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The Association for Accountancy and Business Affairs

The Need for Transparency in Corporate Accounting

or

A modest proposal for reform of International Accounting Standards

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A paper to be presented to the International Expert Meeting of the World Economy, Ecology and Development movement in Berlin on 28 – 30 Berlin on “Making Financial Markets Work for Development”

Abstract

The corporate world argues that high taxation is harming prospects for world wide prosperity. In practice there is evidence of widespread falls in corporate tax rates throughout the world. The causality of this is open to question. There are two possible hypotheses. The first is that governments believe the arguments that the corporate world presents, and are responding. The second is that intergovernmental pressure in the form of tax competition is creating the downward pressure. The OECD has given clear indication that the latter is the cause by waging its campaign on Harmful Tax Competition. But data to assess how legitimate corporate behaviour is distorted by the availability of competing tax rates within their core markets and tax havens is largely unavailable because the nature of consolidated financial statements means that all inter company transactions are suppressed in the reporting process. Given that estimates of inter group trade accounting for at least 66% of world trade exist what is required to appraise the behaviour of the corporate entity in response to tax competition is data on where corporations declare their profits and how much they pay in tax in each jurisdiction. This paper suggests that this data would be a key measure of corporate social responsibility. It goes on to suggest the changes needed in International Accounting Standards to ensure the necessary data is disclosed.

About the author

Richard Murphy is a UK based chartered accountant. Aged 45, he trained as an auditor and in tax with what is now KPMG, London before setting up his own firm of chartered accountants. By the time he and his partners sold this in 2000 it had 800 clients. He has also had an active career in commerce and has been chairman, chief executive or finance director of nine trading companies in either the UK or Ireland. An active writer, he contributes regularly on taxation matters to the Observer newspaper and a range of professional magazines. He has also appeared on television and radio in connection with taxation issues. His papers on pension reform and on the UK consumer credit industry published for the New Economics Foundation in 2003 are known to be influencing government and union thinking in the UK. He has campaigned for the reform of UK and international tax law relating to tax havens for a number of years and is an active member of the think tank, The Association for Accountancy and Business Affairs ("AABA") (http://visar.csustan.edu/aaba/aaba.htm)

The Need for Transparency in Corporate Accounting

Tax is an emotive word. Cutting taxes has, over the last twenty years, become the touchstone of electability, particularly in the UK and USA. This is because neo-liberal economists have argued that:

1. government revenue belongs to taxpayers, not government itself
2. taxpayers know best how to spend their own money
3. low taxes are therefore in the best interests of all.

I would state at the outset that in my opinion all these arguments are wrong. I am, of course, not alone in my opinion, but the argument that tax is bad has been so heavily promoted by economists and the corporations and political parties in whose employ they are that there has been a marked downward trend in corporate tax rates over a number of years. KPMG[1], in their corporate tax rate survey published in January 2003 showed that between 1996 and 2003 the average corporate tax rate in EU member countries fell from 39% to 32% and in OECD countries fell over the same period from 37.5% to just under 31%. These falls are not a matter of chance. They are part of a concerted, organised and apparently successful campaign to reduce tax rates on corporations on a world wide basis, in part undertaken by KPMG and the other large firms of accountants.

That campaign to reduce taxes works on two levels. Firstly, it teaches people that the argument is right. The simple theories of micro economics[2] taught as part of undergraduate and professional education courses suggest that taxation restricts consumer choice by limiting incomes, and does at the same time suggest that maximising income is the goal of the economically rational person. It follows from the assumptions behind such teaching that taxation is seen as a bad thing. It does not, of course follow that this is the case. What is actually bad is that such teaching is offered on the basis of such poor assumptions. But, unfortunately, that teaching is at present both pervasive and persuasive due to lack of offered alternatives.

Secondly, the campaign discourages any questioning of the merit of tax cuts. So, for example, almost no work has been done to question the role of UK professional firms and institutes of accountants in arguing for tax cuts despite the fact that there are more than 1,000 academic accountants in the UK and the call for tax cuts is an annual ritual in which such firms and institutes participate each year prior to the annual government budget statements[3]. The academic world, both under the influence of false assumptions and because it is sponsored by those same institutes and firms as call for tax cuts, has ignored this issue and its behavioural consequences and instead, along with economists, just believes that tax cuts work.

In the light of these two facts it is perhaps unsurprising that the prima facie evidence that tax cuts are occurring is powerful and persuasive. This is revealed not only in superficial reviews such as that undertaken by KPMG on tax rates, but in evidence on the tax take as well. For example, figures published by the UK Treasury show that the UK corporate sector paid only £29,328 billion in tax in the tax year 2002/03 (19.38% of direct taxes) as opposed to £34,322 million on 1999/00 (24.48% of direct tax)[4]. Shifts in corporate profitability in the meantime are not sufficient to explain this downward trend. The actual corporate tax yield is falling.

And, in the limited academic work that has been undertaken to consider the role of international tax competition in fuelling this trend it has been found that countries do compete over tax rates and that competition extends to both the declared tax rate and the actual effective average tax rate[5]. The two, incidentally, are by no means always the same due to differences between profits as declared for accounting purposes and as adjusted for taxation purposes. It has also been found that tax havens do not add to the economic benefit of states, they only reduce tax rates[6].

These findings, coupled with falling real tax takes from corporations suggest two things. The first is that governments might believe the neo-liberal agenda, and are acting to cut tax rates on the basis of that belief. This would suggest that governments now see their own role within the economies they regulate as being generally harmful to trade and well being within it and as such wish to cut taxes. Much political rhetoric from the Republican Party in the USA and the Conservative Party in the UK would certainly conform to this view and suggest this hypothesis is, at least in part, true and persuasive for others e.g. the UK Labour Party which, despite its supposed left of centre credentials has been engaged in successive corporate tax cuts since gaining office in 1997[7].

Secondly, it might be that governments do not believe they have any choice in these matters and have to reduce taxation as a result of the pressure imposed on them by transnational corporations (TNCs) who use lower tax rates in one territory as a reason to apply pressure for tax cuts in another territory when making inward investment decisions (otherwise called foreign direct investment – "FDI").

The simple fact is that both are probably true in part, although one has to be careful in determining the degree of truth one ascribes to any statement in such an emotive area and when the process involved is fundamentally political. For example, even when a government says it believes in the tax cutting agenda it may not be telling the truth. The Thatcher government of 1987 cut corporation taxes in the UK from 52% to 30% but at the same time substantially broadened the tax base so that most companies paid tax after the changes, whereas relatively few had beforehand due to the generous tax reliefs for capital expenditure and the effects of inflation on stocks held. As such that government won a propaganda coup of claiming to cut taxes whilst actually increasing revenues from this source from £8,341bn in 1984-85 to £21,495bn in 1989-90, a trend not capable of explanation but by increase in effective tax rates[4], the extraordinary UK oil revenues of this period being taxed in other ways. It is, however, hard to imagine such a trick being played again. For example, the planned cuts in corporate tax rates by the Bush administration in the USA in 2003 are forecast to give rise to a substantial government deficit. The rhetoric and practice of cuts now appear to coincide.

This evidence as a whole from government sources leaves it as at least a tenable proposition that the "race to the bottom" in cutting corporation tax rates, which is already seeing 0% rates on offer, is a real, and maybe accelerating phenomenon, whose impact is only now being seen.

If that is so the place where the evidence must be tested is not solely on the impact of this competition upon government revenue. It is also vital that the impact of these policies on the levels of actual tax paid by the corporate bodies be considered. That is because TNCs are the medium by which this form of tax competition is transmitted. If there were no TNCs the competition would, of course, be entirely pointless. They are both the major beneficiaries of tax competition between states and the pressure point for its extension. This is because the major transnational corporations dominate world trade. The UK government in a white paper published in December 2000 estimated that two thirds of world trade was conducted between subsidiaries of TNCs rather then between independent trading organisations[8].

This is a significant statistic because it shows the power the TNC has in the face of a national government. Because the TNC conducts so much trade through so many territories (Shell does, for example, suggest on its web site that it trades in over 145 countries[9], and it is far from alone in this) then in effect such companies can say to almost any government that does not wish to trade with them as they wish that they will simply by pass them and route their trade through another country. Given that much of their trade is, in any event, actually a matter of paper moving rather than real trade this is easy to do. For example, even in the case of oil, a physical commodity, it may be bought and sold many times whilst en voyage from its country of origin to its port of destination. And this exercise is, of course, much easier still for a company whose product is primarily intellectual property e.g. most IT and bio- tech companies, where the actual value of physical product is small and the intellectual property rights can be distributed over many territories to make an effective trail of the actual trades difficult to follow.

The reason why that trail is difficult to follow is that a TNC is only required to publish what are called "consolidated accounts" for the benefit of the only stakeholder to whom it has a duty to report, namely the shareholders. These accounts suit shareholder's purpose because they show the sum of transactions between the group of companies that make up the TNC (the "grouping" of the numbers being the "consolidation" referred to) and the rest of the world i.e. third parties. It is only these transactions which can increase or decrease the value of the company for the shareholders, and so are all they are interested in. But in the process of "consolidation" all the transactions between group companies are removed from the accounts and netted off one against the other. As a result the inter group trades that make up two thirds of international commerce are not reported in the accounts of any TNC, even though they are responsible for them. And it is not possible to find out what they are in any other way. This is an extraordinary omission from the accounts of TNCs, just as it is an extraordinary omission that they do not have to declare:

- where they operate
- what scale of activity they have in each territory in which they operate, or what they do there
- how much tax they pay and where.

It is reasonable to say that this problem of establishing just where, how and in what amounts corporations undertake their trades is one that was simply not anticipated even a short while ago. And the ease with which TNCs can hide their tracks through a multiplicity of trades through numerous, wholly owned corporations in a wide variety of territories, both tax haven and otherwise[10], means that this difficulty is the most fundamental problem now faced by the taxation authorities of national governments in seeking to collect the revenues rightly due to them.

Economics has not really considered the consequences of this capacity of the modern corporation to trade, in effect, at its choice at will. This is largely because when the first theories of trade were being written by the classical economists in the eighteenth and nineteenth century and theories of competition and the firm were emerging they made two implicit assumptions, so obvious at the time that they did not need to be stated. These were that:

1. the individual and any company they owned owed a loyalty to the state in which they resided that was unquestionable and utterly reliable. In effect they would "do the right thing" and pay any taxes due by them[11].
2. companies would always be subject to the absolute rule of law of the state, which was therefore always in a position to mandate and control them[12].

Neither assumption is now true, but economists, as already noted, are not good at reappraising their assumptions. The TNC is a normal form of structure for a quoted company. As a result the quoted companies which dominate world trade are now in a very real way not subject to the laws of any state. Nor, as recent evidence of US companies migrating en masse from its jurisdiction[13] and as evidence of the mass tax avoidance and evasion product promotion programmes of the largest firms of accountants[14] shows, can anyone, even in a country as patriotic as the USA, rely on corporate patriotism as a basis for accepting any obligation to pay tax any more.

And this difficulty of determining what a TNC does is not only a tax issue. It also affects:

- the corporate social responsibility lobby who want to know where and how a TNC works
- the environmental lobby who want to know where and how they are using natural resources
- shareholders, who in the wake of the clear tax risk that led them to suffer massive losses in cases such as Enron want to know to what extent a company in which they invest is abusing world taxation rules, at potential risk to them
- shareholders and other financial stakeholders (inlcuding suppliers and customers) who want to appraise the risk inherent in TNC's supply chains which might involve transactions in highly politically or financially unstable states.

In consequence it is clear that the governments of the world and other stakeholders need to have more information about the trading activities of TNCs if they are going to be able to determine the extent of, regulate, appropriately tax and appraise the activities of those companies. This is because that information available from within their own territories and within the published accounts of those companies is now insufficient for these purposes.

It is almost certain that the failure to require disclosure of the information highlighted by this paper to be omitted from TNC accounts is not a planned outcome of the development of Generally Accepted Accounting Standards[15], but it is most certainly a consequence of them. And that outcome must be corrected if the governments of the world, who are one of the most important stakeholder groups to use the accounts of those TNCs are to obtain the reasonable information they need from them to be able to undertake their own duties to the societies which they represent, and which form another key stakeholder group.

The answer to this problem is relatively simple. Full details of the proposed changes were included in my paper "Reporting Turnover and Tax by Location" published in January 2003 and available as a download from the web site of the Association for Accountancy and Business Affairs and reproduced as an appendix to this paper. In summary that paper says that every TNC must publish the following information:

1 the name of the state in which it is located

2 the names of the states in which each of its subsidiaries and associates is located

and in respect of each company in the group it should disclose:

3 its name

4 its principal trading activity

5 the way by which it is related to the parent company, and how much is owned by that parent

In addition the group should report the following in respect of each subsidiary or associate:

6 its sales figure as reported in its own financial statements

7 its sales to third parties i.e. non group members

8 its inter group sales to related parties i.e. other group companies

9 its inter group purchases

10 its labour costs

11 the value of natural resources produced or extracted in the reporting territory included in sales

12 its profit before tax

13 its corporate taxes due for the period

14 taxes paid by it on behalf of its labour force in the territory

The reasons for this are as follows:

1 no company will be able to hide the territories in which it trades

2 if that trade is real i.e. there is a substantial trade taking place with third parties within a territory then it will be clear that this is not an activity undertaken for anything but the aim of meeting the needs of a market. No one, I suspect will wish to argue with such activity (at least, not for taxation purposes)

3 if however it is clear that the sales of a territory are substantially inter group, and more so if the purchases are also largely inter group and at the same time there is little evidence of payment being made for value added supplies, be they either for wages or extracted natural resources, then it is highly likely that transactions in that territory are not being undertaken primarily for the purposes of meeting market need but for the internal purposes of the organisation itself. It is, of course, the hypothesis of this paper that the purpose in question will be primarily linked to taxation benefit but it might also have been to disguise the origin of a product, or to break a liability trail. In either alternative case the action is almost certainly contrary to the best interests of one or more stakeholder groups and as such needs to be exposed. That is the core purpose of this proposal.

The advantages will be:

1 tax avoidance will become apparent, and will therefore be discouraged

2 environmental abuse will be easier to trace

3 shareholders, employees and other stakeholders in the company will be better able to appraise the risk they take in dealing with the TNC

4 investors will be better able to appraise the quality of corporate earnings by seeing how much these are inflated (and so share prices are inflated) by use of tax avoidance practices. Those companies using such practices are bound to see their values fall.

Before assuming these benefits though, the fundamental question that must be asked of any proposal is whether it will be effective. The effectiveness of this proposal was tested in an informal meeting with a group of senior UK tax inspectors, the reaction of whom was that if they could obtain the information noted above in exactly that form (let alone that detailed in the appendix) they could substantially increase the yield of the UK Inland Revenue and close a significant number of their current enquiries, which often reach a tax haven and can go no further. In their opinion this proposal would be highly effective.

It will be noted that the proposed structure for this change is to make the requirement to disclose this information a new International Accounting Standard. International Accounting Standards are, somewhat surprisingly, issued by a private company, and not by a state sponsored body. The International Accounting Standard Board, which has been dominated by the accounting thinking of the UK more than any other territory and which is based in London (both no doubt partly influenced by the pivotal position within it of its Chairman, Sir David Tweedie) is controlled by a board that is itself located in the US tax haven state of Delaware[16]. It is almost entirely funded by TNCs whose own attitude to these matters might make its choice of place of incorporation less surprising.

Despite this apparent lack of authority the European Union is requiring that all TNCs based within its territory adopt International Accounting Standards (IAS) from 2005. Additionally, in the wake of the collapse in the confidence of the US accounting and auditing profession and its approach to regulation which was substantially discredited as a consequence of the Enron, WorldCom and other corporate failures, means that the US Federal Accounting Standards Board is likely to require substantial compliance with IAS's at about the same time, albeit with reluctance on some issues. International Accounting Standards do therefore have substantial influence. An IAS along the lines proposed would be highly effective in producing required information on the trades of the companies it would effect.

It is therefore important to consider in advance what objections might be raised to such a proposal. These might be:

1 this proposal will impose a substantial cost burden upon TNCs

2 the proposal will undermine the competitive advantages of TNCs and as such will be counter productive to the national interests of the states in which they are located.

Both of these objections are easy to dismiss. In the first case this is because all the information I have asked to be disclosed, except for the value of natural resources produced, will, without exception, already be known in the form that I suggest in the accounts files of one of the big audit firms of the world. The fact is that they have to know it now to be able to eliminate it from the consolidated accounts they audit for the transnational corporations of the world. There is therefore no additional cost to preparing this information. Nor can there be argument that it is not known. It must be known now to publish the consolidated accounts already produced by TNCs. Accordingly the first argument is not valid.

A subsidiary argument that might reasonably be presented by the TNCs affected is that to publish this data would unreasonably add to the bulk of the corporate reports they have to produce. With this, I admit, to having some sympathy. But in the proposal I have made I dismiss the objection for the simple reason that the data could be published exclusively on the internet and still be valid, useful and capable of analysis, which is what potential users desire. Indeed, if it was required to be published in Excel format it would be particularly useful. There is therefore still no argument available on the grounds of costs to prevent publication of this data.

Nor is there an argument on the grounds of loss of international competitiveness if this were published as an International Accounting Standard. This is precisely because these are international in nature, which implicitly overcomes this objection. The requirement of most leading stock exchanges for compliance with IASs (or US FASB equivalents, and it would be expected that this proposed standard should apply in the USA) will remove any remaining resistance there might be on these grounds.

In which case it is believed that a fair case has been put forward for this proposed change in International Accounting Standards. The costs are minimal. The benefits are enhanced data which will allow many stakeholders of TNCs to better appraise those organisations with regard to their:

- corporate social responsibility
- investment risk
- environmental risk
- its contribution by way of value added to the societies in which it operates
- and, most importantly as far as this paper is concerned, its contribution to national well-being by way of tax payment within the locations in which it operates.

The proposal made is for a small change in the work required to publish true and fair accounts but would result in a massive change in the quality of data available to the users of those accounts. At a time when the corporate world is taking its social responsibility seriously this seems a price which is worth their while paying.

Notes

1 KPMG Corporate Tax Survey Report January 2003, available as a download from KPMG International web site November 2003. Copies available by mailing gofmicttaxratesurvey@kpmg.com

2 Undergraduate economics, and that taught to trainee professional accountants is highly simplistic and the level of knowledge retained rarely extends beyond that taught in the first year of an undergraduate course. Textbooks used such as Samuelson or Lipsey are notable for not questioning the basis of the assumptions made

3 In more than 20 years of monitoring the pre budget statements of the UK accountancy profession I cannot recall any request for a tax increase. Nor can I recall any suggestion that any new regulation might be beneficial

4 Statement T1.2 published annually by HM Treasury in the UK to show net receipts of Inland Revenue taxes and available as a download from the HM Treasury and Inland revenue web sites

5 "Do companies compete over tax rates?" M Devereux, B Lockwood and M Redoano, University of Warwick, April 2002, downloaded from the internet. It is worth noting that one paper presented to the AABA conference on tax havens, July 2003 entitled "Globalisation and Diversity in Taxing Transnational Corporations by Prof Mike Webb of the University of Victoria (2003) questions whether rates are falling, but it is most notable for being the exception to almost all other published data

6 Unpublished paper by Robert T Kudrle of the University of Minnesota presented to the AABA conference on tax havens, July 2003

7 UK mainstream corporation tax rates for large companies have fallen from 33% in 1997 to 30% in 2003. For smaller companies rates have fallen from 24% to as little as 0% on the first part of their profits over the same period

8 UK Government 's second White Paper on International Development entitled: "Eliminating World Poverty: Making Globalisation Work for the Poor". launched by Prime Minister Tony Blair and Clare Short, Secretary of State for International Development on the 11th December 2000.

9 Shell.com accessed November 2003

10 The number of tax havens in the world is open to debate. The OECD identified more than 40 such territories that might have been described as such in 1988 and criteria other than the ones they used might suggest there are over 60 worldwide, including such places as the City of London.

11 Such reasoning may be found implicit in Adam Smith's "Wealth of Nations"

12 The first multinational companies were not created until the latter 19 century, well after the ideas that are implicit in the theory of the firm were already being written about widely and being built into UK statute and case law

13 Under US state law there is a considerable advantage to moving corporate head offices off shore to places like Bermuda. Companies like Tyco, Ingersoll-Rand, Accenture and many others have exploited this at considerable cost to the US Treasury.

14 In November 2003 the Senate Committee on Governmental Affairs hearing on "U. S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals" found extensive evidence of unpatriotic activity by the "big 4" firms of international accountants. Senator Lieberman said "this investigation reveals the role that accounting firms, law firms, banks and financial institutions play in helping wealthy taxpayers avoid taxes. Among the astounding revelations we will hear about is that

these tax shelter promoters go so far as to telemarket their *illicit* wares, as if they were selling shares in a vacation home or magazine subscriptions." (emphasis added)

15 Generally Accepted Accounting Standards used to be reasonably split between European based standards (largely led by the UK) which were principle based and US standards which were largely rule based. After Enron etc the latter are now somewhat discredited and there is a trend towards a single world standard.

The Need for Transparency in Corporate Accounting

Appendix

A Proposed International Accounting Standard

Reporting Turnover and Tax by Location

A proposal by Richard Murphy BSc FCA

on behalf of the Association for Accountancy and Business Affairs

Contents

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Summary

The proposed International Accounting Standard that follows on Reporting Turnover and Tax by Location suggests that transnational corporations (TNCs) should disclose information about:

- which entities make up the TNC
- where those entities are located
- what those entities do
- what value of sales they make in each state in which a member entity of the TNC is located split between:
    - sales to independent third parties
    - sales to other entities within the TNC
- what value of purchases from other entities within the TNC are made by each member of the TNC
- how much added value each member of the TNC generates
- how much profit each member of the TNC makes in the locations in which it operates
- what tax each member of the TNC pays in the states in which it is located

The purpose of the proposed standard is to provide information that will assist those seeking to appraise the organisation with regard to:

- its corporate social responsibility
- investment risk
- tax risk
- its contribution by way of value added to the societies in which it operates
- its contribution to national well-being by way of tax payment

within those locations

It is important to note that the proposed standard utilises data already substantially available to all reporting entities to which it would apply and can therefore be implemented at very low cost. As the proposed standard will be applied internationally there will be no loss of competitive advantage for any TNC as a result of its adoption.

The proposed standard will not apply to reporting entities whose activities are located solely in one state.

The proposed standard breaks new ground in that the information that it proposes should be disclosed may be published exclusively on the internet.

Objectives

The objective of this proposed International Accounting Standard (IAS) is to ensure that financial statements (accounts) of a reporting entity that is itself a transnational corporation (TNC), or which is a TNC due to being the parent, subsidiary or related party of a reporting entity located in another sovereign state, contain sufficient disclosure to ensure that the user can identify the following:

1 the name, type of entity, place of incorporation and principal activity of the reporting entity and its related parties, making due allowance for the different disclosure required if the reporting entity is an ultimate parent company, an intermediate parent company or a subsidiary undertaking

2 the states of the world in which the reporting entity and its related parties operates

3 the value of sales made by the reporting entity and its related parties in each state in which they are located split between:

3.1 sales to independent third parties

3.2 sales to other entities within the TNC

4 the value of purchases made by the reporting entity and its related parties from other entities within the TNC

5 the value of local resources, be they labour or natural, utilised by the reporting entity and its related parties in each state in which they operate

6 the corporate profits generated in each location in which the reporting entity and its related parties operate

7 the taxes on corporate profit paid by the reporting entity and its related parties in each state in which they operate

Definitions

The following definitions apply in this proposed International Accounting Standard

1 *Financial statements* are balance sheets, profit and loss accounts, cash flow statements, notes and other statements, including those disclosures required to be made by law or convention, whether local or international, and by reason of International Accounting Standards or their local equivalents which collectively are intended to give a true and fair view of the financial position and profit or loss of a reporting entity.

2 *Reporting entity* means any enterprise within the scope of International Accounting Standards. For sake of example only, such entities are likely to include:

2.1 companies, whether publicly or privately owned and whether quoted or not
2.2 partnerships, whether with limited liability or not
2.3 banks
2.4 trusts and similar such entities
2.5 special purpose entities whether created primarily for the undertaking of financial services or not

3 *Transnational corporations* are reporting entities that either themselves operate in more than one location or state or do so through their related parties

4 *Ultimate parent companies* are reporting entities which are not controlled by any other entity which might itself be a reporting entity

5 *Intermediate parent companies* are reporting entities which are controlled by another entity which is itself a reporting entity and which does in turn control subsidiary undertakings

6 *Subsidiary undertakings* are entities controlled by another reporting entity and which do not control other reporting entities

7 *Control* means the ability to command the management of a reporting entity either by reason of votes, or by the exercise of

influence, or by the right to acquire the majority of its assets in the event of winding up or other distribution

8 *The user* means any person or legal entity that might have an interest in the financial statements of the reporting entity for any reason whatsoever including, without suggestion as to limit:

8.1 owners of the reporting entity
8.2 employees of it
8.3 suppliers to it
8.4 customers of it
8.5 third parties affected by its trading, investment, social or other activities
8.6 authorities regulating it, whether state sponsored or not
8.7 taxation authorities whether within the state of incorporation or not
8.8 organisations representing any of the above

9 *State* means a territorial national authority recognised as either having sovereign status or effective unfettered right to create legislation, whether with regard to taxation or otherwise, in respect of reporting entities and their taxation or an equivalent authority holding similar powers whether by reason of the combination of states or otherwise, but with the limitation that in a federal state the State for these purposes shall be the federal organisation and the constituent members of the European Union shall be considered States in their own right

10 *Location.* A corporate entity is located in the state under whose jurisdiction it is empowered to transact, whether by incorporation, agreement, declaration of trust or otherwise. In the case of a reporting entity making declaration in respect of a related party the location to be disclosed in respect of that reporting entity shall be the state in which the related party is located

11 *Operate* A reporting entity or its related parties operate in a state if:

11.1 they are located there

11.2 they have a permanent place of business there although located within another state

If an entity has a permanent place of business in a state other than that in which it is located that permanent place of business shall for the purposes of this proposed standard be considered a separate entity located in the territory in which that permanent place of business is established and it shall be reported as such and the disclosures required by this proposed standard shall be separately made in respect of that permanent place of business although it does not have a separate legal identity

12 Related party

12.1 Two or more parties are related parties when at any time during a financial period:

12.1.1 one party has direct or indirect control of the other party; or
12.1.2 the parties are subject to common control from the same source; or
12.1.3 one party has influence over the financial and operating policies of the other party to an extent that that other party might be inhibited from pursuing at all times its own separate interests; or
12.1.4 the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests.

12.2 For the avoidance of doubt the following are related parties of the reporting entity:

12.2.1 its ultimate and intermediate parent undertakings, subsidiary undertaking and fellow subsidiary undertakings
12.2.2 its associates and joint ventures
12.2.3 the investor or venturer in respect of which the reporting entity is an associate or joint venture
12.2.4 directors (or such other person in accordance with whose instructions or directions the reporting entity is accustomed to act) of the reporting entity and the directors of all ultimate and intermediate parent undertakings, subsidiary undertaking, fellow subsidiary undertakings and other related parties
12.2.5 pension funds for the benefit of employees of the reporting entity or of any entity that is a related party of the reporting entity
12.2.6 trusts or other special purpose, corporate or non corporate vehicles which might act for the benefit of any related party to the reporting entity or the

employees, directors or persons in accordance with whose instructions or directions the reporting entity or its related parties are accustomed to act or the close family of any such person (such term to include those family and household members of the individual who is a related party who may be expected to influence, or be influenced by, that person's dealings with the reporting entity)

12.3 The following are assumed to be related parties of the reporting entity unless it can be demonstrated that neither party has influenced the financial and operating policies of the other in such way as to inhibit the pursuit of separate interests:

12.3.1 the key management (including trustees and nominees) of the reporting entity and the key management of all ultimate and intermediate parent undertakings, subsidiary undertaking, fellow subsidiary undertakings and other related parties
12.3.2 a person owning or able to exercise control over 20 per cent or more of the voting or other ownership rights of the reporting entity whether directly of through nominees
12.3.3 each person acting on concert in such a way as to be able to exercise control or influence over the reporting entity and
12.3.4 an entity managing or managed by the reporting entity under a management contract

12.4 Additionally, because if the relationships with certain parties that are, or are presumed to be, related parties of the reporting entity, the following are also presumed to be related parties of the reporting entity:

12.4.1 members of the close family of any individual defined as a related party elsewhere in this Standard
12.4.2 partnerships, trusts, companies or other entities in which any individual or member of the close family of a person themselves defined as a related party has a controlling interest

12.5 Other parties are related when it is clear that for the purposes of proper disclosure it is necessary that they be so considered whether or not they fall into any of the foregoing categories.

12.6 If there is doubt as to whether a party is related to another or not then such doubt shall always be resolved in favour of disclosure taking place

12.7 The non-availability of any information required to be disclosed with regard to a related party is not a reason not to disclose the relationship with that related party and that information which is available

13 *A third party* is any party who is not a related party

14 *Labour* is a payment made to a person who resides in the state in which the reporting entity is located whether calculated as a wage, salary, piece rate or by some other means in exchange for the periodic supply of their endeavours under a contract for service and shall include payment made in cash or in kind

15 *Natural resources* are those resources either occurring naturally in nature within the territorial limit of the state in which the reporting entity is located and which are extracted, collected or otherwise procured from their natural location by the reporting entity for onward supply or which are grown, harvested or otherwise collected for sale by the reporting entity within the state in which the reporting entity is located

16 *Turnover* means the cash or equivalent value when expressed in monetary terms charged for the provision of goods and services after the deduction of trade discounts and net of taxes based on amounts so derived by a reporting entity or its related parties, including for this purpose only when such term is applied to the provision of goods and services to related parties the supply of financial and property services and income of types generally derived from them such as, but without being exhaustive or suggesting limit, interest, dividends, royalties, licence fees, rents, premiums and exploitation rights.

17 *Purchases from related parties* shall mean any cost charged to a reporting entity (whether expensed in the profit and loss account or otherwise) that is included in the turnover, as defined herein, of the related party which supplied such services to the reporting entity

18 *Profit* shall mean such sums required to be reported as such in the financial statements of reporting entities who must, or voluntarily do, comply with International Accounting Standards

19 *Corporate Taxes* are the amount of tax estimated to be payable to or recoverable from the state in which the reporting entity and its related parties are located in respect of the reported profit or loss for a period

Proposed International Accounting Standard

1 This proposed International Accounting Standard shall apply to all reporting entities irrespective of whether they might be a company, partnership, bank, trust or other special purpose vehicle:

1.1 to which International Accounting Standards apply

1.2 that are transnational corporations

1.3 that have consolidated turnover with third parties exceeding US$15 million for the period to which the financial statements relate or per annum, whichever is the greater time period.

2 If the reporting entity is an ultimate parent company it shall disclose in its financial statements:

2.1 the name of the state in which it is located

2.2 the names of the states in which each of its related parties is located

in respect of each related party it shall disclose:

2.3 its name
2.4 its principal trading activity
2.5 the means by which it is related, and the proportion of the entity controlled

and additionally it shall in respect of itself and each related party disclose:

2.6 its turnover as reported in its own financial statements
2.7 its turnover with third parties
2.8 its turnover with related parties
2.9 its purchases from related parties
2.10 its labour costs
2.11 the value of natural resources included in turnover at sale price
2.12 its profit before tax
2.13 its corporate taxes due for the period

A reconciliation of the following shall be included in the financial statements if reported information is not consistent:

2.14 total third party turnover as reported for the purposes of this proposed standard and consolidated turnover as reported in the profit and loss account or any alternative trading statement
2.15 total turnover with related parties and total purchases from related parties
2.16 total corporate taxes due as reported for the purposes of this proposed standard and those reported as payable by the consolidated reporting entity as a whole in respect of the period

3 If the reporting entity is an intermediate holding company it shall it shall disclose in its financial statements:

3.1 the name of the state in which it is located

3.2 the names of the states in which each of its related parties is located and for the purposes of this disclosure related parties only include:

3.2.1 its ultimate parent company
3.2.2 any intermediate parent companies between its ultimate parent company and itself
3.2.3 its subsidiaries, whether held directly or through further intermediate parent companies
3.2.4 its own immediately related parties, and those immediately related to its subsidiaries
3.2.5 any party related to any of the above with which it has traded in the period

and shall therefore exclude:

3.2.6 those related parties of the ultimate parent company with which the reporting entity is not directly related or with which it has not traded

3.3 In respect of each related party the intermediate parent shall disclose:

3.3.1 its name
3.3.2 its principal trading activity
3.3.3 the means by which it is related, and either:
3.3.3.1 the proportion of the entity controlled or
3.3.3.2 the proportion of the reporting entity controlled by the related party

3.4 Additionally it shall in respect of itself and each related party disclose:

3.4.1 its turnover as reported in the profit and loss account or any alternative trading statement
3.4.2 its turnover with third parties as defined for the purposes of this proposed standard
3.4.3 its turnover with related parties as defined for the purposes of the intermediate parent company
3.4.4 its purchases from related parties as defined for the purposes of the intermediate parent company
3.4.5 its labour costs
3.4.6 the value of natural resources included in turnover at sale price
3.4.7 its profit before tax
3.4.8 its corporate taxes due for the period

4 If the reporting entity is an intermediate holding company it shall disclose in its financial statements those matters required to be disclosed by an intermediate parent company except that no disclosure with regard to subsidiaries shall be required

5 The activities of related parties may not be aggregated but each must be reported individually and without consideration of materiality

6 The information required to be disclosed by this proposed standard shall either be included in the published financial statements of the reporting entity or shall be published on a web site managed and controlled by the reporting entity. Whichever option is adopted the information disclosed shall be considered part of the financial statements. If the information is disclosed on a web site the address of that web site shall be included in the printed financial statements of the reporting entity.

Explanatory notes

The benefits arising from this proposed standard are:

1 Substantially improved statements of corporate social responsibility. For an entity to properly report fulfillment of its obligations with regard to corporate social responsibility the user of its financial statements has to know:

1.1 who it is
1.2 where it is
1.3 what it does
1.4 where it trades with others
1.5 where it trades internally
1.6 where it employs people
1.7 where it uses natural resources
1.8 where it makes money
1.9 where it pays tax
1.10 the necessary quantification of this data

The corollary is that it is also important on occasion to know where these actions do not take place.

By adopting this standard transnational corporations can make clear:

1.11 what the limits of the TNC are
1.12 in which societies they operate
1.13 how they transact with those societies, and
1.14 what they pay to support those societies in which they operate.

By adopting this proposed standard much corporate social reporting will be integrated into financial reporting and the resulting financial statements should meet the needs of a wide range of stakeholders who might wish to appraise the reporting entity from this perspective.

2 Adoption of this proposed standard would enable the investment community to appraise a wider range of risks to which they expose both their own organisations and the clients they represent when they make investment decisions. In particular they will be able to assess the following risks in ways that would not be possible without adoption of this proposed standard:

2.1 geo-political risk; by reason of reporting in detail where and to what extent the corporation trades. This is increasingly important in a volatile international environment

2.2 where value is added, and is not, within a reporting entity; so assisting assessment of vulnerability within the internal supply chain in vertically integrated organisations

2.3 taxation risk; by reason of being able to determine the degree of inherent risk within the reported liability to taxation. This is important, as share valuation is critically dependent upon price/earnings ratios, on which the amount of tax payable has a material impact. If the tax payable is materially affected by tax planning e.g. by the use of tax havens, then risk within the reported liability for tax payable will be higher than for a company trading only in substantial economies. Shareholders need to be aware of this risk in appraising the worth of the entities in which they might invest

2.4 ethical investors wish to know in which economies a transnational corporation trades when making their investment decisions; the proposed standard will enhance their ability to appropriately assess the risk they wish to assume with regard to these matters

3 Governments will be able to assess the contribution transnational corporations are making to their state and appraise whether trading and taxation justice is being done on behalf of the citizens to whom they are responsible

4 Companies themselves will be able to demonstrate the ethical stance they are taking on trading and taxation matters

Consideration of likely objections to the proposed International Accounting Standard

1 **Cost** All the data required to be disclosed by this International Accounting Standard except that for natural resources used has already to be prepared by a transnational corporation seeking to comply with the requirements of International Accounting Standards in the usual course of preparing its consolidated accounts. The number of entities that will have to report on natural resource usage are limited and where this is necessary the preparation of such data will usually be straightforward. As such the additional costs that this standard would impose upon a reporting entity are marginal and would relate to:

- preparing the information in tabular format for disclosure
- the marginal additional cost of having the specific disclosure audited

It is considered that these are small costs to bear for the value of the disclosure made to stakeholder, investment and state communities for whom it is of concern.

2 **Competitive disadvantage** The usual defence to the disclosure of information that this proposed standard requires to be reported has been that unilateral adoption of such standards would impose a significant competitive disadvantage on the reporting entities located in a state that imposed such a requirement. By suggesting that the standard be implemented on an international basis such argument is invalid and can therefore be discounted.

3 **Taxation disadvantage** It may be argued that to disclose the information required by this proposed standard will put TNCs at a taxation disadvantage with regard to the agreement of their taxation liabilities with the taxation authorities of the different states in which they operate. This argument is accepted. That is an explicit purpose of this standard. In saying so it is however argued that:

3.1 at present TNCs have too great an advantage in this respect and that in particular it is very difficult for any taxation authority to identify:

3.1.1 the nature and extent of the corporation with which they are dealing

3.1.2 the nature and extent of its inter group transactions

3.1.3 the locations in which it declares both profits and losses and the degree to which they are correlated to value added at the same locations

3.1.4 the related parties with whom the TNC might transact to influence its reported performance or tax liabilities.

In requiring disclosure the proposed standard:

- redresses the balance between the parties, and will save substantial cost for taxation authorities in achieving acceptable taxation agreements with the TNCs located within their state boundaries

- provides transparency of data to all authorities, which is not currently the case due to the increasing prevalence of disclosure by way of unilateral rather than bilateral agreement

- will save substantial efforts otherwise required to procure similar disclosure between nation states

3.2 the proposed standard creates a level playing field between TNCs and those reporting entities that are only nationally based. The latter form the vast majority by number of all reporting entities worldwide and are largely small and medium sized entities (SMEs). This is because whilst many nation states have required disclosure of related party transactions in financial statements for some time (e.g. under UK Financial Reporting Standard 8) such standards specifically exclude the requirement to report most group relationships. This has provided the TNC with an opportunity to undertake transactions to its taxation and commercial advantage that have been denied to SMEs through reason of their obligation to report all transactions of such sort. This unfair competitive advantage needs to be eliminated.

3.3 related party reporting at a national level as referred to in the preceding paragraph was primarily implemented at the behest of taxation authorities and there is no reason why the same logic for disclosure should not be applied to TNCs

Technical notes

This proposed standard breaks new ground in financial reporting in a number of areas:

1 **Turnover** The definition of turnover used for related party reporting purposes in this standard is new and inconsistent with the definition used both in this standard for third party reporting purposes and in general because:

1.1 many transactions between related parties are with regard to financial services, rents, royalties, licence fees and similar such matters which can be disclosed by a reporting entity as being interest paid, other income, investment income or the like and therefore be excluded from turnover. For this reason a conglomeration of income of all sorts into one declared figure for turnover is required

1.2 such simplification makes local variations through translation less likely

1.3 such simplification makes the definition of purchases from related parties much easier to define, and means that for an ultimate parent company the two should always be in balance (as is required in any event by consolidation process used to produce TNC financial statements)

2 **Related Parties** The definition of related parties used in this proposed standard might appear long and cumbersome. This is, however, appropriate given the complexity of the structure of many TNCs. The definition is in fact largely familiar to many accountant in the UK at least, being based upon that for a related party contained in UK Financial Reporting Standard 8 with specific alteration being made to include group companies, special purpose vehicles and other corporate and non corporate entities to allow for the diversity of structures available and their continuing development, particularly in tax havens.

3 **Inter group transactions** The development of consolidated financial statements was a necessary step to ensure that a true

and fair view could be provided of the activities of a group of related reporting entities. Nothing in this proposed standard undermines the principal of consolidation, which is vital, must be continued, and must be appropriately extended to all related parties.

This proposed standard does however recognise that despite the undoubted advantages of consolidated accounts, their development has enabled TNCs to suppress the reporting of the true nature and extent of their entities and the nature of the transactions between the related members of the TNC. At the time that the publication of consolidated financial statements became normal practice the speed of development of the TNC was not envisaged, nor was the associated development of globalisation. It is now, therefore, necessary to ensure that the TNC provides information as to its internal transactions as well as those with third parties as for many stakeholders those internal transactions are of at least as much importance as those which eventually transpire with third parties. As such the disclosure of the volume of transactions between each and every related party that comprises the TNC is now considered a necessity if a true and fair view of its transactions is to be provided by its financial statements.

4 **Added value** Added value reporting has not been a part of disclosure in financial statements to date. It is however of great significance to the risk appraisal that this proposed standard seeks to encourage, and in particular with regard to:

4.1 the correlation between value added and reported profit

4.2 the correlation between value added and tax paid

It is accepted that the proposed measure of value added is relatively crude, but it has the advantage of being:

4.3 easily calculated

4.4 reasonably objective

5 **Internet reporting** It is only a matter of time before the bulk of financial information is made available almost exclusively on the Internet. That this standard proposes that much of the information to be disclosed need only be supplied in this form is therefore recognition of an inevitable trend in reporting. The proposal also overcomes the objection that the cost of printing

the data required to be disclosed would in the case of some large and complex groups be excessive or an unnecessarily complex exercise.

6 **Location and State** The definitions of location and state used in this proposed standard are necessary developments to ensure that disclosure of activities within a territory is not disguised behind a legal shield of incorporation in another territory.

Support notes for those concerned with Corporate Social Responsibility

Whilst this proposed standard is likely to have considerable appeal to those in the investor community there can be no doubt that its strongest support will probably come from those organisations proposing enhanced corporate social responsibility (CSR) reporting.

This proposed standard:

1 takes CSR into the mainstream of financial reporting

2 makes clear that there is substantial overlap between the concerns of the CSR community and the investor community

3 provides vital data to assist those seeking to determine the nature and extent of TNCs

4 makes transparent to what degree those corporations undertake transactions for their own benefit and for the benefit of others.

This last point requires elaboration and explanation. The proposed standard will enable those who wish to appraise the actions of a TNC to categorise the internal transactions of a TNC as follows:

5 those primarily undertaken for financial purposes. These will be ones in which:

   5.1 the ratio of related party turnover to total turnover will be high
   5.2 the ratio of value added to both related party purchases and related party turnover will be low
   5.3 the ratio of profit to value added will probably be high

   These transactions are typically ones where:

5.4 the trade is in financial services, which are capable of artificial construction and require low labour input in relation to their value

5.5 the trade is one where goods are purchased into a territory and are resold from it in largely unaltered state for the reason of either obscuring the original source of supply or to obtain taxation advantage on the mark up within the location in which the transaction takes place

In these cases there is likely to be doubt as to the necessity for the transactions to be undertaken in the chosen form and those with a concern with regard to:

- the sourcing of products
- taxation avoidance
- the fair allocation of reward to labour
- the financial stability of tax haven states

will all wish to use the data derived from this type of analysis.

6 those primarily undertaken for taxation advantage. These will be ones in which:

6.1 the ratio of tax to profit will be low, or non existent, and

6.2 there will be evidence that the transaction was primarily undertaken for financial purposes.

The second point must be stressed. There are occasions when a low tax charge might be properly due in relation to profit earned but real economic activity has occurred. Reporting entities would be encouraged to explain when such circumstances had occurred.

7 those where "value shifting" through "transfer pricing" is likely to be taking place to the detriment of the location in which value is really being added. "Value shifting" through "transfer pricing" is a process whereby a TNC chooses to charge a low price on sale of goods from a territory which has high taxation rates (usually with regard to profit) and then resells the goods made in that territory through one or more further locations during which process the price is increased on each occasion and profit is recorded, usually in locations where tax rates are low in relation to profit. This practice frequently undermines the taxation yield of states that have large populations or the responsibility for maintaining the environment under the pressure for natural resources located within their territorial limits. The practice is

therefore of great interest to those with a concern for CSR. It will be revealed by there being:

7.1 low profits in proportion to value added probably in association with high taxes in proportion to profits in some territories,

whilst in others there will be

7.2 high profits in proportion to value added in association with low taxes in proportion to profit

In addition to these transaction based issues those with an interest in CSR will also have an interest in knowing:

1 where the TNC is located

2 who its related parties are

3 what the TNC does in each location

4 the relative rewards it makes to its labour between the states in which it is located

5 the natural resources it uses, and from where they are sourced.

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(ii) to facilitate critical scrutiny of professional bodies, regulatory bodies, employer organisations, employee organisations, government departments and business organisations with a primary concern with regard to those related to the accountancy profession
(iii) to campaign for such reforms as will help to secure greater openness and democracy, protect and further the rights of stakeholders and to make disclosures where necessary;
(iv) to engage education and research to further public awareness of the workings, the social, political and the economic role of accountancy and business organisations.

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