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Natural resource transparency: call for urgent EU action on corporate reporting standards

The EU must propose legally binding measures to require natural resource companies to publish key financial information for each country and project in which they operate

What's the problem?

The extractive industries generate billions of Euros a year. This has the potential to drive economic and social development in resource-rich countries. Yet many countries endowed with natural resources like the Democratic Republic of Congo are poor. The North African and Middle Eastern governments experiencing protests against rampant corruption and political marginalisation are funded significantly by oil revenues. In places like Nigeria and Peru, citizens are blocking and attacking oil and mining companies, angry that they carry most of the economic and environmental burden while the companies make huge profits. This threatens European energy security and leads to rising prices.

How corporate transparency would help

Until now, a shroud of secrecy has cloaked the deals and revenue flows within the extractives sector. Money received by governments can be misused or stolen instead of channelled to improve the lives of citizens.

Countries may not get a fair deal for the value of their resources due to secret agreements, poor enforcement of the tax law or its abuse by unscrupulous companies. When companies pay tax, governments are often unaccountable to their citizens for how these revenues are used. Countries also need information on the operations of similar companies in other countries to enable them to get a 'fair' deal. Without the right information, tax authorities struggle to monitor what international companies should be paying and civil society struggles to hold governments and companies to account. In these conditions markets and investors lack sufficient data to assess country and project specific risks. Transparency is therefore a major part of the solution.

> *"Within the remit of their respective competences, the EU and its Member States should also further promote a transparent and cooperative international tax environment, including the principles of good governance in tax matters. In this regard, the EU and its Member States should enhance the aspects of policy coherence for development, and work towards exploring country-by-country reporting as a standard for multinational corporations"*
> **European Council conclusions on tax and development, June 2010**
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> *"A number of developing countries claim that their capacity to mobilize domestic revenues is affected by international tax evasion and avoidance…Since multinational corporations are not required to disclose their financial data on a country-by-country basis enterprises may try to lower their tax liability in developing countries notably through transfer pricing practices."* **European Commission communication on good governance in tax matters (2010)**

This is a crucial time for a European-wide rule change

In September 2010, the Commission undertook to consult and bring forward legislative proposals on country-by-country financial disclosure within one year following repeated requests from the European Parliament. This follows the passing in July 2010 of the Dodd-Frank financial reform bill in the United States, which includes a provision obliging US-listed companies engaged in oil, gas or mineral extraction to report how much they pay to governments in an annual report to the Securities and Exchange Commission.

To make governments more accountable for the revenues they receive, companies should be required to publish the payments they make on a country and project specific basis. In order to track whether countries are receiving what they are owed by companies, additional data is needed including production, profits, sales and intra-group trade on a country specific basis. Both would assist investors to assess risks. Both are needed to raise domestic revenues to combat poverty and build the trust in companies necessary for security of supply.

What is needed from the European Commission's proposals:

1. Adequate scope of information

It is vital that the Commission's proposals cover reporting requirements for the full range of information needed to make for effective legislation, not only payments to governments. Extractives companies must report:

a. Payments to governments

Data must be broken down into different types of payments on a **country** and **project** specific basis, in line with the Extractive Industries Transparency Initiative (EITI) with a breakdown of each type of tax paid. To prevent the most abusive **tax evasion**, companies must also be required to report payments at the country level for any country in which they have a trading presence but no production (i.e. country-level reporting must not be restricted only to operating countries or "third countries").

b. Additional key financial information on a country specific basis

Reporting required on a country specific basis for all countries in which the company has a trading presence:

- **Profits, production volumes and sales,** so that e.g. royalties payments can be understood.
- **Intra-group trade and financing volumes**, to expose high-risk activities and usage of tax havens.
- **Assets and staffing information**, to throw light on the use of 'mailbox' companies in tax havens.

2. Formats and mechanisms for disclosure

Reporting must be mandatory, comprehensive, credible, comparable and accessible across companies and countries, and should therefore be:

- Derived from the general ledgers of the company and published in the **annual financial statements**.
- Presented in a **required format**, rather than left to the discretion of the company.
- Presented annually and **electronically tagged** by key analytical categories.
- Published by a public entity allowing full **public access** to all information (in line with the US law).

3. Full coverage of companies and countries

All companies with extractive activities should be required to report in this way and there must **be no exemptions** for particular countries. This would be consistent with the approach adopted in the US. Exemptions for companies or countries would create dangerous loopholes. In standard practice stock listing requirements take precedence over domestic law and there has been no evidence presented of any country with laws that would prevent such disclosure based on the US law.

> *"I strongly believe it is in everyone's interests that mining companies and others operate to the highest standards. That way we can ensure some of the world's poorest benefit from the wealth that lies in the ground beneath them. The UK will actively support the introduction of binding disclosure regulations on the extractive industry at the EU level."* – **Rt Hon George Osborne MP, Chancellor of the Exchequer, UK**
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> *"It is a contradiction to support increased development assistance, yet turn a blind eye to actions by multinationals and others that undermine the tax base of a developing country."* – **Rt Hon Trevor Manuel, Minister for National Planning, South Africa**

4. Roadmap to other sectors

The rationale for such financial reporting is equally applicable to all other sectors beyond extractives, to improve risk assessments, stability of returns, tax governance and domestic accountability for revenues paid to governments either in developed or developing countries. The Commission should lay out a timeframe for implementing such reporting for all sectors, to fulfil the mandate given to it by the Council and Parliament.

The benefits of country by country reporting are wide ranging:

Accountability and a fair deal: Disclosure of financial information not only strengthens the ability of civil society to hold governments to account for how they spend revenues received from natural resources, but also enables host governments to ensure they are getting a fair deal in comparison to other countries.

Helping uncover tax avoidance: Systematic, comparable country-by-country data would be a risk management tool to identify high-risk taxpayers for audit, to provide contextual information during transfer pricing audits, and a basis for tax information requests to other countries. Without the global picture of a company's structure that this would provide, it is difficult for even well equipped revenue authorities to see and tackle the use of abusive profit shifting mechanisms. At an OECD Taskforce on Tax and Development meeting in April 2011, tax officials from developing countries said that the information proposed would significantly help them to challenge tax abusive behaviour.

Enabling public scrutiny of tax policy and compliance: The IMF's board paper, Revenue Mobilization in Developing Countries (2011), suggests that "effective and fair revenue mobilisation requires informed and careful analysis, and transparent institutions and practices [including] simple and transparent tax laws [and] involvement of the wider community." Country-by-country reporting is cited as a means to further this agenda.

"The way a company manages its tax affairs is directly relevant to shareholders, influencing important figures in the accounts and thus company valuations and investment decisions."
Henderson Global Investors

"How much damage to the group's reputation can a local subsidiary do? This needs to be reviewed on a country by country (or subsidiary by subsidiary) basis. You also need to consider the impact your local reputation has on your ability to do business in that local country."
PriceWaterhouseCoopers

Exerting a deterrent effect on corporate malpractice: Sunlight is the best disinfectant. Transparent companies would be much less likely to abuse revenue rules. Where revenue authority intervention does not act as a major deterrent due to lack of capacity, transparency and public scrutiny would assist in filling the deficit.

Securing returns for companies and investors: Improvements in local governance and revenue collection should help reduce tensions with companies, reduce the pressure for corruption, and improve long-term returns to investment, as well as promoting local development. Otherwise, in areas of conflict exacerbated by unfair redistribution of wealth around natural resources exploitation, companies and investors may face a risk of nationalisation or expropriation, along with disruption to supply and higher levels of political instability.

Providing key information for better functioning of the market: Oil, gas and mining are high risk sectors. Many of these risks are country or project specific, varying by local fiscal and political regime. Yet current reporting requirements allow companies to disclose much information in aggregated groupings like 'region' or 'rest of the world'. Presenting data on a country and project specific basis would help investors identify exposure to risks and improve their buy-sell decisions.

Improving governance of companies: Empirical research shows that requiring strong geographical segmenting requirements (such as country-by-country reporting) would improve the profitability of companies and thus returns for investors. Managers of multinationals have been shown to have a tendency, when left without external scrutiny, to expand in foreign countries. This may increase turnover but may cause profits to fall. In short, country level information is necessary to judge adequately in whose interest the firm is being run and to provide effective oversight.

The European Parliament: *"Calls for the introduction of country-by-country financial reporting obligations for cross-border companies, including pre- and post-tax profits, with the aim of enhancing transparency and access to relevant data by tax administrations. Takes the view that, in order to ensure that all sectors and all companies are uniformly covered, the EU should introduce the principle as part of the upcoming revisions of the transparency directive and the EU accounting directives."*

European Parliament resolution of 8 March 2011 on Tax and Development – Cooperating with Developing Countries on Promoting Good Governance in Tax Matters

Potential impact in Africa

Africa is on the cusp of a major expansion in natural resource extraction. This should generate a windfall of revenues that could drive economic investment and help meet the Millennium Development Goals. However, this will only happen with corporate transparency. Corporate transparency will enable civil society to hold governments to account for the use of these revenues and will equip governments with critical information to ensure they are getting a fair deal.

The founding communiqué of the African Tax Administration Forum states that the continent loses 7.6% of its GDP to illicit capital flight, far in excess of aid receipts from the European Union and other donors. More effective taxation is, as this communiqué states, an "indispensable condition" of ending the continent's dependence on overseas aid. To track whether countries are receiving monies owed to them by companies, country-specific data is needed. Last year's African Economic Outlook report highlighted the problems of "tax evasion and fraud, including the misuse of transfer pricing techniques, the difficulty of taxing extractive industries and overuse of tax preferences," all of which could be combated using country-by-country disclosures. Research by ActionAid, Christian Aid and their partners in Africa demonstrates that mining activities are systematically under-taxed on the continent, as a result of tax avoidance and evasion, discretionary and opaque tax concessions, and poorly designed tax exemptions (*Breaking the Curse,* 2008). Figures from Zambia's most recent EITI report show that less than half of the country's mining companies paid corporation tax in 2008.

The disclosure of country and project specific financial information will enable the public to face challenges beyond domestic corruption and to shine the light of transparency on the roles of governments and companies alike.

Working Example: Mopani, Zambia - In 2010, the Zambian government commissioned some random audits of mining operations. A draft of one of these was leaked to civil society groups. According to this independent report (the findings of which are disputed by the company concerned), transfer pricing abuse and local cost inflation by the Mopani Copper Mine, a subsidiary of Glencore AG, had cost the government as much as US$174m per year in lost revenue, which had not previously been picked up by the revenue authority. As a result, NGOs from France, Canada, Zambia and Switzerland have filed a complaint against Glencore International AG and First Quantum Minerals LTD before the Swiss and Canadian National Contact Points for violating the OECD Guidelines for Multinational Enterprises.

Country-by-country reporting would have helped the resource-constrained revenue authority to identify potential issues at the Mopani mine at a glance; it would have allowed Zambia's civil society to scrutinise the mine's tax contribution, and to investigate the role of tax policy and administration and of corporate behaviour; it may have deterred companies from the kinds of practices described in the audit report.

Based on the leaked report, country-by-country reporting would have shown:

- Consistent losses and corresponding zero tax payments at Mopani, unlike at comparable mines.
- 100% of sales to a related party, a 'red flag' for transfer pricing abuse given the poor profitability.
- A dramatic increase in average staff costs, unlike at comparable mines. This was a major component of the increase in local costs that the audit says 'cannot be trusted'.

While this information would have been far from conclusive, it would have raised questions, stimulated public debate, and allowed the revenue authority to prioritise resources more effectively.

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