The Benefits of Country-by-Country Reporting

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What is country-by-country reporting?

Country-by-country reporting is a new and innovative form of accounting.[1] The basic concept is to require the inclusion in annual audited financial statements of a profit and loss account for each jurisdiction in which a multinational corporation had operations during the year. These profit and loss accounts would include disclosure of both third party and intra-group transactions, which for these purposes are those trades that take place across national boundaries but between companies under common ownership or control. They would be required to be reconciled with the overall group results. In addition, limited cash flow and balance sheet data would also be required to be published.

Country-by-country reporting was first suggested in 2003. By 2012, it was on the agendas of the SEC, the International Accounting Standards Board, the Organisation for Economic Cooperation and Development, and the European Union. It is likely to become law in the USA and European Union soon, at least for companies in the extractive industries. It is an idea whose time has come. This paper explains what country-by-country reporting is, why it is needed, what disclosures it would require, and what the resulting benefits would be to users of financial statements, including all potential stakeholders of the companies that publish them.

Problems in existing accounting that country-by-country reporting will address

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

The organizations calling for country-by-country reporting[2] have identified two key weaknesses in existing reports. The first is that they are published on a group-consolidated basis. Such an overall report is, of course, needed information for the equity holders in the corporation. And no one calling for country-by-country reporting is arguing for dispensing with such consolidated financial statements. However, they also have important weaknesses, including the following:

[1] For a much more detailed report on country-by-country reporting see "Country-by-Country Reporting: Accounting for Globalisation Locally" by Richard Murphy, published in 2012 and available at http://www.taxresearch.org.uk/Documents/CBC2012.pdf .

[2] Organizations involved include the Tax Justice Network http://www.taxjustice.net/, Christian Aid, http://www.christianaid.org.uk/actnow/trace-the-tax/background.aspx, Publish What You Pay, http://www.publishwhatyoupay.org/country-by-country-reporting, ActionAid http://www.actionaid.org.uk/102021/how_to_stop_tax_dodging.html, and many others.

1. They represent an accounting fiction. No entity actually exists that undertakes all the transactions that the accounts report. Those transactions are rather a selection from the full set of transactions undertaken by a large set of related but legally distinct entities located in different jurisdictions.

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

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

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

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

6. They do not supply many users–including many considered suppliers of capital by the International Accounting Standards Board, such as trade creditors and employees–with information about the particular entity with which they are engaged.[3]

7. They do not provide adequate information for determining tax responsibilities because tax is not paid on a group basis but at the level of the individual corporate entity.

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

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

Although there do exist current reporting standards on "segment reporting," they are too limited to address these deficiencies. The current standards are International Financial Reporting Standard 8 in countries where International Accounting Standards Board standards apply and Statement of Financial Accounting Standards (SFAS) No. 131 in the USA. For all practical purposes these standards are the same. They require that if the reporting entity is a multinational corporation it must differentiate trading geographically by reporting trade in its head office location separately from trade in all other locations, and then only if that split is material. No other geographic data need be supplied. Other segment data to be supplied to users of the financial statements must use the same break-down as is used for supplying data to senior management for their decision making purposes. This may or may not be geographic data. For example, the data may instead be broken down by business categories reflecting the different business sectors in which the multinational corporation is engaged.

This type of business sector analysis may well be useful for the multinational corporation itself and other stakeholders. But it is not sufficient for many users of accounting data who require geographic data, whether to assess risk, determine tax responsibilities, or otherwise analyze the impact of the corporation's actions in specific places.

The case for country-by-country reporting is that its absence leaves the following serious gaps:

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

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

3. Those wishing to hold corporation and governments to account for the management of the payment and spending of tax revenue do not have the information they need. Group consolidated financial statements of multinational corporations do not let them do this. Local subsidiary accounts cannot fill this gap because such subsidiaries are either unidentified or do not make their accounts available on public record.

Finally, those arguing for country-by-country reporting contend that it is necessary to supply significant macroeconomic data crucial for managing the international economy. International statistics are kept on a country-by-country basis. But the absence of country-to-country reporting means that much essential data is missing, leading to the skewing of information that is essential for policy decisions by governments. For example, what is left largely unknown includes:

data on the precise value of intra-group trading, although the OECD now appear to estimate that it amounts to 60% of total world trade; data on the location of worldwide profits; data on where multinational corporations declare and pay their tax; .data on employment patterns within multinational corporations; data on where multinational corporations locate their assets and liabilities; and the location of financing flows within multinational corporations.

As noted below, country-by-country reporting can provide these data and more.

Information disclosure required by country-by-country reporting

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

1. The name of each country or jurisdiction in which it operates;

2. The names of all its companies trading in each country or jurisdiction in which it operates;

3. What its financial performance is in every country or jurisdiction in which it operates, without exception, including:
   - Its sales, both third party and with other group companies;
   - Purchases, split between third parties and intra-group transactions;
   - Labor costs and employee numbers;
   - Financing costs split between those paid to third parties and to other group members;
   - Its pretax profit;

4. The tax charge included in its accounts for the country or jurisdiction in question, split as noted in more detail below;

5. Details of the cost and net book value of its physical fixed assets located in each country or jurisdiction;

6. Details of its gross and net assets in total for each country or jurisdiction in which operates.

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

1. The tax charge for the year split between current and deferred tax;

2. Actual tax payments made to the government of the country or jurisdiction in the period;
3. The liabilities (and assets, if relevant) for tax and equivalent charges at the beginning and end of each accounting period;

4. Deferred taxation liabilities for the country or jurisdiction at the start and close of each accounting period.

Sales information may also require additional detail. If sales made from a jurisdiction differ by more than 10% from sales made to that jurisdiction, then data should be declared on both bases for that jurisdiction so that there is clear understanding of both the source and destination of the sales made by a multinational group. Otherwise sales could be artificially recorded as deriving, for example, from a tax haven when in fact they should be attributed to a major jurisdiction, thus understating the sales for that location.

For companies in extractive industries, country-by-country reporting would also imply a full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates, using the reporting categories required by the Extractive Industries Transparency Initiative.[4]

Benefits that country-by-country reporting would provide

In broader terms, country-by-country reporting is important for the following reasons:

Transparency matters. In many countries a corporation does not have to put its accounts on public record. That means that what an MNC does in that country is not a matter of public record. That matters both for the country itself and at a global level. What MNCs do has enormous implications for the well-being of the world: country-by-country reporting overcomes this problem. It puts all MNC activity 'on the record.' Responsible investors, as well as the public, appreciate such transparency.

Corporate social responsibility (CSR) matters. CSR is about the relationship between a company and its host community. This requires that the host community knows the company is there, and knows what it's doing there. Country-by-country reporting provides that information**.**

Accountability matters. A company cannot be accountable unless it can be identified. This means that the names an MNC uses locally must be on public record. Too often they are not. Country-by-country reporting names local subsidiaries.

Trade matters. At least 60% (and maybe more) of world trade is intra-group. Current accounting reports from MNCs completely exclude such trade from public view. Country-by-country reporting shows it all. This is vital if trade relationships are to be understood and made fair.

People matter. MNC accounts include statements on the number of employees a company has and their aggregate remuneration. Country-by-country reporting would require this statement for every country in which an MNC operates. This would provide invaluable information on labor conditions.

Tax matters. MNCs have more opportunity than any other group in a society to plan their tax affairs. They can seek to shift their profits from country to country to find the lowest overall bill. Country-by-country reporting discloses the profits that companies record in each country in which they operate and the taxes that they pay on them. This means they can be held accountable for what they do and do not pay. It's estimated that if this problem were tackled, enough tax could be collected to help meet the cost of achieving the Millennium Development Goals.

Corruption matters. The extractive industries are dominated by MNCs. The Extractive Industries Transparency Initiative seeks to hold those companies to account for the tax payments they make, and the governments that receive those payments to account for what they do with them. Many MNCs resist such disclosure because of competitive pressure, contractual obligations, and

[4] http://eiti.org/files/document/EITI%20Business%20Guide.pdf, page 31.

local political opposition. Country-by-country reporting would overcome these objections by requiring such reports from all companies, significantly enhancing transparency in this sector, and help cut corruption.

Development matters. Developing countries lack revenue to finance public goods and services. Aid helps alleviate this problem but has the potential to create dependency, reduce democratic accountability of developing country governments to their electorates, and itself contribute to corruption. Local declaration of economic activity by MNCs with the resulting accountability for taxes paid could help break this cycle and assist in creating fully independent, accountable governments capable of raising their own tax revenues.

Governance matters. Many of the major corporate scandals of recent times have involved extensive use of offshore subsidiary companies. These are becomingly increasingly common in MNCs, and it is recognized that they pose serious governance issues for MNCs themselves. This results in increased risk for shareholders, employees, local communities, and even national governments that may depend on the MNC's operations.

Where you are matters. Some countries are politically unstable. If a company trades there, shareholders should know. Some are politically unacceptable. If an MNC trades there, civil society should know. Some countries are subject to sanctions, making trading there illegal. Where you are matters. Country-by-country reporting holds a company to account for where it is.

Country-by-country reporting would therefore provide multiple benefits for all users of the financial statements of multinational corporations.

How likely is it that we'll get country-by-country reporting?

In 2003 when I published my very first paper on country-by-country reporting[5] the idea that it would ever really see the light of day was very far from even my mind. I simply put forward an idea that had interested me that arose out of a conversation with a friend. I honestly expected the total audience for the paper to be just two people.

In 2012 a limited form of country-by-country reporting for the extractive industries is now law in the USA and heading to be law in the European Union. It's far from the full version noted above, but in accounting terms, where change is usually glacial, the rate of progress has been phenomenal.

In that case the chance of full country-by-country reporting becoming law has to be considered. It is known that multinational corporations and their auditors oppose such a move, but they have also opposed the moves for its introduction in the extractive industries. That change in the extractive industries happened for two reasons. First, the groundwork had been laid, and second the opportunity arose. That opportunity was created by BP spilling millions of barrels of oil in to the Gulf of Mexico. The mood on regulation in the oil industry in the USA changed as a result.

For full country-by-country reporting the mood change creating political momentum for change is likely to have a different cause. The motivation for the governments involved will be, in this case threefold. The first will be an intense desire for increased tax revenue to close their deficits. The second will be a desire to tax what appear to be ever-rising cash mountains held by the world's multinational corporations (Apple is currently reported to be sitting on $117 billion[6]). The third will be their frustration with those companies' attempts to hide that cash from view, aided by their

[5] http://visar.csustan.edu/aaba/ProposedAccstd.pdf.
[6] http://www.zerohedge.com/news/2012-09-30/presenting-worlds-biggest-hedge-fund-you-have-never-heard.

accountants. That frustration is already notable. Four major tax authorities have now said that country-by-country reporting would help them collect tax.[7] The EU Parliament continues to demand the extension of country-by-country reporting beyond the extractive industries.[8]

We will not get country-by-country reporting overnight, but it is only ten years old now and we nearly have it for the extractive industries. In less than ten more years I suspect we will have it all for all multinational corporations.

[7] http://www.taxresearch.org.uk/Blog/2012/09/27/tax-authorities-back-country-by-country-reporting-to-prevent-transfer-pricing-abuse/.
[8] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bIM-PRESS%2b20120917IPR51496%2b0%2bDOC%2bPDF%2bV0%2f%2fEN.