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KPMG Global Energy Institute

# **EU Directive regarding disclosure of payments to governments**

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Disclosure of payments to governments above 100 thousand Euros is required by the EU Directive from listed and large private companies in the EU operating directly or through subsidiaries in the extraction of minerals or oil and gas or logging of primary forests.

## Background

In June 2013 a *Directive on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings* ('the Directive') was approved by the European Parliament ('EP') and adopted by the Council of the European Union ('CE'). It covers several aspects of financial reporting and includes mandatory public reporting on total payments to governments by country, type of payment and project.

This Directive came into force at the end of July, 2013. EU member states have until July 2015 to issue laws to enforce its application. Member States are allowed to defer application until January 1, 2016 or during the calendar year 2016. Initial application is however expected to be earlier than that in several countries. The Directive does not specify whether comparative information will be required.

## Scope

The Directive applies to companies with an activity involving exploration, prospection, development and extraction of minerals or oil and gas or logging of primary forests. It requires disclosure payments specifically related to these activities and aims to help governments of resource-rich countries to implement the EITI (Extractive Industries Transparency Initiative) principles and criteria.

This Directive requires disclosure of payments to governments in individual and consolidated reports by public-interest and non-public large companies incorporated in the EU. These reports are separate from the financial statements. However they will form part of the company's annual financial reporting obligations and will need to

be disclosed in the same manner as the financial statements.

Public interest entities are defined as limited liability companies that are admitted to trading on an EU regulated market; credit institutions; insurance undertakings; or so designated by Member States because of their significant public relevance. Large companies are defined as those which at their balance sheet dates exceed at least two of the three following criteria: balance sheet total of EUR20 million; net turnover of EUR40 million or average number of employees during the financial year of 250.

## Disclosure

The disclosure is required for all payments above EUR100k to governments (including local authorities, organisations and companies controlled by governments) resulting from extractive or logging activities.

An annual disclosure is required by country and by project. A project is defined as 'operational activities that are governed by a single contract, license, lease, concession or similar legal agreements and form the basis for payment liabilities with a government. None the less, if multiple such agreements are substantially interconnected, this shall be considered a project'.

A parent company is considered to be active in the extractive industry if any of its subsidiary undertakings (defined as an undertaking 'controlled by the entity or its parent') is active in the industry regardless of where those subsidiary undertakings are registered. The Directive requires these companies to prepare a consolidated report on payments to governments (subject to certain limited exceptions).

The payments relating to extractive or logging activities (in cash or in kind) should be disclosed under the following categories:

- production entitlements;
- royalties;
- dividends;
- signature, discovery and production bonuses;
- licence fees, rental fees, entry fees and other considerations for licences/concessions;
- infrastructure improvements; and
- taxes levied on the income, production or profits of companies, excluding taxes levied on consumption such as value added taxes, personal income taxes or sales taxes.

Payments made in respect of obligations arising at the entity level (e.g. income tax) are disclosed without allocation to projects.

The Directive does not require audit of the disclosure on payments to governments although this might be imposed by member states. It is likely that companies will request form of internal or external assurance during the first year to ensure that the requirements are understood and applied correctly across its various geographical locations.

The European Commission is required to report back by July 2018 to the EP and EC on the functioning of this Directive and one of the points to be considered is whether or not the Report on payments to governments should be audited. It will also report back on its possible extension to other sectors and proposing a new legislation regarding conflict minerals.

Disclosure requirements of payments to governments for extractive and logging companies listed in regulated markets are also included in another directive on harmonisation of transparency requirements, currently pending approval from the CE.

## Key Challenges

1. Companies will need to define the scope of entities, activities to be included, and 'projects' as the Directive leaves room for interpretation. These may be clarified to some extent in the future local implementation laws.
2. The Directive's objectives, requirements and the areas open to interpretation are very similar to those of the Section 1504 of the Dodd-Frank law ('DF'). The European Commission will decide which third country reporting requirements are equivalent to the EU ones and therefore the companies applying them would be exempt from the Directive's disclosure requirements. Cross-industry consultations on how to implement DF have already started and the developing practice is likely to influence how the Directive will be interpreted by the extractive industries.
3. In some countries legislations and/or contractual arrangements may prohibit public disclosure of information on transactions with governments. Breaching confidentiality clauses can lead to the loss of licenses and may be considered in some countries as a criminal offence. The Directive does not provide an exemption of disclosure on these grounds.
4. Companies will need to develop policies to enable consistency of application (e.g. how to value a payment in kind) across all operations. Also new processes and controls will be needed at both central and operational levels to ensure consistency of application of these policies.
5. As the reporting is cash based, there will be a need to develop systems enabling tagging specific vendors and transactions to pull together the required information. This can be a significant investment for geographically dispersed groups.

Companies will have to develop policies to interpret the regulations in the business context and develop systems and control framework to ensure collection and review of the information required to disclose payments to governments.

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