



## **Disclosure instead of hide and seek**

### **A fair chance for the poor people of resource-rich countries**

CIDSE submission to the EU consultation by DG MARKT on Country-by-Country Reporting (CBCR), January 2011

#### **} The urgent need for common EU rules on country-by-country disclosure requirements**

CIDSE strongly supports the adoption of common EU rules on disclosure of financial information by multinational companies (MNCs) on a country-by-country basis. This would benefit citizens in the developed and the developing world, investors and tax authorities, as well as contributing towards a strong global standard for corporate disclosure and creating a level playing field for those European companies which will be required to disclose under Section 1504 of the US Dodd-Frank Act.

Developing a common EU approach to CBCR recognises and addresses a gap in the current system of financial reporting for MNCs. The number of companies operating across borders is growing steadily. There are now some 82,000 MNCs with approx. 810,000 foreign affiliates. Despite the international nature of trade, many of these transactions are in fact intra-group, i.e. between subsidiaries or businesses belonging to the same group of companies. Existing disclosure requirements do not capture sufficient information about these transactions.

As Catholic development agencies with partner organisations in many of the poorest countries of the world, CIDSE is acutely aware of the need for greater transparency and accountability in relation to global revenue flows. Local organisations in resource-rich countries such as the DRC, Cambodia and Peru have said how difficult it is for them to get accurate data about payments made by MNCs to their governments. The risk of corruption is well-documented in relation to extractive industries but also affects other sectors. Creating disclosure rules for MNCs which reduce the risk of corruption or bribery and make tax revenues more transparent will be consistent with EU development programmes to support good governance.

The need to improve accountability is not limited only to developing or transition economies. The financial crisis raised questions about the extent to which existing financial reporting requirements provide sufficient data about the operations of MNCs. The introduction of CBCR requirements will mean that MNCs can provide an accurate

picture of their contributions to national economies. Increased corporate transparency and accountability is a legitimate concern for citizens when the costs of state aid to MNCs are borne by taxpayers. EU governments are also seeking to support business models which are sustainable. It is important that political discussions and future policy decisions are based on clear, comparable and robust data about how MNCs operate at a national level. Therefore the current consultation is very timely but its scope should be amended. The EU should use this opportunity to examine CBCR as a international standard which would apply for all countries which a MNC operates rather than only considering it in relation to non-EU member state 'third countries'.

**In order to be consistent and useful, CBCR must also be:**

- a. **Mandatory**, so as to be effectively implemented over time
- b. **Comprehensive and credible** in producing the necessary information
- c. **Comparable** across companies and countries
- d. **Readily accessible** to, and usable by, all key users of information.

In this submission, CIDSE draws on our experience of MNCs' activities in the EU and transition and developing economies, with a focus on oil, gas and mining. This consultation is a chance to examine progress made to date and current gaps in corporate financial reporting regimes. Drawing on models developed with the Publish What You Pay Coalition and the Tax Justice Network, there are actions which the EU can take now to introduce common disclosure rules and lay the basis for a global standard.

**i. Existing disclosure requirements do not provide sufficient transparency**

Under the current accounting rules of the EU, companies do not provide data on a country-by-country basis. The Accounting Directives do require issuers to identify subsidiaries, jointly controlled entities and associates however many companies do not disclose even this information. Research for the Tax Justice Network in 2009 showed that only 33 of the 100 largest companies in the UK filed the information required by UK company law stating the names of each of their subsidiaries and the country in which they were located. Changes in accounting standards have meant that it is harder to understand transactions by MNCs in relation to specific countries. The adoption of IFRS8 has meant that MNCs can choose the basis for their reporting depending on their own internal management systems and fewer companies now structure their financial reporting by geographical segment. This has also led to a situation where it is more difficult for users to compare the financial data provided by MNCs.

Current disclosure requirements do not provide sufficient data on intra-group trading, although this is an increasingly significant aspect of MNC activity and indeed global trade. The OECD estimates that intra-group trade could account for more than 60% of world trade. Introducing common EU rules for the disclosure of financial information by MNCs on a country-by-country basis will address the need to extend accountability and transparency to this important area of business activity.

**ii. Disaggregated information should be disclosed to the public and not consolidated by public authorities**

CIDSE sees many disadvantages in the idea of companies disclosing information only to public authorities which could consolidate such information on a "country-by-country" basis before making it public. We would question why such information should not be made available to the public. The operations and financial performance of individual MNCs can have profound economic, social and political implications at country level and

it is important to recognise the range of stakeholders who have an interest in transparent financial reporting. These include:

- The equity investor group (shareholders)
- The loan creditor group (banks and bondholders)
- Analyst-advisers who advise the above group
- Business partners
- Consumers
- Employees
- The surrounding community – i.e. the public at large
- Civil society organisations
- Governments and their institutions.

Different users of financial data may have a particular interest or focus. If comprehensive information as outlined below in section 2 is available for each MNC reporting on a country-by-country basis, users will be able to access the financial information they require from a standard comparable data set. Advantages for investors in terms of judging company risk would be lost if data from multiple companies were aggregated together at the country level.

### **iii. CBCR requires mandatory reporting of financial information in normal annual reports and must not be confused with CSR reporting**

Some companies have suggested including country specific information in a CSR report, however, this is not a satisfactory alternative to mandatory CBCR in annual reports. We would like to stress the qualitative difference between a general purpose financial report and a CSR or sustainability report. As development NGOs we frequently receive these kinds of reports but they are not regarded as particularly credible sources of data about a company – certainly not decision useful. A company can select what to include and what to omit, often it is very difficult to judge whether the information presented is inaccurate or biased and there are no repercussions if this is the case. This means that in practice such reports are frequently more of a PR tool and not helpful for robust comparisons or investment decisions.

### **iv. CBCR would have important positive and minimal negative consequences for the EU economy**

The model of CBCR which CIDSE is recommending would only apply to a relatively small number of companies with operations in more than one country. The vast majority of EU enterprises would not be required to provide this data.

By introducing a requirement for CBCR for MNCs, the EU will ensure that companies are operating with a level playing field. Some of the largest EU MNCs including Total, Shell, BP and ENI will be required to report on a country-by-country basis anyway because they will be covered by the new SEC rules for enforcing the Dodd-Frank Act.

A mandatory approach will mean that companies which take an ethical and transparent approach to their operations will not be disadvantaged. There are also likely to be economic benefits to tackling illicit practices. In 2007 the UN Office on Drugs and Crime (UNODC) and the World Bank stated that “the cross-border flow of the global proceeds from criminal activities, corruption, and tax evasion is estimated at between \$1 trillion and \$1.6 trillion per year.”

Comparable, robust data about company performance and specific risks would be available to many more investors for their decision-making processes. This point is discussed in more depth below. At a time when all EU governments are seeking to reduce administrative costs and increase efficiency, country-by-country reporting by MNCs would provide comprehensive data for public officials so that any investigations, e.g. on tax issues, could be much more targeted.

#### **v. CBCR will improve corporate governance**

Common EU rules on CBCR will increase corporate transparency and accountability. Such information will support active oversight by the Board and shareholders and enhance internal control systems. There will be clearer expectations on company directors regarding the information that MNCs are required to disclose. Common EU rules could also bring broader benefits by contributing to improved corporate governance at a global level. Almost three-quarters of the world's 100 largest companies have their headquarters in just five countries – the US, France, Germany, the UK and Japan. Therefore the adoption of CBCR by the EU, building on the recent steps taken with the Dodd-Frank Act, would pave the way for the development of an international standard of disclosure for MNCs.

### **} Disclosure, crucial also to investors**

#### **i. Country-by-country reporting would help to identify risks inherent to activities of multinational companies**

While transnational companies are increasingly operating across borders, investors have identified that a significant number of the risks to a company's current and future financial performance are in fact country-specific, for example, the taxation regime, legal and regulatory framework. Country related risk is particularly relevant for the oil, gas and mining industries where assets are geographical concessions or reserves.

As early as 2003, a number of high profile institutional investors signed a public statement supporting the EITI principles and payment disclosure and calling for mechanisms to promote transparency. By 2009 80 institutional investors representing approximately US \$16 trillion supported this position.

Capital providers commenting on the US legislation and the IASB's consultation on the Discussion Paper on Extractive Activities have stressed the value of country-specific information. For example, in May 2010 Calvert stated that country-by-country reporting "could be used by investors to account for material, country-specific, tax/regulatory, reputational risks and would substantially improve investment decision-making regarding the extractive industries sector."

Some investors have also highlighted the longer term financial benefits that country-by-country reporting could offer in terms of helping oil, gas and mining companies to secure the local license to operate (see for example, Railpen's submission to the IASB consultation.)

Although CIDSE has focussed on the extractive industries, it is clear that country-specific risks in relation to the impact of national tax regimes or social and/or environmental legislation are relevant to the performance of MNCs from other industry

sectors as well. Therefore it is important that investors can access reliable, comparable data on costs, assets and liabilities broken down for each country of operation.

**CBCR would require disclosure of the following information by each 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. Its financial performance in every country in which it operates, without exception, including:
  - Its sales, both third party and with other group companies;
  - Purchases, split between third parties and intra-group transactions;
  - Labour costs and employee numbers;
  - Financing costs split between those paid to third parties and to other group members;
  - Its pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which operates.

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

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

**In addition, companies in the extractive industries should also disclose:**

1. 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 Dodd-Frank Act or EITI (whichever is more extensive)
2. the quantities and quality of resources extracted
3. reserves (to be in line with the work of the IASB's Working Group on Extractive Activities)

To be in line with the Dodd-Frank Bill, the information on payments to government should also be broken down for each 'project'.

In the interests of serving the needs of national users of financial reports (like government agents, citizens,) thresholds for reporting should relate to the country and the extractives project, rather than in relation to the scale of corporate activities, given that MNC economies can dwarf that of many countries. In the US, the Dodd Frank follows a de minimis approach which we support for the extractives sector.

As stated before, information should be disclosed for all jurisdictions - without exception - in which a MNC operates, to avoid transactions being lost to view.

**For all sectors, including extractives, CIDSE supports the analysis of the rationale for such disclosure as proposed by the Tax Justice Network, as follows:**

**1. A comprehensive disclosure of the locations in which the corporation trades.**

In principle this is already available to investors in EU located MNCs as a result of requirements in the Fourth and Seventh European Directives on accounting. In practice, as research has shown, disclosure of this information is almost always relegated to secondary documentation when that is possible (as it is, for example, in the United Kingdom) and that disclosure in secondary documentation is noticeably absent. This deficiency would be overcome if the information were to be included in the audited financial statements of the reporting entity because no auditor would then allow that omission.

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

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

**2. The trading names that the company uses.**

**3. The publication of a profit and loss account for each jurisdiction**

Including data on sales and purchases undertaken on an intragroup basis will allow an investor to appraise the following:

- a. The geographic diversity of the external sales of the company;
- b. The risk that this diversity creates for the company;
- c. The risk that the internal sales supply chains create for the company;
- d. The approximate directions of flow of goods and services through the group as a result of intragroup trading;

- e. The profit earned by a group in each location as a proportion of third-party and intragroup sales, both indicating in turn the risk of a transfer pricing challenge arising, particularly if the group is making significant use of tax havens or if the ratios of profit to sales are high in low tax jurisdictions and low in high tax jurisdictions;
- f. The locations in which an MNC employs its labour, the degree of risk that this might give rise to, and any issues or stresses likely to arise as a result of significant variations in average pay by location, particularly when compared to other similar undertakings;
- g. The flow of finance charges within the group, and the particular impact that these might have on an intragroup basis with regard to the re-allocation of profits between jurisdictions, giving rise to risk of transfer pricing or thin capitalisation challenge from taxation authorities, prejudicing the potential quality of future earnings;
- h. The rate of return on capital employed by jurisdiction, suggesting whether or not assets are efficiently allocated by group management to the locations in which the MNC trades;
- i. The constitution of the tax charge by location, so that the impact of taxation allowances and reliefs on the current taxation charge, as indicated by the amount of charge deferred, can be assessed by location, giving indication of the potential for reversal of such benefit in future periods, meaning that the impact of such reversal on future cash flow can be assessed;
- j. Consistent, comparative data between companies allows this analysis to be replicated between MNCs, adding to the basis for assessment of activity by location and the effectiveness of the management of each corporation in allocating resources.

#### **4. Limited balance sheet data by jurisdiction**

This is essential if investors are to appraise:

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

#### **5. Sales data from and to jurisdictions**

This has always been of significance when appraising the geographic spread of markets, and the ways in which a corporation services them. It is highly likely that this type of analysis, which has long been included in segment reporting when undertaken on a geographic basis, will continue to be of interest to investors. To ensure the supply of this data within country-by-country reporting disclosure must be made of the destinations of third party sales made by the reporting entity

In addition, we would assert that, with regard to the extractives sector, the breakdown of payments is required because this sector is particularly prone to corruption and risk.

## **} Disclosure to improve tax governance at a global level**

**Mandatory country-by-country reporting requirements would make a major contribution to improving global tax governance.**

Effective taxation is critical for the sustainable financing of development. CIDSE notes how during the last decade, a net transfer of financial resources from poor to rich countries has developed and steadily increased. Current tax systems based on the nation state face increasing constraints due to the mobility of capital and the activities of transnational corporations. Globalisation has contributed to the weakening of national tax systems. Women who constitute the majority of the poor globally have been particularly affected by this trend. They are dependent to a great extent on public services which are weakened by falling tax revenues. It is essential that the European Union does not undermine its development objectives by failing to address problems with global tax governance such as tax evasion and avoidance.

**Mandatory country-by-country reporting would help tax administrations collect taxes due.** Without systematic and ready access to the information outlined above, tax administrations have little chance of accessing essential information for large multi-nationals on the group structures and intra-group transactions necessary to assess taxes due in their jurisdictions.

**Secondly, it would help other agents in countries hold governments and companies to account for tax policies and agreements.** Parliaments, citizen watchdogs and the media often face challenges in accessing information essential for the kinds of democratic oversight promoted by the EU. Provided with the information outlined above, and presented in tagged electronic form from a limited number sources (such as stock market regulators), country-by-country reporting would overcome some of the symmetries of resources and information needed to provide effective oversight, keeping agreements in line with policy and law and reducing losses from corruption.

**Thirdly, it will help companies better manage, and capital providers better oversee, the tax practices of MNCs.** Tax is clearly a major area of cost, risk and contribution for companies. A few have recently begun to look at tax from a country-specific basis, such as those involved in PriceWaterhouse Coopers 'Total Tax Contribution' approach. This demonstrates that companies are starting to see the importance of looking at tax from a country-specific way. Since the approach is voluntary, it also demonstrates that they do not find the costs of reporting this way to be prohibitive or greater than the benefits of such country-specific analysis. However, there is a need to regularise such a country-specific approach to tax analysis in order to improve internal controls, and also respond to tax and payments risks generated by any non-compliance with rules such as the US Foreign Corrupt Practices Act and the UK's Anti-Bribery law.

To achieve this, the information that would need to be disclosed on a country-by-country basis is the same as that outlined in section 2 above.

### **} Disclosure to improve domestic accountability and governance in natural resource-rich countries?**

As stated above, CIDSE supports country-by-country reporting requirements for all sectors because of the benefits this would bring in terms of corporate governance and transparency. The high risk extractives sector has been a particular focus for such country-specific reporting because extraction of non-renewable resources is statistically related to higher levels of corruption, conflict and poverty in producing countries.

Many developing countries have significant oil, gas and mining industries yet evidence to date shows that all too often exploitation of natural resources has failed to generate lasting development benefits for citizens. It is therefore particularly important for accurate financial statements about remaining reserves, production and payments to be available to the public. There is also clear evidence of links between exploitation of natural resources and increased risk of conflict. This has major implications for investors in extractive companies.

Given the medium and long-term nature of extractives projects, requirements which reduce the risk that extractive activities lead to corruption, conflict and poor governance are in the interests of both investors and of citizens of resource-rich countries.

In many countries rich in natural resources, CIDSE partner organizations have highlighted that citizens have little or no information about the terms of deals signed between extractive companies and their governments, and how much money is being paid to their countries in revenue or whether this appropriate in relation to the profits being generated.

In our view, disaggregated payment data represents an important element in understanding a company's operations in a particular country context. This data would provide investors with better information on country-specific political and reputational risk. It would also make it easier for investors to compare different projects by the same company or between companies. In the longer term this level of financial reporting could contribute to a more stable business environment which would reduce the risk of interruptions of production.

CIDSE believes that the Extractive Industries Transparency Initiative is a useful initiative but that **it is relevant to consider the value and limitations of EITI to date when considering next steps on the introduction of country-by-country reporting.** A number of CIDSE's members and partner organisations in the South have been actively involved in the Extractive Industry Transparency Initiative (EITI) since its inception.

The expansion of the EITI since its launch in 2002 to include over 30 countries and almost 50 major companies indicates an appetite for increasing transparency of payment data, including taxes, within the oil, gas and mining sectors. The experience of countries such as Liberia and Timor-Leste shows that disclosure of this kind of information is

possible. But progress has been very slow: eight years on, only five countries have been recognized as actually complying with the requirements of the initiative. As states decide whether or not to join, coverage is also piecemeal. So for example resource-rich countries such as Angola, Cambodia and Burma have chosen not to participate in EITI. This means that companies may be reporting on payments to government for one country where they operate but not providing the information for other countries where they have significant operations. It also means that millions of citizens of natural-resource rich countries are not able to benefit from the limited disclosure that EITI can bring. Common EU rules on the disclosure of financial information on a country-by-country basis would therefore complement and build on the EITI.

It is important to stress the urgency of improving governance and domestic accountability in relation to exploitation of oil, gas and minerals because these are finite, non-renewable resources. If revenues are not managed wisely, the development chances of many ordinary people will have been squandered. This point was highlighted by the Angolan Catholic Bishops back in 2004:

*“Oil and diamonds, almost exclusively, fed the conflict we suffered for the last twenty-five years. And since the war has ended, many people have been very surprised that these same resources have not been able to feed our internally displaced people ... In this public examination of conscience, we ask the competent authorities correctly to inform Angola’s citizens about the profits coming from the exploration of oil and other natural resources, as well as provide information about how they are used. ... It is essential that the exploration of oil and other natural resources leads to investment which can generate wealth for the country. If this does not happen, the country will become poorer still and will end up with no oil, no diamonds and no lasting benefit whatever.”*

**Statement of the Catholic Bishops of Luanda, 24 March 2004**

In our view there is already sufficient evidence and experience available from implementation of EITI to show that it is now time for the EU to adopt the more systematic approach of mandatory country-by-country reporting.

## **} Predefined standards or formats**

### **i. Predetermined country-by-country reporting standards are essential and data should be reported in annual financial statements**

To ensure the credibility of the information required, it should be derived from the general ledgers of MNCs, and subject to the same standards of consistency and audit. It should therefore be published in the annual financial statements.

The content and format for reporting cannot be left to the discretion of the company. This is essential to:

- ensure comparability between companies and countries
- given the scale of information needed, make the information as easy to navigate and analyse as possible.

To be consistent with the Dodd-Frank requirements and to ease access and analysis, this would require the data to be presented:

- annually

- electronically, and tagged with key analytical categories
- submitted to a public entity who will then compile and publish the full information on their website allowing full public access.

To further ease analysis, reporting could also be based on the standard template for disclosure of profit and loss accounts, balance sheets and cash flow.

**ii. The data should be comparable at the level of the country and the company for all sectors.** This is the basic rationale for country-by-country requirements. Using the data specification outlined under section 2, this will serve the needs of both investors and host country stakeholders, who both need comparable data to understand risks and returns at the company and country level.

In addition, **for extractive companies**, data should be disclosed at the project-specific level for this high-risk sector.

For the reasons outlined above, CIDSE believes that the EU must take prompt and effective action in delivering country-by-country reporting requirements. It must not allow the OECD's current Task Group or the role of the IASB to delay, water down or prevent this happening. Therefore, it would appear prudent to act first to incorporate country-by-country reporting requirements into the 7<sup>th</sup> Accounting Directive and the Transparency Directive.

## } **Country-by-country reporting for whom?**

CIDSE supports the following criteria for deciding which MNCs would be required to report on a country-by-country basis:

- The company trades in more than one jurisdiction or the company and the members of its group trade in more than one jurisdiction, and,
- The company is a very large company (i.e. only those companies with substantial economic impact would be required to report in this way. For convenience this category of 'very large companies' should be subject to automatic updating of its definition. The thresholds for being a very large company might be four times those of a medium-size company, as defined in EU regulations.) And/or
- The company is a public company operating in the financial services or extractive industries sectors.

**Thus, all listed, and very large unlisted, extractive companies should be required to disclose on a country-by-country basis if they trade in more than one jurisdiction.**

Excluding large, medium and small companies makes sense for lower risk sectors to reduce compliance costs for lower risk areas. However, extractive companies operate in a high risk sector so the requirement is set commensurately higher.

## **} Country-by-country disclosure requirements: benefits outweigh additional costs**

CIDSE recognises that there will be some additional costs for MNCs linked to the introduction of country-by-country disclosure requirements in relation to collating, auditing and publishing this data. However it is important not to overestimate these costs. MNCs will already have to gather and audit much of this information in order to ensure that they make complete domestic tax reports and have adequate controls in place to prevent bribery. The information could be presented in an XBRL format in order to reduce publishing costs.

In our view these limited costs will be outweighed by the significant benefits to investors in assessing risk on the basis of robust, comparable data and to citizens and government officials in terms of increased accountability of MNCs and clarity of payment streams including tax revenues.



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**CIDSE** is an international alliance of Catholic development agencies. Its members share a common strategy in their efforts to eradicate poverty and establish global justice. CIDSE's advocacy work covers global governance; resources for development; climate justice; food, agriculture & sustainable trade; and business & human rights [www.cidse.org](http://www.cidse.org)

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