International Accounting Standards Board
1st Floor
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United Kingdom

23 February 2011

Dear Sir or Madam

Public Consultation on the Trustee's Strategy Review

We write to make formal response to the above consultation paper.

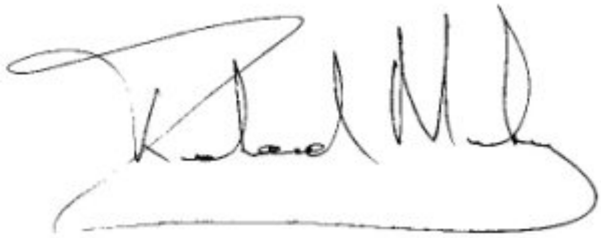
Tax Research LLP is a consultancy that works mainly on taxation and related accounting and economic issues. Its clients are mainly non-governmental organisations and civil society organisations. The objective of its work is the development of taxation mechanisms that can assist the relief of poverty both within domestic economies and internationally. Tax Research LLP is directed by Richard Murphy FCA, the creator of the country-by-country reporting concept for multinational corporations.

Attached to this letter, and to be considered an integral part of it are two appendices. The first contains our responses to the specific issues raised on which we believe it appropriate for us to comment.

The second appendix explores the failure of existing financial statements prepared under International Financial Reporting Standards, why they fail to meet user needs and why the secrecy they permit is harmful to the effective operation of markets and all those who depend upon them. As a result it recommends that the International Accounting Standards Board fully embrace country-by-country reporting as a complementary and not competing form of reporting that will ensure that the Trustees meet their obligation to produce "high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and *other users of financial information* make economic decisions" (our emphasis added). It is our contention that the Trustees fail in their duty to do so now by ignoring the issues we raise in this letter and its appendices.

We provide our explicit permission for our comments to be published by you.

Yours faithfully



Richard Murphy
Director

Appendix 1 to letter to the International Accounting Standards Board dated 23 February 2011

Answers to the questions posed by the IASB in its Public Consultation on the Trustee's Strategy Review

1. The current Constitution states, "These standards [IFRSs] should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets *and other users of financial information make economic decisions*." Should this objective be subject to revision?

There is, as such, no problem with the definition of the objectives for International Financial Reporting Standards noted above. There is, in practice, an enormous gulf between the stated objective and the delivery of International Financial Reporting Standards. The reality is that the International Accounting Standards Board has decided that information supplied to investors and other providers of capital In the world's capital markets is sufficient information to meet the needs of all other users of financial information in the course of making the economic decisions. It is almost impossible to see how this decision can be reconciled with the stated objectives of the Constitution, and it is equally difficult to see how this viewpoint can be sustained in the face of rational argument.

As has been argued by Tax Research LLP[1], there are a wide range of users of financial statements, quite consistently identified over a long period of time to include:

- 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 business contact group;
- The surrounding community;
- Civil society organizations; and
- Governments and their institutions

The first three such groups may (and we stress, may) have their needs met by existing data included in financial statements. This may be because the data they require is, in essence, required to undertake a remarkably limited function. Those users need, in the opinion put forward by the International Accounting Standards Board, to decide whether to continue their engagement with the entity solely in their capacity as suppliers of capital. As participants in the world's financial markets, which are (usually) liquid and functional they have opportunity, often at little more than a moment's notice to change their view on this issue, and engage or disengage as they wish. This then is a simple need of a group with remarkably little, or almost no effective or on-going relationship with the entity to which they provide capital, with which they have little or no effective actual relationship at all. It is this simple need that the IASB has chosen to address.

The needs of the other user groups for financial statements are complex. Those groups tend to have long-term relationships that are undertaken directly with the entity, or components of it, on a recurring basis. It may well

[1] http://www.financialtaskforce.org/wp-content/uploads/2009/06/Final_CbyC_Report_Published.pdf

be very hard for them to change these relationships in the short term. The relationships may be of dependency; they may be ones of oversight; they may be beneficial and they can involve the imposition of harm through the externalities of trade. But in almost no situation because of the complexity of the relationship is the information need of those users the same as that of the transient supplier of capital to an entity in the world's financial markets.

The supplier of capital may well view the entity with which it engages as a whole. The relationship can be viewed globally: financial statements prepared on a consolidated basis suit the need of these users.

The other user groups view the entity locally: their concern is with the part of the entity with which they engage, whether as supplier or customer, nationally or even more locally, as employer, as neighbour, as taxpayer, as polluter, as supporter of civil society, and much more besides. These issues are explored in more depth in Appendix 2 to this submission. The key issue is that the needs we identify these user groups as having in that appendix are not just not being met, they are deliberately not being met as a consequence of the decision of the International Accounting Standards Board to ignore them even though the Trustees accept their duty to do so in their constitution.

It is this failure to provide relevant and reliable information to the great majority of potential users of financial statements (they are of course only potential users since existing financial statements do not meet their needs) that poses the greatest challenge to and greatest threat to the International Accounting Standards Board.

There is no need for the International Accounting Standards Board to change its purpose. It is essential that it embrace the duty that it has accepted and now ensure that the information needed by 'other users of financial statements' is made available to them to enable them to make the economic decisions which are frequently of much greater import to them, their families, their businesses, their localities and their nations than are those undertaken by the suppliers of capital. We stress: the economic decision in question are ones that they need to make based on data extracted from the general ledgers of the reporting entities subject to International Financial Reporting Standard and only capable of delivery to them as part of comprehensive, audited financial statements. Failure to embrace this obligation now will undermine the entire credibility of the International Accounting Standards Board. Embracing it will ensure its future. We think the issue as important as that.

2. The financial crisis has raised questions among policymakers and other stakeholders regarding the interaction between financial reporting standards and other public policy concerns, particularly financial stability requirements. To what extent can and should the two perspectives be reconciled?

This question is easily answered by reference to the previous one: as the Trustees note there they have obligation to provide "high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions". The other users of financial information are noted in the previous answer and do, of course, include governments, regulators and the public, who have now been proven to be the providers of capital of last resort to a great many corporations in a great many countries. In the circumstances it seems that it is essential that IFRS meet the needs to supply data to inform these economic decision making processes by these other users of financial statements. It is not a question of whether these two objectives can be reconciled: they cannot be separated. If the International Accounting Standards Board sought to do so then there would be a need for another regulatory body requiring that the world's major corporations prepare "high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions". In other words, there would be a need for a duplicate set of accounting standards to ensure that the data needs that the IASB had refused to recognise were met, based on information extracted from the general ledgers of the companies in question. There is, however, no room for such duplication. There is a need for one set of comprehensive standards to address this need, and no more.

The question the International Accounting Standards Board has to ask itself is whether it wants to address this need, or move aside and let another organisation that will do see meet it in its place. The International Accounting Standards Board is as such beholden to create standards that ensure information to meet public policy concerns is available to all who need it and if it does not accept that responsibility then it ceases to have any useful purpose.

3. The current governance of the IFRS Foundation is organised into three major tiers: the Monitoring Board, IFRS Foundation Trustees, and the IASB (and IFRS Foundation Secretariat). Does this three-tier structure remain appropriate?

This question is answered with question 4, below.

4. Some stakeholders have raised concerns about the lack of formal political endorsement of the Monitoring Board arrangement and about continued insufficient public accountability associated with a private-sector Trustee body being the primary governance body. Are further steps required to bolster the legitimacy of the governance arrangements (including in the areas of representation of and linkages to public authorities?

There are three main problems where we see the need for reform of the governance structure of the IFRS Foundation:

(a) The narrow profile of the members of the IASB and the Trustees

As outlined above, the Constitution refers to a range of 'other users' of financial reports. Yet the profile of IASB and Trustees members is extremely narrow. We strongly recommend that representatives from the full range of users of financial information, as laid out in the bullet point list above, should be included in both bodies. Only this way will the institution be well placed to consider the needs of, and improve accountability to all those to whom it has responsibility.

(b) The lack of public accountability of these bodies

We know of no mechanism by which these bodies open themselves to direct discourse on key decisions to representatives of each of the key user groups outlined above, as well as elected representatives. Individuals may attend meetings but only as silent observers. We recommend that each body hold public hearings on key issues, and that these are interactive and discursive, as other policy setting bodies do. The proceedings of these hearings should also be open and on the public record.

(c) The lack of formal political endorsement

We support the call for greater linkage to public authorities. However, this must be associated with genuine engagement, debate and accountability to be of value and not a 'rubber-stamping' exercise. The current relationships between the IASB and such bodies appear to be of this nature and are inadequate as a consequence. Given that International Financial Reporting Standards have the effective status of stature in many jurisdiction effective relationships with, and visible coherence with the objectives of the democratic process of enactment of legislation is vital to the credibility of the International Accounting Standards Board and is lacking at present. Worse still, observations heard far too often from those engaged with the International Accounting Standards Board to the effect that politics must be kept out of accounting processes reveals a fundamental lack of understanding of the need for democratic accountability in such activities.

5. Is the standard-setting process currently in place structured in such a way to ensure the quality of the standards and appropriate priorities for the IASB work programme?

Answered with question 6, below.

6. Will the IASB need to pay greater attention to issues related to the consistent application and implementation issues as the standards are adopted and implemented on a global basis?

We have, when working with Publish What You Pay and others sought to engage with the International Accounting Standards Board over an extended period. The process has been disheartening and reveals a lack of willing on the part of the organisation to listen, engage or even take seriously the needs of other users of financial statements in general and civil society in particular. As a result we believe that the International Accounting Standards Board must dramatically improve its processes to ensure:

(i) that it consults with the full range of users of financial statements, and takes their needs and uses into account both when assessing the costs and benefits of International Financial Reporting Standards and in the selection of its priorities. This will be evidenced, for example, by the adoption of country-by-country reporting as outlined in appendix 2;

(ii) that it places much greater empahsis on engagement with actors in developing countries and emerging markets, especially in Africa and Asia;

(iii) it significantly improves its responsiveness – three years is too long for stakeholders to wait for a discussion draft and four years for them still not to have a decision on whether an issue is on the agenda for action, as has been the experience of engaging with the International Accounting Standards Board on the need for country-by-country reporting for the extractive industries.

7. Is there a way, possibly as part of a governance reform, to ensure more automaticity of financing?

The International Accounting Standards Board will retain a credibility problem whilst those whom it regulates largely finance it. The conflict of interest that this creates is unacceptable in a process that results in what is, in effect, statute in many jurisdictions. It is an unavoidable necessity that governments adopt a primary responsibility for financing the International Accounting Standards Board and that the IASB does in consequence become accountable for the use of that funding to those who ultimately have responsibility for regulating the reporting of financial entitles, i.e. the democratically elected governments of the world.

8. Are there any other issues that the Trustees should consider?

The International Accounting Standards Board has concentrated on the reporting of parent entities, whatever size they may be. As Appendix 2 makes clear, the interest of many who engage with multinational corporations is at the local level and at the level of the subsidiary with which they actually engage, or at the national level with regard to the tax paid locally, and so on.

Much of the data civil society needs to make economic decisions is available within multinational corporations subject to International Financial Reporting Standard but is not available locally so that economic decisions can be informed by that information. As a result it is vital that the International Accounting Standards Board promotes the importance of accounting in communities if it is to fulfil its mandate. Means to do so are explored in Appendix 2

Appendix 2 to letter to the International Accounting Standards Board dated 23 February 2011

The reason why existing financial statements fail to meet the needs of all users

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

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

1. They represent an accounting fiction – no such entity actually exists;
2. They ignore all intra-group trades which at a local level may be highly material and which are, for tax purposes, very often the most sensitive transactions undertaken by the companies in the group;
3. They do not locate trades in a place because their reporting is not geographic;
4. They do not identify the assets and liabilities located in a place;
5. They do not reveal the structure of the trading group;
6. They do not supply many users – including many considered suppliers of capital by the International Accounting Standards Board, such as trade creditors and employees – with information about the particular entity they are engaged with;
7. They cannot properly represent tax due because tax is not paid on a group basis but at the level of the individual corporate entity.

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

These deficiencies are not overcome by current reporting standards relating to segment reporting. These are International Financial Reporting Standard 8 in countries where IASB standards apply and SFAS 131 in the USA. For all practical purposes these standards are the same and require that an entity only report geographically if it is a multinational corporation. Then it need only separate trade in its head office location from all other trades if that split is material. No other geographic data need be supplied: other segment data needs to be supplied to users of the financial statements using the same break-down as is used for supplying data to senior management for their decision making purposes. This may be geographic data, of course, but it is as likely to be data analysed by business category when the multinational corporation undertakes diverse trades. This type of business sector data may well suit the multinational corporation; again this is not disputed. It does not however suit the needs of many users of accounting data whose need is to assess geographic risk relating to the place in which the entity is trading and in which they are located.

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

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

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

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

    a. Those subsidiaries are often not identified;

    b. Their accounts are not available on public record.

Finally, those arguing for country-by-country reporting contend that significant macroeconomic data crucial for managing the international economy is missing as a result of the absence of country-by-country reporting:

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

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

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

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

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

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

As is noted below, country-by-country reporting can provide this data, and more besides and as such resolve the problems of opacity inherent in current reporting systems.

How multinational corporations exploit secrecy

The modern multinational corporation (MNC) is complex entity. The multinational corporation is almost invariably headed by a single company – the parent entity. This is almost invariably a limited liability corporation. It then comprises a number of other, usually similar limited liability corporations, spread over one or more other jurisdictions. In the course of researching this paper it was noted that UK based BP plc has more than 3,000 subsidiaries in over 150 jurisdictions.

Those subsidiaries need not be limited liability corporations; as International Accounting Standard 27 notes, a subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent). They can therefore also be limited liability partnerships in all their forms, trusts, charities and other arrangements, but limited liability corporations are by far the most common. What is key is that the parent company controls the subsidiary. Control is widely defined by IAS 27 but most commonly means that the parent has direct or indirect control of a majority of its equity shares.

However control is established, when a parent entity governed by International Financial Reporting Standards (which in this respect operates almost identically to US GAAP) has subsidiary entities then IAS 27 requires that consolidated accounts / financial statements be prepared. These are the financial statements of a group of entities presented as if they are those of a single economic entity.

It is immediately apparent that within this requirement there is an obvious conflict of interest. The parent entity of such a group may be required to present its accounts as if a single entity and yet in practice the group may be made up of thousands of entities which are under the control, but not necessarily the sole ownership of the parent entity. This treatment as a single entity arises because it is claimed that the Board of Directors of the ultimate parent company treat the entity as a single unit over which they have complete control.

That, of course, may be the substance of the matter, but the reality is that each entity within the multinational corporation remains legally distinct, each being subject to the rules of accounting, taxation and disclosure of the jurisdiction in which it operates. As such in a very real sense each subsidiary is without obligation to the other members of the group bar that duty which the directors / managers of that entity might owe under the law of the jurisdiction in which it is incorporated to the owners to whom they might report, and this duty varies widely from place to place.

Curiously, the one thing that is almost always assumed in company law is that the shareholders / owner do not have the right to manage an entity: that right belongs to the directors. Of course the shareholders might have the right to appoint those directors, but it is important to note that in a very real sense the assumption underpinning group accounts pierces the veil of incorporation that in turn underpins the notion of the limited liability entity. The dichotomy is that it does so whilst seeking to reinforce that division inherent in the act of incorporation by presenting the group as one undertaking distinct from its owners, who get what limited information the directors wish to supply, subject to legal constraints.

The inherent conflict in reporting that results is exacerbated by a number of further factors. First, the definition of control used for accounting may be different from that used by some jurisdictions for tax. So some entities that are within the group for tax in some locations might not be in others. For example, tax might require 75% control but accounting requires 50.01% in most cases. Therefore entities that for accounting purposes might be related parties requiring inclusion in a common set of consolidated accounts / financial statements may not be so treated for transfer pricing purposes.

Second, note that some entities are deliberately structured created to exploit the rules on consolidated financial reporting. In particular, the financial services industry has become expert at creating 'orphan' entities. These are companies that are created by a parent organisation that are deliberately structured by that parent entity so that they are "off balance sheet" so that the assets or liabilities that they own are excluded from consolidation in the parent entities accounts / financial statements, as are its trading results.

A common way to engineer this is to create a company to which the off balance sheet assets and liabilities the parent entity wishes to hide from view are transferred. This new entity is owned by a charitable trust. As such it is considered to be neither under the ownership or control of the parent entity. This is why it is described as an orphan; it has become parentless whilst being utterly dependent on the parent entity.

These entities are hard to spot, but commonplace. Whilst used to exclude liabilities from accounts in most cases the rules that permit this will also allow them to be used for transfer mispricing which can pass undetected subject to the caveat that the proceeds must then be used for purposes that the group might wish to keep at quasi-arms length. This purpose could be fraudulent.

Third, it is widely assumed that consolidated accounts / financial statements are created by adding together all the accounts of the individual entities that make up the group and then eliminating all the intra-group transactions and balances. This is a simplistic, but not wholly inappropriate view of what should happen. The reality is that multinational corporations can deliberately obscure the relationship between the underlying accounts / financial statements of the subsidiary companies and the group accounts in ways which make it almost impossible to detect what is really happening within a group. This can be done in a number of ways.

The first is the use of different accounting year end dates for group companies. IAS 27 (section 26) says this should not happen, and any differences should be explained but the reality is (as the author has frequently witnessed) that non-coterminous year ends are commonplace and almost never disclosed or commented upon. If non-coterminous year ends are used transfer mispricing can be used to shift profits (and losses) around groups almost at liberty and almost entirely undetected.

Next, non-standard accounting policies may be used in different places to recognise transactions even though IAS 27 says this should not happen. This is now commonplace. The parent company might account using International Financial Reporting Standards but local entities may well account using local GAAP and there is nothing to prevent this. Some significant transactions have different tax treatments depending on the accounting standards used. There are, for example, conflicts between UK and International Accounting Standards on financial derivatives for tax purposes. These have been exploited by international banks.

In addition entries can be made in the consolidated accounts alone which never appear anywhere in any of the accounts of the underlying entities. In principle this should not happen because the accounts can then be said to not reflect the underlying books and records of the multinational corporation that is publishing them, but in practice if considered a non-material adjustment when assessed from the point of view of the user of the financial statements, which both the International Accounting Standard Board and the US Federal Accounting Standards Board define as ‘ a provider of capital to the company’, then no auditor is likely to object. This can however disguise radically different presentations of profit on trades between related undertakings between group consolidated and individual entity accounts / financial statements, especially when tax implications are taken into account, with the benefit being hidden from view in the accounts of the group as a whole. Interview based evidence suggests that this practice is commonplace. It will never be discovered by tax authorities since it is the accounts / financial statements of the individual subsidiary entities that are used to determine tax liabilities in each jurisdiction in which they trade. The consolidated accounts / financial statements are deemed to have no interest to tax authorities and as such in jurisdictions such as the UK the tax authorities are not entitled to ask questions about the entries that make up these published accounts as they are deemed to have no tax interest, although it is not clear that this is true.

It is this last point that is, perhaps, of greatest significance because the exact entries that are eliminated from view when the consolidated accounts / financial statements are prepared are those same transactions that will always have potential to give rise to transfer pricing disputes. As such the most useful evidence that consolidated accounts / financial statements could provide to tax authorities – the data relating to transfer pricing issues – which is the data on the ‘most contentious issue in tax’ according to a poll of US tax directors in 2007[2], is denied to the tax authorities that need it.

This omission is exacerbated in a number of further ways, all endorsed by International Financial Reporting Standards, and all of which make it easier to hide transfer pricing abuse on intra-group transactions. First, in the individual accounts / financial statements of the subsidiaries that make up the multinational corporation it would seem obvious that the transactions with other group companies should be highlighted – if only to indicate that they will disappear on consolidation. This is theoretically required by another International Accounting Standard – IAS 24 on related party transactions. Broadly speaking IAS 24 (section 9) defines a party as related to an entity if one directly or indirectly controls the other, but associates, joint venturers and some other arrangements are also included in the definition.

IAS 24 defines a related party transaction is a transfer of resources, services, or obligations between the related parties regardless of whether a price is charged (section 9). As a result it would seem that all transactions between group companies must be disclosed in a group’s financial statements because a long list of disclosable transactions of this sort is included in the standard.

Unfortunately, the prospect of disclosure that this requirement creates is then dashed. IAS 24 proceeds to say that whilst the disclosure must be made separately for the parent company, subsidiaries and other identified categories of related parties the information within each such category “may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of the related party transactions on the financial statements of the company”. As a result all trading by a subsidiary with all other subsidiaries can be aggregated into one number in most cases. As a result no indication need be given of with whom a trade has occurred, what has been traded or on what terms and where the other side of the transaction might be recorded.

[2] http://www.tpweek.com/Article/1786798/US-tax-directors-poll-TP-is-most-contentious-issue.html accessed 24-8-09

The result is obvious: the accounts / financial statements end up providing no meaningful information at all on intra-group issues. That is because the information is excluded from consolidated accounts / financial statements because related party trades between parents, their subsidiaries and between fellow subsidiaries are always excluded from those accounts, whilst the disclosure require of individual group members is of such limited amount that forming a view on transfer pricing is almost impossible in most cases, largely because it will be rare for the other party to any transaction to be disclosed, especially within a large and complex group.

This might be thought an accident. Regrettably it is not, as IAS 24 makes clear. In the latest version of the standard, introductory note IN7 says:

> *Discussions [in the standard] on the pricing of transactions and related disclosures between related parties have been removed because the Standard does not apply to the measurement of related party transactions.*

This is an extraordinary statement to make. Accounts prepared under International Financial Reporting Standards and their US equivalents are the basis of corporate taxation in a great many countries in the world but the International Accounting Standard that is responsible for their promulgation says that it is not their purpose to assist measurement of transfer pricing related matters. But if not, then where is that issue to be dealt with, one wonders?

Certainly not in the only other part of the International Financial Reporting Standard environment that might provide information on the issue, which is IFRS 8 on segment. IFRS 8, by default, usually only applies to companies quoted on a stock exchange in a jurisdiction that has adopted International Financial Reporting Standards (as all countries in the European Union have, for example). It defines an operating segment as a component of an entity:

- *that engages in business activities from which it may earn revenues and incur expenses*
- *whose operating results are reviewed regularly by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and*
- *for which discrete financial information is available.*

IFRS 8 requires an entity to report financial and descriptive information about its reportable segments. These are operating segments or aggregations of operating segments that have more than 10% of the revenues, profits or assets of the entity. Smaller segments are combined until ones of this size are created, supposedly to reduce information overload. In practice this might, of course, hide necessary detail.

Required disclosure by reportable segments includes trading data including profit and loss, its assets and liabilities and limited geographic analysis. Such a summary does not, however, show the true level of problem inherent within IFRS 8, which also allows segment data to be published using the different accounting rules from those used in the rest of the accounts / financial statements, meaning as a result that segment data can be stated in a way harmful to appraisal of transfer mispricing. In addition IFRS 8 does not require that segments cover all of the multinational corporations activities meaning some information can be omitted, providing opportunity for transfer mispricing to be hidden from view.

As a consequence considerable support has developed for an alternative form of segment accounting called country-by-country reporting, created by the author of this report[3]. Country by country reporting would require an MNC to disclose the name of each country in which it operates and the names of all its companies trading in each country in which it operates. This data is usually currently unavailable. Country-by-country reporting would then require publication of a full profit and loss account for each country in which the multinational corporation operated plus limited cash flow and balance sheet information. Radically, the profit and loss account would break down turnover between that with third parties and group entities. Costs of sale, overheads and finance costs would require to be broken down in the same way whilst a full tax note would be required for each country, as presently necessary for International Financial Reporting Standards.

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 the categories of reporting required in the Extractive Industries Transparency Initiative.

As Murphy notes 'Country-by-country reporting does not [stop transfer mispricing]. What it does do is provide data that .. tax departments .. can use to assess the likely risk that exists within the accounts of a multinational corporation. They can do this by:

Assessing the likelihood of risk within the group structure;

Reviewing the overall allocation of profits to countries within the group to see if there is indication of systematic bias towards low tax jurisdictions;

Assessing whether the volume and flows of intra-group trading disclosed by country-by-country reporting suggests that this outcome is achieved as a result of mispricing of that trade;

Using that information to assess where that abuse is most likely to occur so that an appropriate challenge can be raised.'

So far the International Accounting Standards Board has only indicated willingness to consider this issue with regard to the extractive industries and current indications are that despite the considerable lobbying of it there is little prospect of advance on this issue. The conclusion is inescapable: as was said by one International Accounting Standards Board member when the issue of country-by-country reporting was being discussed by that Board "This looks like it deals with the issue of transfer pricing, and we do not want to go there"[4]. The comment is succinct but neatly

[3] http://www.financialtaskforce.org/wp-content/uploads/2009/06/Final_CbyC_Report_Published.pdf

[4] Reported by Richard Murphy, September 2006.

summarises the whole design of current accounting standards, which seem purpose made to hide the subject of transfer pricing from view.

The role of secrecy jurisdictions

The literature that alleges substantial transfer mispricing abuse by multinational corporations on the intra-group transactions that are hidden from view in the secrecy space within multinational corporations also suggests that tax havens play a significant role in that process. The term tax haven is, however, so widely misunderstood that this paper does not use it, preferring instead to use the term 'secrecy jurisdiction'. A list of those places currently considered to be significant secrecy jurisdictions is available as appendix 4 to this paper.

The term secrecy jurisdiction is considered more appropriate for the purposes of the current analysis because although the process of transfer mispricing to which this paper refers seeks to secure a tax advantage (by way of reduced tax payment) for those who pursue the activity that advantage is not, it is suggested, available unless the abuse giving rise to it can be hidden from view behind a veil of secrecy that is used to induce artificial relocation of activities to one or more secrecy jurisdictions.

Using twelve criteria of opacity[5] the Tax Justice Network has ranked the opacity of the sixty significant secrecy jurisdictions they have identified, reporting their findings in the autumn of 2009 (Tax Justice Network 2009a and 2009b). The listing of jurisdictions ranked by opacity is appendix 5 to this paper. Thirty-five of the jurisdictions they surveyed had opacity rankings of between 90% and 100% using the criteria used by the Tax Justice Network. As that appendix shows, opacity is widely available. It is often, of course, linked to low tax rates, as Part 1 of this paper showed.

The combination of low tax rates and secrecy has obvious attractions to those seeking to transfer misprice, but to demonstrate whether or not multinational corporations actually use secrecy jurisdictions, and which ones they might use if they do the Tax Justice Network (TJN) coordinated, under the direction of the author of this paper, a survey of where multinational corporations locate their subsidiaries, paying particular attention to the secrecy jurisdictions TJN had identified. The results of the US Government Accountability Office study of January 2009 (GAO 2009) entitled 'Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions' were used as part of the survey. Because that US survey excluded data on the US (unsurprisingly), the UK and the Netherlands these locations were also excluded from the TJN survey, as was Madeira because of difficulties in isolating data independently from Portugal, as were Belgium and Austria, although the latter for practical rather than methodological reasons.

The total sample of multinational corporations surveyed was as follows:

Country	Number of MNCs sampled
France	39

[5] See http://www.secrecyjurisdictions.com/kfsi accessed 16-12-09

Netherlands	23
UK	33
USA	100
Germany	28
Switzerland	20
Total	**243**

It should however be noted that the data selection was pragmatic: the UK data should have been the entire FTSE 100 i.e. the 100 largest companies in the UK, designed to match the US sample. In practice although all UK quoted companies are legally required to publish the names, places of incorporation and percentage of holding for all their subsidiary companies annually, either in their audited accounts / financial statements or as an appendix to their annual declaration made to the UK's Registrar of Companies just 33 of the FTSE 100 companies did so. Enquiry suggested that no company had ever been prosecuted for failing to file this information. It is a curious example of the UK's own opacity.

It should also be noted that substantial problems were encountered with all other samples. The French data undoubtedly under-reports the number of subsidiaries since it only relates to principal subsidiaries, not all subsidiaries; German companies do not always make clear the distinction between subsidiaries and associates, the Dutch and Swiss data relied on databases and not original documentation which suggest some inconsistencies in approach and in particular about whether dormant subsidiaries are counted, or not, and so on. All such issues do, however, reveal one consistent theme, which is that it is immensely difficult to determine the composition of a multinational corporation.

Detailed analysis of the regulatory requirements of the sixty secrecy jurisdictions surveyed by TJN highlights the issues. Of the sixty jurisdictions surveyed accounts of companies were available on easily accessible public record in just six of them[6].

The situation was worse when it came to beneficial (as opposed to nominal) ownership information being available on public record: just Monaco requires that this data be available. In all other cases nominee ownership may be recorded, or there is simply no requirement to record data on public record at all[7].

It is readily apparent as a consequence that unless data is required from multinational corporations on what companies do, or do not, make up their group and what each does, as shown by its audited accounts, then the current legal requirements for data registration within secrecy jurisdictions ensures that the information required to assist appraisal of multinational corporations activities, including those relating to transfer mispricing, will simply be unavailable to most people, and quite possibly to many tax authorities, if that is the multinational corporation's wish, as it will be if it is seeking to hide transfer mispricing activity.

[6] See http://www.secrecyjurisdictions.com/PDF/PublicCompanyAccounts.pdf accessed 16-12-09

[7] See http://www.secrecyjurisdictions.com/PDF/PublicCompanyOwnership.pdf accessed 16-12-09

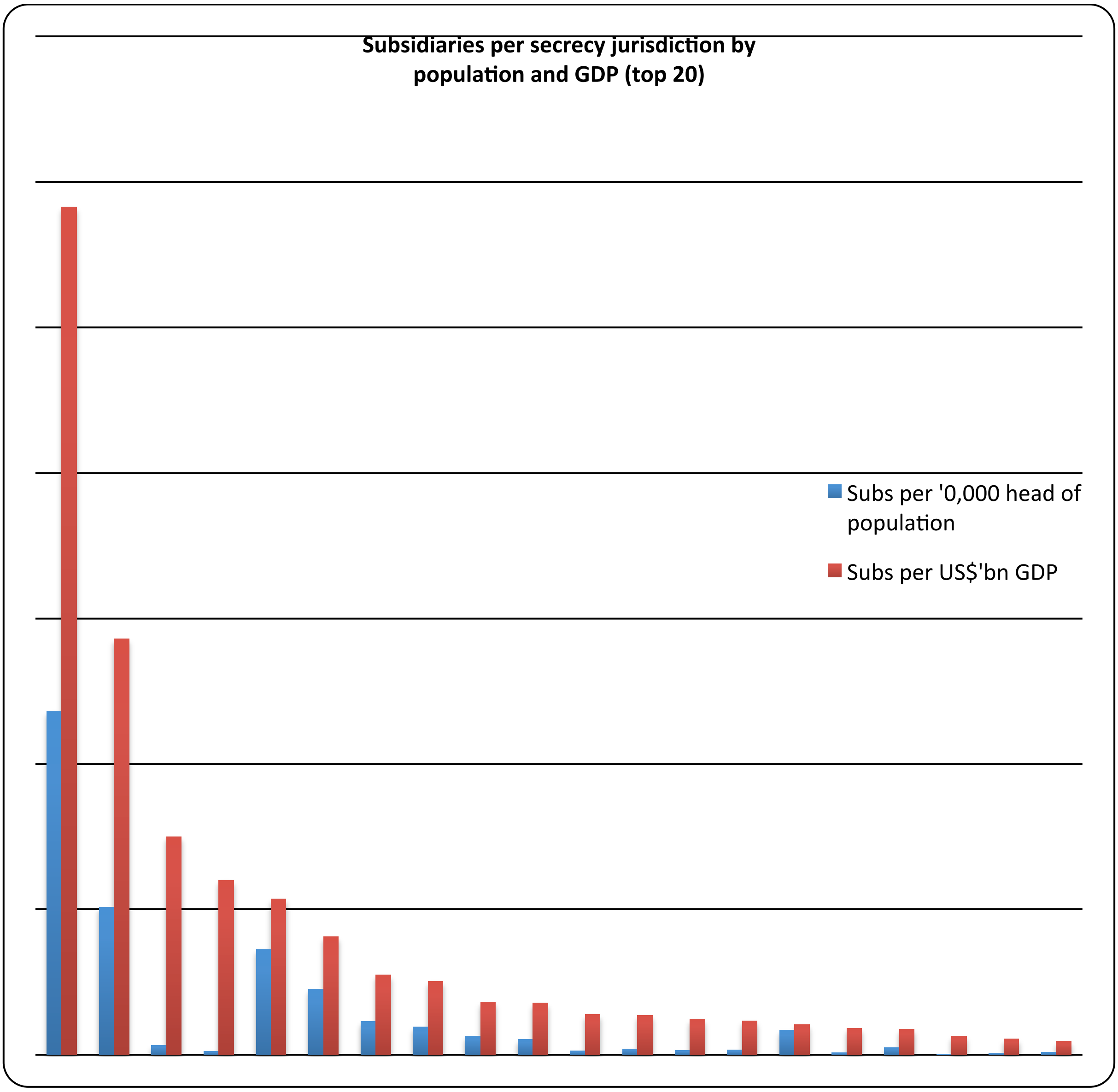
This would not be an issue if multinational corporations did not use secrecy jurisdictions. The reality is that they do use them extensively. 84% of the US sample and 97.2% of the European sample had secrecy jurisdiction subsidiaries as defined by the Tax Justice Network.

The survey of multinational corporation subsidiaries showed the following number of subsidiaries by location:

Ranking	Secrecy jurisdiction	Number of MNC subsidiaries
1	Cayman Islands	1130
2	Ireland	920
3	Luxembourg	824
4	Switzerland	771
5	Hong Kong	737
6	Singapore	661
7	Bermuda	483
8	Jersey	414
9	Hungary	252
10	British Virgin Islands	244
11	Malaysia (Labuan)	177
12	Mauritius	169
13	Bahamas	156
14	Guernsey	151
15	Philippines	126
16	Panama	125
17	Isle of Man	99
18	Costa Rica	85
19	Cyprus	69
20	Netherlands Antilles	68
21	Uruguay	67
22	Malta	60
23	United Arab Emirates (Dubai)	58
24	Israel	56
25	Gibraltar	54
26	Barbados	51
27	Latvia	40
28	US Virgin Islands	37
29	Monaco	35
30	Liechtenstein	32

Data for the next 24 jurisdictions has been ignored; they are immaterial for this purpose.

It is readily apparent that some, unsurprising locations stand out, but the data makes a lot more sense when plotted against two control variables, being population and GDP. When this is done the following graph is plotted:



The data in this graph is ranked by subsidiaries by GDP in US$bn. In most cases the correlation with a ranking by subsidiaries per head of population is very clear. This weighted data gives a much better view of relative importance of these places. It is apparent that some have extraordinary amounts of activity related to their size. There is only one explanation for this: it is obvious that secrecy jurisdictions are not creating entities for use by the local population, but as the definition of them used in this paper suggests likely, for the use of those resident elsewhere. Those companies that are registered there do little or nothing in those places.

That this must be true is indicated by the ratio of those working in financial services as a proportion of the total working populations in secrecy jurisdictions. As the Tax Justice Network has, again, noted this exceeds 20% in Guernsey, Jersey, the Isle of Man and the Cayman Islands and exceeds 10% in

Bermuda, Liechtenstein and Luxembourg[8]. Financial services sectors of that size crowd out the possibility of any other significant economic activity taking place. The overlap between this list and those locations with most multinational corporation subsidiaries is very obvious and the implication is clear: these locations do not create value. They act as locations whose raison d'être is the provision of corporate and financial services structures that might record value, but does not actually generate it. Of course, one way in which that value may be relocated into these places is through transfer mispricing.

The existence of the Big 4 firms of accountants[9] in many secrecy jurisdictions where, once again, their location in these places cannot possibly be justified by the needs of the local population reinforces this view. As Murphy (2010a) shows, the Big 4 firms are significantly over-represented in small secrecy jurisdictions (those with less than 1 million population) when compared with other locations of this size. As he also shows, those locations with the Big 4 present have average GDP per head approximately four times higher than those without the Big 4 present. Of course, cause and effect cannot be proven from this, but the possibility clearly exists, especially in the smallest of such locations, that the income in question is not earned in these places but is, as noted in the previous paragraph, transferred into them through transfer mispricing, and in that case the Big 4 firms do, Murphy suggests, by their presence facilitate the structures that allow this to happen.

The information disclosure required by country-by-country reporting and why it would address these issues

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:

[8] See http://www.secrecyjurisdictions.com/PDF/FS_in_Workforce.pdf accessed 16-12-09

[9] PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG

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

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

In addition, if the company operated within the extractive industries we would also expect to see a full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between these categories of reporting required in the Extractive Industries Transparency Initiative[10].

The proposal requires this information be disclosed for all jurisdictions - without exception - in which a multinational corporation operates. Anything less will not do or transactions might be lost to view. Importantly, this does not require each country to agree to this disclosure since it is suggested that the requirement should be imposed by an International Financial Reporting Standard[11].

Why we want country-by-country reporting

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

1. **Transparency matters.** In many countries a corporation does not have to put its accounts on public record. That means that what an MNC does in that country is not a matter of public record. That matters. What MNCs do has enormous implication for the wellbeing of the world. **CbC** overcomes this problem. It puts all MNC activity 'on the record'. Many investors appreciate this.

2. **Corporate social responsibility (CSR) matters.** CSR is about the relationship between a company and its host community. But this does require that the host community knows the company is there. **CbC** reporting provides that information.

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

[10] http://eitransparency.org/

[11] A revision to IFRS8 on Segment Reporting could achieve this objective. See http://www.iasplus.com/standard/ifrs08.htm for a description of the current inadequate standard or http://www.taxresearch.org.uk/Documents/IAS14Final.pdf for a discussion of its inadequacies.

4. **Trade matters.** At least 60% of world trade is intra-group. In other words it takes place across national boundaries but between companies under common ownership or control. Existing MNC accounts completely eliminate all of this trade from public view. **CbC** shows it all. This is vital if trade relationships are to be understood, and made fair.

5. **People matter.** MNC accounts include statements on the number of employees a company has and their aggregate remuneration. **CbC** would require this statement for every country in which an MNC operates. This would provide invaluable information on labour conditions.

6. **Tax matters.** MNCs have more opportunity than any other group in a society to plan their tax affairs. They can seek to shift their profits from state to state to find the lowest overall bill. **CbC** discloses the profit that companies record in each country in which they operate and the taxes that they pay on them. This means they can be held accountable for what they do and don't pay. It's estimated that if this problem were tackled enough tax could be collected to pay for the Millennium Development Goals.

7. **Corruption matters.** The Extractive Industries are dominated by MNCs. The Extractive Industries Transparency Initiative seeks to hold those companies to account for the tax payments they make, and the governments that receive those payments to account for what they do with them. Many MNCs resist disclosure of information on what they pay because of competitive pressure, contractual obligations and local political opposition. **CbC** would overcome these objections, significantly enhancing transparency in this sector, and help cut corruption.

8. **Development matters.** Developing countries lack revenue to finance public goods and services. Aid helps alleviate this problem but creates a dependency, harms the democratic accountability of developing country governments because they aren't accountable to their electorates for what they spend and aid can itself directly contribute to corruption. Local declaration of economic activity by MNCs with the resulting accountability for taxes paid could break this cycle and help create fully independent, accountable governments capable of raising their own taxation revenues.

9. **Governance matters.** Many of the major corporate scandals of recent times have involved extensive use of offshore subsidiary companies. These are becomingly increasingly common throughout the MNC world, but it is recognised that the problem of managing them creates severe governance issues for MNCs. This results in increased risk for shareholders and others who need to understand the risk inherent in an MNC's activity.

10. **Where you are matters.** Some countries are politically unstable. If a company trades there shareholders should know. Some are politically unacceptable. If an MNC trades there civil society wants to know. Some countries are subject to sanction. Trading there is illegal. Where you are matters. **CbC** holds a company to account for where it is.

The data that country-by-country reporting would provide and the benefits flowing from greater transparency

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

Data disclosed	Information need met
1. The name of each country or jurisdiction in which a multinational corporation operates;	• Discloses geographic spread of the multinational corporation • Advises host communities of the presence of the multinational corporation in their jurisdiction • Indicates presence in locations likely to be subject to geo-political risk • Indicates exposure to local regulatory and tax regimes.
2. The names of all its companies trading in each country or jurisdiction in which it operates;	• Identifies completely and accurately the full groups structure of a multinational corporation, a feat rarely possible at present • Lets a multinational corporation be properly identified in the host communities that facilitate its activities • Allows those engaging with a multinational corporation locally to identify ultimate responsibility for the entity with which they are trading • Ends the corporate culture of secrecy about activities in many jurisdictions, whether they are secrecy jurisdictions or not • Means a multinational corporation is accountable for all its actions – a pre-condition of corporate social responsibility.
3. Sales, both third party and with other group companies. Sales information will also require additional analysis. If sales to any state are more than 10% different from the figure from any state then data should be declared on both bases so that there is clear understanding of both the source and destination of the sales a multinational group makes	• The extent and direction of sales flows by multinational corporations will be documented • The full extent of intra-group sales will be understood for the first time • The use of tax havens / secrecy jurisdictions as locations for the routing of intra-group transactions will be properly understood • The splitting of sales from the location in which a service is received from the jurisdictions from which they are billed will

	be capable of identification, an issue of particular significance in services where limited data on sales flows is currently available • The relocation of sales for tax purposes will be identifiable • The risk inherent in internal supply chains will become apparent
4. Purchases, split between third parties and intra-group transactions	• This data is requested to complement that on sales: when the sales of a multinational corporation from a jurisdiction are largely matched by intra-group purchases it is likely the jurisdiction is being used for re-invoicing purposes and transfer mispricing may be taking place: a cause of concern to almost all tax authorities • The extent of outsourcing in source jurisdictions likely to be at the start of supply chains can be identified, especially when compared to labour data (see below) • The vulnerability of supply chains can be identified • By comparing intra-group purchases and intra-group sales likely intra-group supply chains can be established • Sourcing from locations with high geo-political risk should be identifiable
5. Labour costs and employee numbers	• The organisation of labour by jurisdiction within multinational corporations can be identified • Unusual incidence of value added in proportion to labour cost can be identified • The likelihood of outsourcing can be identified • Average reward per employee by jurisdiction can be calculated • Trends in labour relationships over time can be monitored
6. Financing costs split between those paid to third parties and to other group members	• Financial flows indicate where financial assets and liabilities are located within and beyond multinational corporations: disclosure of income and payments, especially on an intra-group basis will indicate the extent to which profits are

	relocated through the use of debt that creates internal and external financial risk within the multinational corporation

7. Pre-tax profit;	• Pre-tax profit is, without exception, the principle starting point for determining:
	  ○ The location of retained reserves
	  ○ The ability to finance activity without recourse to third parties
	  ○ The likelihood of on-going financial stability of the entity
	  ○ The potential for making payment of taxation liability on income arising
	• Pre-tax profits located in many countries where there is considerable corporate secrecy are currently wholly unascertainable
	• The presence of significant profit in locations where most purchases and / or sales are intra-group might indicate artificial relocation of profits
	• The absence of profits in locations where it would be expected there should be considerable value added e.g. in source locations for extractive industry supply chains, might indicate transfer pricing issues
	• Persistent losses in a jurisdiction might indicate the misallocation of resources by a multinational corporation, as might strongly differing profit rates between jurisdictions
	• Significant profits arising in politically sensitive jurisdictions might indicate vulnerable future earnings
	• Significant earnings in tax havens / secrecy jurisdictions might indicate high tax risk or unsustainably low tax charges indicating a likely change in future after tax earnings ratios
	• Significant profits arising outside a parent company location where corporate taxation is assessed on a remittance basis might indicate limited access to funds for dividend distribution purposes

8. The tax charge for the year split between current and deferred tax;	• The extent to which a tax charge is expected to arise when compared to headline tax rates indicates the effectiveness of a tax regime in capturing income for tax assessment purposes • The degree to which corporate tax liabilities can be deferred indicates the existence of incentive allowances out of alignment with economic costs incurred, and indicates future potential reversal and erratic cash flows • The ratio of tax paid to profitability across jurisdictions is at present unknown: country-by-country reporting would provide it and indicate the extent and nature of cross border tax planning and international tax arbitrage • If a declared tax rate appears aberrant it may indicate unsustainability
9. The actual tax payments made to the government of the country or jurisdiction in the period;	• It is not accruals made for tax that allow governments to meet their obligations – it is cash in its bank accounts that allows it to do that: cash paid is the ultimate proof of tax settled. This data is currently entirely unavailable and as such the contribution of multinational corporations to individual national economies is very hard to assess • It is cash that is the subject to corruption: it is cash for which governments have to be held to account. This data is vital for that purpose • Cash settlements of less than liabilities declared in earlier years suggest the presence of undetected tax planning or corruption. In either case the effectiveness of the tax regime of the jurisdiction is in question.
10. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period	• This data is required to undertake an overall tax reconciliation for a jurisdiction: tax due at the beginning of the period plus the current tax charge for the period less tax paid should equal the closing liability. If it does not there is indication of irregularity in accounting or in the statement of taxes due, in either case

	worthy of investigation • The failure of a jurisdiction to collect tax owing to it is indicated by this data: if tax outstanding relates to more than one year prime facie there is a tax collection problem within the jurisdiction or the entity is declaring liabilities in its accounts that are inconsistent with those declared to tax. In either case problems are indicated
11. Deferred taxation liabilities for the country or jurisdiction at the start and close of each accounting period.	• Deferred taxation indicates any of these things: o Excessive allowances offered by he jurisdiction o The existence of significant tax avoidance o A non-alignment of taxation with underlying economic reality • In each case there is cause for concern
12. Details of the cost and net book value of its physical fixed assets located in each country or jurisdiction and 13. Details of its gross and net assets in total for each country or jurisdiction in which operates.	• Without indication of the capital dedicated by a multinational corporation to a jurisdiction it is not possible to calculate: o Rate of return on capital employed in the jurisdiction and to compare these o To determine whether capital invested justifies the level of profit reported o To determine whether capital assets are being appropriately allocated to support labour productivity, or not o To determine where assets and liabilities are likely to be within a group and whether they are as a consequence available a) to shareholders and b) to creditors
14. A full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between the categories of reporting required in the Extractive Industries Transparency Initiative if the multinational corporation is engaged in extractive industry activities	• Required for all the reasons noted by the Extractive Industries Transparency Initiative

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

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

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

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