accounting rules to ensure that there is a level playing field in the operation of markets across the member states and that this is dependent upon the availability of relevant, reliable and useful data for the purposes of economic decision making both locally and with regard to the interaction of local markets with corporations.
- That the existing accounting rules of the EU do not supply data on a country-by-country reporting basis, meaning that data is not available to make appropriate decisions at the local level within the EU;
- That this prejudices the needs of the users of accounts, who are:
  - The equity investor group (shareholders);
  - The loan creditor group (banks and bondholders);
  - The analyst-adviser group who advise the above groups;
  - Business partners;
  - Consumers;
  - Employees;
  - The surrounding community i.e. the public at large;
  - Civil society organizations; and
  - Governments and their institutions.
- That all these users need country-by-country reporting data.

The EU and accounting regulation

The EU has promoted two directives on corporate accounting by limited liability entities: the Fourth Directive[1] applying to all companies and the Seventh Directive[2] applying to groups of companies. The first was issued in 1978 and the second in 1983.

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[1] http://europa.eu/legislation_summaries/internal_market/businesses/company_law/l26009_en.htm accessed 12-11-10

[2] http://europa.eu/legislation_summaries/internal_market/businesses/company_law/l26010_en.htm accessed 12-11-10

There is good reason for the EU to require comprehensive and consistent accounting reporting across the member states. If there is to be a common market between the member states and a free flow of capital from one state to another, a process assumed to promote the economic well-being for all those who live within the EU, it is vital that comprehensive, complete and comparable accounting data be made available to those seeking to take decisions on the effective allocation of capital within and between member states. That is what the Fourth and Seventh directives seek to provide.

There are, however, significant omissions from the information provided by accounts complying with these regulations, and in particular from the accounts of groups of companies prepared under the Seventh directive using the consolidated accounting methods that it requires. These omissions specifically include data on:

- Where, by country, sales and costs are incurred;
- What the level of intragroup trade between member states within the entity might be;
- In which countries staff are employed, and how much in aggregate they are paid in each member state;
- In which member states and in what amount a group of companies records its profits and losses and in turn its consequent taxation liabilities;
- In which member states the reporting entity holds its assets;
- To which member states the entity actually makes a payment of tax.

This information is of considerable significance to investors in a corporation. It reveals how the entity has undertaken its duty of stewardship with regard to the assets that have been entrusted to its care, and indicates the outcome of the decision-making processes that the directors have undertaken on behalf of the members in seeking to allocate resources to promote an optimal rate of return on the assets employed by the undertaking. Unless this information is made available:

1. The directors of the reporting entity are under no pressure to make optimal decisions;
2. The shareholders cannot appraise whether their directors have made optimal decisions, and
3. Sub optimal allocation of resources is likely to result both within the company and in the allocation of resources between companies.

The consequence is that:

a. The well-being of those living within the European Union will not be maximized;
b. Markets will operate sub-optimally within the European Union;
c. Capital flows within the European Union may be inefficient.

For these reasons alone it is clear that consistent rules on financial disclosure on a country-by-country basis within the European Union will be of considerable benefit to the population of the European Union, the member states and the efficiency of its markets, whether financial or otherwise.

There are, however, further very good reasons for believing that country-by-country financial disclosure is necessary. The Seventh Directive on group financial reporting on a consolidated accounting basis does make a number of fundamental, and key, assumptions that might have been valid at the time the Directive was prepared but which are now subject to question, either because of the passage of time or because of enhanced understanding of the relationship between the corporation and the state which hosts its activities. These assumptions that might now be questioned are that:

- The sole reporting obligation of the corporation is to its shareholders, who have primary interest in its activities.
- The corporation acts as agent for shareholders, and the capital of those shareholders is, therefore, of primary concern in financial reporting.
- Each corporation is relatively small compared to the country that hosts its activities and each is unlikely to be material to the well-being of the locations in which it is incorporated or trades. Disclosure of country specific information is not, therefore, important, because it would be immaterial to the country in question.
- Because it is assumed that each corporation is relatively small, and therefore dispersed relatively narrowly and across few states, the value of intragroup trading between locations is relatively modest, and unlikely to be of significant impact on reporting.
- There is limited interest from those other than shareholders in the activities of quoted companies.

These assumptions no longer hold true:

- The International Accounting Standards Board no longer assumes shareholders are the primary source of capital for companies. They suggest they are just one of a number of providers, with no special priority.
- The International Accounting Standards Board now requires that company accounts be prepared on an entity basis i.e. the corporation stands apart, and entirely separate from their membership. As such the corporation is recognised as a legally distinct and separate entity with its own identity giving rise to its own distinct, distinguishable and separate obligations, including to the countries that host its operations.
- As a consequence of globalisation companies have grown significantly in size. It is now commonplace for companies to be larger than the states that host their activities, and the consequences have been seen during the financial crisis that emerged in 2007/08. The need for states to guarantee the liabilities of entities trading from within their jurisdiction has given rise to crippling financial burdens for some states, such as Ireland, and heavy financial burdens for others, such as the United Kingdom. It is now apparent that the corporation's relationship to the state is not immaterial to either party: the well-being of a country can be dependent upon the activities of the corporations that trade from and within it. This situation is not restricted to the financial services industry. The same scenario is also commonplace in the extractive industries sector, with impact on many developing countries.
- As a result of globalisation it is now estimated by the OECD that at least 60% of world trade is undertaken on an intragroup basis. The extraordinary circumstance has arisen where a

majority of world trade is, as a consequence, excluded from view in the consolidated accounts of the world's major corporations that organise and benefit from that trading activity.

- It is now apparent, not least as a consequence of the development of the corporate social responsibility agenda, that many parties have an interest in the accounts of multinational corporations.

This last point is particularly important. When comparing the analysis of the U.K.'s Accounting Standards Steering Committee in 1975 and that of the United Nations Conference on Trade and Development in 2008 it is apparent that over a 33 year period there was a remarkable uniformity in those considered to have an interest in the accounts of multinational corporations, who can be agreed to be as follows:

- The equity investor group (shareholders);
- The loan creditor group (banks and bondholders);
- The analyst-adviser group who advise the above groups;
- Business partners;
- Consumers;
- Employees;
- The surrounding community i.e. the public at large;
- Civil society organizations; and
- Governments and their institutions.

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The information and data that they seek from financial statements might be summarised as follows, based on the 1975 work of the UK’s Accounting Standards Steering Committee, noted above:

1. The performance of the entity;
2. Its effectiveness in achieving stated objectives;
3. Evaluating management performance, including on employment, investment and profit distribution;
4. The company's directors;
5. The economic stability of the entity;
6. The liquidity of the entity;
7. Assessing the capacity of the entity to make future reallocations of its resources for either economic or social purposes or both;
8. Estimating the future prospects of the entity;
9. Assessing the performance of individual companies within a group;
10. Evaluating the economic function and performance of the entity in relation to society and the national interest, and the social costs and benefits attributable to the entity;
11. The compliance of the entity with taxation regulations, company law, contractual and other legal obligations and requirements (particularly when independently identified);
12. The entity's business and products;
13. Comparative performance of the entity;

14. The value of the user's own or other user's present or prospective interests in or claims on the entity;
15. Ascertaining the ownership and control of the entity.

It has been suggested that of these information needs, established 35 years ago, that financial statements are prepared under the Seventh EU directive provides information to meet categories 1, 3, 4, 5, 6, 12 and 13 in full and 7, 8 and 14 in part. That leaves categories 2, 9, 10, 11, 14 and 15 unaddressed. These are, however, vital issues of concern to those located in particular country who have dealings with the reporting entity preparing financial statements.

As a result it is argued that country-by-country reporting:

- Adds essential information for the effective operation of capital markets to that available in existing financial statements.
- Emphasises the duty of directors to exercise sound governance over the assets of which they have stewardship, including the decisions they make as to where to invest those assets and to undertake trade.
- Ensures that all users of accounts receive the information that they require to appraise the performance of the reporting entity.
- Provides essential information required by users of accounts which is not made available by existing International Financial Reporting Standards.
- Provides that information, if delivered consistently across Europe, on as basis that ensures that comparison can be made between reporting entities, which is a key attribute essential to successful interpretation of financial data.
- Will increase the well-being of the people of Europe as a consequence of the enhanced return likely be made when directors of multinational corporations are held accountable for locating corporate investment in those places where their use is likely to be most advantageous.

2. Would the disclosure of financial information on a country-by-country basis by multinational companies be meaningful to investors in the company concerned?

Issues addressed in this section:

- The disclosure that country-by-country reporting would make;
- The use that might be made that disclosure by investors;
- The benefits arising from that use.

Summary

In this section it is suggested that:

- country-by-country reporting requires the publication of a profit and loss account, limited balance sheet and some cash flow information for all jurisdictions in which a multinational corporation trades, some immaterial locations (when assessed from the perspective of the location) excepted;
- That the information disclosed will have significant impact on the decisions made by investors and other suppliers of capital to multinational corporations;
- That in consequence country-by-country reporting is material to effective decision making on a range of issues including a variety of risks, rates of return, governance, tax and the balance between short and long term rewards.

The disclosure required by country-by-country reporting

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:

- 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 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.

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 corporation operates broken down between these categories of reporting required in the Extractive Industries Transparency Initiative[ii].
As a result of widespread discussion and consultation during the autumn of 2010 the way in which these issues might be presented in the financial statements or a relevant reporting entity required to undertake country-by-country reporting has been refined.

This revision has been undertaken to achieve a number of objectives:
1. To increase the ease with which country-by-country reporting might be introduced;
2. To reduce the potential cost of producing country-by-country reporting data;
3. To facilitate the auditing of country-by-country reporting data by reducing, where appropriate the scale of work to be undertaken;
4. To speed the production of country-by-country reporting data by reducing the scope of the auditing of country-by-country reporting data required;
5. To facilitate the ease with which country-by-country reporting data can be presented within financial statements;
6. To provide as many of the benefits of country-by-country reporting as possible despite these revisions.

The revised proposed disclosures to be made by those entities required to undertake country-by-country reporting would now be, in outline, as follows:

Disclosure	Benefits and reason for change, if any
1. The name of each country in which it operates.	No change. This listing, based on those locations in which the reporting entity had permanent establishments for taxation purpose at any point during a year, is basic information that must be known to any corporation and imposes no additional burden with regard to its disclosure.
2. The names of all its companies trading in each country in which it	No change made except with regard to dormant companies. It is however stressed that:

operates;	• This data is already required disclosure for all EU based companies, albeit many fail to make that disclosure as currently required by law. The requirement to disclose in the accounts is not a a consequence the creation of a new reporting obligation in the EU. Similar obligations do already exist in other countries e.g. the USA. • The disclosure is of company by country: a subsidiary trading in more than one country may therefore be disclosed more than once; • The disclosure is of entities subject to any parent of the consolidation process i.e. of all subsidiaries and associated companies. • It is now agreed that dormant companies need not be individually named but their number, in total, should be disclosed by country of incorporation. This change is suggested to reduce cost where no third party impact from the existence of these entities arises. If the existence of a dormant company is the only reason why a permanent establishment exists in a country that fact and the name of the dormant company or companies must, however, be disclosed together with a note that the company or companies are dormant.
3. A full country-by-country reporting financial statement is required for those jurisdictions meeting these criteria with this disclosure being audited.	This requirement will exist if one of the following four situations arises: 1. Turnover plus financial income (as per pro-forma noted below) in the jurisdiction exceeds US$5 million in the reporting period; 2. The net value of tangible fixed assets in the jurisdiction increases by more than US$ 5 million in the reporting period. 3. Turnover plus financial income in the jurisdiction exceeds 5% of the total consolidated turnover plus financial income of the reporting entity during the reporting period. 4. Any jurisdiction in which upstream extractive industries activity occurs. If any of these circumstances arises then the country for which disclosure is required is considered highly material for country-by-country reporting purposes and full audited disclosure of its activities is required. This will in the case of most reporting entities require disclosure for a quite limited range of the countries in which they operate. A financial *de-minimis* by country is noted because

	materiality for country-by-country reporting purposes must always be determined at the level of the country, not at the level of the reporting entity.
4. A more limited country-by-country reporting financial statement is required for those jurisdictions meeting these criteria with this disclosure not being audited.	This will requirement will exist if one of the following situations arises: 1. Turnover plus financial income (as per pro-forma noted below) in the jurisdiction exceeds US$1 million in a reporting period; 2. The net value of tangible fixed assets in the jurisdiction increases by more than US$ 1 million in a reporting period; 3. The situations noted in part (3) section (3) above have not arisen. In these cases the activities of the reporting entity may be material to the country for which disclosure is required, but that significance is not sufficient to require the additional cost of audit. As such unaudited disclosure of a more limited range of data (as noted below) will be sufficient in these cases.
5. Disclosure of a trading presence within the jurisdiction is required but no further financial disclosure is necessary.	This situation will arise where either: 1. Turnover plus financial income (as per pro-forma noted below) in a jurisdiction is less than s US$1 million in a reporting period and; 2. The net value of tangible fixed assets increased by less than US$ 1 million in a reporting period. If these situations arise then the disclosure to be made for the country in question is unlikely to be material to any understanding of the financial statements, the activity of the reporting entity in the country or to the country itself and as such the cost of financial disclosure is not necessary bar a note to say that the conditions for disclosure have not been met in the jurisdictions in question but a permanent establishment dos exist in the jurisdiction. To ensure reconciliation of the country-by-country reporting data to the full financial statements activity for all these otherwise undisclosed countries should be aggregated and disclosed together as “other individually immaterial jurisdictions”.

The full disclosure required for a jurisdiction to which audited country-by-country reporting disclosure would be required under this proposal (for the reasons noted in (3) above) is now proposed to be as follows:

Profit and loss account			
Turnover	Third party	X	
	Intra-group	X	
	Total		X
Purchases	*Third party*	*(X)*	
	Intra-group	*(X)*	
	Total		*(X)*
Labour costs			*(X)*
Number of employees (note)	*X*		
Operating profit			X
Finance income		X	
Finance expense		(X)	
Net finance cost			X
Operating profit			X
Current tax charge		(X)	
Deferred tax charge		(X)	
Tax charge			(X)
Net profit after tax			X
Dividends paid (Note)	X		
Balance sheet			
Total tangible assets			X
Total intangible assets			X
Total fixed assets			X
Current assets	*Third party*	*X*	
	Intra-group	*X*	
Total current assets			X
Current liabilities	*Third party excl tax*	*X*	
	Corporate Tax	*X*	
	Intra-group	*X*	
Total current liabilities			(X)
Net current assets			X
Deferred liabilities	*Third party excl tax*	*X*	
	Corporate Tax	*X*	

	Intra-group	*X*	
			(X)
Net assets, equivalent to shareholder funds			X
Cash flow			
Corporation tax paid			X
And for extractive industry companies only (and without exception regardless of turnover)			
Production entitlements paid			
Royalties paid			X
Licence fees paid			X
Ground rents paid			X
Bonuses and signing fees paid			
Dividend paid to host government			X
Sales and other turnover related taxes paid			X
Employee taxes paid			X
Local government taxes paid			X
Other fees, levies and charges paid to host government (specify)			X
Total paid to host government			X

The advantages of this disclosure for the investor

This disclosure provides the following additional or easier to access information for investors in any multinational corporation reporting on a country-by-country basis:

1. **A comprehensive disclosure of the locations in which the corporation trades.** In principle this is already available to investors in EU located MNCs as a result of requirements in the Fourth and Seventh European Directives on accounting. In practice, as research has shown, disclosure of this information is almost always relegated to secondary documentation when that is possible (as it is, for example, in the United Kingdom) and that disclosure in secondary documentation is noticeably absent[iii]. A 2009 study for the Tax Justice Network showed that of the 100 largest companies in the UK just 33 filed the information required by UK company law stating the names of each of their subsidiaries and the country in which they were located. This deficiency would be overcome if the information were to be included in the audited financial statements of the reporting entity because no auditor would then allow that omission.

If this disclosure were required investors would be empowered to form opinion on the following issues which in many cases is currently denied to them:

a. Whether they wish to invest in corporations with assets in locations they do not wish to associate with. This is of particular importance to ethical investors.
b. To what extent, if any, the MNC is dependent upon the use of subsidiary companies in tax haven locations.
c. The degree of exposure to geopolitical risk that the company is likely to face, simply by presence in certain locations.
d. The degree of reputational risk that the company might face as a consequence of its decision to trade in certain locations.
e. Trends in the geographic spread of the company's activities over time, indicating diversity, or absence thereof.

2. **The trading names that the company uses.** Whilst there are, of course, occasions when an MNC trades almost universally under its own name this is relatively rare. Many corporations that will be subject to country-by-country reporting are conglomerates by nature and it is hard for an investor to identify accurately the trade it undertakes by location and by name. Given that ultimately all investors are real people who are located in a place it is vital that they can identify the MNC in which they might invest with the local economic activity it undertakes in their home jurisdiction if they are to undertake proper investment appraisal of its activities in the location with which they are familiar. Evidence suggests that this is surprisingly hard in some cases with some MNCs.

3. **The publication of a profit and loss account for each jurisdiction** (excluding those considered wholly immaterial as noted above) in which an MNC trades, including data on sales and purchases undertaken on an intragroup basis will allow an investor to appraise the following:

a. The geographic diversity of the external sales of the company;
b. The risk that this diversity creates for the company;
c. The risk that the internal sales supply chains create for the company;
d. The approximate directions of flow of goods and services through the group as a result of intragroup trading;
e. The profit earned by a group in each location as a proportion of third-party and intragroup sales, both indicating in turn the risk of a transfer pricing challenge arising, particularly if the group is making significant use of tax havens or if the ratios of profit to sales are high in low tax jurisdictions and low in high tax jurisdictions;
f. The locations in which an MNC employs its labour, the degree of risk that this might give rise to, and any issues or stresses likely to arise as a result of significant variations in average pay by location, particularly when compared to other similar undertakings;
g. The flow of finance charges within the group, and the particular impact that these might have on an intragroup basis with regard to the re-allocation of profits between

jurisdictions, giving rise to risk of transfer pricing or thin capitalisation challenge from taxation authorities, prejudicing the potential quality of future earnings;

h. The rate of return on capital employed by jurisdiction, suggesting whether or not assets are efficiently allocated by group management to the locations in which the MNC trades;

i. The constitution of the tax charge by location, so that the impact of taxation allowances and reliefs on the current taxation charge, as indicated by the amount of charge deferred, can be assessed by location, giving indication of the potential for reversal of such benefit in future periods, meaning that the impact of such reversal on future cash flow can be assessed;

j. Consistent, comparative data between companies allows this analysis to be replicated between MNCs, adding to the basis for assessment of activity by location and the effectiveness of the management of each corporation in allocating resources.

4. **Limited balance sheet data by jurisdiction** is essential if investors are to appraise:

a. The rate of return on capital by jurisdiction;
b. The allocation of resources by the reporting entity;
c. The exposure to risk of capital loss by jurisdiction, particularly in politically vulnerable situations;
d. The contribution that deferred tax makes to financing by jurisdiction;
e. Policy with regard to the retention of earnings by jurisdiction, giving indication on taxation management and planning and any resulting vulnerabilities and their impact on allocation of resources, particularly when dividends are taxed in the parent location on receipt;
f. The vulnerability of dividend policy to the retention of reserves in low tax jurisdictions.

5. **Sales data** from and to jurisdictions has always been of significance when appraising the geographic spread of markets, and the ways in which a corporation services them. It is highly likely that this type of analysis, which has long been included in segment reporting when undertaken on a geographic basis, will continue to be of interest to investors. To ensure the supply of this data within country-by-country reporting disclosure must be made of the destinations of third party sales made by the reporting entity excluding those locations where such sales are less than US$5 million or 5% of third party turnover declared in the financial statements, if lower.

6. **Data on payments made by companies in the extractive industries** to the governments that host their upstream activities are of considerable importance to investors, because the proper governance of such payments and the elimination of illicit flows arising from them is critical to the maintenance of low risk, long-term, stable earnings from these jurisdictions, whose own well-being is dependent upon receipt of such funds in a controlled, accountable and managed fashion. The more an MNC engaged in this sector cooperates with those seeking to eliminate corruption and abuse associated with the “resource curse” that has long plagued this activity, the more likely it is to enjoy long-term stable earnings from the

extractive industries in the current world political environment and as such this data is vital to the proper appraisal of the degree of cooperation the company is offering in the elimination of illicit financial flows whilst assessing the contribution made to the countries who host its activities, which is fundamental to the maintenance of the critical long-term relationships that underpin success in this sector.

For all the reasons noted, country-by-country disclosure is vital to investors who wish to properly appraise the activities of the MNCs which a loan funds or in which they hold equity stakes.

In addition, because the matters referred to are, to a very large degree of intuitive interest and may be comprehended without detailed financial training in many cases, this data will substantially increase the understanding of the financial reports of multinational corporations for many investors.

3. Would the disclosure of financial information on a country-by-country basis by multinational companies be useful for the purposes of improving tax governance at a global level?

Issues addressed in this section are country-by-country reporting and governance:

- Tax governance and the corporation;
- Tax governance and jurisdictions;
- International tax governance.

Summary

In this section it is argued that:

- Tax governance is a relatively new issue of concern to corporations, but is one that is vital to the effective operation of systems of internal control within multinational corporations;
- Tax governance is an issue inextricably linked to specific jurisdictions since taxing power only rests with national and sub-national governments;
- International tax governance is now an issue of considerable political significance where decision making is hampered by a lack of data required to fully appraise corporate behaviour.

In each case it is argued that country-by-country reporting data provides information to enhance governance mechanisms and that country-by-country reporting will as a consequence enhance well-being.

An overview of tax governance and country-by-country reporting

The country-by-country reporting concept was created to have an impact on tax governance, within the corporation, within a jurisdiction, and internationally. That contribution to tax governance is, as has already been noted, by no means its sole benefit since those benefits also arise across the whole stakeholder spectrum, and with regard to a much broader range of issues that tax represents, but it is important to note that tax governance was a primary motive when the country-by-country reporting concept was created.

That contribution arises within the corporation, within individual jurisdictions and internationally, and each will be considered in turn.

Country-by-country reporting, tax governance and the corporation

The concept of tax governance is little known or studied and many of the best-known papers on the issue have arisen in response to the challenges posed by country-by-country reporting as presented by the Tax Justice Network since its first publication in 2003. These include KPMG's "Developing the concept of tax governance[iv]" dating from 2007, KPMG's earlier report "Tax in the boardroom[v]" dating from 2004 and PWC's work of a similar title from 2005[vi] and the paper by think tank Sustainability called "Taxing Issues" published in 2006. These papers also reflect interest in this issue from a number of tax authorities at that time who were seeking to use it to mitigate tax avoidance by promoting tax governance by corporations. The Australian Taxation Office led thinking in this area, followed by HM Revenue & Customs in the United Kingdom.

What is apparent is that the issue remains underdeveloped. As KPMG said in 2007:

Historically, boards of directors have not always given tax the attention it deserves. Instead, it has been seen as a technical matter for the tax department2 or specialist advisers to deal with. A number of factors are now combining to change attitudes in this area: a heightened level of public debate on the ethics of tax avoidance and of companies' tax contributions in the developing world; the requirements of the Sarbanes-Oxley Act3 as regards internal controls; the effect of globalisation in giving companies an element of choice as to where and at what rate their tax liabilities arise; and a growing realisation that, as a commercial matter, directors cannot ignore a factor which may account for a significant proportion of a company's profit. In summary, tax is now too important to be left to the tax specialist.

In this environment what is needed is data that can readily draw attention to taxation issues requiring attention with regard to tax governance within the corporation reporting on a country-by-country basis. As a matter of fact all taxation is due to governments. All governments are, again as a matter of fact, geographically constrained. It is, therefore, essential that data be available for the use of the board of directors of the multinational corporation that shows:

1. In which locations they are trading;
2. What revenues, costs and resulting profits arise in each location in which they trade as a consequence;
3. How the allocation of those revenues, costs and profits is distorted by the impact of intragroup trading;
4. The relationship between profits and tax by location;
5. The impact of that relationship on taxation risk, largely as a consequence of transfer pricing challenges or challenges with regard to the use of tax havens under controlled foreign company legislation;
6. The impact of deferred taxation on financing by location;
7. The degree to which tax influences decisions on where to allocate resources, and the desirability and sustainability of the resulting decisions.

This data is not available to the boards of directors of the vast majority of / multinational corporations at present because this information, consolidated on a country-by-country basis, is not conventionally prepared by multinational corporations at this time, although the data to enable it preparation must exist.

As a consequence it is highly unlikely that effective tax governance takes place within the boardrooms of most major multinational corporations. This, almost invariably means that risk from tax transactions is unlikely to be properly appraised by those boards. The consequences are that:

1. The internal control of taxation is likely to be weak;

2. Shareholders are exposed to excessive risk as a consequence;
3. Declarations made to taxation authorities may be materially incorrect, or fail to represent the view of the Board of Directors of the MNC as a whole;
4. Compliance with relevant legislation e.g. Sarbanes Oxley in the USA may be weak, or absent.

The provision of country-by-country reporting information to the board of directors of MNCs on a regular basis would overcome this governance risk, enhance internal control, reduce the risk of shareholders and increase the likelihood of legal compliance on the part of major MNCs and as such is to be strongly recommended.

Country-by-country reporting, tax governance and the jurisdiction

Corporate governance of taxation within a jurisdiction is dependent upon a number of key factors:

1. The existence of an effective (and hopefully democratic) legislature;
2. A transparent and accountable budgeting process;
3. An independent civil service capable of assessing and collecting tax;
4. An independent judiciary capable of hearing appeals from that tax assessment and collection process;
5. A legislature capable of holding the government to account for the outcome of these processes;
6. An independent press capable of raising questions on the tax setting and collection process;
7. A strong civil society that can create an effective dialogue on taxation within the jurisdiction;
8. Information to inform all these processes.

It is, of course, true that the failure of any one of these processes would be significant but without information then it is fair to say that the process as a whole will substantially fail. That being noted, it is important to realise that there are at present significant obstacles in place in many jurisdictions preventing relevant and reliable information being collected that might inform debate on taxation governance. These obstacles include:

1. Taxation often being collected on a contractual rather than a legislative basis. This is particularly common in the extractive industries and in developing countries.
2. Weak legislatures, poor budgeting processes, a failure to report outcomes against expectations and governments that are not held to account are commonplace in many states.
3. Even when independent civil services exist they are frequently hampered by an inability to access information, including data on:
   a. group structures;
   b. intragroup transactions;
   c. the identity of beneficial ownership;

d. data on economic performance in other countries in which an MNC operates to assist appraisal of transfer pricing arrangements.

The absence of this information makes the assessment of appropriate tax, particularly in the case of MNCs, very difficult.

4. Legislatures, the press and civil society in many countries are all hindered by a deliberate policy of preventing access to information and commercial activities by arrangements such as:

a. accounts of locally incorporated companies not being filed on public record;

b. an absence of geographic segmental information in the financial statements of multinational corporations;

c. an absence of financial information about other constituent parts of an MNC in other jurisdictions such as tax havens, which make secrecy a key part of their commercial offering.

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As a result it is commonplace for information on the identity of companies trading in a jurisdiction and information on sales, profits and tax paid in that place to be completely unavailable.

The result is obvious. Governments are not held to account for tax collected. The civil service in a jurisdiction is not held accountable for its actions. The enforcement of law with regard to practices such as transfer pricing is almost impossible and neither the press, elected members of the legislature or civil society can hold any party to account for their actions.

Country-by-country reporting would remedy these defects with regard to the activities of multinational corporations trading in jurisdictions where these obstacles to obtaining information exist when those MNCs were themselves incorporated in jurisdictions where country-by-country reporting might be required in future, whether by EU law, or by an International Financial Reporting Standard or as a consequence of a stock exchange listing agreement. As a result country-by-country reporting would enhance:

1. Tax governance within a government;
2. Tax collection;
3. The upholding of the law on matters such as transfer pricing;
4. The accountability of government to a population for its management of taxation within a jurisdiction.

It is our suggestion this will, in turn, support the effective maintenance of democratic government in countries where information on tax paid is currently hard to obtain.

Country-by-country reporting, tax governance and international regulation

International cooperation on taxation matters was more notable by its absence until recently then by its presence. The current international financial crisis appears to have changed sentiment on this issue, and tax cooperation is now a matter of international significance and diplomatic importance.

International tax governance concerns the following issues:

1. Harmful tax competition, an initiative led by the OECD;
2. Tax haven abuse;
3. Information exchange to facilitate the proper collection tax;
4. Dispute resolution;
5. The prevention of double taxation;
6. The prevention of international tax avoidance.

As in the cases of corporations the availability of appropriate information is critical to this task. That information is seriously deficient in many cases. If country-by-country reporting information was available many of these deficiencies would be eliminated. For example:

1. The value of trade undertaken in and through tax havens is largely unknown and has instead to be estimated. This is an inadequate basis for determining international taxation policy. Country-by-country reporting would provide this data.
2. The level of profit recorded in tax havens is unknown and as such their impact on the corporate tax base of the world is impossible to quantify with the degree of accuracy required to inform debate on this issue. Again, country-by-country reporting would provide this data.
3. The burden of proof on a state requesting information from another for taxation purposes is high. If alternative information on the activities of a corporation in all the states in which it trades was available as a result of the introduction of country-by-country reporting firstly the number of information exchange requests would probably be reduced and secondly they would almost certainly be better targeted, meaning that the resources of tax administrations around the world would be better focused on collecting tax due from those most effectively seeking to avoid it.
4. Dispute resolution on issues such as transfer pricing will be substantially easier if information on the margins earned within vertical supply chains of multinational corporations in all the locations through which they pass product is better known as would be the case if country-by-country reporting were introduced. This is because country-by-country reporting would enhance the quality of the comparable data required to assess the effectiveness of the arms length pricing model used to administer and regulate transfer pricing around the world. As a result there should be fewer transfer pricing disputes, greater harmony in tax administration, less cost expended and a reduction in the burdens of administration for multinational corporations.
5. It is also the case that some corporations, and most especially those in high risk industries such as pharmaceuticals, are subject to tax demands on many times their profits until disputes on transfer pricing and other related issues are resolved. This is inappropriate and is largely the consequence of an absence of information on the overall allocation of profits within these corporations. If they disclose their profits on a country-by-country basis there is a significant probability that the agreement of their taxation affairs will prove to be much less troublesome, to the benefit of all involved.
6. Many claims for additional tax arise because jurisdictions believe that their best interests are being prejudiced by corporations that undertake tax avoidance activity. All jurisdictions have limited resources to challenge those undertaking such activity. If country-by-

country reporting data were available then jurisdictions would have a significant part of the information they need to determine which cases to take, and which corporations to leave alone when allocating their resources dedicated to tackling international tax avoidance. This would yield a significant return for those companies that are seen to be tax compliant*, whilst enhancing the effectiveness of tax administrations and at the same time reduce the cost of tax collection. Country-by-country reporting would, therefore, pay a significant yield for all who are seeking to oppose international tax avoidance.

The consequence of these changes in behaviour resulting from the introduction of country-by-country reporting would be a substantial increase in the quality of governance of international tax relationships. All governments, excluding those of tax havens, would benefit as a consequence. The cost of tax collection would fall, rates of tax compliance would increase and it is highly likely that those companies who seek to be tax compliant would see a significant fall in their cost of tax administration.

* In this context tax compliance is defined as 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.

4. Would the disclosure of financial information on a country-by-country basis by multinational companies active in the extractive industries be useful in order to improve domestic accountability and governance in natural resource rich countries?

Issues addressed in this section

- The issues relating to the extractive industries;
- The Extractive Industries Transparency Initiative and its limitations;
- Why country-by-country reporting overcomes those limitations;
- How country-by-country reporting complements the EITI and Dodds-Frank processes.

Summary

In this section it is argued that:

- That there are particular issues of concern relating to the extractive industries and the so called "resource curse" that increase the obligation to be accountable in this sector;
- That the Extractive Industries Transparency Initiative has made a valuable contribution to progress on this issue but cannot of itself meet the needs for information that will eliminate the curse of corruption associated with the extractive industries;
- Country-by-country reporting is completely reconcilable with the EITI and recent US legislation and enhances the benefits of both without duplicating cost

Accountability and the extractive industries

Many of those civil society organisations promoting country-by-country reporting have strong links to the extractive industries. Most are concerned about:

1. Corruption in the extractive industries;
2. Mismanagement of taxation resources in those countries that host extractive industry activities;
3. The consequent failure of the extractive industries to enhance the well-being of the populations of the countries that host their activities in far too many cases.

As noted in the previous section with regard to tax governance within jurisdictions, significant problems can arise if any of the eight conditions for effective tax governance noted there are not found within a jurisdiction. It is an unfortunate fact that in very many countries where the upstream extractive industries are located many of these conditions are not found. In particular, information is frequently absent for the reasons noted or because its publication is prohibited under the terms of the mineral extraction agreements signed between the government of the jurisdiction and the MNC operating by concession within its domain. As a result many in the legislature, if there is one, the press and in civil society act without any effective information at all with which to hold their government and those companies operating in the upstream extractive industries to account for their actions. The consequence is all too apparent and is aptly called the "resource curse".

The Extractive Industries Transparency Initiative has sought to tackle this issue by seeking publication of the financial flows from MNCs that are working within a jurisdiction to a government, and to then require that the government account for its use of those funds. This process has been welcome, and beneficial, but is subject to significant limitations. In particular, the flows can only be accounted for within the jurisdiction under the EITI. There is no accounting for flows diverted outside the jurisdiction to, for example, a tax haven but which should have been accounted for within the jurisdiction, In that case the Extractive Industries Transparency Initiative cannot comprehensively address the problems that have been encountered within this industry.

To date the only mechanism known that can overcome the obstacles placed in the path of the supply of information to those needing it to hold the governments of jurisdictions that host upstream extractive industries to account is country-by-country reporting. Because the obligation to report on a country-by-country basis would be imposed by international regulation, and in a separate jurisdiction from that in which the upstream activity is hosted, with which obligation the upstream operator would have no choice but to comply, disclosure of its activities within the jurisdiction that hosted those activities would be mandatory and entirely beyond the control of the upstream host jurisdiction itself. In addition, any provisions in a local mineral extraction agreement prohibiting publication of the data would be overridden by the international obligation to publish imposed upon the parent MNC that was responsible for producing the information as part of its annual financial statements.

The result of mandatory country-by-country reporting of this type would be significant. Details of the financial flows from most extractive industry companies to their upstream host jurisdictions would be readily available, and easily consolidated into overall data with which the governments of the jurisdictions in question could be held to account. The current process, requiring considerable expenditure of effort under the terms of the Extractive Industries Transparency Initiative to achieve this goal, would be entirely circumvented saving cost for all involved. In addition, the information on financial flows would be available on a disaggregated basis i.e. on a company by company basis, whereas most data currently published under the terms of the Extractive Industries Transparency Initiative is produced on an aggregated basis i.e. without information provided on which company is paying. This does, of course, remove accountability from the companies in question, and that is a serious weakness in governance arrangements required by the EITI process.

As a consequence country-by-country reporting is the only known mechanism that can deliver enhanced accountability and improved governance inside the extractive industries and require that the governments that receive income from such activities are held to account for the use of those funds for the benefit of the populations they are meant to serve.

In doing so, however, country-by-country reporting is designed to achieve a number of complementary tasks:

1. It provides consistent disclosure of the data required by the EITI process;
2. In doing so within a cash flow statement it assists integration of the EITI process into mainstream accounting and recognises the difference between cash flow and accruals based disclosure;

3. It aggregates but in no way replaces the disclosure required under the Dodds-Frank Act for the extractive industries, and is therefore complementary to those disclosures as well whilst integrating them into the broader accounting environment;

As such it is important to note that country-by-country reporting is not in conflict with either of these arrangements but does instead provide consistency and accounting contextualization to them and as a result enhances the disclosures and procedures they have to offer without duplicating procedures or increasing cost.

5. Would it be useful if financial information on a country-by-country basis by multinational companies were to be presented according to predefined standards and formats?

Issues addressed in this section

- The importance of comparison in accounting reporting;
- The need for regulation to enforce consistency in accounting reporting;
- The weaknesses in corporate social responsibility data;
- Why country-by-country reporting is not CSR data;
- How country-by-country reporting data should be presented;
- The scope of country-by-country reporting.

Summary

In this section it is argued that:

- Country-by-country reporting data is accounting information derived from the general ledgers of multinational corporations and tat as such this is accounting data that must be reported in the financial statements or relevant multinational corporations;
- Because it is financial reporting data country-by-country reporting needs to be subject to the same standards of consistency and auditing as all other financial data reported in financial statements;
- Because of its nature country-by-country reporting data is not corporate social responsibility data which ash fundamentally different characteristics;
- Accordingly country-by-country reporting is not suitable for disclosure in corporate social responsibility reports;
- That the format of country-by-country reporting data for disclosure is based on the standard template for disclosure of the profit and loss account, balance sheet and cash flow familiar to all users of financial statements.

The credibility of financial information

Accounting data is only of use in the process of comparison. So, for example, in accounting terms any number in isolation is almost entirely meaningless. €6 billion is an impressive number. It is more impressive if it is profit rather than sales, somewhat less impressive if it is a loss. But without description the number is meaningless in itself and without a yardstick to gauge significance in comparison to other, equivalent, data then any measure of relevance is almost impossible. As such all meaningful accounting information is dependent upon:

1. The existence of an accounting framework that specifies:
    i. The format for accounting disclosure;
    ii. The frequency of accounting disclosure;
    iii. The content of each disclosure;
    iv. The measurement concepts inherent in accounting disclosure;

v. The assumptions that underpin those measurement concepts, and what is to happen when those assumptions do not hold true;

vi. Those for whom the financial reports are to be prepared;

vii. How, if appropriate, conflicting demands for information are to be resolved;

2. The existence of regulation that enforces this accounting framework;
3. The publication of data on a basis consistent with this framework so that comparison both between periods for which financial reporting takes place for one entity and between entities preparing financial reports can take place.
4. Consistency in this framework over time, and consistency in the assumptions underpinning particular sets of financial statements prepared in accordance with this framework over time;
5. Widespread understanding and acceptance of this framework.

Without this framework accounting reporting is:

a. Voluntary;
b. Potentially incomplete;
c. Inconsistent;
d. Lacking objectivity;
e. Not comparable between periods or entities;
f. Uncertain or misleading as to meaning.

Alternatively, it may best be described as being of no use to the user because the risk of using it may be greater than the risk of ignoring it. The result is that the risk of mistaken judgment arising from using it would be so significant that the data is best ignored

This is exactly how most corporate social responsibility (CSR) data is currently described by investment managers. CSR data is subject to all the deficiencies noted in (a) to (f) above and they do, as a consequence, ignore it.

If country-by-country data was to be published by multinational corporations on a voluntary basis the same situation would occur: users of accounts would ignore the information because it would be considered inherently unreliable. As such the entire cost of its production would be wasted. Worse than that, those companies voluntarily disclosing might suffer competitive disadvantage as a result, and yet provide information of no consequence to the users of their financial statements. This is the worst possible outcome: all would lose. This is, no doubt, why no company has as yet voluntarily adopted a country-by-country reporting approach. As a consequence it is apparent that firstly country-by-country reporting will never be adopted voluntarily and secondly that country-by-country reporting is not part of CSR reporting.

Corporate social responsibility data

This last point is similarly important. CSR data appears, by definition, to be voluntary disclosure, but quite what it relates to, even what CSR is, and what disclosure is required with regard to it, are areas where there is considerable debate, uncertainty, and fundamental disagreement. The essential framework necessary for the supply comparable information is absent with regard to the CSR information.

If there is any agreement on CSR data then the European Union summarises it by saying that CSR is:

A concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis

However, this is not a description of country-by-country reporting. Country-by-country reporting is designed to supply information to investors and other users of financial statements on the trading activities of a corporation, its profit and loss, use of assets, resulting taxation liabilities and allocation of resources between states. This is not data with regard to social and environmental concerns: this is data with regard to the core commercial purpose of a corporation. Furthermore, this is not data that requires additional reporting systems to be created on activities not previously monitored; this is data extracted directly from the general ledgers of the reporting financial entity.

As a consequence country-by-country reporting data can only be seen as core financial information essential to the proper appraisal of the activities of a multinational corporation. In that case it is accounting data like any other accounting data, and as it has been found that the presentation of accounting data must be undertaken on the basis of predesigned standards and formats, the same must be true of country-by-country information.

How country-by-country data must be presented

In that case country-by-country reporting data should be disclosed as part of the annual audited financial statements of each entity required to report in this way by the resulting predefined standards and formats.

The scope and enforcement of country-by-country reporting

Since, by definition, country-by-country reporting is about the disclosure of information at the level of the jurisdiction consistency in disclosure at this level is vital, and since the only appropriate basis for comparison is at the level of the jurisdiction it is vital that that each reporting entity be required to disclose data for every jurisdiction in which they operate, without exception. Unless this were done the information disclosed would be voluntary, potentially incomplete, inconsistent, lacking objectivity, not comparable between periods or entities, and therefore might be uncertain or misleading or in other words it would embrace all the weaknesses that undermine the credibility of accounting information.

There are only two potential sources of regulation that can require this type of accounting disclosure. They are either national legislation or internationally applicable accounting standards.

Since within the European Union national legislation on accounting disclosure has, to very large degree, been unified by national adoption of the Fourth and Seventh Directives on accounting it would fall to the European Union to create such nationally enforced standards for legislation in each of the member states by updating the Seventh Directive so that it imposes the requirements of country-by-country reporting on those relevant reporting entities registered in or trading in the EU member states.

Alternatively, the same results can be achieved by the adoption of an International Financial Reporting Standards requiring country-by-country reporting by the International Accounting Standards Board. Arguably both are necessary as IFRS are afforded their status by the EU requiring their adoption into national legislation.

6. If country-by-country reporting were to be considered useful, what kind of multinational companies would usefully be targeted?

Issues addressed in this section

- The difficulty of reporting for one type of activity;
- What indicates presence in a country;
- Why size is important – and that this is already recognised in accounting;
- The exceptions for economic significance;
- The costs of country-by-country reporting.

Summary

In this section it is argued that:

- It is hard to differentiate extractive industry activities from all others that a corporation might undertake and as such full country-by-country reporting disclosure for all relevant multinational corporations is required;
- The presence of a tax permanent establishment indicates presence of a multinational corporation in a jurisdiction;
- That reporting should be required of all 'very large' companies and some other quoted companies that do not meet this new proposed definition of size for reporting purposes.
- Whilst country-by-country reporting will create new costs for multinational corporations these are relatively modest in amount and far outweighed by the benefits of country-by-country reporting.

Disclosure based on size of reporting entity

The question of which countries should be required to report on a country-by-country basis is a relatively straightforward one, but which seems to excite considerable attention.

Firstly, whilst there is undoubted appropriate attention given to the benefits arising from country-by-country reporting in the upstream extractive industries and yet to require country-by-country reporting from this business segment alone would be exceptionally difficult. To do this would require a corporation engaged in these activities to separate upstream activities from downstream activities, and its extractive industries activities from all others that it undertakes. In principle this might be possible with regard to some aspects of the trade of the company, but when intragroup transactions are to be disclosed (as is necessary under country-by-country reporting) the problem becomes more complex. Many group services are hard to define in this way, particularly when they relate to the operation of central group management activities or financing activities. As such whilst upstream extractive industries data is of significance, and has rightly been highlighted as a priority because of the risks inherent in this activity, a differential demand for disclosure for one part of one industry makes relatively little accounting sense, and as a consequence it is important that disclosure be made by all MNCs falling within the suggested scope of country-by-country reporting as noted already, without exception and irrespective of the industry in which they operate.

Secondly, and by default, it is important to note that that the vast majority of corporations will never be subject to country-by-country reporting disclosure because they, or the group in which they are a member only trades in one country or jurisdiction. It is important to note that for the purposes of country-by-country reporting presence in a jurisdiction would be indicated by the existence of a permanent establishment for taxation purposes within that country or jurisdiction. A permanent establishment (PE) is a fixed place of business which generally gives rise to an income tax, corporation tax or value added tax liability in a particular jurisdiction. The term is defined in many income tax treaties and is as a consequence widely understood. Use of this definition enables an objective basis for determination of presence to be established for country-by-country reporting purposes. As noted previously, once established then disclosure will be required, without exception, if the size criteria for reporting noted below are met.

Third, it is important to note that under existing European law there are generally considered to be three sizes of company. First there are small companies, which in the UK at present are defined as those meeting at least two of the following criteria: an annual turnover of less than £6.5 million, with balance sheet totals of less than £3.26 million and with an average of less than 50 employees in a year (with these numbers being broadly translatable for other EU member states). It is suggested here that these entities should be entirely outside the scope of country-by-country reporting.

The same is also suggested for medium-size companies: these meet at least two of the following criteria : annual turnover of less than £25.9 million, balance sheet totals of less than £12.9 million and an average of less than 250 employees during a year.

Large companies are by default those that are neither small or medium. In practice, public limited companies are always large companies, as are many companies operating in the financial services sector, even if they do not for any reason meet the above criteria.

This data needs to be set in its proper context. In the UK in the year to March 2010 there were approximately two million active companies filing accounts[vii]. Of these jut 16,500 were group accounts, a number which largely coincided, but not precisely, with the number of public limited companies, which in October 2010 reached 10,000 for the first time[viii]. It is readily apparent as a consequence that the number of companies likely to be required to prepare country-by-country reporting data, which will only apply to group parent companies, is very small indeed compared to the total population of companies required to report to their members in accordance with the requirements of law compliant with the EU Fourth and Seventh Directives.

That said, this still leaves a relatively large number of companies of relatively modest size whose individual economic impact is unlikely to be small outside their jurisdiction of incorporation but which might have permanent establishments in more than one country, albeit of relatively little significance to the group as a whole. This does suggest that for the purposes of country-by-country reporting an additional category of ‘very large companies’ might be created so that only those companies with substantial economic impact would be required to report in this way. For convenience this category of ‘very large companies’ should be subject to automatic updating of its definition, as are small and medium-sized entities at present. If the thresholds for being a very large company were four times those of a medium-size company then at present the threshold for being a very large company would be, in the

United Kingdom, turnover of £103.6 million a year, balance sheet assets of £51.6 million and 1,000 employees. It is suggested that this definition be used in the test noted below to determine the requirement to present financial statements on a country-by-country reporting basis.

In the light of this evidence it seems reasonable to suggest that country-by-country reporting should apply only if the following criteria are met:

1. The company trades in more than one jurisdiction or the company and the members of its group trade in more than one jurisdiction and
2. The company is a very large company (as noted above) or
3. The company is a public company operating in the financial services or extractive industries sectors but is not a very large company as defined above.

This can be summarised as follows:

Type of company	Very large company (as defined here)	Quoted company that is not a very large company (as defined here)
All	Yes	No
Extractive industries	Yes	Yes
Financial services	Yes	Yes

This test is definitive, easy to follow, auditable and restricts disclosure to those companies of greatest public interest. That group must, because of their economic significance, always include those quoted companies within the extractive industries and financial services sector. Due to their potential economic impact on the states in which they trade disclosure should be required for these companies if quoted on a stock exchange, whether or not they are very large companies.

In making the above observations we have already noted the benefits that country-by-country reporting might bring. It is now important to note the potential costs for that limited range of companies that would have to prepare their accounts on this basis, and the potential consequences of doing so.

The cost of country-by-country reporting

The costs of country-by-country fall into the following categories:

a. Preparing appropriate books of prime entry to categorise transactions so they may be reported on a country-by-country basis;
b. The cost of preparing country-by-country accounts;
c. The cost of auditing country-by-country accounts;
d. The cost of publishing country-by-country accounts.

Each of these issues is dealt with in turn.

There should be no additional cost for any MNC required to prepare country-by-country accounts as a result of having to categorise its records of accounting prime entry to record individual transactions on a country-by-country basis. This is because as a matter of fact all the transactions that a multinational corporation currently undertakes must be located in a jurisdiction if its obligation to prepare tax returns reflecting the transactions it has undertaken is to be properly fulfilled.

No transaction should take place “nowhere” (although this is an issue we return to later). In that case, As a matter of fact, therefore, the books and records of every MNC must already be prepared on a country-by-country basis.

This will also be true, as a matter of fact, whether or not the MNC structures itself on geographic or business product lines. It is often claimed that it, in a modern global corporation, if the business is structured on the basis of vertically integrated business product lines then it will not have individual subsidiaries for each country in which the product line operates. However, given that there will be a geographic obligation within each product line to report the transactions undertaken for tax purposes to the relevant jurisdiction that hosts them every single MNC that organises itself on a non-geographic basis must, as a matter of fact, still record all transactions on geographic basis to meet the obligations that it has to settle its tax liabilities, which can only ever be geographically assessed. If it does not have those records then it has failed to maintain appropriate internal control systems required by company law and international regulation.

In that case no additional cost can arise with regard to preparing basic books and records to deliver country-by-country reporting.

It is true that country-by-country reporting requires that information on a corporation's activity within a jurisdiction be presented on a consolidated jurisdictional basis and that the corporation may not at this point of time prepare data on that basis. However, every multinational corporation has to have what is called an accounting consolidation package. This is the method of adding together the accounts of individual constituent member companies to create the overall consolidated results that is presented to the public. To undertake such a consolidation all intragroup transactions between member companies have to be identified. Therefore, as a matter of fact, every multinational corporation has the basic methodology in place to prepare consolidated accounts on a country basis because they do as a matter of fact have the necessary prime entry data on a country-by-country basis, and a consolidation package which clearly identifies the intragroup transactions which have to be highlighted in country-by-country reporting. In that case, the additional cost of running the consolidation package on a country-by-country basis as a subsidiary process before in turn consolidating them into the overall group result is an interim step which can impose little additional cost. The value of the additional management information created (for example for tax governance considerations, already noted) will more than justify that spend.

It is, however, the case that at present significant numbers of subsidiary companies within most multinational corporations are not audited. When preparing an audit opinion on the accounts of multinational corporation auditors express an opinion upon the true and fair view of the financial statements which is based on their perception of materiality. Since materiality in a set of consolidated accounts only relates to third-party transactions: intra-group transactions are ignored for the purposes of calculating this perception of materiality. As such, in many cases significant numbers of subsidiaries which undertake transactions that impose considerable taxation, trading, reputational, geopolitical and other risks on shareholders are ignored, rightly or wrongly. It is inevitable as a consequence that if data on a country-by-country basis is to be reported in the group financial statements of a multinational corporation that the audit costs for these MNCs will increase. One Big 4 firm of accountants has estimated that audit fees might rise by 25% as a result. It is our opinion that this is an immaterial sum for the corporation itself and for its shareholders when compared to the value of the risk transfer that will arise as a consequence, with the auditors and corporation then having liability to verify the truth and fairness of transactions where the risk is now borne by shareholders who have no way knowing the quantum of the risk which is transferred to them as a result.

The final cost of country-by-country reporting is publishing the data. In our opinion country-by-country reporting data should not be included in the printed financial statements of multinational corporations but should instead be made available exclusively on the internet versions of such statements which will by the time any such standard is introduced be produced in an XBRL format which will allow easy download of data for those who wish to use this information for comparative analysis, as we are sure many will seek to do. We do not envisage any significant additional publishing costs as a consequence.

All this being noted, we have taken into consideration the objections we have heard on three issues; namely materiality, dormant companies and audit fees and have modified our proposal for country-by-country reporting to reflect those concerns that have been raised. As a result country-by-country reports for small jurisdictions will not need audit and in the smallest cases will not need disclosure beyond the fact that a permanent establishment exists.

In conclusion, there can be no cost objection to the production of country-by-country reporting data, and any benefits will by a substantial margin outweigh any cost involved.

The competition consequences of country-by-country reporting

Some have suggested that country-by-country reporting will have implications for a company's competitiveness, either in third countries, particularly if those countries do not wish the disclosure to take place, or with regard to its impact upon the EU capital markets. We do not think that either concern can be justified.

There will, of course, be some places which do not wish disclosure to take place about the activities that are located there. Many of these will be locations where the risk of corruption is high. This is precisely why disclosure about activity in these places should take place and it is precisely why international regulation which overrides local legal obstruction must be enacted to ensure that all such corruption, which corrodes the effective operation of markets in these places and internationally, be drawn to public attention, and by risk of exposure be eliminated. So long as the requirement to disclose is imposed upon substantially all market competitors, which would be true most especially if required by an International Financial Reporting Standards, but with regard to which EU regulation would also have a significant impact, then a level playing field in disclosure is created and the risk of competitive disadvantage arising is almost entirely eliminated. Any residual remaining risk is then also easy to identify, and can then be subject to focused targeting to eliminate abuse.

It is almost impossible to see why EU capital markets would be prejudiced by the provision of information that would substantially enhance the data available to investors making use of those markets, which would in turn enhance the quality of their decision making, consequentially reducing risk, and as result the cost of capital to European companies. If, as anticipated, country-by-country reporting did reduce the cost of capital not only would the rewards to society be high, the competitive advantage to European capital markets would also be significant.

7. Please provide information on the cost that you estimate that the introduction of country-by-country disclosure requirements could entail

Already noted in the previous section.

8. Please provide any additional comments you may have that have not been addressed above

Issues addressed in this section

The most significant issue on which we have not commented above is that of materiality. We address that in this section

Summary

- Materiality for country-by-country reporting purposes has to be appraised at tow levels: firstly whether country-by-country reporting should be included in the accounting framework and secondly whether when included whether disclosure should take place.
- It is concluded that because of the obligations noted by the IASC Foundation in its statement of objectives that country-by-country reporting should be included in International Financial Reporting Standards.
- It is then concluded that unless country-by-country reporting would be immaterial to a jurisdiction that disclosure for all jurisdictions in which a reporting multinational corporation has a presence should take place.

Materiality – the environment for assessment of the issue

The International Auditing and Assurance Standards Board (IAASB) (which is not the same as the International Accounting Standards Board, but which is also dominated in identical fashion by the Big 4 firms of accountants) says in its standard 320 on materiality[3] that:

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

It adds:

• Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

• Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

• Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

[3] http://web.ifac.org/download/a018-2010-iaasb-handbook-isa-320.pdf

As a result it is clear that auditors have the duty to ensure no material item required to be reported in a set of financial statements is omitted from it.

However, in this regard it is essential to note what IAASB standard ISA 200 on the Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing says about the duty of auditors, which it says are[4]:

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling ***the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework***

Emphasis has been added to the second half of the statement because it is central to the discussion of materiality in the context of country-by-country reporting: it makes clear that the auditor does not form their opinion on the truth and fairness of the financial statements, although that is what is commonly perceived to be the case. Instead they determine the truth and fairness of those financial statements in the context of the particular standards with which it is claimed they comply.

This difference in emphasis is very important. For example, if International Financial Reporting Standards require disclosure of a particular piece of information and the activity to which that disclosure standard applies is undertaken by the reporting financial entity then the omission of information on it is material in its financial statements, and its exclusion would be an error from the auditor's point of view. However, if IFRS did not require reporting of that particular item of data then its omission may well not be an error even if the activity takes place. In that case the financial statements might be considered true and fair without the data being disclosed.

As a result it is clear that the concept of materiality is multi- layered. First there is a decision required as to whether information disclosure is required by a relevant financial reporting framework such as International Financial Reporting Standards. Secondly, the decision has to then be made as to how to define materiality with regard to that disclosure within IFRS i.e. whether that disclosure is mandatory or not. Thirdly, if disclosure is not mandatory but only required when the item in question is considered material then criteria have to be set for determining what materiality means in this context.

In the context of country-by-country reporting it is unfortunate that it is only the last of these three issues that has received much attention and, for example, the International Accounting Standards Board discussion paper on IFRS 6 and country-by-country reporting[ix] entirely ignored the first two issues. As a result all three are considered here within the context of the IASC Foundation statement of objectives and the IAASB statements noted above.

The IASC Foundation statement of objectives says that its purpose is[x]:

(a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable

[4] http://web.ifac.org/download/a008-2010-iaasb-handbook-isa-200.pdf

information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
(b) to promote the use and rigorous application of those standards;
(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and
(d) to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

Materiality with regard to inclusion of country-by-country reporting in IFRS

As the IASB statement 320 noted above says:

Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

However according to the IASB in its discussion of country-by-country reporting and the extractive industries (6.10)[xi]:

the Framework *indicates that financial reporting is primarily directed to meet the needs of existing and potential equity investors, lenders and other creditors (i.e. capital providers). Information that is useful to capital providers for making decisions may also be useful to other users of financial reporting. These other users include suppliers, customers and employees (when not acting as capital providers), as well as governments and their agencies and members of the public.*

There is an obvious dilemma here: the IAASB clearly think that the particular needs of individual users of accounts can be dismissed. This is probably reasonable. It is highly unlikely that the requests of all users of financial data could be met by any set of financial statements. However, it is not clear that the IAASB in saying so is endorsing the IASB position that there is just one group of users, with all having common information needs. As is noted in previous sections, above, respected and authoritative bodies identify seven or more user groups for financial statements. To argue that they all have the same information needs and that existing financial disclosures are relevant or useful to all of them is clearly wrong. As a matter of fact, for example, those organisations requesting country-by-country reporting would not be doing so if the information currently supplied to capital providers met their needs. It does not.

In consequence it is important that there be explicit recognition that there are different users of financial statements when assessing materiality and that the differing needs of all these groups be considered when creating an International Financial Reporting Standards. This has of course, implicitly, been recognised in the IASC Foundation constitution when they say (emphasis added) that they seek:

*to develop, in the **public interest**, a **single set** of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in **financial statements** and other financial reporting to help participants in the world's capital **markets and other users** make **economic decisions***

This clearly says that only one set of accounts can be produced; they must serve the public interest; that the public interest is broader than the needs of the capital markets and includes other users and it is specific that those other users do make economic decisions. In that case the Trustees of that Foundation have a duty to ensure that this mandate is fulfilled. It is argued here that existing International Financial Reporting Standards do not do that and that country-by-country reporting, which can only be included in financial statements as it is not corporate social responsibility data must be added to those statements if they are to meet public need so that appropriate economic decisions can be made. Using this criterion the information provided by country-by-country reporting is material and must be included in the International Financial Reporting Standards reporting framework.

Materiality for assessing country-by-country reporting disclosure within individual financial statements

If that is the case then materiality with regard to disclosure of that information in financial statements subject to International Financial Reporting Standards has to be established with regard to the likely use to be made of that information by the user group(s) most likely to use it, and not just with regard to the information needs of the suppliers of capital with whom the IASB only concerns itself at present.

The data that many of those requesting country-by-country reporting want, whether they are concerned about the extractive industries or not, relates to the dues paid by companies are paid to governments with a right to receive them. Other data relates to local trading within a country. Governments are by definition jurisdiction specific. Only country-by-country data can meet these needs in that case.

Unfortunately, however, some governments are complicit in the process of hiding data from public view. For precisely that reason disclosure within a jurisdiction cannot always be relied upon to ensure that a reporting entity discloses its activities within such jurisdictions. It is particularly unfortunate that those jurisdictions where corruption is most likely have a strong propensity to ensure that data is not available locally. That is why group financial statements may well be the only place where such disclosure may take place.

Those group financial statements are now, in most cases regulated by International Financial Reporting Standards. IFRS have the effective force of law in many locations: they do so in the places of registration of almost all holding companies operating in the extractive industries, for example. If IFRS do not apply, their equivalent standards, such as those of FASB in the USA, have that same impact. As such local objection to disclosure can be overruled by a requirement that a parent company make disclosure. No voluntary disclosure arrangement in any other report can have this impact. Only IFRS issued by the IASB can have this impact globally. As such – and most importantly – providing data on a country-by-country reporting basis within International Financial Reporting Standards and equivalent standards meets the public interest test laid down in the IASC Foundation, even when local governments fail to do so.

In addition, since it is inconceivable that data on turnover, profits, tax, balance sheets and tax provisions could be supplied by any other medium but financial statements and this data meets proven need in the public interest then it must be included in the single set of financial statements that the IASC Foundation promotes through IFRS. There is no alternative bar the production of this data in an alternative, second, set of financial statements and such a set of alternative financial statements would be contrary to IASC objectives. Therefore country-by-country reporting data must be included in International Financial Reporting Standards.

It is important to note before moving on to the materiality levels to be applied to this data to note that it is implausible to argue that the necessary country-by-country does not exist in a suitable form for disclosure. It has to exist to ensure that taxes of all sorts in all multinational corporations and royalties and taxes, dividends, licence fees, bonuses and concession payments in the extractive industries are all settled on time. None of these liabilities can be computed unless the data to compute the liabilities exists. That requires that the data to do so be in the general ledgers of the companies in question on a country-by-country reporting basis since all such liabilities are due to particular companies – or are not due because particular countries have deemed that they are not payable. In either case evidence to prove where transactions are undertaken is needed as a pre-requisite for calculation within the general ledgers of the companies in question. Those general ledgers also form the basis for IFRS financial statements. It follows that the required data is available for disclosure in country-by-country format or the reporting entity cannot be maintaining the systems of internal control required of it by law. Without exception countries have a requirement that these books and records be kept.

That requirement is implicit in the "licence to operate" that all multinational corporations enjoy in each jurisdiction in which they trade. This concept is familiar to many who engage with the extractive industries but the limited liability corporation universally has a licence to operate. After all, it has no natural existence and must, therefore, owe its existence to the statute and regulation that facilitates its creation. This statute and regulation has its foundation in the law of the jurisdiction in which the reporting entity was incorporated.

The right to incorporate has been created in the public interest. In exchange for the privileges they grant to corporations legislatures impose obligations on at least some of the entities that they permit to exist; obligations in turn imposed in what they perceive to be the public interest. One of those obligations is that multinational corporations report their financial statements in a form that is widely accessible and at low cost for the benefit of any party that wishes to access them. The other implicit duty is that they pay their taxes when due. Of course the two obligations are related: the accounting of an multinational corporation must show that it has fulfilled its obligation to all those places that have licenced it to undertake trade. This can only be done if accounting takes place for each jurisdiction in which it operates. Nothing less will do. This is how the public obligation arising from the public benefit granted in the public interest is honoured.

In that case the only relevant criteria for assessing materiality for disclosure in the financial statements of a multinational corporation is that disclosure must be made on a country-by-country reporting basis for each and every jurisdiction in which the multinational corporation operates.

Important proviso

That said, it has been accepted in this submission that there are reasons for reducing country-by-country reporting disclosure requirements when the data to be disclosed will be immaterial to users in the country in question. It is stressed: the criterion used is based on materiality to the under in the country and not to the company itself. This is because of the public interest objective, noted above.

In this regard it is suggested that there is universal interest in having disclosure of a) the presence of a permanent establishment of a relevant multinational corporation required to report on a country-by-country basis in a jurisdiction and b) the names of all its trading subsidiaries in that location (dormant companies excepted, it being accepted are of no real concern).

There is however reason for reduced trading disclosure when the disclosure in question is bound to be immaterial in those in the country in which the multinational corporation is trading. Please note, materiality here remains rooted in the needs of the community in the host country that grants the multinational corporation its licence to operate. It is not rooted in the multinational corporation itself.

These exceptions are noted above. In the first exception noted where either a) turnover plus financial income in a jurisdiction is less than s US$1 million in a reporting period or b) the net value of tangible fixed assets increased by less than US$ 1 million in a reporting period then no country-by-country reporting financial disclosure is needed except to note that the multinational corporation does have a permanent establishment in the jurisdiction, and to disclose the name(s) of those subsidiaries that constitute that permanent establishment, excluding dormant companies (unless all are dormant). Trading data for the jurisdiction would then need to be aggregated with that for all other jurisdictions of similar type for aggregate disclosure as a group as a whole of such immaterial jurisdictions.
Alternatively when one of the following situations arises:

1. Turnover plus financial income (as per pro-forma noted below) in the jurisdiction exceeds US$1 million in a reporting period;
2. The net value of tangible fixed assets in the jurisdiction increases by more than US$ 1 million in a reporting period;
3. The situations noted in part (3) section (3) above have not arisen;

then the activities of the reporting entity may be material to the country for which disclosure is required, but that significance is not sufficient to require the additional cost of audit. As such unaudited disclosure of a more limited range of data will be sufficient in these cases.
With these exceptions disclosure on a country-by-country reporting basis for all jurisdictions in which a multinational corporation reporting entity has a permanent establishment should be mandatory if it meets the other qualifying criterion noted in this report.

9. Endnotes

[i] http://ec.europa.eu/yourvoice/ipm/forms/dispatch?form=CBCRep&lang=en
[ii] http://eitransparency.org/
[iii] http://www.taxresearch.org.uk/Documents/WoERevisedVersion.pdf accessed 15-11-10
[iv] http://www.kpmg.com.co/files/documen_corp_gov/2007/Developing_Tax_Governance.pdf accessed 15-11-10
[v] http://www.kpmg.com.au/aci/docs/tax-boardroom.pdf accessed 15-11-10
[vi] http://www.pwc.co.uk/pdf/PwC-Tax_Risk_Considerations.pdf accessed 15-11-10
[vii] http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2009_2010.pdf accessed 18-11-10
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