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cutting through complexity

Financial transparency in the extractive industries

Dodd-Frank Section 1504

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Dodd-Frank Section 1504

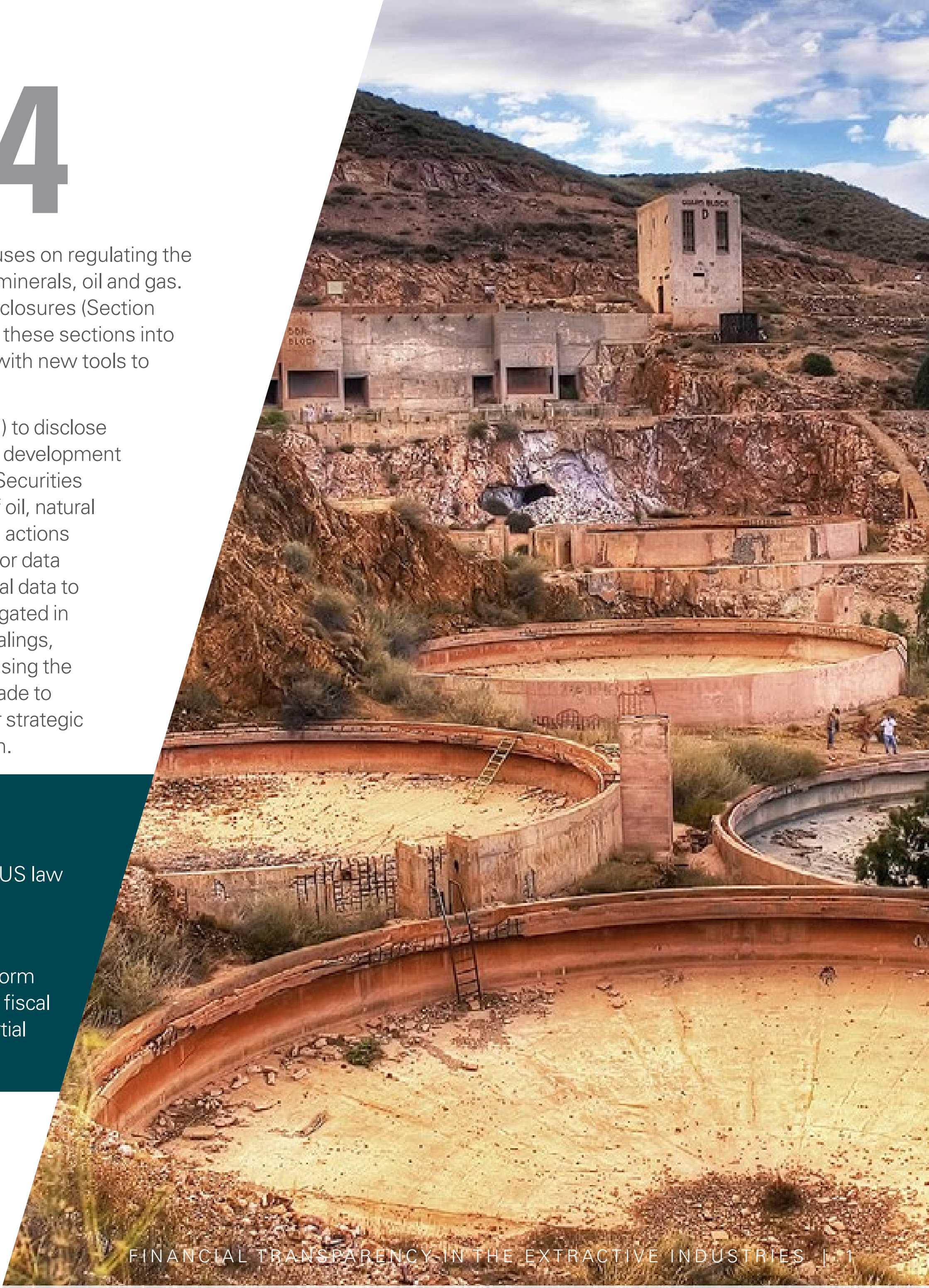
The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) focuses on regulating the US financial markets, but it also covers non-financial companies that use minerals or extract minerals, oil and gas. Title XV of the Act includes sections relating to Conflict Minerals (Section 1502), Mine Safety Disclosures (Section 1503), and Payments to Governments by Resource Extraction Issuers (Section 1504). In passing these sections into law, the US Congress aims to improve industry transparency and provide investors and citizens with new tools to hold companies and governments accountable for their actions.

This KPMG report covers Section 1504 of the Act, which requires a resource extraction issuer (REI) to disclose certain payments made to the US federal government or foreign governments for the commercial development of oil, natural gas, or minerals.[1] An REI is an issuer that is required to file an annual report with the Securities and Exchange Commission (SEC or Commission) and engages in the commercial development of oil, natural gas, or minerals, including exploration, extraction, processing, export, and other significant related actions or the acquisition of a license related to these activities. The provision has significant implications for data collection at these companies and will lead to the release of a considerable amount of new financial data to the public. Section 1504 should be seen in the context of a growing number of regulations promulgated in the US and elsewhere that cover company-to-government transactions, international business dealings, resource extraction and supply chains. In October 2011, the European Commission proposed[2] revising the Transparency and Accounting Directives to require the extractive industries to report payments made to governments on a country-by-country basis. Seen in this light, Section 1504 may require a broader strategic response from companies than simply complying with a single provision of one piece of legislation.

Current status

- Section 1504 is part of title XV (Miscellaneous Provisions) of Dodd-Frank, which became US law on July 21, 2010.
- Final rule for Section 1504 was published by the SEC on August 22, 2012.

An REI must comply with the new rules for fiscal years ending after September 30, 2013. The form must be filed with the SEC no later than 150 days after the end of its fiscal year. If a Company's fiscal year begins before September 30, 2013 (e.g., January 1, 2013) the Company may provide a partial report for the period beginning October 1, 2013 through the end of its fiscal year.



1 SEC Release No. 34-67717, Disclosure of Payments by Resource Extraction Issuers, available at www.sec.gov. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010. The Dodd-Frank Act contains many sections that may have significant implications to companies subject to the annual reporting requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (Exchange Act).

2 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1238&format=HTML&aged=0&language=EN&guiLanguage=en

Rationale

Dodd-Frank is primarily focused on financial services, but three sections aim to shed light on extractive industries and some of the supply chains linked to them. Section 1502 deals with "conflict minerals" exported from the war-torn Democratic Republic of the Congo and neighboring countries. Section 1503 promotes the disclosure of mine safety violations at US mines. Section 1504, the subject of this report, concerns financial payments to governments and government agencies for the purpose of developing oil, gas and mineral reserves. It is part of a global movement to enhance the public scrutiny of the relationship between extractive industries and host governments. For example, the United States is one of several countries that support the Extractive Industry Transparency Initiative (EITI), which is a voluntary coalition of investor groups, governments, and companies dedicated to improving transparency of company payments to, and government revenues from, mineral rich countries.

The US implementation of EITI will be overseen by the US Department of Interior (DOI) and they are pulling together a multi-stakeholder group (MSG) which will be comprised of industry representatives (some from mining, some from O&G); government representatives, and other interested parties (e.g., NGOs) EITI requires, firstly, governments to report on all payments received from oil, gas and mining companies and, secondly, companies to report on amounts paid to governments, in order to see whether there are discrepancies between the two. The relevant sections of Dodd-Frank were influenced by the EITI and in many places the final rule is consistent with the EITI except in some instances where the SEC believed Dodd-Frank went beyond what is required by the EITI. As an example, the SEC concluded that the definition of commercial development was broader under Dodd-Frank than what was contemplated by the EITI so the SEC included processing and export activities in the final rule.[3]

3 See Implementing the Extractive Industries Transparency Initiative, available at http://eiti.org/document/implementingtheeiti.

Requirements
for issuers

Section 1504 requires REIs (that complete forms 10-K, 20-F and 40-F) to provide to the SEC information relating to any payment made by the issuer, its subsidiary, or entity controlled by the issuer to a government or government agency for the purpose of the commercial development of oil, natural gas or minerals. "Commercial development" includes: exploration, extraction, processing , export "and other significant activities relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the Commission."

What sort of companies must comply:
Any issuer, US or foreign, that commercially develops oil, natural gas or minerals and files an annual report to the SEC will have to comply. Companies directly involved in exploration, extraction, processing and export or the acquisition of a license for any such activity will have to do so. But firms indirectly involved (such as pipe or drill manufacturers) will not. Issuers that help with the processing of the raw material, such as firms that remove impurities from oil or natural gas, fall under the disclosure requirement. Issuers will also be required to provide the disclosure for joint ventures or entities that are proportionately consolidated or other contractual arrangements if they determine they have control of the entity.[4]

Companies must report:

- Type and total amount of payments made for each project.
- Type and total amount of payments made to each government.
- Total amounts of the payments, by category.
- Currency used to make the payments.
- Financial period in which the payments were made.
- Business segment of the resource extraction issuer that made the payments.
- The government that received the payments, and the country in which the government is located.
- The project of the resource extraction issuer to which the payments relate.

The types of payments related to commercial development activities that need to be disclosed include:

- Taxes;
- Royalties;
- Fees (including license fees);
- Production entitlements;
- Bonuses;
- Dividends*;
- Infrastructure improvements.

*The final rule also clarifies that dividends paid to a government as a common or ordinary shareholder of the REI need not be disclosed if the dividend is paid under the same terms as other shareholders. However, dividends paid to a government in lieu of production entitlements or royalties must be disclosed.

4 Defining Issues 12-42 SEC Issues Final Rule for Extractive Industry Payments, KPMG LLP

The obligation to publicly report payments, project by project, is virtually unprecedented in the oil, gas and mining industries. To comply with Section 1504, companies will have to identify all payments to governments relating to any of their operations or projects, be they drilling wells, building roads or training workers. Part of the definition of payment in Section 1504 is that it is "not de minimis", which means that it has to be of a certain size to be counted. The SEC has defined "de minimis" payments; defined as any payment (whether a single payment or series of related payments) less than $100,000 during a company's most recent fiscal year.

Format of Report

Section 1504 specifies that the information about payments to governments must be presented in a new form (Form SD) filed in eXtensible Business Reporting Language ("XBRL"), an online interactive data format whereby certain attributes are electronically "tagged."

Challenges
of implementation

Depending on the complexity of financial systems, decentralization, and location of operations, it can take a large, global company in the extractive industries 12 months or more to organize the financial data it collects in order to comply with Section 1504. It is therefore important to set up a process, an IT system and a governance structure that will enable the issuer to comply within the time required, as soon as possible.

There are several reasons why this is likely to be challenging:

- There are many different kinds of payments to governments that fall under the provision. Such payments can be in cash or in kind and can include taxes, royalties, fees (including licensing fees), production entitlements, bonuses.
- There are many kinds of government entities that are included in the provision, from a mining ministry to an environmental agency to a state-owned enterprise. It will be time-consuming to pull together all payments to all these entities.
- The final rule does not have exemptions for government prohibitions, confidentiality provisions, or commercially sensitive information. (This contrasts with other SEC disclosure rules for oil and gas reserves that exempt certain disclosures if they would be prohibited by a foreign government.)
- The new rules leave the term "project" undefined to provide resource extraction issuers flexibility in applying the term to different business contexts. However, the rule release provides some guidance[5] on the SEC's view of what a project would be.
- Even assuming that these terms are clearly defined, it will be difficult for issuers to break down expenditures project by project or to separate payments to government entities from payments to the private sector.
- Not all companies will have centralized the information, or have a single source for the information. Thus, gathering and consolidating data from different parts of the world and on different IT platforms adds to the complexity.

There is a partial precedent for this process. More than 60 companies have chosen to support the EITI, including Alcoa, Chevron and ExxonMobil, and firms that operate in the countries that are implementing the initiative, publish what they pay to governments. ExxonMobil's statement of support for EITI said, "We believe transparency initiatives should apply to all companies – publicly traded, private and state-owned – with an interest in a country's extractive sector." But the granularity of information required under Section 1504 is much finer than what EITI calls for. And the information covers all governments, not just those that have signed on to EITI. Furthermore, companies that do not support EITI or report to the SEC do not have to provide the information.

Finally, as the DOI establishes the multi-stakeholder group (MSG) for EITI, and that group begins its process, there remains the possibility for further differences in reporting requirements between the implementation for EITI in the US, and the requirements under Section 1504.

5 See SEC final rule pp 174-177.

KPMG's point of view

This paper has sought to show that although Section 1504 may seem simple, the implications are complex and far-reaching. It requires companies to evaluate three aspects of their operations to see whether they are able to handle these reporting requirements efficiently and well.

Process

Companies will need to assess whether their existing external and internal financial-reporting processes are robust and rigorous enough to collect data in a way that, for many, will be new. Many may not have the details of the population of payment activities encompassed by Section 1504. A good first step would be to set up a pilot project that would examine a set of transactions with, say, a government and government entities in a particular country over the most recent 12-month period. These payments should then be analyzed according to some key financial metrics, such as the ratio of expenditure to pre-tax profit or expenditure to R&D. Any ratios that are outliers could then be placed under a microscope to determine why. Firms should include all government payments required for the extraction of oil, gas or minerals – whether the payments are for the direct purpose (such as a mining royalty) or the indirect purpose (such as the building of a road to the mine).

A good rule of thumb as a metric would be perhaps leveraging a concept from section 1502, Conflict Minerals. The term is "necessary to the functionality" and within section 1502 is used to determine whether minerals are necessary to the functionality of a product to determine whether a Company is required to determine if the mineral is sourced from the defined conflict region. With respect to 1504, a Company may want to assess whether a payment to a government is necessary to its ability to extract from the respective country as a starting point.

Priority should be given to analysis of payments in countries that are not signatories of EITI, in the first instance. Payments to government entities in resource-rich countries with the least transparency and the weakest infrastructure are likely to undergo the greatest scrutiny by companies and from the SEC.

Global firms have amassed a great deal of experience in dealing with other laws and regulations that require the reporting of international transactions. These include the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act (UKBA), as well as rules administered by the Office of Foreign Assets Control (OFAC) under the US Treasury. Although OFAC enforces economic sanctions against a limited number of countries and individuals, the process of compliance (in particular, the screening of payments) is likely to hold useful lessons for firms dealing with Section 1504.

IT systems

Many companies continue to suffer from legacy IT systems that are not integrated. In particular, firms that have acquired a large number of companies or individual project sites are likely to have the hardest job finding the relevant financial data and consolidating it into a single corporate view. All firms, though, are likely to have to isolate and collect all data on payments to government entities, and this may require substantial investments in new IT systems, enabling a "single point of view" across the enterprise. The investment, however, is likely to be worthwhile in the long run.

Governance

Although Section 1504 is but one provision in a complex regulatory landscape, its importance requires supervision at the highest level of the company. Senior personnel from different disciplines are likely to be involved in collecting and analyzing the data, including Finance, Legal, Risk, Audit, Procurement, Supply Chain and Operations. They should report to a C-level executive who in turn reports to the Chief Executive Officer and the Board of Directors.

Section 1504 is best seen as part of a jigsaw of regulations whose pieces interlock to some extent. These pieces include Section 1502 (conflict minerals), Section 1503 (mine safety), as well as OFAC, FCPA and UKBA. The purpose of each is different but they are part of a push toward greater transparency of the business dealings of companies and governments around the world. Global supply chains are coming under ever-closer scrutiny.

Furthermore, all public companies must comply with certain provisions of Dodd-Frank including, among other things, enhanced incentives and protections for corporate whistleblowers, new disclosures relating to executive compensation, and heightened independence requirements for compensation committees and their advisers.

But the increased level of transparency will benefit not just the regulators and the public, but the companies themselves. A more granular understanding of payments to governments and of the way supply chains operate is likely to lead to improved efficiency – even if the process of achieving this may be expensive, laborious and slow.

How KPMG can help

Conclusion

Overall, the Dodd-Frank Wall Street Reform and Consumer Protection Act represents several challenges for extraction companies. Companies subject to the Act must understand the disclosure requirements and consider if their current system can provide the necessary reporting. Given the challenges of organizing the data to comply with Section 1504, companies are encouraged to take steps toward compliance now. In KPMG's experience, companies that embed new compliance processes as early as possible are likely to reap cost savings and operational improvements that ultimately offset the cost of compliance.

KPMG professionals can assist in gap-analysis reviews to define the impact of proposed regulatory reform from various perspectives: people, process, technology, data requirements, and reporting. We assign the people with relevant experience to understand the company's major economic, operating, and regulatory risks – and factor in the company's specific needs, dynamics, and culture.

About KPMG's Americas' Regulatory Center of Excellence

While the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) is profoundly changing risk profiles and business models in every corner of the financial services industry, the impact for our clients reaches virtually every line of business. KPMG's FS Regulatory Center of Excellence (CoE) includes a number or regulatory specialists who are focused on the Dodd-Frank Act and its implications. The Dodd-Frank legislation contains requirements dealing with numerous aspects of corporate governance, executive compensation, public company disclosures, whistleblower procedures and protections, the mining and use of certain minerals, and much more. Working in a collaborative effort with the CoE's in EMA and ASPAC, the function of the CoE is to provide you with support and insights on these global regulatory developments.

Based in New York, the CoE is made up of key industry practitioners and regulatory advisers from across KPMG's global network who work with member firm clients to distill the impact of regulatory developments on their businesses and advise them on how to adapt their business models to better thrive in this dynamic environment.

Visit **www.kpmg.com/regulatorychallenges**

Links and resources

Additional information on the requirements of the *Miscellaneous Provisions* of Dodd-Frank can be found below:

- Dodd-Frank and Practical Considerations for the Mining Industry
- SEC Issues Final Rule for Extractive Industry Payments
- KPMG's Conflict Minerals Website: www.kpmg.com/conflictminerals
- KPMG's Defining Issues: SEC Proposes Rules for Disclosures About Conflict Minerals, Extractive Industry Payments
- Conflict Minerals Provision of Dodd-Frank – Immediate implications and long-term opportunities for companies

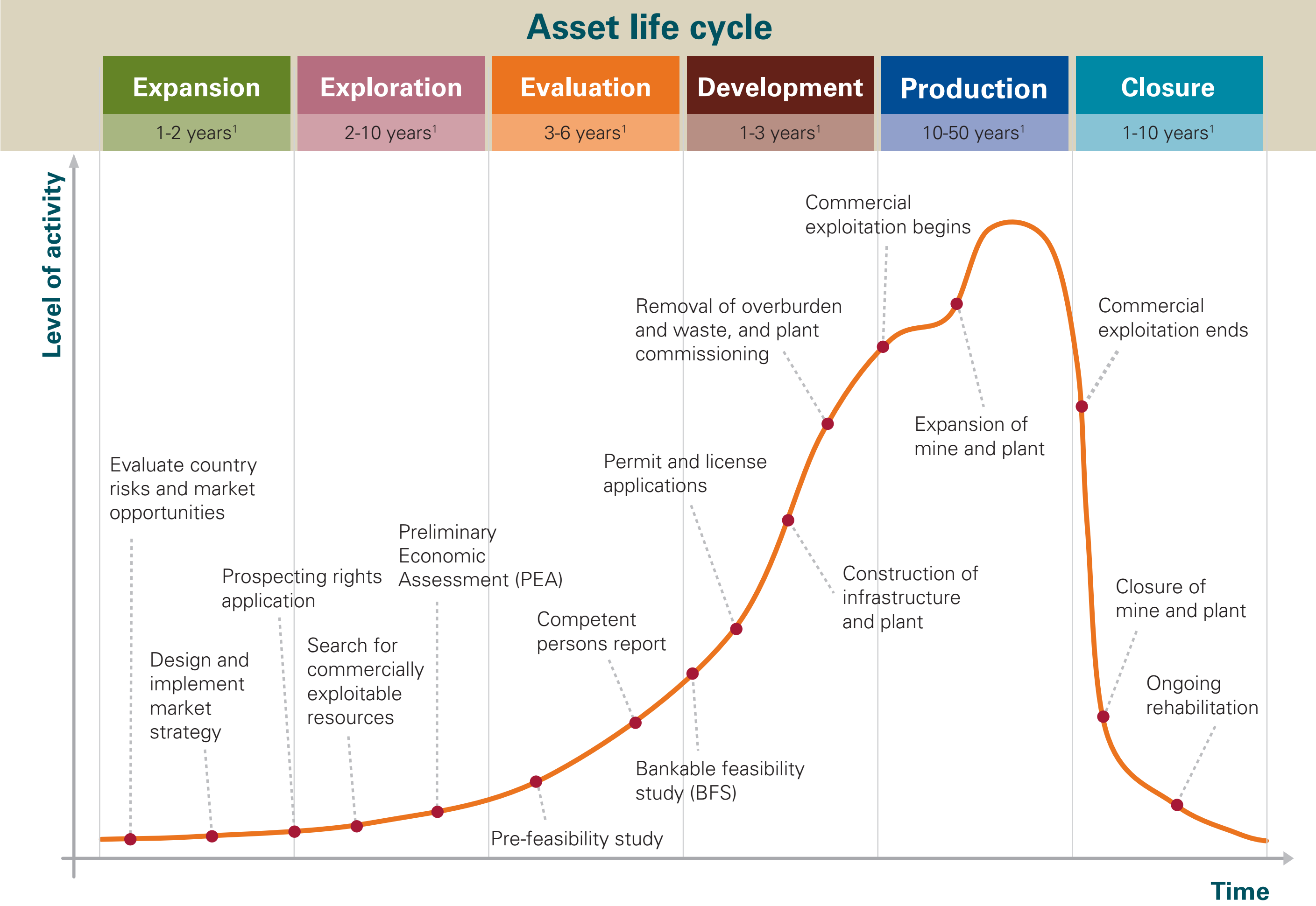
KPMG's mining practice

KPMG is committed to the mining industry. We have considerable investments in the industry in personnel, research, and hard-won experience. Through these investments, we strive for the highest quality in everything we do, turning our experience and industry knowledge into real value for our clients. KPMG has built a team of professionals designed to help our clients comply with Section 1504. Professionals in our mining practice are working with others in our regulatory and forensic groups that advise clients on compliance with similar types of regulation.

KPMG member firms offer global connectivity through our Mining Centers of Excellence in our three main operating regions: the Americas; Europe, Middle East, and Africa; and Asia Pacific. These Centers of Excellence create a framework to help KPMG member firm mining professionals access people and share skills, knowledge, and resources.

This approach is client-focused and progressive, backed by our local country experience and implementation. KPMG's Mining professionals assist organizations through all stages of the mining project lifecycle, from exploration through to production.

Mining asset life cycle

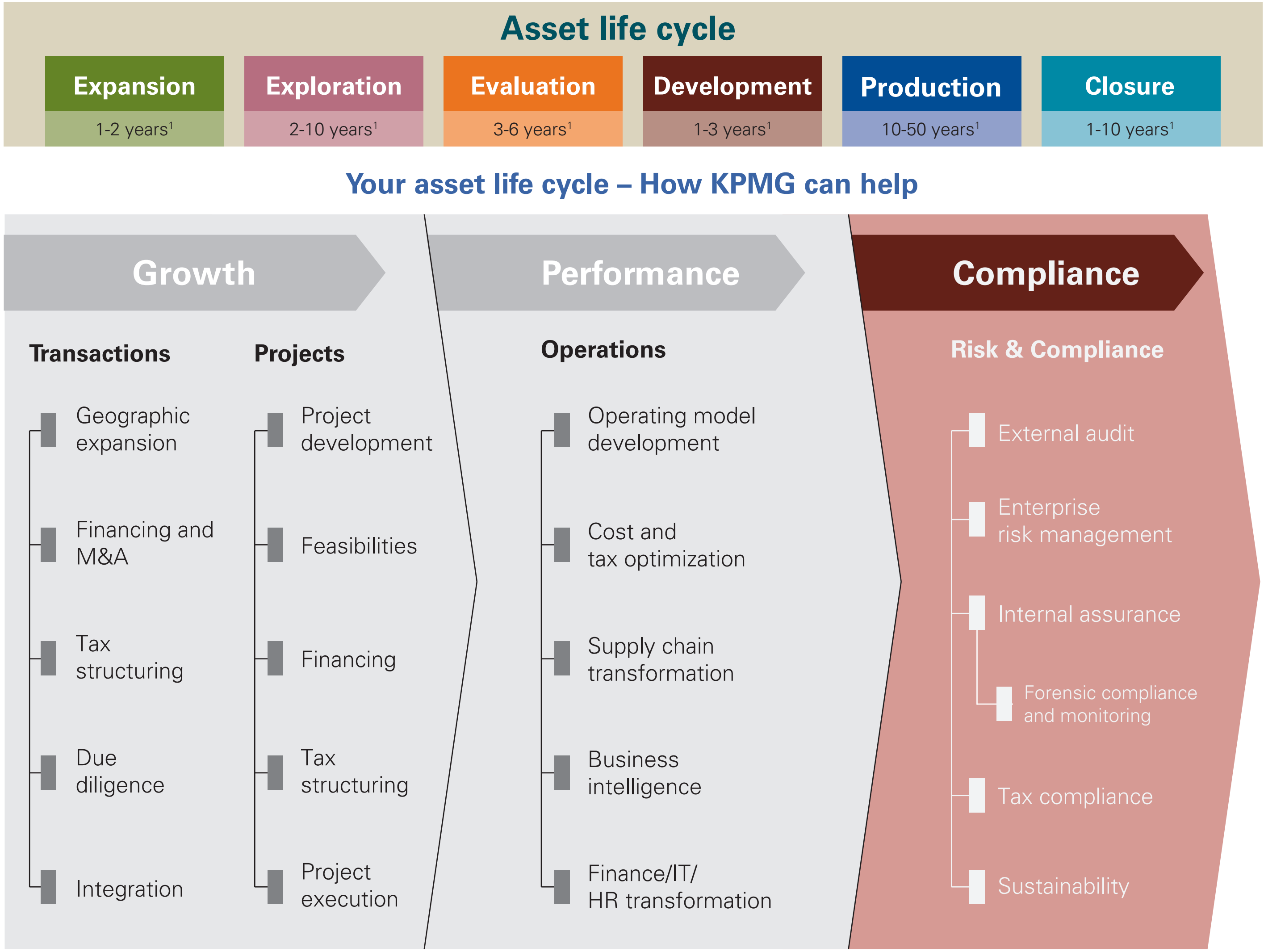


Source: KPMG International, 2012.

Note: (1) Estimated duration of stage in the mining asset life cycle

(2) Reflects key activities only at each stage of the mining asset life cycle

KPMG mining compliance solutions



Further Insight

Growth Series

Commodity Insights Bulletins

Our series of bulletins focus on key mining commodities. Each bulletin is aimed to provide insight into trends, issues and changes within the key mining commodity sectors.

The series currently includes Aluminum, Copper, Gold, Iron Ore, Metallurgical Coal, Nickel, Platinum, Thermal Coal and Platinum.

Mining M&A Quarterly Newsletter

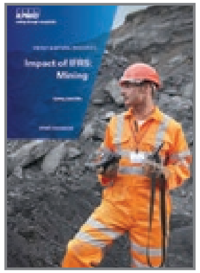
This quarterly publication provides a current snapshot of the M&A market providing a review of select key transactions while focusing on the rationale behind those deals as trends take shape.

Performance Series

KPMG's Mining Operational Excellence Framework

KPMG member firms have developed their own operational excellence framework over the last several years of association with leading mining companies. It starts off an organization on a journey of efficiency and then over time embeds such characteristics in its organization that makes the change sustainable over business cycles. This puts together all the capabilities necessary to assure the CEO of that "operation" will be able to adapt to support their hunt for the next opportunity, whatever its nature.

Compliance Series



Impact of IFRS: Mining

This publication provides assistance to companies in the mining sector who are considering converting to IFRS. It gives an overview of the IFRS conversion process and looks at the impact of conversion on IT systems, people and business processes. It also considers the main accounting and reporting issues faced by mining companies, and discusses the related elements of the IASB Discussion Paper Extractive Activities.

Future Trends in Mining Industry Business Resilience

KPMG International examined a number of existing and emerging risks faced by mining organizations around the world and identified the attributes of the more resilient organizations. This publication moves ahead of those findings and looks at some practical solutions that can be employed by mining executives to increase resilience and provide a platform on which sustainable, profitable growth can continue.

For more information or to access these and other mining publications, please visit: **www.kpmg.com**

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