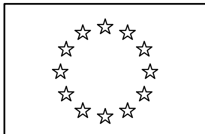


EUROPEAN COMMISSION

Brussels, 25.10.2011
SEC(2011) 1289 final

COMMISSION STAFF WORKING PAPER

Part I

IMPACT ASSESSMENT

Accompanying the document

Proposal for a Directive of the European Parliament and the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

{COM(2011) 684 final}
{SEC(2011) 1290 final}

TABLE OF CONTENTS

1. Introduction ... 3
2. Procedural issues and consultation of interested parties ... 4
2.1. Policy context ... 4
2.2. Consultation of Interested Parties ... 6
2.3. Recommendations of the Impact Assessment Board ... 7
3. Problem definition ... 7
3.1. The purpose, use and benefits of financial statements ... 7
3.2. Preparers of financial statements: on the costs side ... 12
3.3. Users of the financial statements: on the benefit side ... 15
3.4. Drivers ... 16
3.5. Impact of the micro economic problems on the macro level ... 18
3.6. How large is the problem? ... 19
3.7. Subsidiarity and proportionality ... 20
4. Objectives ... 21
5. Policy options ... 22
5.1. Broad policy options ... 23
5.2. Detailed options – within the context of the review of the Accounting Directive ... 31
6. Analysis of impacts ... 36
6.1. Overview of preferred options ... 36
6.2. Expected primary impact of the preferred policy options ... 37
6.3. Other impacts: ... 39
7. Monitoring and evaluation ... 40
7.1. Monitoring ... 40
7.2. Evaluation ... 41

ANNEX 1 - Legal environment in the EU and in the main trading partners of the EU ... 42

ANNEX 2 - Summary of consultation activities ... 45

ANNEX 3 - The International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) ... 48

ANNEX 4 - Problems differ across different company sizes ... 52

ANNEX 5 - Estimation of administrative burden reduction through full use of existing exemptions ... 56

ANNEX 6 - Policy options in the frame of a review of the Accounting Directives ... 57

ANNEX 7 - Breakdown of savings as a result of preferred policy options ... 75

1. INTRODUCTION

The Fourth Council Directive 78/660/EEC on annual accounts and the Seventh Council Directive 83/349/EEC on consolidated accounts (hereafter the "Accounting Directives" or "Directives")[1] deal with the annual and consolidated financial statements of limited liability companies in Europe. During the past 30 years, amendments to the Accounting Directives[2] have added many requirements, such as new disclosures and valuation rules, including detailed provisions on fair value accounting. Less attention has been paid to considering whether existing requirements could be simplified or removed. Whilst every amendment may have been justified in its own right, these additions have led to increased complexity and regulatory burden for companies.

Since listed companies became subject to the IAS regulation in 2005[3], SMEs have become *de facto* the main users of the Accounting Directives. Small and medium-sized companies, which are the backbone of the European economy and the main contributors to the creation of employment in the EU, have especially felt the impact of these new requirements. The Commission is committed to release the growth potential of these companies by reducing the administrative burden by 25% by 2012[4]. The Commission's approach is outlined in the Europe 2020 Strategy[5] which aims to make the EU a smarter, more sustainable and inclusive economy, as well as in the Single Market Act[6].

Developments in the business environment and users' needs have resulted in situations where the reporting requirements of the Accounting Directives no longer effectively match users' needs. These needs differ depending on the size or other features of companies, whereas the Directives tend to address this in an uneven and complex manner. Yet, any financial statement must remain useful and

---

1 See Annex 1 "Legal environment in the EU". The Accounting Directives comprise the following legislation: Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01978L0660-20070101:EN:NOT; Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01983L0349-20070101:EN:NOT

2 For previous amendments to the 4th Directive, see http://ec.europa.eu/internal_market/accounting/legal_framework/annual_accounts_text_en.htm. For previous amendments to the 7th Directive, see http://ec.europa.eu/internal_market/accounting/legal_framework/consolidated_accounts_text_en.htm

3 See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002R1606:20080410:EN:PDF

4 The Commission introduced in 2006 a distinction between administrative costs and administrative burdens: the latter designate costs specifically linked to information that businesses would not collect and provide in the absence of a legal obligation. For more information see http://ec.europa.eu/governance/better_regulation/admin_costs_en.htm

5 More details about the Europe 2020 strategy are available at http://ec.europa.eu/europe2020/index_en.htm

6 See Communication of April 2011 from the Commission to the Council, the European Parliament, The European Economic and Social Committee and the Committee of the Regions: "*Single Market Act – Twelve levers to boost growth and strengthen confidence, 'Working together to create new growth*'", available at http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf#page=2

understandable to the intended users. The acknowledgment of the distinct needs of the SME group as well as the segments within that group have been clearly addressed through the "think small first" principle enshrined in the Small Business Act (SBA) of June 2008[7]. Applying this principle should lead to differentiated and simpler reporting requirements for smaller companies and to a new structure of the Directives.

The revision of the Accounting Directives is part of the Commission's Simplification Rolling Programme and Administrative Burden Reduction initiatives for 2011. This impact assessment presents the Commission's initiative to modernise and simplify the financial reporting requirements so as to make them less burdensome whilst ensuring they remain fit to users' needs. The work has been guided by the "think small first" principle.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Policy context

Under the Europe 2020 Strategy, the single market should be deepened by streamlining single market rules and harmonising where rules differ between Member States. The Industrial Competitiveness side of the strategy encourages "fitness checks" of existing legislation to identify the potential for reducing the cumulative effects of legislation so as to cut costs for European business. Work is also needed to improve access to the single market for small businesses and to develop entrepreneurship, in part by simplifying company law.

Moreover, the Commission's Smart Regulation strategy[8] is aimed at designing and delivering regulation of the highest quality, respecting the principles of subsidiarity and proportionality, whilst ensuring that administrative burdens are proportionate to the benefits they bring. The Commission's political will to recognise the central role of SMEs in the EU economy is also reflected in the "Small Business Act", which has the objectives of improving the overall approach to entrepreneurship and anchoring the "*think small first*" principle in policy-making from regulation to public service. In this respect, the Single Market Act stresses the need to reduce the regulatory burden,

---

7 See Communication of 25 June 2008 from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on "Think Small First, a Small Business Act for Europe", COM(2008) 394 final, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0394:FIN:en:PDF and http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/report_think_small_first.pdf. See also http://ec.europa.eu/enterprise/entrepreneurship/think_small_first.htm

8 See Communication of 8 October 2010 from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on "*Smart Regulation in the European Union*", COM(2010)543. In order to improve existing legislation the Commission has inter alia put in place the Action Programme for Reducing Administrative Burdens, COM (2007)23, which is on track to exceed its target of cutting red tape by 25% by 2012 (see Press Release IP/10/1670 of 7 December 2010 "Good progress in cutting red tape" available at http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/index_en.htm

in particular for SMEs, at both European and national levels, and calls for a simplification of the Accounting Directives[9].

The Commission issued a Communication putting forward several ideas for simplifying the current accounting requirements for SMEs in July 2007[10], and followed this up by proposing a number of targeted simplification measures which were adopted by the co-legislators in June 2009.[11] In May 2008, the European Parliament welcomed the objectives of reducing administrative burdens and enabling SME's to compete more effectively[12], encouraging the Commission "to continue its activities with regard to the simplification of company law, accounting and auditing for SMEs via the relevant legislative acts, in particular the Fourth and Seventh Company Law Directives"[13].

Most of the suggestions presented in the Communication were then taken up by the *High Level Group of Independent Stakeholders on Administrative Burdens* in its Opinion of July 2008[14]. In view of strong stakeholder support for further simplification for SMEs, the review of the Accounting Directives began. Later in the same year the European Parliament reiterated its support for a simplification initiative in this field[15].

The Commission published on 26 February 2009 a proposal for exempting micro companies[16] from the scope of the Fourth Directive. This proposal received strong

---

9 The Single Market Act flags as a key action in section 2.11 the simplification of the Accounting Directives as regards financial information obligations and reduction of the administrative burden, particularly for SMEs.

10 For more details see "European Commission: Simplifying the business environment for companies", available at http://ec.europa.eu/internal_market/company/simplification/index_en.htm

11 See Directive 2009/49/EC of the European Parliament and of the Council of 18 June 2009 amending Council Directives 78/660/EEC and 83/349/EEC as regards certain disclosure requirements for medium-sized companies and the obligation to draw up consolidated accounts (Text with EEA relevance), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009L0049:EN:NOT

12 See resolution of the European Parliament of 21 May 2008 (A6-0101/2008) on a simplified business environment for companies in the areas of company law, accounting and auditing (2007/2254(INI)), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0220+0+DOC+XML+V0//EN

13 See resolution of the European Parliament of 24 April 2008 on International Financial Reporting Standards (IFRS) and the Governance of the International Accounting Standards Board (IASB) (2006/2248(INI)), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0183+0+DOC+XML+V0//EN

14 For more details see http://ec.europa.eu/enterprise/admin-burdens-reduction/highlevelgroup_en.htm

15 On 18 December 2008, the European Parliament adopted a non-legislative Resolution stating that the Accounting Directives are "*often very burdensome for small and medium-sized companies, and in particular for micro-entities*". In the same Resolution the Commission was asked "*to continue its efforts to review the Fourth and Seventh Company Law Directives*".

16 See Proposal for a Directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities, COM/2009/0083, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52009PC0083:EN:NOT. The proposal defines Micro-Entities as companies which on their balance sheet dates do not exceed the limits of two of the three following criteria: balance sheet total: EUR 500.000, net turnover: EUR 1.000.000 and average number of employees during the financial year: 10.

support in the European Parliament[17]. Negotiations in the Council were still ongoing at the time of drafting this Impact Assessment. Proposals examined in this document should be seen as complementary to the 2009 proposal concerning micro-entities.

2.2. Consultation of Interested Parties

Since 2008 the Commission has continued to thoroughly consult with all interested parties. In particular, the following specific initiatives were undertaken:

- The setting up of an informal ad-hoc SME reflection group composed of 10 experts with diverse experience.[18]

- The conduct of two public consultations, respectively on the Review of the Fourth and Seventh Company Law Directives (February-April 2009) and on the International Financial Reporting Standard for Small and Medium-Sized Entities (November 2009 – March 2010). Both consultations were followed by stakeholders' meetings to consider and further discuss the results.

- Several targeted meetings with stakeholders, including national standard setters, representatives of small and medium-sized businesses, banks, investors and accountants across EU.

- Consultations with the EFRAG (European Financial Reporting Advisory Group) Working Group on SMEs and the Accounting Regulatory Committee (ARC) ad hoc Working Group on SMEs.

- A study into the effects on administrative burden from changes to Accounting Directives conducted in 2010 by the Centre for Strategy and Evaluation Services (CSES)[19]. The European Business Test Panel (EBTP)[20], a panel of enterprises set up by the Commission, was used to survey enterprises in the EU.

- A study on "Accounting requirements for SMEs, conducted by CNA Interpreta until 2011. The goals were (i) to provide an overview of existing accounting requirements and the perceived needs for accounting information from SMEs in Europe in the non-financial business economy from both the users' and preparers' point of view; and (ii) to come forward with concrete proposals on possible future accounting requirements for SMEs in the non-financial business economy[21].

These consultations indicated support from stakeholders for burden reduction measures, especially for the smallest companies, as well as a need to modernise the

---

17 Full text of the resolution adopted by the European Parliament is available at http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2010-0052&language=EN&ring=A7-2010-0011

18 The group, set up in the end of 2008 to prepare the review of the Accounting Directives, met five times between December 2008 and February 2009.

19 Full text of the CSES study on " 4th Company Law Directive and IFRS for SMEs" (hereinafter "CSES Study") is available at http://ec.europa.eu/internal_market/accounting/docs/studies/2010_cses_4th_company_law_directve_en.pdf

20 http://ec.europa.eu/yourvoice/ebtp/index_en.htm

21 http://ec.europa.eu/enterprise/policies/sme/business-environment/accounting/

European accounting framework. More details on consultations are provided in Annex 2. Diverging views were expressed with regard to a number of policy ideas, especially about the potential adoption of the IFRS for SMEs (see Annex 3). The outcome of these consultations has been taken into account in this Report.

Finally, an Impact Assessment Steering Group gathering all relevant Directorates General was set up and convened on three occasions[22].

2.3. Recommendations of the Impact Assessment Board

The opinion of 11 March 2011 of the Impact Assessment Board of the European Commission [23] on an earlier version of this impact assessment was that the report provided adequate evidence to demonstrate the potential of a burden reduction initiative in the area of accounting, although certain issues had to be explained in a more transparent and balanced fashion so as to inform decisions about its finer details. Firstly, the impact assessment had to more carefully assess and explain the negative or uncertain impacts of its options, in terms of: the value of regulated accounts information, transition costs, demand for accountancy-related services and cost of statistical data collection. Secondly, the impact assessment had to specify which Member States are likely to be most affected, referring to the take-up of existing derogations under the baseline scenario and later using this and other evidence to give some indication about Member States where SMEs are most likely to see practical benefits or costs. Thirdly, the impact assessment had to more fully record the differences in stakeholder views. Finally, the impact assessment had to clarify the political context and intervention logic by explaining at an early stage both how this initiative relates to the related pending proposal on micro-entities and what is considered to be essential information in the context of accounts.

The present document has been updated to take account of the above-mentioned comments, especially in Sections 3, 5, 6 and in Annex 6.

3. PROBLEM DEFINITION

Financial statements consist of a Balance Sheet, which presents a company's assets and liabilities at the end of an accounting period, and the Profit and Loss account which presents the income and expenditure for the accounting period. Financial statements also include Notes that provide more detail on certain items presented in the Balance Sheet and Profit and Loss account.

3.1. The purpose, use and benefits of financial statements

The Directives oblige limited liability companies as defined in Article 1 of the Fourth Directive and certain other companies to prepare financial statements. Financial statements assist investors in making informed decisions on the allocation of capital.

---

22 The Impact Assessment Steering Group (IASG) included members from the Secretariat General, Legal Service as well as the following DGs: Economic and Financial Affairs; Enterprise and Industry; Eurostat; Taxation and Customs Union; Employment and Social Affairs; Trade; Health and Consumers. The group met on 31st May, 14th December 2010 and 17th January 2011.

23 Please refer to the following site: http://ec.europa.eu/internal_market/accounting/index_en.htm for the full text of the opinion of the Impact Assessment Board.

They convey information to those stakeholders that otherwise do not have access to the financial information of a company. Such stakeholders include shareholders, creditors such as banks for whom the financial statements may provide evidence on the ability of a borrower to service debt, and also other parties interested in the financial performance and position of a company such as tax authorities, clients, suppliers and other business partners, factoring companies, credit rating agencies, employees and the public at large. Other public bodies, for example statistical offices, may use financial statements as a source of data for micro and macro economic purposes.

Absent a 'think small first" approach when designing the Directives, no common sense has been developed so far in the EU as to whether there should be limits to the level of accounting obligations to be required from the smaller companies. The Directives themselves contribute to require many items, disregarding the size of companies. Exemptions to these requirements are offered in a number of areas for small companies, but are optional for the Member States. Nothing in the Directives prevents that small companies follow the same regime as that of larger companies.

Based on literature and own analysis (see Annex 4), a clear distinction tends to appear depending on the size of companies. The Commission Services consider that micro / small companies on the one hand, and medium-sized / large companies on the other hand, have different problems that need to be addressed. Therefore the analysis that follows will categorize according to these size groups[24]. This is important to consider, as given the limited resources of especially small companies, the challenge is to match the reporting requirements with the information needs of users. Some users who do not incur the cost of providing information may want to see information of only marginal value i.e. information which is "nice to have"[25]. However the information needs of users differ, especially in relation to the size of a company.

---

24 See article 2 of Directive 78/660/EEC.

25 See e.g. Knutson and Wichmann, 1984

The thresholds for the different categories of companies used in this impact assessment, using the current definitions in the Accounting Directives and the proposed definition for micro-companies of 2009, are as follows (at least two out of three criteria must be met):

Table 1 - Thresholds for the different categories of companies.

Threshold \ Category	Micro	Small	Medium
balance sheet total	≤ € 500,000	≤ € 4,400,000	≤ € 17,500,000
Net turnover	≤ € 1,000,000	≤ € 8,800,000	≤ € 35,000,000
Average number of employees during the financial year	≤ 10	≤ 50	≤ 250

Source: The Fourth Directive 1978, Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing 2007. Proposal of 2009 for a Directive on micro-entities – 2009/0035 (COD)

Depending on the purpose of EU policies, the Union may use definitions that differ to a certain extent from the above[26].

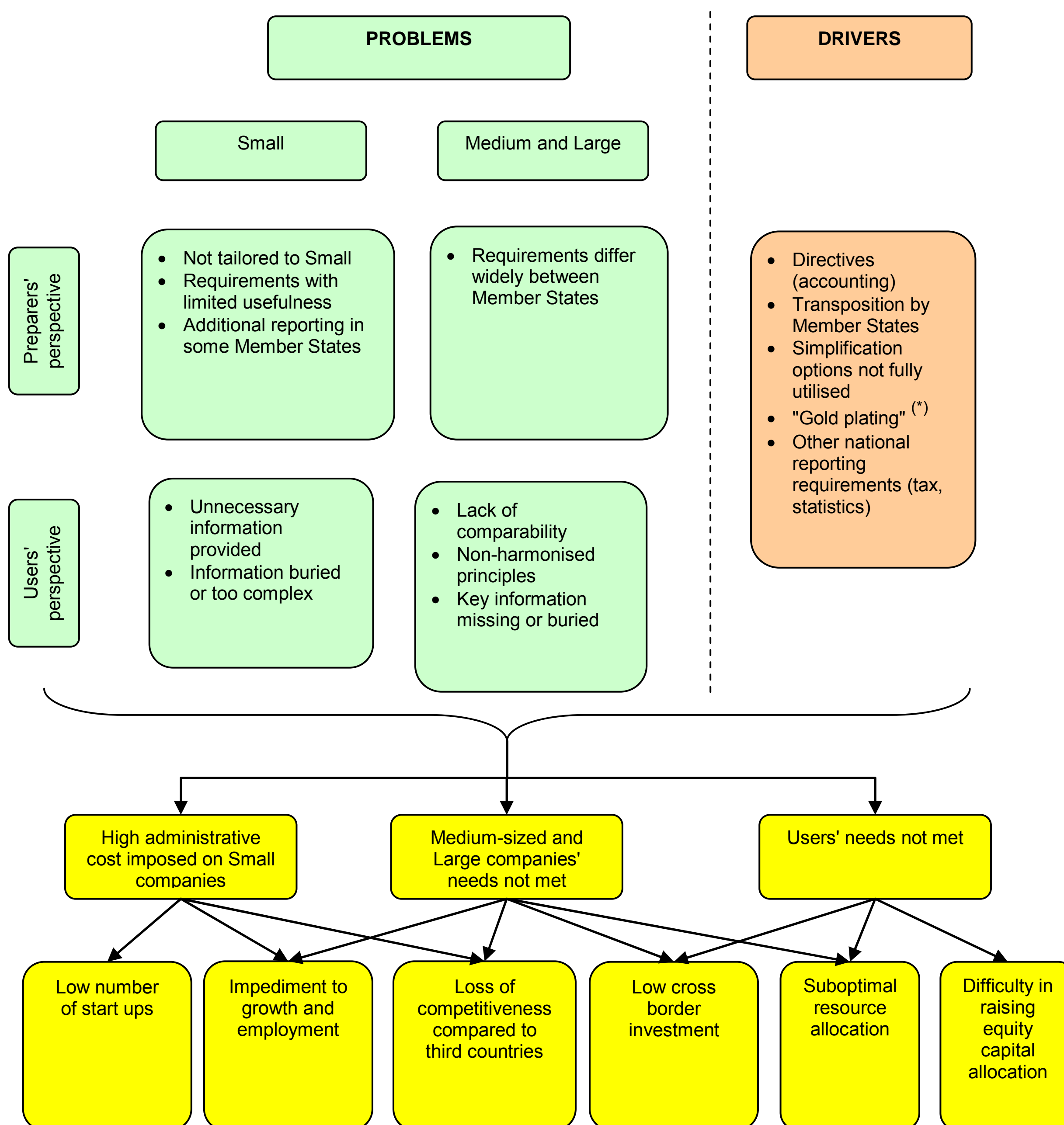
[26] For instance, the Commission promotes definitions of micro, small and medium-sized enterprises that are defined only for certain matters, such as State aid, implementation of the Structural Funds or Community programmes, particularly the Framework Programme on Research and Technological Development. These are given by the Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises [Official Journal L 124 of 20.05.2003]. Under this frame, a medium-sized enterprise is defined as an enterprise which employs fewer than 250 persons and whose annual turnover does not exceed EUR 50 million or whose annual balance-sheet total does not exceed EUR 43 million. A small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million. And a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million. See also http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

In addition, given that, in other economically comparable jurisdictions and key trading partners of the EU, financial reporting requirements for small companies are generally less demanding than those imposed currently by the Accounting Directives[27], it seems appropriate to also examine whether the current EU accounting regime for the smallest companies is unnecessarily complex.

[27] See Annex 1 for further analysis.

Figure 1 below provides an overview of the problems:

Fig.1 – Overview of key issues



Source: Commission own analysis

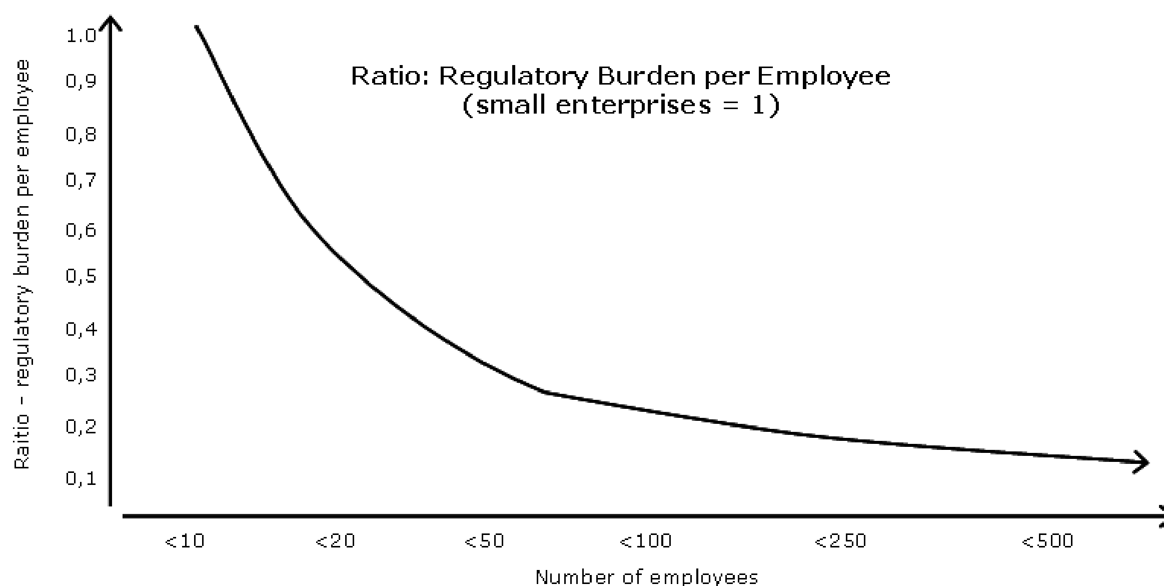
(*) 'Gold plating' is an expression used in the present impact assessment to describe the introduction by the Member States of accounting legislations that go beyond the EU requirements. Whether a Member State may make use or not of an option offered by EU legislation, including an option to exempt companies from an accounting obligation is not meant to be considered as 'gold plating'.

3.2. Preparers of financial statements: on the costs side

An expert group report[28] identified that on average, a business with fewer than ten employees has to face an administrative burden[29] (measured per employee) that is roughly twice as high as the burden of a business with more than ten but less than twenty employees and about three times as high as the burden of businesses with more than twenty but less than fifty employees. For bigger companies, the burden per employee is only one fifth or less of that of small enterprises. This is typically because a substantial part of the administrative cost is fixed.

In simple terms: where a big enterprise spends one Euro per employee to comply with a regulatory duty a medium-sized enterprise might have to spend around four Euros and a small business up to ten Euros. This is illustrated by Figure 2 below.

Fig. 2 - Administrative burden by company size



Source: European Commission. 2007. Report of the Expert Group. Models to reduce the disproportionate regulatory burden on SMEs, p. 17.

It appears that the relative burden tends to stabilize above 50 employees, which is one of the dividing lines between small and medium-sized companies in the Directive.

3.2.1. Rules not tailored to small companies

National measurements carried out in the years until 2006 and the results of the stakeholder consultation identified company law, including the fields of accounting

---

[28] See Report of the Expert Group, Models to reduce the disproportionate regulatory burden on SMEs, European Commission, 2007, pp. 16-17, available at http://ec.europa.eu/enterprise/entrepreneurship/support_measures/regmod/regmod_en.pdf

[29] Costs incurred only because of a legal obligation to provide information (without real business need to provide that information) constitute administrative burden. Such burden may arise not only from accounting, but also from other regulations such as tax, customs, social laws, etc.

and auditing, as one of the most burdensome areas of EU law[30] for smaller companies.

Recent studies[31] indicate that, given the numerous disclosure requirements currently in the Directives, the notes are laborious to comply with and preparing these represents the most time consuming part of the process especially for smaller companies. The notes are descriptive, require additional analysis and contain information that, most of the time, cannot be easily obtained from the accounting software. It is estimated that for small companies up to 50% of time spent on preparing financial statements is devoted to the preparation of notes. Even though the Member States are permitted to allow small companies to file abbreviated financial statements (a balance sheet with any notes pertaining thereto), the Directives require these same companies to prepare more detailed financial statements for their shareholders. The option offered to Member States to allow small and medium-sized companies to prepare abridged accounts does not prevent them from preparing fully fledged notes.

There is currently no general principle of materiality in the Directives. Materiality is a concept that would allow companies to dispense with separately presenting trivial or non-significant items in financial statements. Presenting non-material information entails unnecessary burden, and can lead to unnecessarily long and detailed financial statements.

3.2.2. *Requirements with limited usefulness*

The Directives require an Annual report from all companies, but allow the Member States to exempt small companies provided certain conditions are met[32].

Also, the Directives have a general requirement that the financial statements should be audited, whatever the size of the company. However, the Member States can exempt small companies. A number of Member States have chosen to not implement that option, leading to more than 170,000 small company statutory audits each year, at an annual cost of €0.5bn[33]. This has been identified as a burden by the High Level Group of Independent Stakeholders on Administrative Burdens, and is questioned in the Commission Green Paper on Audit of 13 October 2010[34].

---

30 13 priority areas for better regulation have been selected by the European Commission based on a 2006 pilot study, including Annual accounts/company law, see http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/priority-areas/index_en.htm. This has been used by the High Level Group of Independent Stakeholders on Administrative Burdens as a reference, see http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/high-level-group/index_en.htm. See also EU Project on Baseline Measurement and Reduction of Administrative Costs, by Consortium (Capgemini, Deloitte, Ramboll), hereafter "Consortium", available at http://ec.europa.eu/enterprise/policies/better-regulation/documents/ab_studies_2009_en.htm#h2-1 under heading Annual Accounts / Company Law

31 See in particular CSES 2010 and Consortium 2009

32 See Article 46 of Directive 78/660/EEC

33 Ibid

34 http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf, section 7.

3.2.3. *Requirements differ widely between Member States*

Currently there are around 80 significant options in the Fourth Directive on annual financial statements for Member States to choose, and about 40 options in the Seventh Directive on consolidated financial statements. Each option is utilized by at least one Member State.

Options generally relate to presentation, recognition, measurement and disclosure in financial statements. They often allow for totally different valuation rules, such as fair value or historical cost, or FIFO ("first in, first out") and LIFO ("last in, first out") method for stocks which results in financial statements that are not fully comparable. Furthermore options around presentation allow for different layouts to present accounting information. Differences can also be of more fundamental nature, such as whether the financial statements should reflect the economic reality of transactions rather than comply with their legal form[35]. More explanations on the "substance over form" principle are given in section 3.3.3 below.

This poses a problem for those companies that have subsidiaries in different Member States, as financial statements prepared under local accounting rules have to be reworked to produce consistent financial information suitable for the parent company to include in its consolidated financial statements. This also represents a non negligible hurdle to companies looking to expand their business cross border.

According to Eurobarometer[36], 19.9% of large and 8.2% of medium-sized enterprises have a foreign subsidiary, which contrasts with respectively 5.8% and 3.6% for small and micro enterprises. Additionally almost every third large (27.3%) and every fifth medium-sized (19.5%) company is a subsidiary itself, while these figures drop to 8.8% and 4.1% for small and micro ones respectively.

Whilst the Directives currently contain some simplified measures for smaller companies the Member States can set lower thresholds than those provided for in the Directives when defining small or medium-sized companies locally. As a result, companies that would be considered as small under the Directives are considered as medium-sized or even large companies under national law in many of Member States. These companies face more regulatory burden than that foreseen at EU level. Only eight Member States have transposed or are about to transpose the maximum amounts of turnover, balance sheet and headcount allowed for in the Directives[37]. Other Member States may use slightly to significantly lower amounts. This also affects competition between companies in the EU as the disclosure of sensitive business information can differ from one Member State to another for companies of the same size.

Options offered by the Directives to the Member States represent therefore an issue for many companies across the EU.

---

35 See Article 4(6) of Directive 78/660/EEC.

36 Eurobarometer 2007, Observatory of European SMEs. Analytical report, pp. 56 and 100.

37 See Commission survey at http://ec.europa.eu/internal_market/accounting/docs/2010-options_en.pdf

3.3. Users of the financial statements: on the benefit side

3.3.1. Unnecessary information

The literature and analysis support the comments from stakeholders that the financial statements often contain information that is of little relevance. This is especially the case with the standard disclosures required by the Directives[38], most of which are not used by banks or other stakeholders – banks often ask for other information instead. Feedback from stakeholders and expert groups[39] suggests that a number of these notes have only little informative value to stakeholders. This is also supported by literature on the SME user needs[40]. In short, for smaller companies the costs of preparing sophisticated and complex statutory financial reporting usually outweighs the benefits for the users.

In addition, absent a general principle of materiality in the Directives, as seen above, the chances of unnecessary information being produced are higher.

3.3.2. Key information hidden in notes due to numerous or complex disclosures

For the users of smaller company financial statements, over-sophisticated and complex reporting requirements are less useful than simple and clear ones. Discussions with stakeholders suggest that the current complexity of financial statements can make them meaningless for small entrepreneurs. They often cannot understand the content of the financial statements without the advice of an analyst or accountant. Thus the usability of the financial statements for micro and small companies is reduced both for owners and for business partners. This lends support to the idea that small companies' accounting requirements should be simplified.

3.3.3. Lack of comparability, key information missing due to high number of options and non harmonized principles

Because of the many options currently available to the Member States in the Directives, national accounting legislations are inconsistent in a number of areas across Europe. Non-harmonised principles can result in similar transactions being accounted for very differently across the EU. Both issues increase the lack of comparability of financial reporting across the Member States and hence can prevent optimal cross border investment decisions by the users.

Depending on the option retained, this may entail in addition key information to be missing in the financial statements.

For example, the "substance over form" principle is currently an option. This means that the Directives allow transactions to be accounted for according to their

---

38 For example, small companies can be required to disclose particulars of share capital, which would already be in the public domain, having been filed at the Companies' Register. A further example: small companies can also be required to disclose details of deferred tax assets and liabilities, when the whole concept of deferred tax is not generally understood by the users of small company financial statements.

39 Namely the EFRAG SME Working Group, http://www.efrag.org/wg/detail.asp?id=67, and the ah hoc Working Group on SMEs established within the framework of the Accounting Regulatory Committee (ARC)

40 See in particular Eierle et al, 2009

commercial substance (or economic reality) or alternatively according to their *legal form.* This can lead to quite different presentations of similar transactions from one company to another. Leasing transactions are a good example of where the legal form and commercial substance of a transaction can differ quite markedly. Take the example of a lease of a machine over its useful life: the legal transaction is a commitment to make a series of periodic payments to the lessor over the life of the lease. The commercial substance is tantamount to the purchase of the machine using long-term finance. Accounting for the substance of such a transaction would mean recognising the machine as an asset in the balance sheet and the future payments as a liability. In contrast, accounting for the legal form would only see the periodic lease payments being charged as expenses in the profit and loss account - the lease would not be reflected in the balance sheet.

3.4. Drivers

3.4.1. Directives

When the Accounting Directives were developed they were focused mainly on the needs of large and listed companies. Some regard was given to needs of the users of SMEs financial statements – though clearly not enough – as at the time the prevailing idea was that SMEs were not fundamentally different from large companies and should therefore follow similar financial reporting requirements.

3.4.2. Varied rules as a result of Member States' transposition

Since the Directives offer options, leeway in defining company sizes or layouts, etc., the transposition by the Member States result in a very varied accounting landscape within Europe.

The analysis of the implementation of these options[41] shows clearly that many Member States do not fully apply them. Moreover, they have often chosen lower thresholds than those in the Directives when defining the size of small and medium-sized companies locally.

The table below provides an analysis of how key aspects of the Directives regarding simplification have been implemented. Key aspects include the definitions of small or medium-sized companies, and the use of key exemptions offered to the Member States such as on notes, annual report or statutory audit.

---

[41] See Commission survey at http://ec.europa.eu/internal_market/accounting/docs/2010-options_en.pdf

Table 2 – Analysis of the use of main simplification options by the Member States

	TRANSPOSITION OF THRESHOLDS			NOTES	ANNUAL REPORT		AUDIT	
	MEDIUM-SIZED COMPANIES Member State where medium-sized companies are not defined, or defined with much lower thresholds than the Directive	SMALL COMPANIES Member States where the thresholds are lower than half those of the Directive, or where small companies are not defined	SMALL COMPANIES Member States where the thresholds are below maximum, but higher than half those in the Directive	SMALL COMPANIES Member States which have made no or only moderate use of exemptions on notes offered by the Directive (*)	MEDIUM SIZE COMPANIES Member States requiring disclosure of the full set of notes	SMALL COMPANIES Member States where there is no exemption to prepare an annual report	SMALL COMPANIES Member States where an audit is required for any small company	SMALL COMPANIES Member States where an audit is required only for certain types of companies (i.e. public limited, non micro)
AT **Austria**								▲
BE **Belgium**	▲		▲					
BG **Bulgaria**	▲	▲						
CY **Cyprus**			▲	▲	▲	▲	▲	
CZ **Czech Republic**	▲	▲		▲				
DE **Germany**								
DK **Denmark**							▲(**)	▲
EE **Estonia**	▲	▲		▲	▲	▲	▲(**)	
EL **Greece**	▲		▲	▲		▲		▲
ES **Spain**			▲	▲				
FI **Finland**	▲		▲	▲			▲ (**)	
FR **France**	▲	▲		▲		▲		▲
HU **Hungary**	▲	▲					▲(**)	
IE **Ireland**			▲	▲		▲		
IT **Italy**	▲							
LT **Lithuania**	▲	▲			▲			
LU **Luxemburg**								
LV **Latvia**	▲	▲				▲		
MT **Malta**			▲				▲(**)	
NL **Netherlands**								
PL **Poland**	▲	▲		▲	▲	▲		▲
PT **Portugal**	▲	▲			▲	▲		▲
RO **Romania**	▲		▲	▲	▲	▲		
SE **Sweden**	▲		▲	▲		▲	▲ (**)	
SK **Slovakia**	▲	▲		▲	▲			▲
SL **Slovenia**					▲	▲		
UK **United Kingdom**						▲		

Source: survey on Member States published by the European Commission in 2011 ▲: policy tends to increase burden

(*) Member States which have made use of less than half of the exemptions offered on notes by Article 44 of Directive 78/660/EC
(**) whereas an audit is required for small companies, micro-companies are exempted based on thresholds locally defined

Asked about the reasons for not making full use of the options available in the Accounting Directives, Member States put forward the differences in economic, cultural, accounting traditions, the varied legal systems, as well as the influence of taxation and statistical systems. It is pointed out that the financial statements may serve different purposes in Member States, which explains why some options are not used. Many countries apply lower thresholds levels as they consider the Directive's maximum levels are too high for their economies[42].

3.4.3. *'Gold plating'*

The term 'Gold plating' describes requirements imposed on companies by the Member States beyond the requirements imposed by EU legislation, as defined in section 3.1. Not using an option offered by the Directives should not be regarded as 'gold plating'. 'Gold plating' in the area of accounting is estimated to give rise to 1.6% of the total administrative burden faced by companies in the EU[43].

3.4.4. *Other local reporting requirements*

EU limited liability companies also face other local financial reporting requirements in addition to those stemming from the Accounting Directives, such as tax and

[42] Consultation of 2009 on the Review of the Accounting Directive, p8.
[43] See Consortium, 2009, p 324-328.

statistical reporting. This has been flagged by respondents to public consultations as a source of considerable burden on companies.

In a recent Commission survey, 17 Member States stated that in their jurisdiction tax valuation and measurement rules cannot be fully used in company financial statements, or vice versa. This means that companies have to prepare additional statements, or reconciliation statements in addition to their financial statements to satisfy the information needs of tax or other authorities. Indeed, 9 Member States require customized reports for tax purposes. Tax laws sometimes use recognition and valuation methods that are different from those used in general purpose financial statements. For example, Member States often allow for accelerated depreciation of certain assets in taxation in order to promote investment. Timing differences on the recognition of certain types of income and expenditure can also give rise to deferred tax assets and liabilities in the financial statements.

In 11 Member States, special statements need to be sent to the statistical authorities and in 9 Member States there are also other governmental institutions that can demand specific reports from companies.

Many respondents to the Commission consultations called for a "one-stop-shop" reporting environment where one set of financial statements could satisfy all the reporting needs of especially micro-entities, but also small companies. While the review of the Accounting Directives can facilitate the creation of a single reporting environment this can only be actually established at Member State level due mainly to differences in reporting requirements coming from other fields of non-harmonised legislation (such as tax).

3.5. Impact of the micro economic problems on the macro level

The problems discussed above may have an impact not only at a micro economic but also on a macro economic level. Companies, in particular SMEs, have indicated that the increased complexity and the widening scope of accounting requirements have led to extensive costs and/or use of resources.

Unnecessary and disproportionate administrative burden imposed on small companies obviously hamper economic activity. This is especially true for start-up businesses and small enterprises with limited administrative and financial resources which are sensitive to excessive administrative obligations. This results in a lower number of start-ups and less economic activity in the EU.

High levels of administrative burden can be an impediment to growth and increased levels of employment in existing companies. Resources consumed by administrative work are resources diverted away from the core business, especially for small companies. Disincentives to growth means unutilized economic potential within the EU in terms of job creation, innovation and it also means competitive disadvantage vis-à-vis third countries.

Differing accounting regulations pose a barrier to cross-border activity. For a company, to have subsidiaries in different Member States, it must be able to deal with different accounting regimes and reconcile the figures calculated on different bases to produce meaningful consolidated financial information.

For investors, a lack of comparability in financial reporting makes cross-border investments more difficult and risky. As a result, the allocation of capital in the EU is potentially sub-optimal and the full potential of a single market may not be exploited.

3.6. How large is the problem?

According to the latest available data there are around 7.3 million companies within the scope of the 4th Directive on annual financial statements and around 150,000 within the scope of the 7th Directive on consolidated financial statements. There are also around 7,400 companies that follow IFRS.

Table 3 - Number of companies in the scope of the 4th and 7th Directive and the IAS Regulation

Directive	Micro	Small	Medium-sized	Large	Total
4th Directive on Annual Financial statements*	5,936,774	1,117,214	245,431	45,301	7,344,720
7th Directive on Consolidated financial statements**	86,748	33,657	12,365	14,095	146,865
IAS Regulation	~150****	≤ 1,100****		≥ 6,115****	7,365***

Source:

* *CSES 2010*

** *Consortium 2009*

*** *European Commission. 2008. Report from the Commission to the Council and the European Parliament on the operation of Regulation (EC) No 1606/2002 of 19 July 2002 on the application of international accounting standards. p. 5'*

**** *Commission estimation based on EC.2008 (number of companies) and ICAEW 2007[44] p. 35 (turnover data)*

All these companies face administrative burden as a result of obligations imposed by the Accounting Directives. The information required for the preparation of a small / medium-sized company's balance sheet and profit and loss account can, to a large extent, be taken directly from the in-house accounting system. The notes, which often require professional accountant's involvement, need more time to produce and constitute a major cost element, representing around 50% of the cost of preparing financial statements for micro and small companies and 30% for medium and large companies[45].

Any company would incur some of these costs anyhow, for internal use or to provide the necesary information to its shareholders, business partners and other interested parties on its financial performance and position: these are Business As Usual costs ("BAU"). Costs incurred only because of a legal obligation to provide information (without real business need to provide that information) constitute administrative burden. As presented in the table below administrative burden as a percentage of

[44] See http://ec.europa.eu/internal_market/accounting/docs/studies/2007-eu_implementation_of_ifrs.pdf

[45] See CSES study, p. 39

total administrative cost is highest for smaller companies. The numbers below relate to cost incurred in addition to the regular bookkeeping cost.

Table 4 - Annual administrative cost and burden per company from the Accounting Directives

Directive	Micro	Small	Medium-sized	Large	Average
Administrative cost (€/company)	1,558	2,799	16,660	61,878	2,756
Administrative burden (€/company)	1,169	1,555	4,290	0	1,363
Administrative burden (% of administrative costs)	75%	56%	26%	-	49%

Note: regular bookkeeping costs are not included

Source: Consortium 2009

As shown in the table below, the estimated total cost related to the requirements coming from the Accounting Directives stands at €19.4bn annually, half of which constitutes an administrative burden. Around 65% of the total costs and 90% of the total burden are incurred by micro and small companies.

Table 5 - Total annual administrative cost and burden from the Accounting Directives (€bn)

Directive	Micro	Small	Medium-sized	Large	Total*
Administrative cost (€bn)	9.3	3.1	4.1	2.8	19.4
Administrative burden (€bn)	6.9	1.7	1.1	0.0	9.8
Administrative burden (% total)	*71%*	*18%*	*11%*	-	*100%*

Note: regular bookkeeping costs are not included

* Total contains additional cost/burden of €0.09bn that could not be split into segments

Source: Consortium 2009 (cost/burden per company), CSES 2010 (population)

The proposal for a Directive in 2009 on micro-entities[46] already strives to ease the burden on micro-companies. The main focus should now be on small, medium-sized and large entities.

[46] Proposal for a Directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities, COM/2009/0083

3.7. Subsidiarity and proportionality

Financial reporting in the EU has been regulated by the Accounting Directives for the last 30 years. As seen above, many of the problems we describe find their origin in the Accounting Directives and their transposition at Member State level.

According to the subsidiarity principle the EU should act only where it can provide better results than intervention at Member State level. In addition, the preferred options identified in this document should be limited to what is necessary in order to attain the objectives laid down in Section 4, and comply with the principle of proportionality, including where maximum harmonisation is envisaged.

It seems that due to their increased level of cross-border activity and relatively low number of stakeholders, small companies would need basic EU level requirements, however less burdensome than under the current Directives. In order to ensure that small companies in the EU do benefit from simplified regimes under a "think small first" approach, there is a need to ensure that companies of similar sizes are treated equally across the EU, and that Member States do not require more than necessary i.e. "gold plate". This can be best achieved through EU law, whilst any necessary latitude can be given to the Member States within pre-defined limits. Regarding medium-sized and large companies, financial reporting needs to be further harmonized and made more comparable at EU level as their activities and stakeholders are more often EU wide. EU instruments appear to be more suitable in achieving such a goal than individual action by the Member States. However Member States should have a degree of leeway to add to EU requirements for this type of company.

Table 6 - Desired level of regulation by company size

	Small	**Medium-sized**	**Large**
external stakeholders	few	many	many
Cross-border activity	limited	Moderate / active	active
	⇩	⇩	⇩
EU level regulation	basic	minimum harmonisation	minimum harmonisation
Member State level regulation	limited	moderate	advanced

Source: Commission Services analysis

4. OBJECTIVES

In line with the overarching objective of improving the business environment for EU companies, the review of the Accounting Directives aims at (1) reducing the administrative burden on companies that are relatively small in size to free up

resources for growth and employment creation; (2) increasing the effectiveness, relevance and understandability of financial reporting; and (3) protecting the needs of users. The improvements should facilitate the functioning of the EU Single Market by encouraging cross-border business activities.

In order to achieve the three specific objectives listed above, the review intends to:

- Simplify and eliminate burdensome requirements for small companies. Many requirements are not particularly necessary for the users of the financial statements of these companies or do not meet the cost / benefit test;

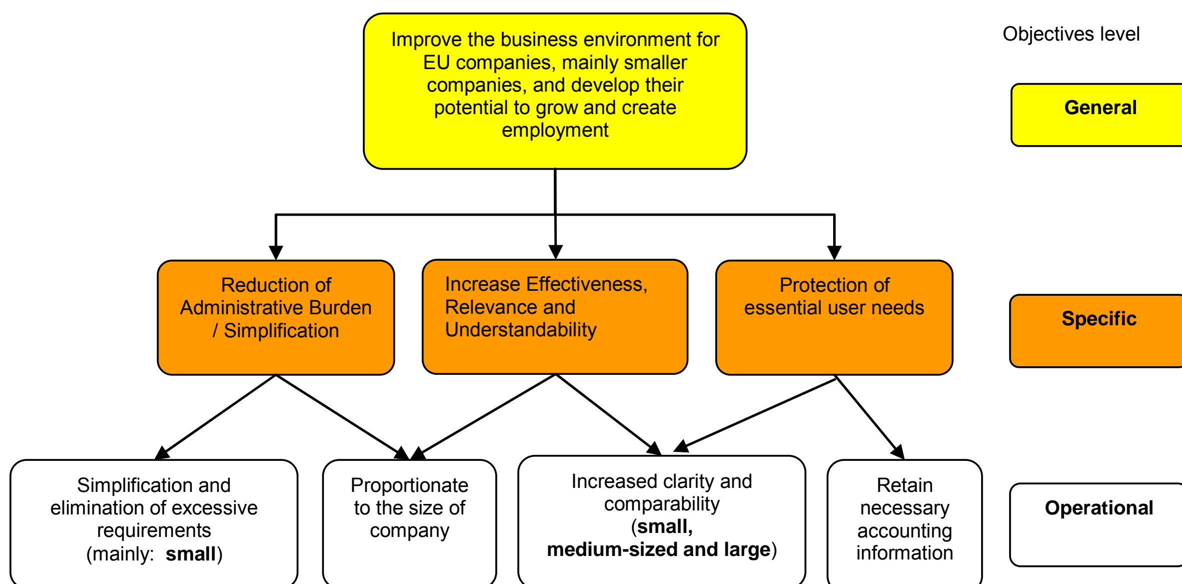
- Make requirements proportionate to the size of the company. In practical terms, in the context of the review, an 'additive' approach should be implemented (starting with the requirements for small companies, then adding requirements for medium and large companies) rather than the currently applied 'subtractive' approach (starting with the requirements of large companies then eliminating requirements for medium-sized and small companies);

- Increase the clarity and comparability of financial statements. The current level of complexity is partly the result of a very high number of Member State options in the Directives;

- Maintain the information value of financial statements so that they remain useful to users.

The hierarchy of objectives is summarised in the chart below:

Fig. 3 – Overview of objectives



Source: Commission Services analysis

5. POLICY OPTIONS

In order to meet the objectives set out in Section 4 the Commission services have identified and considered a number of policy options.

The financial information needs of different users may vary significantly and there is no single solution to all information needs i.e. no "one size fits all". Moreover, the limited administrative resources of small and medium-sized companies cannot accommodate all the needs of potential users. Deciding on the most relevant information needs and defining to what extent they should be served is therefore always a matter of policy judgement. Especially in the case of small and medium-sized companies, a balance needs to be struck on how to sufficiently serve the most relevant needs of users and at the same time efficiently use the limited resources (i.e. reduce the administrative burden) of these companies.

Proposals examined in this section should be seen as complementary to the 2009 proposal concerning micro-entities.

The possible policy options are discussed in detail in two sub-chapters below which consider, first, the **broad policy options** and the choice of **legal instrument** to be used (section 5.1.) and, second, a choice of **specific policy options** in the context of the review of the Accounting Directives (section 5.2.). Nine specific policy options are examined in a comprehensive way in Annex 6.

5.1. Broad policy options

5.1.1. No change to the requirements of the Accounting Directives (baseline scenario)

In the baseline scenario no action would be taken and all EU limited liability companies would continue to follow unchanged accounting rules based on the Directives with the exception of micro entities. For this category of companies the Commission published on 26 February 2009 a proposal for exemption from the scope of the Fourth Directive. The negotiation of this proposal by the co-legislators was still ongoing at the time of drafting this Impact Assessment.

Consultations have revealed that many stakeholders seem to be broadly content with the current framework which has, on the whole, functioned well over the years. However they do see room for simplification, especially to benefit the smallest companies. A public consultation carried out in 2009[47] showed that users and public authorities seemed most satisfied with the current rules, whilst preparers were the most dissatisfied.

From discussions with Member States it is clear that some Member States do not see a need for fundamental changes to the Accounting Directives. They are satisfied with the current system while others have recently modernised their own accounting rulebook. For instance, in 2009, Germany introduced a new accounting law (BilMoG) that reduced the number of options and provided additional simplification for small companies compared to the previous framework[48]. Other countries have all

47 See Summary report on the responses received to the Consultation paper on the review of the Accounting Directives, p.7, available at http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf

48 On overview of the main changes introduced by the German Accounting Law Modernization Act (BilMoG) approved by the German parliament on 26 March 2009 is available at http://www.ey.com/Publication/vwLUAssets/Broschuere_BilMoG_englisch/$FILE/Broschuere_BilMoG_englisch.pdf. Full text is available at

but reached the limits of simplification possible under the current Directives. For example, the Danish accounting law introduced back in 2001 created a building block model that focuses on small businesses[49]. The UK FRSSE is also an example of modern accounting designed for small companies, and has been in force since 1997[50]. The 2009 Commission consultation has also highlighted that the relative stability of EU accounting law is seen as an advantage.

However, there are flaws of the current regime, as presented in Chapter 3 above, which the baseline scenario will not address effectively. First of all, the current administrative costs stemming from the Directives for European companies are around €19.4bn annually. Half of this amount is a burden that impinges primarily on the smallest companies. It is not expected that market and national regulatory developments would achieve a substantial decrease in administrative burden without a change. The proposal for a Directive of 2009 already strives to ease the administrative burden on micro-companies. There has been so far no proposal regarding small companies, whereas they incur 18% of the burden.

The discrepancy between preparers' and users' needs would remain together with the resulting administrative burden. This option would not make improvements to the clarity of the Accounting Directives, nor the comparability of financial statements prepared following national laws based on the Directives.

The smallest companies in the EU would continue to needlessly spend resources complying with some excessive reporting requirements. Furthermore, all companies within the scope of the Directives would still be obliged to comply with some less pertinent requirements stemming partly from EU requirements and partly from requirements added by the Member States. At present there are around 120 significant Member State options in the Directives that hamper the intra-EU comparability of financial statements – these would remain.

For an analysis of how effectively this option may achieve the objectives and how it compares with the other options, please refer to the table in section 5.1.6.

5.1.2. *Better use of existing options in the Accounting Directives by Member States*

Not all possible reductions of administrative burden would require changes to the Accounting Directives. Even if no legislative changes were made, the Commission could nevertheless call on Member States to utilise all the simplification options already available in the Directives. Many options target small and medium-sized companies and could in theory produce burden reduction in those Member States which have not fully made use of them[51].

---

http://www.bgbl.de/Xaver/start.xav?startbk=Bundesanzeiger_BGBl&bk=Bundesanzeiger_BGBl&start=//*%5B@attr_id=%27bgbl109s1102.pdf%27%5D

49 See http://www.eogs.dk/graphics/Regnskab/Regnskabslov_en.html

50 See http://www.frc.org.uk/asb/technical/frsse.cfm

51 A recent analysis in Sweden shows, for instance, that a full use of all options and threshold levels would reduce the administrative burden by 20%, see SOU,2008, Enklare redovisning. SOU 2008:67, p.176, available at http://www.regeringen.se/content/1/c6/10/76/85/4f21026a.pdf

A recent Commission survey[52] on the use of the options in the Accounting Directives by the Member States reveals that:

- All options are used at least once, but each Member State uses a different set of options;
- The thresholds for exempting small and/or medium-sized companies from certain requirements may not always be transposed. When transposed, they are often set by the Member States at a lower level than that possible under the Directives[53].

A wider use of the existing options in the Accounting Directives could be encouraged via a range of policy tools. Encouraging the use of current options by a non-binding instrument would avoid the time delay associated with the normal legislative procedure. However, there is no guarantee when, if ever, any recommendations would have effect on the accounting requirements set by the Member States, as Member States could simply ignore such recommendations.

At the same time, it must be noted that the characteristics of national economies, as well as the accounting and business cultures are different. The 2009 Consultation also identified that reasons for not taking advantage of options include differences in economies, culture, accounting traditions and legal systems, as well as the influence of taxation and statistical systems[54]. The options in the Directive were introduced precisely because there were different accounting legacies in Member States, and the Fourth Directive was one of the longest to negotiate. Without changes to the Directives, it may be very difficult to convince Member States to give up their options and pursue a standardised approach towards the use of all options and maximum threshold levels. The estimate by a consultant of the potential savings from the full use of permitted thresholds and exemptions amount to at least €0.7bn for small to large companies (See Annex 5).

In addition to the requirements of the Accounting Directives, Member States can impose national rules ("gold plating") that further increases the burden on the smallest companies. These additional requirements are estimated to amount to a further €0.3bn of burden per year for all companies. For an analysis of how this option compares with the objectives and the other options please refer to the table in section 5.1.6.

5.1.3. *Revision and modernisation of selected requirements currently in the Accounting Directives*

This approach would recognise the fact that the Directives have served as a solid foundation for financial reporting rules in the EU for three decades. At the same time, it would provide an opportunity to revisit the relevance of certain sections,

---

[52] See Commission survey at http://ec.europa.eu/internal_market/accounting/docs/2010-options_en.pdf

[53] Medium-sized companies: maximum allowed levels are transposed by only 9 Member States and 14 Member States do not use the exemption for medium-sized companies at all; small companies: maximum allowed levels are transposed by only 8 Member States and 2 Member States do not use the exemption for small companies at all.

[54] Summary Report of 2009 on the responses received to the Consultation paper on the review of the Accounting Directives, p8

based on recommendations from stakeholders. Notably, the current requirements could be reconsidered in terms of company size (proportionality) based on the needs of users.

Stakeholders have commended the partial harmonisation in financial reporting brought about in the EU by the Directives. At the same time, they broadly agree that a degree of simplification is necessary, especially for small companies. A "bottom-up" approach was also broadly supported in the 2009 public consultation. Support was highest amongst preparers, accountants and auditors (around 85%) and was above 60% in all other groups[55].

The opinion of banks as a major source of financing is particularly important. This stakeholder group requires a significant amount of information from companies and it has the power to ask for additional information to what is made available publicly. The CSES study[56] reveals that of the external stakeholders of companies, banks are the most likely to require more information in addition to what is contained in statutory accounts. In general terms, the banks and national banking associations interviewed for the study were of the opinion that the Directives have worked well for the last 30 years – they could be completed and modernised but not simplified.

In the same study, the accounting associations and accounting firms interviewed are of the view that many of the requirements in reporting are driven by tax or statistical authorities and it is likely that much of the information will be collected anyway. Accounting associations surveyed in the context of the study are, however, supportive of simplification and modernisation as long as the value of the financial information provided is not reduced.

In the context of a partial revision, the requirements for small companies could be reconsidered with a view to relaxing some of them to achieve administrative burden reduction.

This option would provide a possibility to strike a better balance between general principles and detailed provisions. The general underlying principles could be included in a dedicated section in the Directive. Additional principles, such as "materiality" and "substance over form", could be added[57]. Lesser used Member State options could be removed in order to obtain a shorter, more comparable and simpler EU accounting framework. One example could be a reduction in the number of layouts for the balance sheet and the profit and loss account.

The downside to this approach compared with the previous options is that it would take some time to negotiate (via the ordinary legislative procedure) and that the outcome of these negotiations would be uncertain.

The estimated potential for annual savings from this partial revision option is €1.7bn. This excludes the impact the proposal for a Directive of 2009 may have on micro

---

55 Ibid., p. 6 of the Summary Report

56 See footnote 20

57 “Substance over form” and “materiality” were the most commonly cited principles by respondents to a public consultation – See Summary Report on the Responses Received to the Consultation Paper on the Review of the Accounting Directives, 2009, p6.

companies. There would be one-off transition costs arising mainly from changes to layouts and disclosure requirements. These transition costs would, in our estimation, be shared among the firms concerned, software developers and accounting professionals. How exactly they are shared would depend on the environment in which the company operates. Based on estimations in the CSES study the Commission Services conclude that the one-off transition costs could not exceed a single year's savings[58] and in all likelihood they would in reality chip off only a fraction of the first year's savings. It is also possible that the one-off transition costs arising from the update of EU legislation in the field of accounting would be bundled with more general needs for professional training and software update.

For an analysis of how this option compares with the objectives and the other options please refer to the table in section 5.1.6.

5.1.4. Create a wholly new EU accounting framework and adopt the "International Financial Reporting Standards for SMEs" for mandatory use within the EU

Another option would be to implement the IFRS for SMEs (see Annex 3) at a European level for all companies except micros. This would allow replacing the current Accounting Directives by a less extensive legislative framework. Some form of approval mechanism and endorsement procedure would need to be established at EU level, possibly similar to the one currently used for the endorsement of IFRS.

With regard to the benefits of using the IFRS for SMEs, many respondents to the 2009 public consultation[59] commented that its use would allow intra European and international comparison of financial statements, and that could lead *inter alia* to easier access to finance, reductions in the cost of capital, increased trade, and increased levels of cross-border merger and acquisition activity. International groups that would be eligible to use it could see compliance costs fall and an increase in information usefulness from dispensing with different local reporting regimes. There have been mixed reactions to the IFRS for SMEs among the Member States'

---

[58] The CSES study quantified one-off set-up costs arising from the need to change systems for the simplification of accounts layout and to make other changes to implement some new disclosure requirements. There is not always an exact correspondence between the measures proposed in the study and the proposal presented in this impact assessment. However, where there is a slight mismatch, one can use the study as a proxy to assess the impact on transition costs of the main options examined in the present document. To give an idea about the relationship between the set-up costs and the first year's annually savings in the study, a small company would save EUR 738.9 on the simplification of layout and alleviating disclosure requirements as described in the study while it would spend on a one-off basis EUR 448.9 on setting up these changes (this is 61% of its first year savings).

[59] A consultation on IFRS for SMEs carried out in 2009 shows that respondents from 13 Member States would generally favour a widespread use of IFRS for SMEs in the EU, whilst respondents from 9 other Member States would not. Supporters argued that the Standard is best suited for Large and Medium-sized companies, for international groups and subsidiaries of companies reporting under full IFRS as well as for companies active internationally, listed on non-regulated markets, seeking foreign financing or "non publicly accountable" (as defined in the IFRS for SMEs) due to enhanced ability to invest and trade cross borders. Opponents stressed the complexity of the Standard, and underlined the cost of changing accounting rules. See web page: http://ec.europa.eu/internal_market/consultations/2009/ifrs_for_sme_en.htm. A summary report of the public consultation is available at http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-31_ifrs_sme_consultation_summary_en.pdf. Full text of the minutes of a subsequent stakeholders event is also available at http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-25-ifrs-sme%20meeting_minutes_en.pdf

authorities but several of them are entirely against its endorsement for use in the EU, especially those that have recently reformed their domestic legislation or have a close link between taxation and accounting.

Others opined that the IFRS for SMEs would be too complex and costly for small businesses, whist being too simple for the largest businesses eligible to use it. The cost of changing accounting systems and re-training staff was also raised as an issue. In countries where there is presently close alignment of tax and accounting some were concerned that adopting the IFRS for SMEs could increase compliance burdens rather than reduce them. For enterprises that are active only locally it was pointed out that there is little need for the international comparability that the IFRS for SMEs could bring.

The table below provides an overview of the estimated implementation costs of introducing the IFRS for SMEs as a European accounting standard. The estimates come from a study recently completed by CSES. Introducing IFRS for SMEs for all companies except micro-companies would induce additional costs in the region of €0.16bn.

Table 7 - Additional cost due to introduction of IFRS for SMEs

	Small (excluding micros)	**Medium-sized**	**Large**	**Total**
Annual additional cost per company (€)	116	97	145	n/a
Set up cost per company (€)	147	228	166	n/a
Total additional annual cost for entire population (€ million)	130m	24m	6m	160m

Source: CSES 2010

The main advantage of introducing the Standard would be the creation of a harmonised system of financial reporting. This was also the main advantage of introducing IFRS for the consolidated financial statements of listed companies in 2005. Introducing the IFRS for SMEs would certainly address the objectives of clarity and comparability, whilst maintaining the necessary information value of financial statements.

However, it would not serve the objectives of simplification and reduction of administrative burden as seen above. Furthermore, the IFRS for SMEs is a new standard (released in July 2009) and its implementation worldwide is still going on and to be assessed. The opinion of stakeholders towards the IFRS for SMEs is also mixed with, as said above, many public authorities in the EU strongly opposed to it. Overall, we can conclude that there is no sufficient support nor evidence for introducing the IFRS for SMEs at EU level as an alternative to the Accounting Directives.

It does seem likely that certain Member States will adopt the IFRS for SMEs, in an amended form due to inconsistencies between the requirements of the Directives and the Standard, insofar the Directives and the IFRS for SMEs would be inconsistent (current inconsistencies are listed in Annex 3). However the requirements of the Directive would still have to be followed.

For an analysis of how effectively this option may achieve the objectives and how it compares with the other options, please refer to the table in section 5.1.6.

5.1.5. *Repeal the Directives and let the Member States put in place whatever basic accounting regime they choose for unlisted companies*

In this scenario, no administrative burden would be placed on companies at the EU level as there would be no EU-wide financial reporting requirements. This scenario would theoretically reduce the compliance costs stemming from EU legislation for companies down to zero.

However, the *raison d'être* for the Accounting Directives is to establish the requirement for limited liability companies to prepare financial statements and set minimum requirements in order to improve the EU-wide comparability of financial statements. This, in turn, should lead to a better functioning of the Single Market and, more concretely, to an increased confidence in financial statements and reports, to better access to finance, reductions in the cost of capital and increased levels of cross-border trade, merger and acquisition activity. Medium-sized and large companies have more external stakeholders and cross-border activities, hence the benefits described above are more pronounced in their case.

This option would allow in theory to reduce the burden down to a minimum, as the Member States would be given full latitude to achieve this. As a result, the potential for administrative burden reduction amounts in theory to the total burden identified in Table 5, i.e. € 9.8 bn including micro-companies, or €2.8bn excluding micro-companies. The discussions with Member States and the experience as regards the use of the current simplification options has shown however that if the EU accounting requirements were to be abolished, a large majority of the Member States would retain the current or similar accounting requirements for limited liability companies. Consequently, the theoretical administrative burden savings would not be achieved but only replaced with similar burdens at Member State level for small to large companies. With the possibility of different Member States' requirements substituting the ones currently in the Directives, there would be less harmonisation and comparability - without a significant reduction in the overall reporting burden. Furthermore, when responding to a question in the 2009 public consultation about the future role of the Directives, all respondents were in favour of retaining these[60].

For an analysis of how effectively this option may achieve the objectives and how it compares with the other options, please refer to the table in section 5.1.6.

[60] Summary Report of 2009 on the responses received to the Consultation paper on the review of the Accounting Directives, p. 25.

5.1.6. Comparison of broad policy options

Table 8 - Comparison of the broad policy options 1 → 5

Option	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?	Potential impact on administrative burden (EUR) "-" = lower burden "+" = increased burden
1. Baseline	**0**	**0**	**0**	**0**	**N/A**	**0**
2. Better use of current options	+	+	**0**	**0**	**No**	**- €0.7bn**
3. Revision of selected requirements	++	++	++	+	**Yes**	**- €1.7bn**
4.Mandatory use of IFRS for SMEs (except micro)	**-**	**--**	+	+	**No**	**+ €0.16 bn**
5. Repeal current Directives	**?**	**?**	**--**	**-**	**No**	**- €2.8bn**

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Having compared the five broad policy options above, the preferred option is the third one - proposing a revision of selected requirements currently in the Accounting Directives.

Now that this option has been selected one needs to consider whether a Directive is still the preferred legal instrument to achieve the objectives of the review. There would be the possibility of bringing together the Fourth Council Directive on annual financial statements and the Seventh Council Directive on consolidated financial statements into a single instrument as the basis for the EU's financial reporting framework. The revised Directive would create an opportunity to make textual improvements and to rearrange the current provisions into a more rational order. It would also provide an opportunity for maximum harmonisation to achieve specific policy objectives, where necessary.

An alternative approach could be to transform the Directives into a Regulation. The main advantage of such solution would be that a Regulation is directly applicable and does not have to be transposed into national law. On the other hand, the Member States would need some discretion at national level to tailor the financial reporting obligations to local needs. There is a very strong likelihood that the far-reaching changes that a uniform approach would require could not get the necessary support from the Member States.

On balance, the most suitable choice appears to be a revised Directive merging and repealing the existing Fourth and Seventh Council Directives.

5.2. Detailed options – within the context of the review of the Accounting Directive

In the context of a review of the existing Directives which is the preferred option above, the Commission services have identified and analysed policy options in Annex 6. These are listed below:

Options with an overall reach

(1) Harmonising the definitions of the size of companies under the Directive; and/or

(2) Increasing the company size thresholds; and/or

(3) Mandating the preparation of financial statements under an electronic format such as XBRL;

Options with an overall reach (mutually exclusive)

Either

(4) Harmonising and clarifying certain basic principles; and/or

(5) Reducing the number of options available to Member States;

or

(6) Developing a European Accounting Standard;

Options specific to small companies (mutually exclusive)

(7) Simplifying layouts or requiring only key financial data instead of a fixed balance sheet and profit and loss account structure (mainly for small companies); or

(8) Reducing the information given in notes by small companies and ensuring harmonisation across the EU ("mini-regime");

Options specific to medium-sized / large companies

(9) Introducing a compulsory cash flow statement for certain categories of company.

We examine further below two key options that would mainly contribute to reduce the administrative burden on companies chosen from the above.

5.2.1. Ease the administrative burden on small companies (by creating a "mini regime") i.e. option n° 8

As described in Section 3 small companies currently endure a disproportionately large burden compared with larger companies. In particular, preparing notes is the most time consuming part of the process for smaller companies. A balance has to be found between the essential information needs of the users of financial statements of

smaller companies, and the need to reduce the burden when preparing annual financial statements.

To this end, a "mini-regime" could be established for small companies which would restrict their financial statements to a simple profit and loss account, a simple balance sheet and a limited number of disclosures. To avoid gold-plating, the requirements would follow the principle of maximum harmonisation to which the Member States would not be allowed to add requirements at national level. Hence, micro-companies would in any event benefit from this 'mini-regime' at a minimum.

The main sources of burden reduction for small companies would be:

- A reduction in the amount of information to be disclosed in the notes to the financial statements[61] in the areas of (i) accounting policies, (ii) financial commitments, (iii) related party transactions, (iv) secured debt and (v) post balance sheet events. These notes would represent a significant lessening of the current disclosure regime and would bring substantive burden reductions for small companies. At the same time what is considered to be the key information that the stakeholders of small companies need, would be kept or even increased in some Member States;

- The abolition of the requirement to audit small company financial statements and related options to exempt;

- No requirement to prepare consolidated accounts for small groups;

- “Maximum harmonisation” of the relevant requirements.

Regarding notes, accounting experts and stakeholders see the above as the minimum information that is useful for the users of financial statements. Banks, especially, value the disclosure of guarantees and commitments.

The limitation of disclosures will reduce the burden mainly in the Member States that have made only moderate use of exemptions, as described in Section 3.4.2: Cyprus, Czech Republic, Greece, Spain, Finland, France, Ireland, Poland, Romania, Sweden and Slovakia. However a detailed analysis on the extent to which small companies are currently exempt of the above obligations (see Annex 6, Option 8) indicates that small companies would nevertheless be subject to new obligations in many Member States, especially regarding the disclosure of guarantees and commitments, related parties, and post balance sheet events. This would entail additional costs of €227m for these companies, mainly in Austria, Germany, Hungary, Ireland, Italy, Lithuania, Luxemburg, the Netherlands, Latvia, Malta, Slovakia, Slovenia, Sweden and the United Kingdom.

Regarding statutory audits, whether an audit is required or not will depend on each Member State's policies, as the proposal would not foresee full harmonisation in this area. The most significant potential impact of removing the statutory audit

[61] In occasion of the 2009 public consultation, the majority of stakeholders supported the idea of reducing the number of disclosures requested for small companies. Only 4 respondents called for keeping the current rules. See p.21 of the summary report.

requirement should be concentrated in the Member States which currently require a statutory audit for all or mostly all small companies (Cyprus, Finland and Sweden), and in the Member States where the threshold defining small companies and the audit exemptions are very low, as shown in Section 3.4.2 (Bulgaria, Czech Republic, Denmark[62], Estonia, France, Hungary[63], Lithuania, Latvia, Malta[64], Poland, Portugal, Slovakia).

From the comparison of options in Annex 6, we have determined that Option 9 would best ensure that the objectives are met, with potential high acceptability, as shown in the table below:

Table 9 - Analysis of an option to reduce the information in notes with harmonisation for small companies

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
Reduce the information given in notes by small companies and ensure harmonisation across the EU (mini-regime)	**Small**	++	++	+	-	**Yes**

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

It is estimated that the potential for administrative burden reduction of this proposal would reach €1.5bn attributable to: relaxation of disclosures (€1.0bn); potential relaxation of statutory audit (€0.5bn); and relaxation of consolidation obligations (€0.04bn).

It is estimated that the above "mini regime" would also have an impact on micro-companies; as the simplifications suggested above overlap to a certain extent with the simplifications foreseen through the 2009 proposal for a Directive Overall, the burden reduction observed by micro companies will either come from the "mini regime" above, or from the 2009 proposal when the corresponding legislative texts are adopted and one or more options therein used by Member States. Assuming a Member State would not take advantage of the options offered by legislation stemming from the 2009 proposal, the "mini regime" would bring about to micro companies at least the same type of simplification as that offered to small companies through the "mini-regime". The Commission Services estimate that the "mini-

[62] In Denmark, only micro-companies with less than 12 employees, a turnover below DKK3,000,000 (≈€400,000) and/or a total balance sheet below DKK1,500,000 (≈€200,000) are exempted from audit.

[63] In Hungary, the exemption from statutory audit applies only to small companies with less than 50 employees whose net turnover do not exceed HUF100,000,000 (≈€360,000).

[64] In Malta, micro companies only – balance sheet lower than €46,587, Turnover lower than €93,175 and/or less than 2 employees – are exempted from audit.

regime" could achieve a maximum of two thirds of the savings foreseen in the impact assessment for micro-companies on the basis of the 2009 proposal, absent a "micro-regime" at Member State level.

5.2.2. *Increase of the thresholds for small and medium-sized companies, i.e. option n° 2*

Article 53 (2) of the Fourth Council Directive calls for a review of size thresholds in the Directive every five years. The last revision of the thresholds defining small and medium-sized companies took place in 2006[65]. In the context of the review of the Directives and in line with the objective to reduce administrative burden it is therefore time to consider an increase.

An increase of monetary thresholds by around 14%, leading to the figures below, would represent roughly the increase due to inflation from 2007 till 2012. Two out of the three criteria would have to be met for any company to fall within a particular size category (small or medium-sized):

Table 10 - Suggested level for thresholds after a revision

	Small companies	Medium-sized companies
Balance sheet total (EUR)	≤ € 5,000,000	≤ € 20,000,000
Net turnover (EUR)	≤ € 10,000,000	≤ € 40,000,000
Average number of employees during the financial year	≤ 50	≤ 250

Source: Commission Services.

The average number of employees during the financial year measured, which has worked well over the years, would not change.

Table 11 - Analysis of an option to increase company size thresholds

Option	**Size of the companies mainly affected**	**Requirements targeted to the size of the company**	**Simplification and elimination of excessive requirements (small)**	**Clarity and comparability (small/medium/large)**	**Maintain information value of financial statements (relevance of information)**	**Preferred option (yes / no / N/A)?**
Revise the thresholds	Small, Medium, Large	++	++	**0**	-	**Yes**

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

65 Thresholds defining SMEs are available at http://ec.europa.eu/internal_market/accounting/sme_accounting/thresholds_en.htm

As a result of this threshold increase the Commission services have estimated that around 62,000 medium-sized companies would shift to the small category, resulting in a total administrative burden reduction potential of this proposal of €0.2bn. This calculation has been made under the assumption that large companies shifting to the medium-size category would benefit from only marginal savings, therefore not estimated.

The table below provides an overview of the analysis of possible options (summary from Annex 6).

Table 12 - Overview of options under a review of the Directives

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
1. Harmonising company size definition	Small, Medium, Large	++	++	+	-	**Yes**
2. Increasing the company size thresholds	Small, Medium, Large	++	++	**0**	-	**Yes**
3. Mandating an electronic format / XBRL	Micro, Small, Medium, Large	**0**	**0**	++	+	**No**
4. Harmonising and clarifying basic principles	Small, Medium, Large	**0**	**0**	++	++	**Yes**
5. Reducing the number of options available to Member States	Small, Medium, Large	**0**	+	++	**0**	**Yes**
6. Developing a EU accounting Standard	Small, Medium, Large	**?**	+	++	**?**	**No**
7. Simplified layouts or only key financial data	Small	++	++	-	--	**No**
8. Reducing the information given in notes by small companies and harmonisation across the EU	Small	++	++	+	-	**Yes**
9. Introducing a cash flow statement	Medium, Large	+	**N/A**	+	+	**No**

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

6. ANALYSIS OF IMPACTS

6.1. Overview of the preferred options

Table 13 - Summary of the preferred options

Scope	Preferred Options
Small Companies ~ 1,1 million ~15 % of all companies	• Companies will have to prepare a profit and loss account and a balance sheet following the accounting principles laid down in the Directives. • Limited, but fully harmonised disclosures in the notes to the financial statements. • Introduction of general principles of "materiality" and "substance over form". • Reduction in the number of Member State options. • There would be no requirement for audit in the Directive • There could be a maximum harmonisation aiming to avoid the preparation of consolidated financial statements.
Micro-Companies[66] ~ 5,9 million ~81% of all companies	• Micro companies will at least benefit from the same regime as small companies. • If the proposal tabled by the Commission in February 2009 is adopted by the co-legislators then it is expected that the latter would take the form of options to depart from the regime applicable to small companies. The Member States could tailor their own "micro regime" on that basis.
Medium/Large Companies ~ 0.3 million ~ 4%	• Introduction of general principles of "materiality" and "substance over form". • Reduction in the number of Member State options, resulting in a better comparability of the financial statements within this category of companies.

Source: Commission Services analysis.

[66] This summary does not take into account the impacts of the proposal for a Directive on Micro-Entities tabled by the Commission in February 2009.

6.2. Expected primary impact of the preferred policy options

In general terms, the initiative should reduce the administrative burden of financial reporting for all companies. In line with the objectives of the review, the impact is likely to be greatest for smaller companies, as the review Directive would require them to only present and disclose the most relevant and useful information. The key needs of financial statements' users would continue to be met, but information of lesser importance, and which is burdensome to prepare would no longer be provided.

Table 14 - Analysis of the primary impacts of the preferred options

	Primary impacts of the preferred policy options
Reduction of administrative burden.	The burden reduction potential of the review Directive amounts to EUR 1.7 bn. The main beneficiaries of the burden reduction would be small companies (around EUR 1.5 bn per year). Medium-sized companies would altogether save EUR 0.2 bn per year. The comparison of this potential with the overall burden identified in Table 5, is as follows: (€ bn) — Small — Medium — Large Overall burden — 1.7 — 1.1 — - Reduction — 1.5 — 0.2 — - This calculation does not take account of a significant level of burden reduction that would come from savings realised by micro companies as a result of the mini-regime explored in Section 5.2.1. This is because a large portion of these savings could be equally considered as being achieved through the 2009 proposal, to which the policy choices in this document are considered to be complementary, and which effects have been assessed in a separate Impact Assessment[67].
Impact on the information available to external stakeholders, investors and creditor protection.	Small companies: Creditor protection would be kept or even strengthened due notably to the fact that disclosures of "Guarantees and commitments, contingencies, arrangements" and "Related party transactions" would become mandatory for this category of company. Medium-sized and large companies: Slightly positive impact due to an improved comparability of the financial statements.
Impact on the single market and level playing field.	For all other categories of company the impact would be positive due especially to the maximum harmonisation of company size thresholds, a significant reduction in the number of Member State options and maximum

[67] Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities - Impact assessment. SEC(2009) 206, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2009:0206:FIN:EN:PDF

	harmonisation of reporting requirements for small companies.
Impact on collection of statistical data.	For all categories of company the maximum harmonisation of thresholds could make the collection of statistical data more difficult from small companies. In the 11 Member States where the statistical authorities require customised statements there should be no impact on the collection of statistical data. In one Member State where the statistical authorities have the power to require additional information beyond the financial statements some adjustment (cost) would be involved if the statistical offices find that some crucial financial information is missing from the less burdensome statements. In the Member States where all governmental institutions use the same financial statements, if some crucial financial information would be missing for statistical purposes, it would have to be requested from some companies separately. At the same time, the maximum harmonisation of thresholds would allow the collection of data for companies that are objectively the same size across the EU, thereby improving comparability.
Impact on collection of information for taxation.	No discernible impact - tax authorities would retain the power to decide how income / profits for tax purposes should be computed and measured and what should be the associated reporting requirements. The power to carry out verifications of financial information would not be disturbed. In certain countries a modification of legislation may become necessary.
Impact on accountants and auditors.	Some decrease in the demand for external accountants and auditors' services due to reduced requirements, including for small accounting and audit firms. However, it is estimated that the impact of the proposal on fees and jobs at accounting firms should be limited[68].

---

[68] Overall, it is expected that a substitution of consulting on accounting issues to other services will take place. This is because when statutory audits are lifted due to new exemptions or the increase in thresholds, anecdotal evidence shows that either companies will continue to voluntarily have an audit, or they will use the savings on statutory audit to get new services from the same accounting firms. Only in a minority of cases will companies not recycle at least part of the savings with an external accountancy firm. We provide below more material to support this assertion.

Currently, the Directives require an audit for all companies, but enable the Member States to exempt small companies. Table 2 in Section 3.4.2 provide an overview per Member State. Savings of €0.5bn for small companies would follow in the first place from simpler audits along with simpler accounting regime supported by this proposal. Resources spent on the statutory audit of a small company would be reduced by around 15% as a result of this simplification (CSES 2010, p41). As for the remaining 85%, savings would depend on how the Member States will implement the policies of this proposal in terms of audit exemption, and whether the thresholds defining small companies will be harmonised in the EU as a result of the adoption of a revised Directive as contemplated in this report.

For the Member States that will exempt their small companies of an audit, surveys performed in the UK

Source: Commission Services analysis

6.3. Other impacts:

6.3.1. Economic Impacts

- **SMEs** are the main focus of this initiative. They should benefit from a significant reduction in administrative burden which, in turn, should free up resources for productive purposes. Cutting "red tape" gives further encouragement to entrepreneurial citizens to start-up in business. In addition, burden reductions applicable to limited liability companies may to a certain extent also similarly relieve other types of companies in member States where the regime for the latter overlaps with the regime for limited liability companies.

- **Competitiveness, trade and investment flows**: for larger companies, fewer options lead to increased comparability of the financial statements and a better focus on information that is really useful in decision-making. This will result in better investment decisions and a better allocation of capital, thus facilitating cross-border investment, trade and competition.

- **Operating costs of business/Small and Medium Enterprises**: simplification and burden reduction is likely to lower the operating cost of EU SMEs.

- **Public authorities**: the revision will not have budgetary consequences for public authorities.

- **Third countries and international relations**: A reduction of administrative burden on the smallest companies should benefit EU small companies in terms of competitiveness vis-à-vis companies from other jurisdictions with lighter regimes (e.g. USA). In addition, better comparability and clarity of the financial statements

---

(Directors' Views on Accounting and Auditing Requirements for SMEs by Dr Jill Collis, 2008 / Directors' Views on the Exemption from the Statutory Audit" Jill Collis October 2003 URN 03/1342 available at http://www.bis.gov.uk/policies/business-law/research/audit-accounting-and-reporting-research) tend to demonstrate that the impact on accounting firms would be limited. The surveys show that first, some companies will continue to voluntarily have an audit for various reasons (32% of small companies surveyed in 2006 – Collis/BERR, 2008). Second, for companies discontinuing the audit, the relationship with the external accountant or auditor will continue, as it is "apparent that amongst the companies having the accounts audited the external accountant is also the auditor" (Marriott, N., Collis, J. and Marriott, P. - 2006 - Qualitative review of the accounting and auditing needs of small and medium-sized companies and their stakeholders, http://www.frc.org.uk/documents/pagemanager/poba/Case%20studies%20report.pdf). This is even truer as the company is smaller. In France, where stricter independence rules prevent an auditor from providing non-audit services to audit clients, an auditor would be allowed to offer other services than an audit as soon as the audit firm/he/she is no longer the auditor. In the UK, "more than half of the companies whose directors had discontinued the audit since 2003 (54%) reported no difference in their total accountancy fees. The reasons for this offer scope for further investigation, but case study evidence from previous research suggests the amount saved may have been offset by a re-apportioning of the fees for accounts preparation or the provision of additional services" (Collis/BERR, 2008). Such services may be for instance to assist companies on their funding, their structure, their organization and internal control, their systems, taxes, acquisitions, etc. The external accountant may also be in a position to offer new services if and when a Member State would implement "one stop shop" solutions, as it is foreseeable that in such case, external accountants would generally be the one to assist the companies preparing electronic filings etc.

of EU companies could make the EU more attractive to foreign capital and entrepreneurs.

- **Macroeconomic environment**: the proposal is likely to contribute to economic growth by freeing firms' resources for productive use.

6.3.2. *Social Impacts*

- **Employment and labour markets**: by freeing up resources available to companies, it is expected that the initiative would contribute, at least marginally, to the creation of jobs in the EU. Simplified accounting requirements should foster a business climate that encourages company formation and entrepreneurship. Some of the savings at company level will stem from a reduction of fees paid to accountancy firms or external accountants, but the impact on accountants' jobs due to this transfer of resources is expected to be neutral or only marginally negative, as explained in section 6.2.

- **Standards and rights related to job quality**: the proposal should not significantly reduce the information that is useful to employees.

6.3.3. *Environmental Impacts*

No measurable environmental impacts are expected. Shorter financial statements would diminish printing needs.

7. MONITORING AND EVALUATION

The revision of the Accounting Directives represents a major initiative to reduce the administrative burden stemming from excessive accounting requirements, and to further align the accounting rules to the real needs of users and preparers. In light of the policy objectives set out in Section 4, the following arrangements are proposed in order to set up an appropriate monitoring and evaluation framework.

7.1. Monitoring

The Commission will monitor the implementation of the review Directive in cooperation with the Member States throughout the implementation period which is expected to last possibly until mid 2014. In compliance with the principle of subsidiarity, the relevant information should be gathered primarily by the Member States. They appear to be best positioned to do this as they shall have relevant necessary information at their disposal (data collected from national statistical authorities, social data etc.). The Accounting Regulatory Committee (ARC) could serve as effective fora for information sharing. Monitoring activities should be based on a thorough assessment of a number of indicators such as the number of companies in existence, the number of start ups, relevant changes in the number of foreign subsidiaries established in the EU Member States.

During this time, implementation workshops will also be organised by the Commission in order to share best practices and clarify questions that might arise in the course of the implementation period.

7.2. Evaluation

On the basis of the data collected, and three years after the expiration of the implementation deadline, the Commission will consider the need to produce an ex-post evaluation report.

The evaluation of effects and functioning of the revised Directive will include an ex-post assessment as regards the key objectives of overall reduction of administrative burden and better alignment of the accounting rules with the needs of users and preparers of the financial reports. Consideration will also be given to the quality and accessibility of relevant financial information to stakeholders. Possible indicators in this respect could include *inter alia* the analysis of actual changes experienced by small companies as a consequence of the implementation of the revised Directive and a qualitative analysis of the reporting practices of the small companies including the reports required by stakeholders, especially the providers of finance.

Such an evaluation will be carried out by the Commission services in cooperation with the Member States, on the basis of all the relevant information collected in the framework of the monitoring activities described above. Further information could also be directly gathered by the Commission by surveying members of the ARC. Consultations could be carried out via other already existing platforms such as the European Business Test Panel (EBTP)[69]. All the above listed options could allow data collection at limited cost at EU level, as they would make broad use of existing structures and would not require the setting up of new instruments. The possibility of contracting an external study on the implementation and effects of the review Directive will be considered.

The results and feedback from monitoring and evaluation will be considered with a view to propose further amendments where appropriate.

---

69 See http://ec.europa.eu/yourvoice/ebtp/index_en.htm

ANNEX 1
Legal environment in the EU and in the main trading partners of the EU

The Accounting Directives, together with IAS Regulation, are the main legal instruments to form the EU aquis in accounting.

(1) Accounting Directives

In the fields of accounting and auditing, the Company Law Directives establish minimum requirements for the annual financial statements of mainly limited-liability companies (Fourth Directive)[70]and group financial statements (Seventh Directive)[71]. A separate Directive lays down the requirements for the audit of annual and consolidated financial statements[72].

The purpose of general financial statements is to inform stakeholders (investors, creditors, employees and other interested parties) about the financial position of a company. The Fourth Directive was adopted in 1978 in order to create a harmonised set of requirements for the external financial reporting of limited liability companies in the EU. In 1983, the Seventh Directive was adopted and added a common set of requirements for consolidated financial reporting.

The Fourth Directive aims at harmonising Member States' provisions concerning the presentation and content of annual financial statements and annual reports, the valuation methods used and their publication and audit in respect of companies with limited liability. The Seventh Directive harmonises national laws on consolidated financial statements.

The Accounting Directives mainly follow a principles-based approach, but also provide for detailed rules in many accounting areas. They represent "minimum harmonisation" beyond which Member States can develop additional requirements (i.e. gold plating). They currently contain around 120 significant options at Member State level, many of which are aimed at reducing the reporting requirements for small and medium-sized companies. The Directives have been amended several times, but they have not been subject to a fundamental revision since their inception.

The Accounting Directives have established, since 1978, the minimum framework for financial reporting of limited liability companies in the EU. These Directives have served as the basis for general purpose financial reporting in the European Union for about three decades. It is generally agreed that they have led to an improved financial reporting environment in the EU and that has been in the interest of preparers[73] as well as users[74].

---

[70] Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01978L0660-20070101:EN:NOT

[71] Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01983L0349-20070101:EN:NOT

[72] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (Text with EEA relevance), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:02006L0043-20080321:EN:NOT

[73] Defined as company / management preparing the financial information.

[74] Defined as stakeholders relying on the financial information, such as for example investors, providers of financing, employees.

The structure of the Accounting Directives dates back from 1970's, with primarily large companies in mind. Since then, the business environment, accounting practices and user needs have changed significantly.

(2) International Financial Reporting Standards (IFRS)

A fundamental change in the EU financial reporting environment took place in 2005 when International Accounting Standards (IAS/IFRS) became mandatory for listed companies and those companies with listed debt securities[75]. Consequently, the Accounting Directives were modified to accommodate the use of IFRS for listed companies. Through the adoption of the IAS Regulation N° 1606/2002 EU-listed companies have to present consolidated financial statements according to IFRS, and consequently, IFRS has become the most relevant framework for listed companies.

The International Financial Reporting Standards (IAS/IFRS) are set by the International Accounting Standards Board (IASB), which is an independent private standard setting body based in London. IFRS is a comprehensive set of financial reporting standards designed for listed companies. IFRS can be complex, given the sophisticated needs of the users of listed companies' financial statements, and is not an ideal basis for financial reporting for smaller non-listed companies. The IFRS for SMEs was developed to address the needs of smaller non-listed entities (see Annex 3 for more detail).

(3) Practices in the main trading partners of the European Union

In other economically comparable jurisdictions and key trading partners of the European Union (EU), financial reporting requirements for small companies are generally less demanding than the requirements of the Accounting Directives. The comparison is of relevance with regard to EU's relative competitiveness and the goals of the Europe 2020 strategy[76].

In the US, only companies listed on stock exchanges regulated by the U.S. Securities and Exchange Commission (SEC) are required to prepare and publish their financial statements under US Generally Accepted Accounting Principles (GAAP), with the exception of third country issuers that can also report under IFRS. For unlisted companies there is generally no legal obligation to prepare or publish financial statements. They must only prepare tax returns following the tax accounting rules, or they may choose to prepare financial statements on a voluntary basis to their stakeholders. If financial statements are prepared, companies may utilise simplifications available for private (not listed) companies, depart from some standards or follow standards other than US GAAP. It is estimated that around 30% of private companies do not release any financial information to external users.

---

[75] Regulation (EC) No 1606/2002 of the European parliament and of the Council of 19 July 2002 on the application of international accounting standards, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002R1606:EN:NOT

[76] See http://ec.europa.eu/growthandjobs/pdf/european-dimension-200712-annual-progress-report/200712-annual-report-integrated-guidelines_en.pdf

In Japan, small incorporated companies prepare financial statements under Japanese GAAP for taxation purposes. In Canada, in addition to tax reporting, all incorporated companies must prepare financial statements for their shareholders. There are simplified options for small companies and no requirement to file them in a public register.

ANNEX 2
Summary of consultation activities

(1) Informal ad-hoc SME reflection group

In the end of 2008, the Commission set up an informal ad-hoc SME Reflection Group to prepare the review of the Accounting Directives. The Reflection Group was composed of 10 qualified experts with diverse but highly relevant profiles. This group met five times between December 2008 and February 2009. The task of the Group was to reflect on the kind of issues that would be relevant in the context of the review in order to help the Commission to identify the issues relevant for the public consultation.

(2) Public Consultation on the Review of the Accounting Directives and a stakeholders' meeting

In compliance with the better regulation principles, the Commission held from 25 February 2009 to 30 April 2009 a public consultation on the simplification of accounting rules in the scope of the Accounting Directives[77]. A stakeholders' meeting was organised on 12 June 2009 to consider the results. This Stakeholders consultation raised a number of issues relating to the modernisation and simplification of the Accounting Directives. The Commission's legal proposal is based on an analysis of the comments received on the consultation paper[78]. On the basis of responses to the Stakeholders consultation a number of preliminary ideas were rejected.

(3) Public Consultation on the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) and a stakeholders' meeting

See Annex 3 for further details.

(4) Series of targeted stakeholder consultations – meetings with stakeholders

In 2009 and 2010 the Commission services carried out a series of consultations with stakeholders including national standard setters, representatives of small and medium-sized businesses, banks, investors and accountants across EU. The objective of the consultations was to hear the views of the stakeholders on the IFRS for SMEs, on the reporting needs of SMEs and on other issues of relevance to the EU SME accounting framework.

(5) EFRAG Working Group on SMEs

The European Financial reporting Advisory Group (EFRAG)[79] established in 2009 a Working Group on SMEs. The role of the group is to support EFRAG on issues related to the 4th and 7th directives, IFRS for SMEs and on other accounting matters related to small and medium sized companies. It also provides EFRAG with publication-ready reports etc. on selected issues.

---

[77] Available at http://ec.europa.eu/internal_market/consultations/2009/company_law_dir_en.htm

[78] Available at http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf

[79] See http://www.efrag.org/homepage.asp

The group consists of 12 members with technical expertise in financial reporting from a variety of international backgrounds. Members have been selected to ensure balanced representation of different backgrounds including preparers, auditors, academics, standard setters, credit providers and other users of financial statements from small and medium sized companies[80].

The group met several times in 2009 and 2010. The group considered a number of questions related to the revision work. In 2009 it gave its contribution on issues including the general orientation of the overhaul, user needs and problems, objectives of the revision, general and detailed comments and suggestions on proposals put forward and indications on impacts and effects on administrative burden. In 2010 the Group conducted a comprehensive analysis of differences between IFRS for SMEs[81].

(6) Study on the effects on administrative burden from changes to Accounting Directives

In December 2009, the Commission contracted a study with the Centre for Strategy and Evaluation Services (CSES) to provide information to assist the review of the 4th Company Law Directive in connection with its simplification and also the potential implementation of IFRS for SMEs.

In line with the preliminary proposals on the basis of the first public consultation, the first objective of this assignment was to evaluate the potential change in administrative burden associated with simplifying the balance sheet and profit and loss account layouts and requiring the preparation of a cash flow statement. Hence the study separately assessed the savings from simplification / reduction measures and also the increased costs of imposing a cash flow statement.

CSES was also asked to assess costs associated with various disclosures currently required and evaluate the potential burden reduction a reduced level of disclosures would bring.

Furthermore, CSES was asked to quantify implementation costs of the IFRS for SMEs and the annual costs of reporting according to IFRS for SMEs.

Costs associated with the changes were defined as those internal to the company such as bookkeeping time and accounting system upgrades and external costs such as professional accountant's time.

---

80 For more details on the EFRAG SME Working group and list of Members, see http://www.efrag.org/wg/detail.asp?id=67

81 Full text of the EFRAG Compatibility Analysis, "IFRS for SMEs and the EU Accounting Directives", is available at http://www.efrag.org/news/detail.asp?id=548

The output[82] from the study has served as background for Commission Services work on the proposal for changes to the Directives. It has also been used as an input to this Impact Assessment.

82 Full text of the study available at http://ec.europa.eu/internal_market/accounting/docs/studies/2010_cses_4th_company_law_directve_en.pdf

ANNEX 3
The International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)

Currently IFRS[83] must be followed when preparing the consolidated financial statements of listed companies. 18 Member States permit or require the use of IFRS in preparing annual financial statements for certain types of companies, and all 27 Member States permit or require the consolidated financial statements of unlisted companies to be prepared in accordance with IFRS[84].

In July 2009 the IASB finalized the IFRS for SMEs[85]as best practice accounting reporting for unlisted companies. The IFRS for SMEs is an accounting standard designed to be used by any entity that does not have public accountability. It was published by the IASB in its final form in July 2009. It is a 230-page standard tailored to the needs and capabilities of smaller businesses. Many of the principles in IFRS for recognising and measuring assets, liabilities, income, and expenses have been simplified; topics in IFRS that are not relevant to SMEs have been omitted; and the number of required disclosures has been significantly reduced.

It is a "stand-alone" standard with the exception of one "fallback" option to IFRS; that is an option to use IAS 39[86] to recognise and measure all financial instrument transactions, but their disclosure must be in accordance with the IFRS for SMEs, not IAS 32[87] or IFRS 7[88].

Inconsistencies with the Directives

After an extensive analysis[89], EFRAG has concluded that there are six differences between the IFRS for SMEs and the extant Directives. These comprise the following:

(1) Disclosure of extraordinary items is prohibited by the IFRS for SMEs, and allowed by the Directives;

(2) There are different measurement criteria on certain financial instruments;

(3) For goodwill where useful life cannot be estimated, the indicative amortisation period is 10 years under IFRS for SMEs, versus 5 years under the Directives;

---

83 The International Financial Reporting Standards (IFRS) are prepared by the International Accounting Standards Board and adopted in the EU following comitology procedures.

84 See http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options2010_en.pdf

85 The IFRS for SMEs was designed with a hypothetical company of 50 employees in mind. Therefore it would be better suited for Medium/Large unlisted companies rather than Micro/Small companies. In accordance with this, those Member States that are interested in using it (e.g. UK) do not plan to use it for small companies

86 International Accounting Standard 39 – Financial Instruments: Recognition and Measurement

87 International Accounting Standard 32 – Financial Instruments: Presentation

88 International Financial Reporting Standard 7 – Financial Instruments: Disclosures

89 See letter to European Commission of 28 May 2010 on compatibility of the IFRS for SMEs and the EU Accounting Directives available at http://www.efrag.org/files/EFRAG%20public%20letters/IFRS%20for%20SMEs%20compatibility%20analysis/The%20Letter.pdf

(4) IFRS for SMEs require any negative goodwill to be immediately recognised in the profit and loss account, whereas under the Directives this can only happen if certain conditions are met;

(5) IFRS for SMEs require unpaid called-up capital to be presented as an offset to equity and not as an asset, whereas the Directives require unpaid called-up capital to be presented as an asset;

(6) The reversal of a goodwill impairment is prohibited by the IFRS for SMEs, whilst the Directives require a reversal whenever the reasons giving rise to the goodwill impairment have ceased to apply.

Public Consultation conducted by the European Commission

After its issuance in July 2009, the IFRS for SMEs was widely discussed amongst stakeholders (including Member States, accountants, auditors and preparers). The European Commission conducted a public consultation that run from November 2009 until March 2010.

Our consultations have shown that there is a clear cut divergence of views of EU companies about a possible adoption of IFRS for SMEs. Many companies support an adoption, but many others do not. For some companies, including multinationals with subsidiaries in different countries, companies that are part of a group, and companies seeking international finance, IFRS or the IFRS for SMEs are a preferred reporting standard, the latter being seen as easier standard to comply with than full IFRS. Similar conclusions are drawn from the study evaluating application of IFRS in the EU[90], which notes that SMEs have more problems with IFRS and would prefer to follow IFRS "light" if the application of IFRS was to be generalised.

Some of the respondents expressed the view that the IFRS for SMEs would allow international comparison of financial statements and that this may lead inter alia to increased access to finance, reductions in the cost of capital, increased trade, and increased levels of cross-border merger and acquisition activity. International groups that would be eligible to use it could see compliance costs fall and increased information usefulness from dispensing with different local reporting regimes.

Others commentators questioned whether the Standard was simple enough for small businesses or whether it represented an over simplification for the largest businesses eligible to use it. The cost of changing accounting systems and re-training staff was raised as an issue also, as was the effect on tax liabilities in making the transition from local GAAP to the Standard. Some commentators, especially from countries where there is presently close alignment of tax and accounting, questioned whether adopting the IFRS for SMEs would increase compliance burdens by duplicating reporting requirements as it would be less aligned to tax provisions than national accounting rules. In compliance with the better regulation principles and given the potential significance of the IFRS for SMEs for the European accounting framework, the Commission held a

[90] See Ineum. 2008. Evaluation of the Application of IFRS in the 2006 Financial Statements of EU Companies. p. 15, http://ec.europa.eu/internal_market/accounting/docs/studies/2009-report_en.pdf

public consultation on IFRS for SMEs from 17 November 2009 until 12 March 2010. The objective of the consultation was to gain an understanding of EU stakeholders' views on the Standard and its role in the European accounting framework. A stakeholders' meeting was organised on 25 May 2010 to consider the results[91].

Summary of stakeholders' events in the Member States

Moreover, the Commission services carried out a series of meetings with stakeholders in the course of 2009 and 2010, attending a number of events organised across the EU. A detailed list of the meetings is provided in the table below. These events saw the participation of key stakeholders including public authorities, national and international standard setters, academics, representatives of small and medium size businesses, banks, investors, preparers and accountants established in several Member States. The Commission services were consequently given the opportunity to gather their views on issues related to, *inter alia*, the IFRS for SMEs and its role in the European accounting framework, the reporting needs of SMEs as well as other general issues of relevance to the EU SME accounting framework and the revision of the Accounting Directives. The outcome of the discussions highlighted a number of arguments in favour and against the adoption of IFRS for SMEs in the EU accounting framework, as well as some more general remarks concerning the revision of the Accounting Directives.

As regards the potential benefits linked to the adoption of IFRS for SMEs, the main aspects mentioned by the stakeholders included: greater international comparability (especially in case of international subsidiaries); easier access to finance; easier consolidations for groups operating cross-border; smoother transitions to different frameworks where companies grow or become listed; enhanced efficiency in management, competitiveness and allocation of capital.

However, some potential drawbacks were also identified. In particular, some stakeholders stated that international comparability would not be a significant issue for all SMEs, since only some of them are internationally active; IFRS for SMEs might constitute an additional administrative burden for the smallest companies not necessarily enhancing the quality of the information provided; the prohibition on capitalisation of interest and development costs may have material effects on some balance sheets; accountants without knowledge of IFRS may find it difficult to deal with the standard; and more time and studies would be needed to properly assess its applicability.

Further general remarks concerning the revision of the Accounting Directives included the need to bring legislation in line with international developments in order to meet new standards of transparency and relevance; the need for further reflection on the scope of application and on some specific definitions (i.e. public accountability); the need for increased cooperation between different authorities (tax, accounting, statistics, etc); the inclusion of cash flow statements, which was widely supported especially for large companies; and the creation of a potential EU-wide electronic publication platform.

[91] For complete results of the public consultation, see http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-31_ifrs_sme_consultation_summary_en.pdf. Full text of the minutes of the stakeholders event is also available at http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-25-ifrs-sme%20meeting_minutes_en.pdf

Wide support was also expressed for the think small first principle and for the bottom-up approach. With regards to possible implementation, a number of different views were expressed such as granting a "company" option, a "Member State" option, and a potential exemption for micro companies, a tier-based approach, or a 2-3 years' phase-in period.

Meetings held by the European Commission with stakeholders on IFRS for SMEs

Date	Member State/country/city	Organiser
7 – 8.10.2009	Geneva, Switzerland	UNCTAD/ISAR – United Nations Conference on Trade and Development – Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
20.10.2009	Brussels, Belgium	UEAPME - European Association of Craft, Small and Medium-sized Enterprises
26.11.2009	London, UK	ICAEW - Institute of Chartered Accountants in England and Wales
01.12.2009	Frankfurt, Germany	DRSC - Accounting Standards Committee of Germany
9.12.2009	Dublin, Ireland	ICAI - Chartered Accountants Ireland
9.12.2009	Bucharest, Romania	ACCA - Association of Chartered Certified Accountants
10.12.2009	Prague, Czech Republic	ACCA - Association of Chartered Certified Accountants
10.12.2009	Rome, Italy	OIC - Italian National Standard Setter
17.12.2009	Brussels, Belgium	Regional Representation of Basse-Normandie to the EU
12.1.2010	Brussels, Belgium	ACCA - Association of Chartered Certified Accountants
25.02.2010	Riga, Latvia	EU Representation
5.3.2010	Lisbon, Portugal	EU Representation
12.3.2010	Warsaw, Poland	EU Representation
15.03.2010	Finland, Helsinki	EU Representation

ANNEX 4
Problems differ across different company sizes

The ownership of companies, as well as the users of financial statements differ significantly according to the size of companies. We explain below on this basis why it appears relevant to differentiate the approach between micro/small companies on the one hand, and medium-sized/large on the other.

Ownership structure

About 30% of companies under the Accounting Directives are owner-managed companies[92]. This information is also corroborated by Eurobarometer[93] data:

Ownership structure of EU enterprises (all legal forms)

Type of ownership	Micro	Small	Medium-sized	Large	All sizes
Shareholders - company is listed on a stock market[94]	5%	11%	16%	27%	6%
Family or entrepreneurs (more than one owner)	44%	52%	48%	33%	45%
One owner	40%	22%	11%	6%	38%
Other firms or business associates	9%	14%	18%	27%	10%
Venture capital firms or business angels	1%	1%	4%	3%	1%

Source: Eurobarometer. 2009. Access to finance. Annex p.28[95]; Commission own calculations

Around 85% of micro companies and 75% of small companies are owned either by a single entrepreneur, or a family or small group of owners. In the case of medium-sized and large companies there is a significant decrease in single-owner companies and an increase in the spread of shareholdings. In all size groups the majority of shareholders have direct access to financial information (single owners, family and entrepreneurs, other firms, venture capital firms).

At the other end of the spectrum are large companies that issue shares to the general public. An individual investor in such a company usually has no powers to obtain information available to management and must rely on the public financial statements. Investors need information upon which to judge the performance of the company and its management.

---

92 CSES 2008, p. 16 - http://ec.europa.eu/internal_market/accounting/docs/studies/micro_entity_en.pdf

93 Eurobarometer. 2009. Access to finance. Annex p.28, Report available at http://ec.europa.eu/enterprise/policies/finance/files/survey_access_to_finance_analytical_report_en.pdf. Annex 1available at http://ec.europa.eu/enterprise/policies/finance/files/survey_access_to_finance_annex_part_a_en.pdf Annex 2 available at http://ec.europa.eu/enterprise/policies/finance/files/survey_access_to_finance_annex__part_b_en.pdf

94 Most SMEs in this caption are not necessarily listed on a regulated market, and most of those which are listed in a regulated market have no subsidiaries and hence do not prepare consolidated accounts. As a result, most SMEs in this caption are not subject to the IAS Regulation (EC) No 1606/2002 of the European Parliament and the Council.

95 http://ec.europa.eu/public_opinion/flash/fl_271_annex_en.pdf

Looking at the Eurobarometer data above, a clear correlation between size and dispersed shareholding emerges - the number of micro and small companies with dispersed shareholdings is 5% and 11%, growing to 16% and 27% for medium-sized and large companies.

Users of financial statements

There is a clear and uniform pattern that the users of financial statements differ with the size of company:

- For micro companies, the owner-manager structure is the most prevalent. There are few other stakeholders due to limited influence of the company on its surrounding environment. A Eurobarometer survey[96] found that 78% of micro companies considered banks as their main source of finance, followed by leasing companies (22%) and public institutions (10%). Private investors constituted only 7% and venture capital companies 2% of all answers[97]. On the basis of information from stakeholders, also supported by statistical information, Eurobarometer[98] estimates that only 7% of all micro companies in the EU (regardless of their legal form) are involved in export. Moreover, 95% of companies with less than 10 employees do not have any foreign subsidiaries.

- Generally, stakeholders of small companies are limited and differ significantly from those of big corporations. These companies are in most cases owner-managed - or there is a close relationship between the owners and the managers. Therefore statutory financial statements do not have the same relevance for the shareholders in reviewing the company's performance. Investors in small companies are often limited in number, often directly involved in running the company and with direct access/insight into the company's accounts. The source of financing is not the stock market but own resources, credit from banks or other financial institutions.

- Large and medium-sized companies have significantly larger group of stakeholders interested in monitoring their performance. Due to their size these companies have a bigger impact in their environment and (in addition to shareholders) they have a bigger number of other stakeholders. These include for example employees, public authorities, clients, business partners, other companies / competitors, and public at large. These stakeholders, have generally, less often, direct access to management data. Financial statements tend to be the main (or only) source of financial information.

As a result, different users of financial statements have different needs according to the size of companies.

[96] Eurobarometer in 2005 conducted a survey on EU15 SMEs access to finance. The population studied comprises all legal forms of companies, i.e. not only limited liability companies covered by the Directives. However due to lack of more precise studies the results of this survey may be indicative of general sentiment in the SME group that should not differ significantly for limited liability companies.

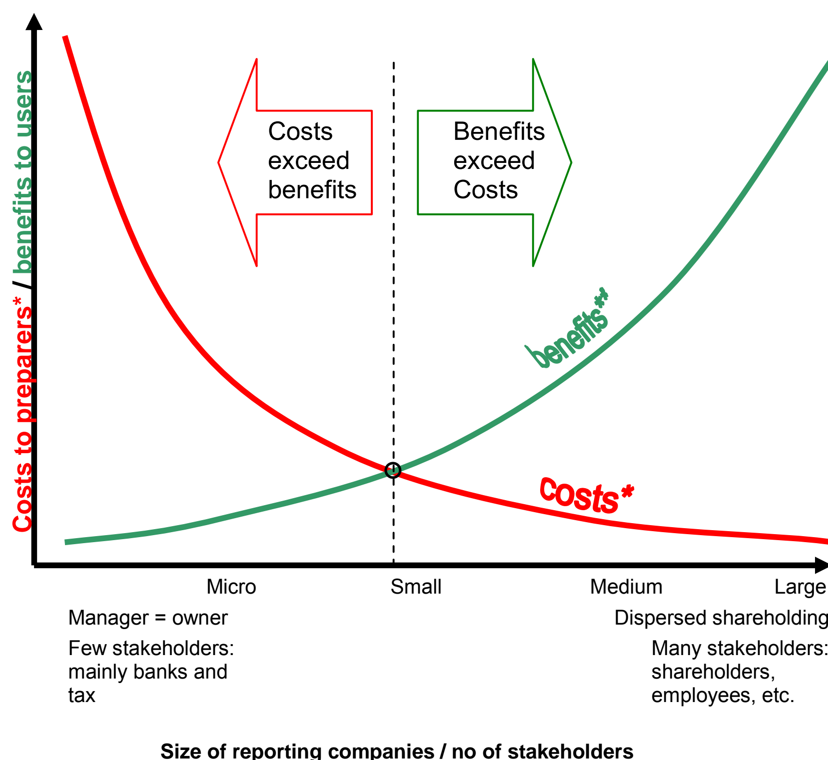
[97] The percentages do not add up to 100% as it was possible to select more than one source of financing.

[98] See EUROSTAT 74/2007, Statistics in focus: Export of business services, available at http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-07-074/EN/KS-SF-07-074-EN.PDF

Balance between costs and users' needs

The figure below illustrates evolution of the cost / benefit balance of current requirement in relation to company size.

Fig. 4 - Cost / benefit analysis of reporting requirement by company size.



* - Costs are presented as percentage of total cost of company
** - Benefits as percentage of total information about a company that is gained from published financial statements
Source: Commission Services analysis

Looking at the issue from an agency theory viewpoint, literature indicates that as regards smaller companies, agency relationships differ compared to large companies and the stewardship function is largely absent in small companies. Instead, the financial statements appear to play an agency role between the owner-manager and the bank[99]. The main users of financial statements are usually found to be the owners themselves[100], tax authorities and banks[101]. It is also suggested that there is an obvious demand for differentiated reporting requirements associated with business size and structure[102] and also that the needs of the smallest companies are best served by a system developed by national regulators, taking into account their specific economic environment.[103]

The other main stakeholders are the tax authorities, lenders and business partners. Usually these stakeholders have the powers to obtain direct access to financial information, and they

[99] E.g. Collis and Jarvis 2000
[100] E.g. Abdel-khalik 1983; Carlsberg et al 1985 and McCahey 1986
[101] E.g. Page 1984; Pratten 1998; Collis and Jarvis 2000
[102] Holmes, Kent and Downey 1991
[103] Evans et al 2005

do not rely on the published financial statements[104]. As regards the stakeholders, the following general characteristics can be identified:

- Users of small company financial statements are few and most of them have power to demand customized financial statements (e.g. tax authorities, banks) while owners are interested in much more detailed information for managerial purposes than that presented in the financial reports. Such information is delivered by the enterprise's accounting system. At one end of the spectrum there is a special group of companies whose manager is also the (only) owner. In this case the manager has a direct access to financial information about the company and would not need general purpose financial statements.

- Tax authorities are mostly interested in calculation of taxable income according to tax law which often uses different valuation, measurement and recognition rules to those used in the financial statements.

- Creditors/banks are interested in calculation of recoverable amount of assets as collateral to granted credit – a recent survey of German banks[105] showed for example that figures produced by more sophisticated (and complex) accounting methods are not helpful. On the contrary, for example when analyzing financial statements banks tend to eliminate "intangible assets" and "deferred tax assets" from the total recoverable assets. Banks also often rely on other sources of information, such as cash flow projections because statutory financial reporting is not forward looking and timely enough. Representatives of banks have mentioned that for example the transactions on the bank accounts are often of more relevance as a source of information than the statutory financial statements.

---

[104] E.g. Deaconu et al 2009: "*the significant users […] are the shareholders-managers, and to a little extent the financial creditors. Their needs can be satisfied through internal information, less formalised if it is about managers and through information upon request if it is about the other external financing bodies. All these converge on supporting the simplification of the content and of the reporting manner of the accounting information* […]."

[105] DRSC, UR. 2008. Financial Reporting from the Perspective of Banks as a major User Group of Financial Statements. p.27, http://www.standardsetter.de/drsc/docs/press_releases/080917_ASCG_Surveyontheexpectationsofbanks.pdf

ANNEX 5
Estimation of administrative burden reduction through full use of existing exemptions

Based on the report "*EU project on baseline measurement and reduction of administrative costs*" by Consortium[106], the following table presents estimates of the burden reduction potential if the Member States were making full use of some of the exemptions offered by the Fourth Directive :

Estimation of administrative burden reduction through full use of existing exemptions.

Art	Exemption	Estimated administrative burden reduction (€)			
		Micro	Small	Medium -sized	Total
11	Small companies definition, abridged balance sheet.	91,063,909	21,918,777	0	112,982,686
27	Medium companies definition, simplified Profit and Loss account layout.	39,214,746	14,640,465	2,389,720	56,244,931
44	Abridged notes for small entities.	25,546,254	9,341,882	0	34,888,136
45	Certain simplification of disclosures in the notes.	67,810,872	25,182,240	6,352,388	99,345,501
46.3	Exemption for small companies to prepare annual report.	117,272,759	24,762,992	0	142,035,751
46.4	Certain simplifications for medium companies in the annual report.	56,614,015	17,515,488	3,988,270	78,117,773
47.2 47.3	Simplifications of publication requirement for small and medium companies.	124,656,708	80,801,230	3,306,574	208,764,512
51.2	Exemption for small companies from audit.	1,303,097,224	495,819,610	0	1,798,916,834
57	Exemptions for certain subsidiary undertakings	n/a	n/a	n/a	824,236,589
Total		**1,825,276,487**	**689,982,684**	**16,036,952**	**3,355,532,712**

Note: Art. 57 - Exemptions for certain subsidiary undertakings: the breakdown of the total per size of companies is not available. Should this amount be considered, savings available to small and medium-sized companies would be higher than those reported in this Impact Assessment.
Please also note that the numbers presented above (with exception of Article 51.2), take into account only estimation for the Member States that did not transpose the relevant articles at all, and do not address transpositions that impose additional restrictions to the full use of exemptions.

Source: Consortium study 2009, Commission Services analysis.

Were all of these exemptions to be used by the Member States, the administrative burden for all companies could be reduced (according to the calculation of the Consortium) by as much as €3.3bn, with audit exemption for micro and small companies contributing the bulk of the sum. If only small and medium-sized companies are considered, the savings would amount to at least €0.7bn.

[106] See EU Project on Baseline Measurement and Reduction of Administrative Costs, by Consortium (Capgemini, Deloitte, Ramboll), available at http://ec.europa.eu/enterprise/policies/better-regulation/documents/files/abs_development_reduction_recommendations_en.pdf

ANNEX 6
Policy options in the frame of a review of the Accounting Directives

This Annex which corresponds to section 5.2 in the body of the document identifies, analyses and compares detailed policy options that could constitute the substance of a European level action. The extent to which options have been examined in this Annex is limited due to the policy choices favoured in section 5.1 that have led to consider a review of the existing Accounting Directives as the preferred overall option. For the same reasons, the Baseline scenario is not examined again in this Annex.

The issues raised in the Problem Definition section can be examined in the light of the folowing statements:

- While **small companies** suffer most from the administrative burden of the current reporting requirements, it also seems that the users of these companies' financial statements have the least need for sophisticated accounting and extensive disclosures. Also, even though the Member States may allow small companies to file abbreviated financial statements (a balance sheet with any notes pertaining thereto), the Directives require these same companies to continue to prepare detailed financial statements for their shareholders. The option offered to Member States to allow small and medium-sized companies to prepare abridged accounts does not prevent from preparing fully fledged notes. All these requirements tend to come in addition to local reporting requirements (tax returns, statistics).

- **Medium-sized and Large companies** require more sophisticated accounting regimes due to the greater complexity of their operations and because their main stakeholders often have less direct access to management information. The clarity and comparability of information is key whereas the Accounting Directives allow for many different accounting treatments because of the numerous options offered to the Member States. The information presented by smaller companies could be streamlined, but nevertheless it should be based upon a framework of accounting principles common to small, medium and large companies.

- The **categorization of companies by size** varies from one Member State to another. Hence companies of similar sizes within the EU can be considered as large, medium or even small depending on the Member State where it is located. This is made possible as the Accounting Directives provide for upper limit thresholds (based upon headcount, balance sheet assets and turnover) that Member States can transpose with lower figures.

The objectives of the revision of the Directives are that small companies should have simpler, yet clearer and comparable financial reporting than today. It is estimated that there are around 1,117,000 small companies in the EU which are in the scope of the Fourth Directive.

The objectives from the revision of the Directives for medium and large companies are narrower, being an improvement in the clarity and comparability of financial reporting. It is estimated that there are respectively 245,000 medium-sized and 45,000 large companies in the EU which are in the scope of the Fourth Directive.

The thresholds for the different categories of companies used in this section, using the current definitions in the Accounting Directives and the proposed definition for micro-companies, are as follows, before considering Option 2 consisting in the revision of the thresholds:

Thresholds for the different categories of companies.

Threshold \ Category	Micro	Small	Medium
balance sheet total	≤ € 500,000	≤ € 4,400,000	≤ € 17,500,000
Net turnover	≤ € 1,000,000	≤ € 8,800,000	≤ € 35,000,000
Average number of employees during the financial year	≤ 10	≤ 50	≤ 250

Source: The Fourth Directive 1978, Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing 2007.

In light of the problems and objectives identified, policy options regarding all companies could include the following:

Options with an overall reach

(1) Harmonising the definitions of the size of companies under the Directive; and/or

(2) Increasing the company size thresholds; and/or

(3) Mandating the preparation of financial statements under an electronic format such as XBRL;

Options with an overall reach (mutually exclusive)

Either

(4) Harmonising and clarifying certain basic principles; and/or

(5) Reducing the number of options available to Member States;

or

(6) Developing a European Accounting Standard;

Options specific to small companies (mutually exclusive)

(7) Simplifying layouts or requiring only key financial data instead of a fixed balance sheet and profit and loss account structure (mainly for small companies); or

(8) Reducing the information given in notes by small companies and ensuring harmonisation across the EU ("mini-regime");

Options specific to medium-sized / large companies

(9) Introducing a compulsory cash flow statement for certain categories of company.

Policy option 1 – Harmonising company size definitions across the EU

Company categories currently include small, medium-sized and large companies, and could soon include a new category relating to micro companies. In order to categorise companies, Member States can currently set lower thresholds than those permitted in the Directives. As a result, companies that would be considered small or even micro under the Directives may, for instance, be considered as large under Member States' law, thus imposing more burden than that intended by EU law. Based on a survey conducted among the Member States[107] only eight have transposed or are about to transpose the maximum amounts of turnover, balance sheet assets and headcount permitted in the Directives for small companies. Other Member States use slightly lower to significantly lower amounts.

The harmonisation of thresholds across the EU would *de facto* entail a shift downwards to a lower size category for many companies in the EU. Such a shift towards harmonised definitions will remove competitive disadvantages currently faced by certain EU companies located in Member States with lower thresholds than those permitted in the Directives. This would also achieve a significant burden reduction for those companies becoming subject to a downward re-categorisation of size. At the same time, those Member States that currently have not implemented the whole range of company categories would have a more complete system to implement. This is the case for Belgium, Bulgaria, Czech Republic, Estonia, Greece, Finland, France, Hungary, Italy, Lithuania, Poland, Romania, Slovakia and Sweden.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
1. Harmonising company size definition across the EU	Small, Medium, Large	++	++	+	-	Yes

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

The impact of harmonising the thresholds in the EU for all companies up to the current highest levels in the Directives has not been calculated separately, mainly due to limitations in data collection. However, the calculations of the impacts made elsewhere in this document include the impact on savings or costs based on the assumption that such harmonisation has been achieved.

Policy option 2 – Increasing the company size thresholds

Article 53 (2) of the Fourth Council Directive calls for a review of the amounts expressed in the Directive every five years. The last revision of the thresholds defining small and medium-sized companies took place in 2006[108]. In the context of the review of the Directives and in line with the objective to reduce administrative burden it may therefore be timely to consider

[107] See Commission survey at http://ec.europa.eu/internal_market/accounting/docs/2010-options_en.pdf

[108] Thresholds defining SMEs are available at http://ec.europa.eu/internal_market/accounting/sme_accounting/thresholds_en.htm

an increase. Considering the need to regularly revise these thresholds in the future, appropriate powers could be delegated to the Commission, based on predefined criteria.

With an increase of monetary thresholds by around 14 per cent we arrive at the following figures, out of which two would have to be met for any company to fall within a particular category:

	Small companies	Medium-sized companies
Balance sheet total (EUR)	≤ € 5,000,000	≤ € 20,000,000
Net turnover (EUR)	≤ € 10,000,000	≤ € 40,000,000
Average number of employees during the financial year	≤ 50	≤ 250

Source: Commission Services.

As a result of this threshold increase 62,000 medium-sized companies would shift to the small category. The average number of employees during the financial year measure, which has worked well over the years, would not be changed.

The Member States that have transposed the maximum threshold levels are expected to support this change. In the 2009 consultation, smaller Member States tended to say that the current thresholds were too high, whilst those from the large Member States thought that they were too low. In the context of the same consultation, there were calls for periodic inflation adjustments to the thresholds.

Raising the thresholds will result in a reduction of administrative burden by €0.2bn peryear.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
2. Increasing the company size thresholds	Small, Medium, Large	++	++	0	-	Yes

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 3 – Mandating the preparation of financial statements under an electronic format such as XBRL[109]

Stakeholders have repeatedly highlighted that different reporting requirements for similar or identical information for different purposes is regarded as a big administrative burden. A system whereby enterprises could fulfil most of their information requirements by providing the information to others (national tax or statically authorities, banks, company registers, etc.) following the "only once" principle or "one-stop shop", would be seen as a major improvement. Initiatives such as e-government programmes at Member State level or BRITE[110] at EU level stem from this principle. Requiring financial reporting under the XBRL electronic format could make it easier to: speed up filing; prepare consolidated financial statements; provide uniform data and creates an opportunity to centralise reporting, which would allow the integration of national reporting systems with business registers and publishers.

Asked about XBRL in the 2009 consultation on the review of the Accounting Directives, respondents stated that electronic tools could contribute to the creation of a one-stop shop reporting system (whereby a company is only required to file its financial statements once to meet various users' needs). The benefits of XBRL data tagging were outlined for financial analysis used by large groups, banks or financial analysts. For instance, interactive reporting separates data from visualisation tools and everybody can have the layout he likes or needs. Some argued that the choice of using an electronic format should be for companies to decide.

Making financial statements accessible and easy to analyse would contribute to increased transparency of financial information and would be accompanied by potentially cheaper credit, higher market confidence, enhanced competition, and the extension of trade (within and outside EU) thus improving access to the single market for businesses.

There could be potentially relatively significant setup costs for smaller business if XBRL were to be required as a reporting format, as the "XBRLsation" would necessitate the update or purchase of software, as well as broadband internet connection. Anecdotal evidence indicates that a not-insignificant proportion of smaller companies do not have access to a computer[111]. Mandating electronic filing would therefore necessitate either the computerisation of all micro companies that have no computer yet, or outsourcing the electronic filing to a third party (external accountant, service provider, etc).

More importantly, a major stumbling block is that smaller companies have no direct benefit to expect from XBRL other than the potential for reduced costs resulting from the implementation of one-stop shops or swift IT transfer solutions. Yet, nothing ensures to date that all Member States will effectively implement one stop shop solutions or IT based communications. Mandatory electronic filing under XBRL at EU level for financial

---

109 XBRL stands for eXtensible Business Reporting Language. It is a language for the electronic communication of business and financial data. It is already being put to practical use in a number of countries and implementations of XBRL are growing rapidly around the world. http://www.xbrl.org/Home/

110 The goal of the Business Register Interoperability Throughout Europe (BRITE) project is to interconnect business registers throughout Europe. http://www.briteproject.eu

111 According to a research report commissioned by the HM Revenue & Customs of the United Kingdom: ‘The Extent and Nature of the use of Computerised Accounting by Businesses to meet their VAT and Corporation Tax Obligations" published in December 2008, 10% of businesses do not have access to a computer.

statements therefore appears unnecessary and potentially disproportionate as long as the conditions ensuring that companies will ripe full benefits from such measure are not in place.

Electronic filing systems are already developed or in place in certain Member States. A variety of standards are currently in use for that purpose in Member States: beyond XBRL (Belgium, Italy, Germany and others[112]) used or contemplated by many Member States, some Member States use XML (Portugal, Slovenia) or proprietary standards. Considering a shift to XBRL by those MS would require an analysis of potential benefits and costs as any change in technology needs initial investments.

It appears that the proponents of widespread electronic filing such as XBRL come from either the private sector (e.g. banks, larger companies) or national governments considering that the reporting requirements originates from legislation at Member State level. Introducing XBRL or other forms of electronic filing at EU level as part of a review of the accounting obligations of companies therefore appears neither necessary nor proportionate at this stage.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
3. Mandating the preparation of financial statements under an electronic format / XBRL	Micro, Small, Medium, Large	0	0	++	+	No

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 4 – Harmonising and clarifying basic principles

The Accounting Directives contain both principles, some detailed rules and numerous options. The fundamental principles could be made clearer and placed in a separate section in the beginning of the Directive. It is assumed that by doing so, the principles-based nature of the Directives would be much better emphasised and the readability and understandability of the Directives would be improved. Also the options that give a possibility for Member States to deviate from these principles could be removed to achieve more harmonisation on EU level.

Consultations with interested parties [113] indicated support for placing the basic principles in a separate section at the beginning of the Directive to improve the understandability, user friendliness and clarity of the Accounting Directives. The most commonly cited principles that stakeholders would like to see harmonised were the principles as regards substance over form and materiality.

[112] For more information on other projects see http://www.xbrl.org/eu/frontend.aspx?clk=SLK&val=63

[113] See the summary report available at http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-31_ifrs_sme_consultation_summary_en.pdf. 98% of respondents to question 1 agreed to group basic principles in one section of the Directive. Support for clarifying the basic principles was also expressed by the stakeholders that took part in the public consultation on the IFRS for SMEs carried out by the Commission in 2010.

At the same time certain terminology could be modernised and streamlined with other accounting literature. This could bring about more clarity. Such an approach received a favourable reaction from consultations with interested parties[114].

To mitigate any possible increase in burden associated with this approach it is also proposed that the principle of materiality should become a general principle in the revised Directive. Presenting non-material information entails unnecessary burden and also makes the financial statements less clear and less relevant for the users of financial reporting of companies of all sizes. A general principle of materiality will ensure that only essential accounting information is presented, and so will result in shorter and more succinct financial statements, which will be less costly to prepare. In practice, this would allow financial statements' preparers to disregard any requirements of the Directive where the information provided to users would be of limited value or significance. For example, one profit and loss account layout in the Fourth Directive requires the presentation of 23 separate lines of income and expenditure. Applying the principle of materiality would mean that the preparer could ignore those lines of income and expenditure where the amounts involved were only trivial, so the profit and loss account presented could be much shorter than the 23 lines prescribed.

There would also be a general requirement that the commercial substance of a transaction be presented. Such a means of presentation is currently permitted by the Directive, and 17 Member States require it. But there may be increased burden from introducing such a requirement in the 10 Member States that have, so far, not followed this principle[115]. It is likely that the most common transaction to be effected would be longer-term leases, so called finance leases. The assets used under such leases would need to be included in the balance sheet, and liabilities would need to be recognised for future lease payments due to the lessor. Whilst accounting in this manner in annual or consolidated financial statements will require, in a number of cases, the use of professional accountant time, accounting for leases as an operating lease would ordinarily require analysis by a professional accountant to ensure that advance payments/rentals paid at the inception of the lease are properly treated as prepayments. Hence the incremental effect of accounting for leases as finance leases may be limited. Equally in many cases the lease concerned will be immaterial to the financial position of the company.

Accounting for the commercial substance of a transaction is considered to provide users with more relevant information with which they can make economically sound decisions. To bring about a more harmonized treatment in this regard the option should be removed so that accounting for the commercial substance of a transaction becomes a general principle applicable to all companies.

It is estimated that the introduction of these two general principles will have a combined neutral effect overall on administrative burden, even though uneven per company. It is

---

114 Ibid. Around 85% of respondents who gave answer to question 36 of 2009 Consultations supported modernisation of wording and terminology in the directives. Authorities from 12 countries (out of 13 who responded), lobbyists and pan-EU organisations were in favour. The concerns raised referred to legal certainty, conversion costs and applicability of older court rulings. Support for the modernisation objectives was also expressed in occasion of the stakeholders' meeting on the Review of the Accounting Directives and IFRS for SMEs organised in Brussels on 25th May 2010, see http://ec.europa.eu/internal_market/accounting/docs/ifrs/2010-05-25-ifrs-sme%20meeting_minutes_en.pdf

115 Austria, Belgium, the Czech Republic, Denmark, Finland, France, Latvia, Sweden, Slovakia Slovenia.

assumed that any increase in burden from accounting for the substance of transactions is mitigated by a burden reduction from no longer having to present immaterial transactions. In certain Member States, the introduction of these principles could have an impact on national legislation (such as tax).

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
4. Harmonising and clarifying basic principles	Small, Medium, Large	0	0	++	++	Yes

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 5 – Reducing the number of options available to Member States

Under this option, t he proposal would involve removing significant numbers of Member State options to create a more harmonised European accounting framework. The following commentary gives some examples of areas of the Directives where options could be removed:

Layouts: The use of differing layouts hinders direct comparison of the performance, profitability, and financial position of companies. Two balance sheet layouts are permitted by the Fourth Directive. By moving to one balance sheet layout, information provided to users on companies' financial position would be fully standardised across the Community. By moving from the current four possible profit and loss account layouts to two, greater comparability of companies' relative performance would become possible[116].

Disclosures / Notes to the financial statements: The Directives require additional financial information to be disclosed, in notes to the financial statements, to further inform users about certain aspects of a company's performance, profitability and financial position. Much of this additional information is descriptive, and therefore would not be suitable for inclusion in the profit and loss account or balance sheet. Furthermore, disclosing information by way of notes avoids the profit and loss account and balance sheet being cluttered with information, often of less importance. An extensive range of disclosures is currently required, from analyses of turnover by activity and geographical market through to explanations of different classes of share capital. To reduce burdens upon smaller companies the Directives have permitted the Member States to exempt such companies from some of these disclosures. However, the take-up of these options by the Member States is far from uniform, so the disclosure regime is different in every Member State. Whilst this obviously prevents direct comparison of similar businesses' results in different Member States, it can also lead to distortions in the competitive environment as certain business sensitive information can be disclosable in certain Member States, whilst it remains confidential in others.

[116] It is not considered desirable to move to one single profit and loss layout as there should remain the possibility of presenting expenditure information according to either its function e.g. distribution costs, or its nature e.g. raw material costs. For instance, the performance of a manufacturing company may be best understood when a "by nature" presentation of the profit and loss account is used

To overcome these difficulties the disclosure regime across Europe could be harmonised. Harmonised disclosures would benefit all EU micro and small companies from a simplification perspective. Medium and large companies would have to make further disclosures, broadly in line with current requirements, but these would be harmonised in line with a "building block approach" to reflect greater user needs from the financial statements of larger companies.

Valuation: A number of different valuation methods are permitted by the Directives. This can result in similar transactions being accounted for differently in different companies, leading to a loss of comparability between reported profits or losses, and the asset side of the balance sheet. The valuation of stocks is one area where greater harmonisation is possible. Currently two diametrically opposed valuation methods are permitted: FIFO (first in, first out) and LIFO (last in, first out). FIFO values stock by assuming that the oldest items of a particular stock line would be sold before more recently acquired stock. LIFO values stock by assuming that a business would sell the most recently acquired items in a particular stock line first. Where stock prices are volatile or rising over time the two methods can give very different stock valuations, and can affect reported profitability. LIFO would tend, other things being equal, to give a lower reported profit and lower stock valuation than FIFO.

A policy option is to no longer allow LIFO as a valuation method within the revised Directive. This together with the removal of other options around inflation accounting and replacement cost accounting (a special method of revaluing fixed assets) would lead to greater comparability in reported profits/losses and the valuation of assets generally.

Consolidation: There is a general requirement within the 7th Directive that a parent company should include all its subsidiaries within its consolidated (or group) financial statements. This ensures that the consolidated financial statements give a true and fair view of the performance and financial position of the group as a whole. There is currently an option on whether so called "special purpose entities" (or SPEs) are consolidated or not - a SPE is an entity created by a sponsoring company to achieve a narrow, specified objective such as the granting of a lease. But, as illustrated in the financial crisis, the sponsoring company is very often liable for any losses the SPE may incur. This indicates that in reality SPEs are often little different to other subsidiaries, and therefore to ensure that the consolidated financial statements of groups with interests or investments in SPEs are comparable, it would be necessary that the Directive should move to a harmonised position whereby all such entities are consolidated.

The 7th Directive also allows, in certain conditions, alternative methods of consolidation. The standard approach (known as acquisition accounting) typically involves goodwill being recognised as an asset within the balance sheet. The alternative method (known as merger accounting) presents consolidated financial statements without goodwill. Given that goodwill can sometimes be the single largest asset in a consolidated balance sheet, and the amortisation or impairment of such goodwill can be a significant expense in the profit and loss account, consolidated financial statements prepared using the different bases would lack direct comparability. A possibility is to therefore allow only one method, that being acquisition accounting, which is the most commonly used option and which allows for the presentation of goodwill, which is a key accounting number to many users.

All of the above possibilities received wide stakeholder support during the consultation made in 2009 on the Review of the Accounting Directives, as a preferred means to simplify and increase the clarity and comparability of financial reporting for EU companies. Business stakeholders were of the opinion that whilst the options may only reflect the wide variety of

tax or other systems within the EU and therefore be useful to a certain extent, the main drawback is that options allow the Member States to comply with the Directive without any incentive to seek actively to improve the business environment. The accounting profession supported as few options as possible for reasons of comparability and enhancement of the internal market. A number of respondents representing Member States' authorities were in favour of eliminating options as much as possible while pointing out that some of the options would have to be kept as they relate to divergences in Member States' domestic economic, legal and fiscal situation.

Overall, it should be possible to reduce the current number of around 120 options available to Member States, in the Accounting Directives, down to around 35, without impairing the ability of companies to prepare clear and meaningful financial statements. Options remaining, i.e. around 30 for the individual financial statements and 5 for consolidated financial statements do seem necessary to ensure further simplification for SMEs, to allow compliance with the generally accepted layouts (e.g. profit and loss account by function / nature), etc.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
5. Reducing the number of options available to Member States	Small, Medium, Large	0	+	++	0	Yes

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 6 – Developing a European Accounting Standard

The Directives are principles based by nature. That is, they provide for basic accounting principles such as prudence, accruals, consistency etc. with an overriding obligation that financial statements should show a true and fair view. However most commentators would agree that they cannot be seen as a fully fledged accounting framework.

A possible way of ensuring clarity and comparability may be to use the Directives as a vehicle to develop and introduce a European Accounting Standard addressing both individual and consolidated financial statements. This would require the Directives to become much more rules based than they currently are, much lengthier as detailed provisions would be needed to prescribe how certain transactions should be accounted for (for instance, there would need to be sections on leasing, revenue recognition, pensions, areas in which the current Directives are silent). Equally as the business environment continually evolves and develops there would be a need for frequent revisions. To develop a standard that at the same time offers a robust reporting regime for large companies, but would be simple for smaller companies to deal with would be very challenging.

Developing an EU centralised accounting framework would prevent the Member States from tailoring their accounting framework to their needs and it would take a very long time to negotiate. Such an option would also require establishing an EU accounting standard setter. The appetite for such an approach with the Member States would therefore be limited, with many preferring the current primarily principles-based approach.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
6. Developing a EU accounting Standard	Small, Medium, Large	?	+	++	?	No

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 7 – Simplifying layouts or requiring the presentation of only key financial data instead of a fixed balance sheet and profit and loss account structure (mainly for small companies)

Currently the Directives allow for two layouts for the balance sheet and four layouts for the Profit and Loss (P&L) account. Additionally Member States may allow for a current/non-current presentation of balance sheet items and a performance statement instead of a P&L.

One possibility could be to impose very limited balance sheet, profit and loss and note requirements. According to CSES, 68% of enterprises would take advantage of such a simplification of financial statements format, and 38% consider this would result in time or cost savings. However, banks did not support the potential loss of information. As far as burden reduction is concerned, this proposal is estimated to produce up to €0.2bn of cost savings per year for small to large companies[117] with an initial setup cost of up to €0.3bn (due to software updates, etc).

In the 2009 consultation on the review of the Accounting Directives, the Commission proposed a radical simplification to require only key financial data for smaller enterprises instead of a fully structured balance sheet and profit and loss. The vast majority of respondents did not support this idea because traditional financial statements are more meaningful to users, allow some comparability, give a better picture of a company's performance and offer less room to data manipulation.

The rather insignificant cost savings implied by such simplification could be outweighed by initial setup costs and the mixed views of stakeholders on this option. It seems that stakeholders are satisfied with the current layouts, and that priority should be given to further harmonisation of layouts (i.e. fewer layouts), a possibility which we also examine and for which public support seems stronger[118].

[117] See CSES 2010, p.7 and p 36, and EBTP questionnaire, available at http://ec.europa.eu/internal_market/accounting/docs/studies/2010_cses_4th_company_law_directve_en.pdf

[118] See summary report of the responses received to the consultation paper on review of the Accounting Directives, p. 18, available at http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small/medium/large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
7. Simplifying layouts or requiring only key financial data	Small	++	++	-	--	No

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 8 – Reducing the information given in notes by small companies and ensure harmonisation across the EU ("mini-regime")

Preparation of notes to the financial statements is the most time consuming part of the process especially for smaller companies. The notes are descriptive, require additional analysis and contain information that, most of the time, cannot be easily obtained from the accounting software. It is estimated that for small companies up to 50%[119] of time spent on preparing financial statements is devoted to the preparation of notes. On the other hand, users' needs should not be compromised.

The Commission contacted accounting experts (e.g. ARC working group, EFRAG) to identify the key notes that are most useful in understanding the financial statements and assessing the risks of a company. The following disclosures were considered as essential:

- Accounting policy and estimates;
- Guarantees and commitments, contingencies, arrangements;
- Related party transactions;
- Post balance sheet events;
- Amounts payable after five years and total secured debt.

Thus the option would be to eliminate all but these five disclosures for small companies. These disclosures would be contingent upon a materiality check, so small transactions or events that do not affect the overall picture of a company could be omitted.

The limitation of disclosures will reduce the burden mainly in the Member States that have made only moderate use of exemptions, as described in Section 3.4.2: Cyprus, Czech Republic, Greece, Spain, Finland, France, Ireland, Poland, Romania, Sweden and Slovakia.

[119] CSES 2010, p.39

However a detailed analysis on the extent to which small companies are currently exempt of the above obligations indicates that small companies would nevertheless be subject to new obligations in many Member States. The table below outlines the current situation within each Member State with respect to these disclosures by small companies:

		Member States (shown with O) where small companies are currently exempt from the obligation ….					
		To disclose accounting policies and estimates in the notes	**To disclose details of "off balance sheet" financial guarantees and commitments, including regarding pensions and affiliated undertakings in the notes**	**To disclose details of off balance sheet arrangements in the notes**	**To disclose related party transactions in the notes**	**To disclose post balance sheet events in the annual report**	**To disclose the amounts payable after five years and total secured debt (at least in total) in the notes**
AT	**Austria**		O	O	O	O	
BE	**Belgium**		O			O	
BG	**Bulgaria**		O	O		O	
CY	**Cyprus**						
CZ	**Czech Republic**					O	
DE	**Germany**		O	O	O	O	
DK	**Denmark**			O	O	O	
EE	**Estonia**						
EL	**Greece**		O				
ES	**Spain**		O			O	
FI	**Finland**		O			O	
FR	**France**						
HU	**Hungary**		O	O	O	O	
IE	**Ireland**		O	O	O		
IT	**Italy**		O	O	O	O	
LT	**Lithuania**		O	O	O	O	
LU	**Luxemburg**		O	O	O	O	
LV	**Latvia**		O	O	O		
MT	**Malta**		O	O	O	O	
NL	**Netherlands**			O	O	O	
PL	**Poland**						
PT	**Portugal**						
RO	**Romania**						
SE	**Sweden**			O	O		
SK	**Slovakia**		O	O	O	O	
SL	**Slovenia**		O	O	O		
UK	**United Kingdom**			O	O		

Source: Commission analysis base Source: survey on Member States published by the European Commission in 2011

The disclosure of *accounting policies* briefly outlines the fundamental principles used in preparing the financial statements, including measurement and valuation rules, and items for which measurement methods other than historic cost are used. In most cases accounting policies are stable, and currently being disclosed by all companies as mandated by the Directives. So in terms of burden, this disclosure is assumed to be cost neutral.

Guarantees and commitments show the exposure of a company to potential liabilities that are not shown on the face of the balance sheet but may materialise in the future. As such they are important for the analysis of a risk of the company. For example, where a company guarantees the borrowing of an associated company, *Contingent liabilities* are the exposure to potential losses dependent upon future events (e.g. litigation, where a company could risk paying an award of significant damages which could impact upon its financial position). An

example of an *arrangement* is a special purpose entity transaction, although these are uncommon for smaller companies.

In the CSES study banks were unanimously of the view that disclosures on guarantees and commitments (including information on amounts payable after more than five years and details of amounts payable where valuable security had been given) are necessary and that if they were not in the financial statements companies would be asked for this information anyway. Accounting associations and firms also agreed that this information is necessary although accounting firms added that it is less important for companies that do not use bank finance.

Many Member States have made their small companies exempt of the obligation to disclose guarantees, commitments, arrangements, etc. As such, to introduce disclosure for small companies would be akin to require a new requirement. The corresponding increase in administrative burden for small companies is expected to cost around €159m annually and €43m in one-off system change costs[120].

Related party transactions are transactions entered between a company and its owners or managers (e.g. a shareholder renting a personally owned property to his company). Their disclosure can indicate the inter dependency of the company and its owners and can reveal non-arms-length transactions.

Many Member States have made their small companies exempt of the obligation to disclose related party transactions. Making this mandatory would be akin to a new disclosure requirement in 15 Member States. This is expected to cost small companies around €95m annually with €25m in one off system change costs[121].

In the CSES study, banks said that they ask for this information anyway whether it is in the statutory accounts or not. Accounting associations and accounting firms were of the opinion that it is useful to include this information in the financial statements.

Post balance sheet events are events which arise after the accounting period end but before the date on which financial statements are approved (e.g. a destruction of a company's premises due to fire after year end). Their disclosure ensures that the reader of the financial statements is not mislead by the important transactions/events after year end and is better placed to be able to assess the going concern. Whereas many Member States have exempted their small companies from disclosing such information, making this mandatory would cost virtually nothing to companies as it is seldom that post balance sheet events have to be disclosed (depends on whether post balance sheet events have actually taken place).

Disclosing amounts becoming payable after more than 5 years and secured debts presents the amount of long-term and secured debt (that is where a lender has a right to take possession of assets in a default). This disclosure assists unsecured creditors to assess the assets available in insolvency. In the current regime small companies need to present the information. As such this disclosure is deemed cost neutral.

Moving to the disclosure of only the five items above is expected to reduce financial reporting costs annually by around €962m, taking account of the fact that some provisions would

[120] CSES 2010, p36 table 8.3 and 8.6
[121] CSES 2010, p36 table 8.3 and 8.6

increase costs by respectively €159m and €95m, i.e. €254m in total based on CSES study as explained above. This represents additional costs of €227 in average per small company, a figure which has been posted in Annex 7 under caption "Additional Costs per Company Resulting from Preferred Policy Option #8".

Audit: Due to the "think small first" approach, there would be no requirement for small companies to have a statutory audit in EU law.

The Committee of the European Banking Supervisors notes that audited financial statements are currently used by banks as part of the credit granting process. Any proposal to reduce the level of assurance given on SMEs financial information could have unintended consequences for the availability of credit for such business. However an audit, especially for the smaller companies, is not the primary source of information or comfort that finance providers use. According to academics, there is no real reason to require a statutory audit for all corporations, as most SMEs do not need one. For private entities, the users (banks, lenders, other users) should decide what type of service is needed[122]. The fact that the vast majority of Member States have made full or quite full use of the exemption offered by the Directive to exempt small companies from audit is a strong indicator supporting this assertion (see Table 2 in Section 3.4.2). Auditors tend on the contrary to not support further audit exemptions and put forward the benefits brought about by audits in raising confidence in financial information and their duties to address fraud at companies. Auditors, when intervening in companies, are subject to the obligations of the anti-money laundering directive and contribute to the fight against money laundering. It is expected that companies becoming exempt will use at least part of the savings to continue having an audit on a voluntary basis, or to buy other services from external accountants or auditors.

The potential for savings for companies where an audit is no longer required will be in the region of €0.5bn for small companies (see Annex 7). Whether an audit is required or not will depend on each Member State's policies, as the proposal would not foresee full harmonisation in this area. The most significant potential impact of removing the statutory audit requirement should be concentrated in the Member States which currently require a statutory audit for all or mostly all small companies (Cyprus, Finland and Sweden), and in the Member States where the threshold defining small companies and the audit exemptions are very low, as shown in Section 3.4.2 (Bulgaria, Czech Republic, Denmark[123], Estonia, France, Hungary[124], Lithuania, Latvia, Malta[125], Poland, Portugal, Slovakia). There should also be an impact, although relatively less pervasive, in the Member States which require an audit for all companies of one particular type whatever the size (such as e.g. public limited liability companies). These include Austria, Denmark, France, Greece, Poland, Portugal and Slovakia.

Consolidated acounts of small groups: The proposal would discourage Member States from requiring the consolidation of small groups, to be consistent with approach being followed for small companies' annual financial statements (thereby avoiding a small parent company

---

[122] Summary of the Green paper on Audit policy: Lessons from the Crisis, 2010. http://ec.europa.eu/internal_market/consultations/docs/2010/audit/summary_responses_en.pdf

[123] In Denmark, only micro-companies with less than 12 employees, a turnover below DKK3,000,000 (≈€400,000) and/or a total balance sheet below DKK1,500,000 (≈€200,000) are exempted from audit.

[124] In Hungary, the exemption from statutory audit applies only to small companies with less than 50 employees whose net turnover do not exceed HUF100,000,000 (≈€360,000).

[125] In Malta, micro companies only – balance sheet lower than €46,587, Turnover lower than €93,175 and/or less than 2 employees – are exempted from audit.

having a "light-touch" annual financial statements regime, but unduly burdensome consolidated financial statements regime). Most Member States have already adopted the current option to exempt small groups from preparing consolidated financial statements into national law, However in Estonia, Greece and Romania, where there has until now been no exemption, this outright exemption will bring burden reduction.

Maximum harmonisation

Maximum harmonisation means that the Directives set the requirements and that the Member States cannot exceed those in their legislation. It brings more harmonisation and creates a level playing field by ensuring that no Member State can impose additional requirements and must use all the simplifications provided by the revision. This is especially necessary to ensure that any construct based on "think small first" is not distorted and actually delivers benefits for those companies that will remain in the scope of the Directives. Therefore, this approach is more effective from the point of view of reducing administrative burden.

Maximum harmonisation would entail some reduction of Member State discretion over the legislation. This as such may be a cause for some opposition. The Commission Services however believe that maximum harmonisation is achievable where the benefits are clearly demonstrated.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
8. Reducing the information given in notes by small companies and ensure harmonisation across the EU ("mini-regime")	Small	++	++	+	-	Yes

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis.

Policy option 9 – Introducing a cash flow statement for certain categories of companies

The cash flow statement is a primary financial statement that can capture the flow of cash and cash equivalents in and out of a company. Or, as defined in the IFRS for SMEs: "The statement of cash flows provides information about the changes in cash and cash equivalents of an entity for a reporting period, showing separately changes from operating activities, investing activities and financing activities".

The preparation of a cash flow statement is currently not required by the Directives. It is however considered a useful tool to gauge the cash generating ability of the company.

Thus the Commission queried in the 2009 consultation on the Directives whether a cash flow statement should be required in the Directives. The majority of respondents supported such an approach but only for larger companies[126].

Several Member States currently require the preparation of a cash flow statement as permitted – but not required – by Article 2.1 of the Fourth Directive. The CSES study shows that the vast majority of medium and large companies already prepare a cash flow statement, whether for internal purposes of for publication, but less than half of small and micro companies prepare one. Banks said that where there was no cash flow statement available they could use software to generate cash flows relatively easily and carry out more sophisticated analysis or they asked firms to prepare the cash flow statements themselves. Some banks were of the view that if a simplified cash flow statement was to be introduced that could reduce the usefulness of information available. Accounting associations and firms said that a cash flow statement could be easily generated from the data collected already.

If the cash flow statement were to be introduced it would therefore create an additional cost mainly for micro and small companies of up to €1bn a year, with set-up costs of up to €1.5bn. For medium-sized companies, additional costs would be in the region of €13m in annual cost and €20m in setup cost. For large companies, there would be virtually no additional costs[127].

The Commission Services believe that introducing the obligation to present a cash flow statement would not fit with the objective of administrative burden reduction for micro entities and small companies. In addition, despite strong stakeholder support, introducing such requirements only for medium-sized and large companies may not bring about significant increase in the clarification and comparability of financial reporting as the vast majority of these companies already prepare such statements in accordance with local requirements or market led demands.

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
9. Cash flow statement for certain categories of companies	Medium, Large	+	N/A	+	+	No

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis

126 Around 73% of respondents to question 12 of 2009 Consultation considered that Cash Flow statement should be required by the Accounting Directives, out of these 87% found CF appropriate for large companies, 60% for medium-sized and 18% for small ones. In response to question 16 on current legal requirement to produce CF, public authorities from 11 (out of 15 who responded) said there have one, while 4 claim the opposite.

127 CSES, 2010

Summary of options

Option	Size of the companies mainly affected	Requirements targeted to the size of the company	Simplification and elimination of excessive requirements (small)	Clarity and comparability (small / medium / large)	Maintain information value of financial statements (relevance of information)	Preferred option (yes / no / N/A)?
1. Harmonising company size definition	Small, Medium, Large	++	++	+	-	**Yes**
2. Increasing the company size thresholds	Small, Medium, Large	++	++	**0**	-	**Yes**
3. Mandating an electronic format / XBRL	Micro, Small, Medium, Large	**0**	**0**	++	+	**No**
4.Harmonising and clarifying basic principles	Small, Medium, Large	**0**	**0**	++	++	**Yes**
5 – Reducing the number of options available to Member States	Small, Medium, Large	**0**	+	++	**0**	**Yes**
6. Developing a EU accounting Standard	Small, Medium, Large	**?**	+	++	**?**	**No**
7. Simplified layouts or only key financial data	Small	++	++	-	--	**No**
8. Reducing the information given in notes by small companies and harmonisation across the EU	Small	++	++	+	-	**Yes**
9. Introducing a cash flow statement	Medium, Large	+	**N/A**	+	+	**No**

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable

Source: Commission Services analysis

ANNEX 7
Breakdown of savings as a result of preferred policy options

BREAKDOWN OF SAVINGS RESULTING FROM PREFERRED POLICY OPTIONS

CURRENT ADMINISTRATIVE COSTS PER COMPANY DUE TO ACCOUNTING (AS PER BASELINE SCENARIO)

	Small (€)	Medium (€)
1. Obligation to draw up annual account and disclosure of account	2.178	1.847
2. Annual reports	251	219
3. Auditing of annual accounts	3.876	14.452
4. Auditing of consolidated accounts	1.715	14.367
5. Consolidated accounts and consolidated annual reports	1.293	1.473
AVERAGE COST	**2.799**	**16.660**

Source: Consortium

ADDITIONAL COSTS PER COMPANY RESULTING FROM PREFERRED POLICY OPTION #8

	Small (€)	*% cost*	Medium (€)	*% cost*
1. Obligation to draw up annual account and disclosure of account: harmonised obligation to disclose certain footnotes	227	*10%*		

Source: CSES and Annex 6 / Option 8 of this Impact Assessment

SAVINGS PER COMPANY RESULTING FROM PREFERRED POLICY OPTIONS

	Small (€)	*% cost*	Medium (€)	*% cost*
1. Obligation to draw up annual account and disclosure of account	(1.089)	*-50%*		
2. Annual reports	-	-		
3. Auditing of annual accounts	(2.907)	*-75%*		
4. Auditing of consolidated accounts	(1.286)	*-75%*		
5. Consolidated accounts and consolidated annual reports	(970)	*-75%*		
AVERAGE SAVINGS	**(1.264)**	***-45%***	**(2.478)**	***-15%***

Source: CSES, Consortium, Commission analysis

POPULATION OF COMPANIES**	Small	Medium
1. Obligation to draw up annual account and disclosure of account	1.117.214	
2. Annual reports	470.282	
3. Auditing of annual accounts	170.553	
4. Auditing of consolidated accounts	21.841	
5. Consolidated accounts and consolidated annual reports	33.657	
TOTAL	**1.117.214**	

Source: Consortium, CSES

** The population for items 2 to 5 are from Consortium study and have not been updated. The population for these items can be lower than total population because not all companies may have such obligations. The population of companies has been updated regarding item 1. on the obligation to draw up annual account and disclosures based on 2010 study by CSES.

Number of Medium-sized companies becoming small companies with higher thresholds: **62.395**

Source: Commission estimate

TOTAL NET SAVINGS RESULTING FROM THE PREFERRED POLICY OPTIONS

	Small (€)	*% savings*	Medium (€)	*% savings*
1. Obligation to draw up annual account and disclosure of account	(962.554.947)	*63%*		
2. Annual reports	-	-		
3. Auditing of annual accounts	(495.819.610)	*33%*		
4. Auditing of consolidated accounts	(28.098.000)	*2%*		
5. Consolidated accounts and consolidated annual reports	(32.641.640)	*2%*		
TOTAL	**(1.519.114.197)**	***100%***	**(154.617.540)**	***100%***

TOTAL SAVINGS (€) **(1.673.731.738)**

REMINDER FOR INFORMATION PURPOSES: SAVINGS ESTIMATED FOR THE COMMISSION PROPOSAL OF 26.2.2009 AS REGARDS MICRO-ENTITIES

	Micro	
Total administrative cost per company (€)	*1.558*	
Savings resulting from the removal of all administrative burden per company (€)	*(1.169)*	*-75%*
Total population of micro-entities	*5.369.738*	
TOTAL SAVINGS BEST ESTIMATE PROPOSAL 2009 (€)	*(6.276.031.947)*	*NB: due to evolutions in time of the population of micro versus small companies, this amount cannot be added to the above savings in a fully consistent manner.*

Source: Impact assessement accompanying a Proposal for a Directive amending Council Directive 78/660/EC on the annual accounts of certain types of companies as regards micro-entities, 26.2.2009

Methodology:

The amounts of administrative costs per company are given by a study commissioned by the European Commission to a Consortium of contractors (Ramboll, Cap Gemini, Deloitte) and published in 2009. These costs have not been updated (e.g. inflation, further studies).

The savings per company are calculated on the basis of a study performed by CSES in 2010 available at http://ec.europa.eu/internal_market/accounting/docs/studies/2010_cses_4th_company_law_directve_en.pdf

CSES based part of its work on the Consortium's work and on a questionnaire addressed through the European Business Test Panel (EBTP) http://ec.europa.eu/yourvoice/ebtp/index_en.htm . When a policy option leads to potentially removing all administrative costs for a given activity, the potential savings take into account what constitutes only administrative burden. For example, supposing the administrative cost of drawing up an annual report is 100, and assuming that 25% of the companies would prepare such annual report even in the absence of a legal obligation, the administrative burden equals 75.

The savings and population figures for medium sized companies result exclusively from an option to increase the thresholds of 14% throughout the EU. These have been estimated by the Commission services.

Generally, it has been estimated that the savings will reduce the burden on companies rather than the "business as usual" part of administrative costs.

EUROPEAN COMMISSION

Brussels, 25.10.2011
SEC(2011) 1289 final

COMMISSION STAFF WORKING PAPER

Part II

IMPACT ASSESSMENT
for financial disclosures on a country by country basis

Accompanying the document

Proposal for a Directive of the European Parliament and of the Council amending Council Directive 2004/109/EC on the harmonisation of transparency requirements
and
Proposal for a Directive of the European Parliament and of the Council on the annual annual financial statements, consolidated financial statements and related reports of certain types of undertakings

{COM(2011) 684 final}
{SEC(2011) 1290 final}

TABLE OF CONTENTS

1. Introduction 4
2. Procedural issues and consultation of interested parties 5
2.1. Internal Consultation Impact Assessment Steering Group 5
2.2. Consultation of interested parties 5
2.3. Study on compliance costs of country by country reporting (CBCR) 6
2.4. Recommendation of the Impact Assessment Board 7
3. Policy Context 7
3.1. EU extractive and logging industries in a global economy context 7
3.2. Existing EU CBCR disclosure requirements 8
3.3. International Financial Reporting Standards (IFRS) 9
3.4. Mandatory disclosure requirements in the USA 10
3.5. Practices in the other jurisdictions 10
3.6. The Extractive Industry Transparency Initiative (EITI) 11
3.7. Existing complementary requirements in the EU 13
4. Problem definition 14
4.1. Voluntary initiatives 16
4.2. How large is the problem? 16
4.3. How will the problem evolve without action? 18
4.4. Subsidiarity and proportionality 19
5. Objectives 20
6. Policy options – description and analysis 21
6.1. Analysis 22
6.2. Summary comparison of broad policy options 30
6.3. Choice of instrument 33
7. Cumulative impacts of the preferred option 33
7.1. Expected primary impacts of the preferred policy option 34
7.1.1. Increased transparency 34
7.1.2. Potential strengthening of the EITI 35

7.1.3. Improved operating environment for extractive industry and loggers of primary forests 36

7.1.4. Increased administrative costs........ 36

7.1.5. Competitive disadvantage 38

7.2. Other impacts 40

7.2.1. International relations and public authorities........ 40

7.2.2. Energy security and environmental impacts 40

7.2.3. Social Impacts and fundamental rights 41

8. Monitoring and evaluation 41

8.1. Monitoring........ 41

8.2. Evaluation........ 42

Annex 1: CBCR of payments to government on a country- and project- basis........ 43

Annex 2: Full CBCR for all listed MNCs........ 44

Annex 3: Comparative table of types of payments to governments suggested by the EITI, PWYP, and US Dodd Frank........ 46

Annex 4: EITI revenue streams (payments to governments)........ 47

Annex 5: Comparison of CBCR disclosure approaches 48

Annex 6: Outcome of the Public Consultation........ 49

. Annex 7: Meetings with stakeholders........ 50

Annex 8: Compliance cost of the preferred option 52

Annex 9: Compliance cost of full CBCR........ 55

Annex 10: Acronyms 57

1. INTRODUCTION

Europe's largest multi-nationals have hundreds of subsidiary companies, and worldwide operations in over 100 countries. Until now all the activities of a group have been brought together, every year, into a single set of consolidated accounts. This allows investors, and other accounts' users to understand the financial position and profitability of the group as a whole.

Country-by-Country Reporting (CBCR) is a different concept of financial reporting, which would see certain financial information being presented at a country rather than a global level. For instance, in the consolidated profit and loss account global revenues and global profits are reported. In a set of country by country (CbyC) accounts revenues and profits in every country in which the group operates would be shown. CBCR is not seen as a replacement for consolidated accounts, but a complementary scheme of reporting that can help to show the financial impact a multi-national has in the various countries in which it operates. CBCR can also take different forms including a full set of accounts as previously explained, or can be limited to certain key data, in particular payments to government, which are considered to be relevant for some stakeholders.

In recent years there have been regular calls for multinational companies[1] (MNCs) to provide more financial information on a country by country basis. Often these calls concerned a particular industry sector (such as the extractive industry). On several occasions, most recently in its *Communication on Tax and Development – Cooperating with Developing Countries on Promoting Good Governance in Tax Matters*[2], the European Commission supported ongoing research on CBCR requirement as part of a reporting standard for multinational corporations, notably in the extractive industry. In the recent EP Resolution[3] on Tax and Development the EP also reiterated its support for CBCR requirements for the extractive industries.

Advocates of CBCR consider that it would enhance government accountability on payments received from the primary extraction of natural resources in developing countries and in turn support development and growth in such countries.

On 22 September 2010 the Commission agreed with the European Parliament, in the context of the negotiations of the new European financial supervisory package, to evaluate the feasibility of requesting certain issuers of shares in the EU regulated markets to disclose key financial information regarding their activities in third countries[4]. This impact assessment considers the case for CBCR for MNCs, and whether CBCR could lead to better governance.

---

1 MNC is a corporation that operates in two or more countries.

2 COM (2010) 163 final.

3 In Resolution 2010/2102 (INI) the European Parliament when considering extractive industries "*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 for 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, while at the international level the Commission should exert pressure on the IASB swiftly to develop the corresponding comprehensive standard.*"

4 http://register.consilium.europa.eu/pdf/en/10/st15/st15650-ad01.en10.pdf

It is acknowledged that other policy options in the field of development (for instance making aid conditional upon improved governance and transparency) could also achieve some of the above objectives. However, this Impact Assessment focuses on the possible role that a CBC regime in financial reporting could have in achieving this objective.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Internal Consultation Impact Assessment Steering Group

This Impact Assessment was guided and monitored by an Inter-Services Steering Group (ISC). The Group met on 15/10/2010, 01/04/2011 and 15/4/2011. The following services were consulted: Secretary General, Legal Service, Taxation and Customs Union, Development, Trade, Enterprise, Energy, and Environment. The minutes of the final meeting of the Group on 15/4 were provided to the Impact Assessment Board. A revised draft of this report was submitted to the ISC on 15/06/2011. Therefore an addenda to the minutes was prepared and submitted to the IAB.

This initiative has been included in the Commission's Work Programme (Reference number 2011/MARKT/030)[5].

2.2. Consultation of interested parties

The Commission conducted a public consultation on CBCR by multinational companies between 26 October 2010 and 9 January 2011[6] in order to obtain stakeholders' views on possible additional disclosure requirements. The summary of the results[7] is attached to this Impact Assessment (see Annex 6). The overall result of the consultation shows a rather diverse pattern of opinions depending on the category of respondents. Companies preparing financial statements and their representative bodies (hereinafter "preparers"), accountants and auditors were in general opposed to requirements to report on a country by country basis. However, a detailed analysis of the responses showed that preparers in the most concerned industries (oil and gas companies) expressed a constructive view as they consider this to be conducive to improving domestic accountability and governance in resource-rich countries. Users (mainly NGOs) were in favour of CBCR requirements. The opinions of public authorities were split and half of them had a neutral position on several of the questions.

During 2010 and 2011 the Commission services had a series of bilateral meetings with stakeholders. A list of these bilateral contacts is attached to this Impact Assessment (see Annex 7).

During both the public consultation and bilateral contacts various opinions were expressed and the Commission Services sought further views on detailed aspects of this policy area. Preparers (companies, representative bodies, etc) expressed their concern about the possibility of requiring disclosure of full accounts on a country by country basis. In their

---

[5] http://ec.europa.eu/governance/impact/planned_ia/roadmaps_2011_en.htm#internal_market

[6] The consultation document can be found at: http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm

[7] The complete summary report of the public consultation can be found at: http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm

view, this type of reporting would be very burdensome, would reveal commercially sensitive information, and would place EU industry at a competitive disadvantage. Preparers argued that such information is not useful to investors, and instead would make financial statements complex and unreadable.

The extractive industry (oil, gas, and mining) also viewed full accounts on a country by country basis as burdensome and disproportionate. Instead some extractive companies favoured initiatives like the EITI. Some extractive companies viewed a mandatory disclosure requirement of payments to governments at a country level as a tool for enhancing transparency and building trust. Certain extractive companies stated that they already voluntarily disclosed payments to governments and that it was not harmful to their competitive position. Listed companies suggested that in order to achieve a level-playing field, the scope should include listed and non-listed extractive companies. Extractive companies also suggested that CBCR should not form part of the financial statements, nor be subject to audit as this would be very costly. Finally they also expressed concerns over the publication of information on both a country- and project- basis as required under the US legislation.

During bilateral consultations with some parts of the forest-based sector, the view was expressed that it is different from the extractive industry because it uses renewable forest resources, and payments to government are much lower than in the extractive industry. It was argued that there are already initiatives (like the EU FLEGT Action Plan, including the Timber Regulation) in place, and that additional requirements would be burdensome to the industry.[8] Others viewed CbC disclosure requirements of payments to governments as a positive policy initiative, although few EU companies would be affected by it.

Users expressed their support for disclosures of *payments to governments* on a country- and project- level by all extractive companies (listed and non-listed). Some NGOs stated that although EITI was a very useful initiative, it was a voluntary initiative and that only a few countries were compliant. In their view, mandatory CBCR by MNCs in the extractive industry and loggers of primary forests[9] would contribute to better governance and accountability in resource-rich countries. NGOs supported the view that payments to governments should be disclosed at country- and project- level because it would allow for accountability even at the local level. They suggested that the costs would be outweighed by the benefits to investors and civil society. Some NGOs also expressed their support to go even further and disclose full accounts on a CBC basis.

2.3. Study on compliance costs of country by country reporting (CBCR)

The European Financial Reporting Authority Group (EFRAG) provided input on the evaluation of the administrative costs associated with possibly requiring country by country financial reporting (see Section 7).

---

8 EC Public Consultation on "Additional options to combat illegal logging": Summary Report 2007 http://www.cc.cec/dgintranet/env/i/e2/doc/pdf_docs/forests/AddlOptionsSynthFinal.pdf

9 Whether clear-cutting, selective logging or thinning, on land classified as containing primary forest areas or other disturbance of such forest or forest land caused by mining, mineral, water, oil or gas exploration or extraction or other detrimental activities

2.4. Recommendation of the Impact Assessment Board

On 22 July 2011 the Impact Assessment Board gave its positive opinion on this impact assessment. The present document takes account of the comments expressed on the draft impact assessment, namely:

The report needed to establish more clearly the scope and core objective of the initiative. Secondly, it needed to provide a fuller baseline scenario. Thirdly, options needed to be better presented. Fourthly, the report needed to better consider the costs and benefits of the policy options and strengthen the proportionality analysis of the proposed measures. Finally, the report needed to provide more information on stakeholders' views.

3. POLICY CONTEXT

This section first looks at the EU extractive and logging industries in a global economy context. This section also looks at existing CBCR requirements in different jurisdictions as well as existing complementary requirements.

3.1. EU extractive and logging industries in a global economy context

Extractive industry

Within the FT rankings of the top 100 listed companies, seven companies are EU oil, gas or mining companies (BHP, Shell, BP, Total, Rio Tinto, Eni, Statoil) while 4 are US companies (Exxon, Chevron, ConocoPhillips and Occidental) and 9 BRICs (Brazil, Russia, India and China) companies (Petrochina, Petrobas, Vale, Gazprom, Sinopec, China Shenha Energy, Rosneft, Reliance and CNOOC). This illustrates the importance of the extractive sector in the EU economy but also its exposure to international competition, as half of the leading operators come from emerging economies. Major EU and US oil and gas companies[10] control approximately 12% of world production and reserves, whilst OPEC[11] and non-OPEC[12] national oil companies account for approximately 60% of oil and gas production and 70% of oil and gas reserves[13].

Three EU-listed companies feature among the top ten oil and gas companies according to Energy Intelligence 2010[14] which bases its ranking on operating metrics (oil production, gas production, oil reserves, gas reserves, product sales and refinery distillation capacity) rather than more traditional measurements such as market capitalisation or revenues. The top 100 companies control 87% of the world's oil reserves and 72% of its gas reserves. This ranking shows the growing influence of Asia's government-controlled national oil companies. Malaysia's Petronas (17), China's CNOOC (38), India's Reliance industries (40), Thailand's PTT (53) and Korea's National Oil Corp. (77) have been among the fastest rising companies in this ranking in recent years.

---

10 ExxonMobil, Shell, BP, Chevron, ConocoPhillips, Total

11 Saudi Aramco, NNPC, Sonatrach, PDVSA, QatarPetroleum, NOC, ADNOC, NIOC, KPC, Sonangol, TAQA, PetroEcuador, Mubadala , Emirates Oil Company, Iraqi Oil Ministry

12 CNPC (inc. Petrochina), Petrobras, PEMEX, Gazprom, Statoil, Petronas, Sinopec, CNOOC, Rosneft, Ecopetrol, ONGC

13 Quoted from Total with reference to BP Statistical Review,Wood Mackenzie, Total estimates, IFP, Barclays Capital, PFC

14 NIOC, Exxon Mobil, PDV, CNPC, BP, Royal Dutch Shell, Chevron, ConocoPhillips, Total, Pemex

The emergence in recent years of three major Chinese NOCs also illustrates that EU (and US) companies face increasing competition within the global marketplace: China National Petroleum Corporation (CNPC), China Petroleum & Chemical Corporation (Sinopec) and China National Offshore Oil Corporation (CNOOC) have emerged as significant players in global competition for oil and natural gas[15]. According to International Energy Agency (IEA) data[16], in 2009, Chinese companies spent US$ 18.2 billion on mergers and acquisitions (13% of total global oil and gas acquisitions (US$ 144 billion) and 61% of all acquisitions by national oil companies (US$30 billion)). In 2010, they again spent approximately US$ 29 billion, with more than half invested in Latin American (US$ 15.74 billion). Chinese oil companies are now operating in 31 countries and have equity production in 20 of these countries. Their equity shares are mostly located in four countries: Kazakhstan, Sudan, Venezuela and Angola.

Logging industry

Exact industry data for the logging industry is difficult to come by, but in 2004, trade in all wood-based forest products accounted for an estimated 3.7% of the world trade in commodities, valued at US$327 billion (UN Food and Agriculture Organisation 2007 report). Europe accounts for nearly half of the world's trade in forest products with imports of US$158 billion and exports of US$184 billion (FAO 2007). The tropical logging industry in particular has seen the biggest demand for imports from China and India (80%, 2007-2009). During this same period, EU imports have fallen. Imports by France (the EU's largest tropical log importer) have witnessed a decline of 16% (at the same time there were greater export restrictions imposed by the host countries such as Cameroon, Gabon, Liberia and Congo).
The major timber exporting African states lie in the Congo River Basin and coastal regions of West/Central Africa. In some of these countries, revenues from forestry accounts for 8 - 12% of GDP (such as Guinea-Bissau, Chad, and Liberia).

Unlike the extractive sector, the logging sector is not characterised by very large listed companies (for instance, no logging companies feature in the top 100 listed companies), but the leading EU MNCs in this sector include (according to UNCTAD), Rougier[17], HFC, SIBAF *(Société Industrielle des Bois Africains)***,** Thanry and Sonae**,** all of whom have extensive operations in Africa. EU MNCs are more present in Africa than in Asia or Latin America.

3.2. Existing EU CBCR disclosure requirements

At EU level, MNCs are not required to disclose financial information on a country by country basis in their consolidated accounts. Some EU legal acts, however, refer to relevant disclosures that provide information below the group level:

- The Fourth Company Law Directive[18] on annual accounts and the Seventh Company Law Directive[19] on consolidated accounts set out accounting rules for all

---

15 Examples also include national oil companies such as Saudi Aramco, National Iranian Oil Company. See also Attachment C to API submission to US SEC of 12 October 2010

16 IEA 2011

17 Which extends from forest exploitation and processing in Africa; international timber trade and imports to France; and timber processing in France.

18 Directive 78/660/EEC

19 Directive 83/349/EEC

limited liability companies incorporated in the EU. The Seventh Directive requires the parent company (whether listed or not) to disclose in its consolidated accounts its subsidiaries, jointly controlled entities and associates[20].

- The First Company Law Directive[21] requires all companies registered in the EU and incorporated with limited liability to file their annual accounts with national business registries, which are accessible to any interested party.

- The Transparency Directive (TD)[22] sets out the minimum transparency requirements for listed companies. Recital 14 of the Transparency Directive (TD) encourages EU countries to request their national listed extractive industry to disclose payments to governments. So far none of the EU Member States have made this requirement mandatory.

3.3. International Financial Reporting Standards (IFRS)

The International Accounting Standards Board (IASB) is an independent standard-setting body located in London, and is responsible for the development and publication of International Financial Reporting Standards (IFRS). IFRS are applied in more than 100 countries (including the EU Member States, Australia, Hong Kong, New Zealand, Singapore, South Africa, Brazil)[23]. The consolidated accounts of listed EU companies have to be prepared in accordance with IFRS issued by the IASB, and adopted by the EU[24]. Two IFRS are relevant in the policy context of CBCR.

IFRS 8 on Operating Segments

The IASB issued *IFRS 8 Operating Segments* on 30 November 2006 (adopted by the EU in November 2007 and effective from 1 January 2009). While IFRS 8 contains some geographical disclosure requirements, companies tend to organize and report on their operations on non-geographic lines (i.e. product or service lines)[25]. Even when a company opts to report on its operations on a geographical line, it may only be on a continental or sub-continental and not country level. The IASB has indicated to the Commission that it will start a post-implementation review of IFRS 8 later in 2011, as the standard only became mandatory for reporting periods starting on or after 1 January 2009.

IFRS 6 on the Exploration for and Evaluation of Mineral Resources

The IASB issued *IFRS 6 on the Exploration for and Evaluation of Mineral Resources* on 9 December 2004 (adopted by the EU in November 2005 and effective from 1 January 2006),

---

20 Article 34 (2) of Directive 83/349/EEC

21 Directive 68/151/EEC: Article 1 for the types of companies covered by this obligation and article 2 for the obligation.

22 Directive 2004/109/EC

23 Some countries are in the process of adopting or converging towards IFRS by the end of this year (such as Canada, China and South Korea) while other countries like the US and Japan will announce in 2011 and 2012 respectively whether they will make IFRS mandatory in their countries.

24 Regulation (EC) No 1606/2002/EC

25 In its basis for conclusions on IFRS 8 (see IFRS 8 paragraph BC50) the IASB took the view that the issue of CBCR would need to be taken forward in discussion with agencies such as the UN, IMF and World Bank.

as an interim standard pending completion of a research project. Before that date, there were no standards to address the particularities of the extractive sector industry. In April 2010, the IASB published a Discussion Paper on IFRS 6 for comment in order to analyse the unique financial reporting issues applicable to extractive activities and to identify a basis on which a financial reporting model might be developed to address these issues. The Discussion Paper has a chapter on the *Publish What You Pay* (PWYP)[26] proposals on country-specific reporting of payments to governments, as well the reporting of reserves volumes, production volumes, production revenues and costs.

In the IASB Comment Letter summary[27] of October 2010, the staff states that the IASB clarified that "*the objective of financial reporting is directed towards meeting the needs of investors and lenders and that information that meets their needs may also be useful to other users. Consequently, assessing the PWYP proposals from the perspective of the benefits they provide to other users would appear to go beyond that objective*." Many of the commentators suggested that such disclosures are within the scope of corporate social responsibility. The IASB will only decide whether to pursue development of extractive industry-specific standards during the second part of 2011. Given that CBCR is not on the IASB's current work programme, any initiative on the part of the IASB is likely to take several years to reach the status of a final standard and there would be a further implementation period of at least two years beyond that.

3.4. Mandatory disclosure requirements in the USA

The US Dodd-Frank Act[28], which was adopted in July 2010, is the Wall Street Reform, whose purpose is to increase regulatory oversight of the banking and financial sectors in the US. Section 1504 requires extractive industry companies (oil, gas and mining companies) registered with the Securities and Exchange Commission (SEC) to publicly report payments to governments[29] on a country- and project-specific basis. The US rules will apply to many of the foreign, including 15 EU, oil, gas and mining companies, if they have securities listed on the New York Stock Exchange. The US rules build on the principles of payment transparency established by Extractive Industries Transparency Initiative (EITI). The proposed implementing rules were published in December 2010[30]. Once the final implementing rules are issued by the SEC (initially due in April 2011, but now expected during the second half of 2011) companies will have one fiscal year to implement the new requirements.

3.5. Practices in the other jurisdictions

From June 2010 the Hong Kong Stock Exchange introduced new listing rules to require new applicant mining, oil, and gas companies to disclose "payments made to host-country governments in respect of tax, royalties, and other significant payments on a country by

---

26 Publish What You Pay (PWYP) is a global network of civil society organisations. See http://www.publishwhatyoupay.org/en/about

27 http://www.ifrs.org/NR/rdonlyres/DB7A2F15-3B38-493F-B295-FFE4CF6E4742/0/Extractives1010b07Aobs.pdf, p 29.

28 http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

29 Taxes, royalties, fees (including license fees), production entitlements, bonuses, and other material benefits.

30 http://www.sec.gov/rules/proposed/2010/34-63549.pdf

country basis,"[31] if relevant and material to the company's business. This rule applies to each new applicant whose major activity is the exploration and/or extraction of natural resources, or which has 25% or more of its total assets, revenues or operating expenses in natural resources. These are "one-off" disclosures on an initial listing, and companies would only be required to make similar disclosures if they were to conduct a major acquisition or disposal of mineral or petroleum assets. Otherwise, there is no such specific annual disclosure requirement.

Similarly, the UK Alternative Investment Market (AIM), a non-regulated stock market for smaller enterprises within the London Stock Exchange, also requires a one-off disclosure by the extractive industry companies of payments to governments on a CBC basis[32].

3.6. The Extractive Industry Transparency Initiative (EITI)

This is a process driven by national governments which means that all extractive companies (oil, gas and minerals) active in the country fall with the scope of the relevant national regulations and must comply. The Initiative was launched in 2003 by the UK government, with a view to ensuring that natural resource wealth serves as an engine for sustainable development and poverty reduction. Although the EITI is a voluntary initiative, participation in the process is mandatory for all extractive industry operators (including state-owned enterprises) once the host country endorses the initiative – thereby a level playing field is created for all extractive operators within the relevant country. The EITI applies to operators with activities in exploration and production. As of March 2011, 11 countries[33] are EITI compliant (fully implementing EITI and having undergone successful external validation in line with the EITI validation indicators - including the publication and distribution of an EITI report); 24 countries[34] have candidate status (starting the process, fulfilling at least four of the EITI criteria[35] but not having yet finished a full round of EITI reporting); and 4 have started the process but do not fulfil at the moment the four minimum criteria to be considered as candidate[36]. 50 of the world's largest oil, gas and mining companies have signed up to this process[37].

Out of the 11 compliant countries, 9 countries are considered as resource-rich countries by the IMF. Five are considered by the IMF as hydrocarbon-rich countries (Azerbaijan, Nigeria, Norway, Timor-Leste, Yemen) and these account for 4.6% of the world's oil

---

31 http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/Documents/mb96_miner.pdf, p 10.

32 The AIM guidelines state that the new applicant should disclose "any payments aggregating over £10,000 made to any government or regulatory authority or similar body made by the applicant or on behalf of it, with regards to the acquisition of, or maintenance of its assets." See AIM Note for Mining, oil & gas companies (2009), http://www.londonstockexchange.com/companies-and-advisors/aim/publications/rules-regulations/guidance-note.pdf , p. 4.

33 Azerbaijan, Central Africa Republic, Ghana, the Kyrgyz Republic, Liberia, Mongolia, Niger, Nigeria, Norway, Timor-Leste and Yemen.

34 Afghanistan, Albania, Burkina Faso, Cameroon, Chad, Côte d'Ivoire, Democratic Republic of Congo, Gabon, Guatemala, Guinea, Indonesia, Iraq, Kazakhstan, Madagascar, Mali, Mauritania, Mozambique, Peru, Republic of the Congo, Sierra Leone, Tanzania, Togo, Trinidad and Tobago, and Zambia.

35 Committing to implement the EITI; committing to work with civil society and the private sector; appointing an individual to lead implementation; and producing a Work Plan that has been agreed with stakeholders

36 Equatorial Guinea, Ethiopia, Sao Tome and Principe, Ukraine

37 http://eiti.org/supporters/companies

reserves and 5.3% of the world gas reserves; four are considered by the IMF as mineral-rich countries (Ghana, Kyrgyz Republic, Liberia, Mongolia); two countries (Central Africa Republic and Niger) do not feature on the IMF list of resource-rich countries[38].

Many resource-rich countries have not yet joined the EITI. The 2008 IEA statistics[39] indicate that only two EITI compliant countries are represented in the top ranking of net exporters for crude oil (Norway (4.6% of world net exports) and Nigeria (5.2%)) while countries like Saudi Arabia (18.2%), Russia (12.3%), Iran (6.1%), United Arab Emirates (5.5%), Angola (4.7%), Kuwait (4.6%), Iraq (4.5%)[40] and Venezuela (3.8%) account for 60% of world exports of crude oil. The 2008 IEA statistics also indicate that the only EITI compliant country represented in the top ranking of net exporters for natural gas is again Norway (13.6% of world net exports) while countries like Russia (21.7%), Canada (10.3%), Qatar (9.1%), Algeria (7.5%), Indonesia (4.9%), Netherlands (4.1%), Turkmenistan (3.7%), Malaysia (3.3%) and Trinidad and Tobago (2.9%) account for 67.5% of world exports of natural gas. Most of these countries' production is controlled by National Oil Companies (NOC), which are fully or partially owned by governments.

According to the EITI rules, the company and the government must make independent statements of the amounts paid to government by the company. The EITI suggests that the following revenue streams should be disclosed: production entitlements, profits taxes, royalties and licence fees, dividends, bonuses and other significant benefits to host governments (these payments are explained in more detail in Annex 4) as agreed by the country's multi-stakeholder group[41]. The payments and revenues must be reconciled by an independent administrator applying international auditing standards[42]. It is up to the country to define the materiality level for reporting payments or company participation (that is, the size of payment or the threshold size of company operations below which they are excluded from the process for reasons of cost/benefit). Although the company has to provide fully disaggregated statements to the independent administrator/auditor, the data can be published in an aggregated[43] or disaggregated form in the final EITI report published by the government of the relevant country[44]. The obligation to publish the information rests with the government. The EITI also requires civil society participation and oversight in the country through a multi-stakeholder group process. This inclusive process provides a forum for civil society to engage with corporate and government decision-makers and is thereby

---

[38] IMF data (2004). Out of the remaining 24 candidate EITI countries, only eight are considered by the IMF as hydrocarbon-rich countries (Cameron, Chad, Gabon, Indonesia, R. of Congo, Iraq, Kazakhstan, Trinidad and Tobago) and these account for 13.64% of world oil reserves and 5.3% of world gas reserves; six are considered by the IMF as mineral-rich countries (DR of Congo, Guinea, Mauritania, Peru, Sierra Leone, Zambia); and ten countries (Afghanistan, Albania, Burkina Faso, Côte d'Ivoire, Guatemala, Madagascar, Mali, Mozambique, Tanzania, Togo) did not figure on the IMF list.

[39] Key World Energy Statistics, 2010, OECD.

[40] Iraq is a EITI candidate country.

[41] http://eiti.org/files/document/sourcebookmarch05.pdf , p. 27-28.

[42] According to EITI (2005), "all payments and revenues under EITI should have been the subject of credible, independent audit. When companies submit payments data that has been verified by their own independent auditor, no other audit will normally be required. Where such audits have not been done – or the audit is not regarded as credible – then an audit will need to be undertaken." p. 32.

[43] Payments made by individual companies are consolidated by revenue type so that individual company payments are not identified in a published EITI report.

[44] World Bank (2008). Implementing Extractive Industries Transparency Initiative.

conducive in building trust among stakeholders as well as enhancing the domestic accountability of extractive sector activities.

3.7. Existing complementary requirements in the EU

The Kimberley process

The Kimberley Process Certification Scheme (KPCS)[45] is an existing international governmental certification scheme for the diamond mining industry that was set up to prevent the trade in diamonds that fund conflict. Launched in January 2003 by the United Nations, the scheme requires governments to certify that shipments of rough diamonds are free from "blood diamonds". Countries that participate must pass legislation to enforce the Process[46]. Countries must also set up control systems for the import and export of rough diamonds. Companies in Participant Countries are only allowed to trade rough diamonds with companies from other Participant Countries, with the aim to prevent "blood diamonds" from entering the Kimberley Process system.

The KPCS can be viewed as a complementary scheme rather than overlapping with CBCR disclosure requirements. While the KPCS requires the country-participant to certify one particular mining product (diamonds) with the objective to stop the trade in conflict diamonds, CBCR would require diamond mining companies to disclosure certain financial information on a CbC basis, e.g. payments to government with the objective to enhance government accountability on revenues derived from permitting the relevant mining operations. Whilst the ultimate objective of KPCS is to eradicate the possibility of funding conflicts from the sale of diamonds, CBCR endeavours to bring transparency on government revenues in order to tackle corruption. Also, whilst the burden of proof with KPCS falls on the country-participant, CBCR would create mandatory reporting requirements for companies (not countries).

The Forest Law, Governance and Trade Program (FLEGT) and the EU Timber Regulation

The EU FLEGT Action Plan (Forest Law Enforcement, Governance and Trade)[47] set out a voluntary licensing system, which ensures that only legally harvested timber is imported into the EU from countries agreeing to take part in this scheme.[48] This system is being developed through the negotiation of bilateral Voluntary Partnership Agreements (VPAs) between the EU and timber exporting countries. Both parties commit to putting in place a scheme designed to guarantee that only licensed products from these partner countries will enter the EU. So far, VPAs have been concluded between the EU and Cameroon, Ghana, Republic of Congo, Indonesia, Liberia and Central African Republic.

---

45 The Kimberley Process currently has 71 countries-participants: 46 countries and the European Union.

46 Council Regulation (EC) No 2368/2002 of 20 December 2002 implementing the Kimberley Process certification scheme for the international trade in rough diamonds http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:358:0028:0048:EN:PDF

47 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:347:0001:0006:EN:PDF

48 According to the UN, illegally harvested timber represents 20-40% of global production of industrial wood, or 350 million to 650 million cubic metres. The environmental group WWF estimated that in 2006 the EU imported around 30 million cubic metres of timber and wooden products made from illegal logging, mostly from Russia, China and Indonesia.

Because VPAs are bilateral and voluntary, the EC proposed in 2008 legislation that would require all operators placing timber products on the EU market to put into place systems to ensure that their timber is of legal origin. In 2010, the EP voted in support of the Timber Regulation[49] to ban illegal timber imports to the EU in a bid to fight climate change, deforestation from the Amazon, Central Africa and Asia, and the loss of revenue to governments.

The EU Timber Regulation will be enforced by all EU Member States as of 3 March 2013. The law is aimed to break the supply chain of illegal wood from the world's forest-rich countries. It requires all operators who place timber products on the EU market to exercise *due diligence*. To ensure traceability along the supply chain, each timber operator will need to declare from whom they bought timber and to whom they sold it. Member States will be responsible for applying sanctions, ranging from fines to criminal law penalties.

These initiatives can be viewed as complementary rather than overlapping with CBCR disclosure requirements. Unlike disclosure of certain financial information on a CbC basis, the EU FLEGT and Timber Regulation will require traders of timber products to exercise *due diligence* in order to prevent illegal wood from entering into the EU market. The focus on the latter requirement is on trading companies, not extracting companies whilst in some cases companies may possibly be active in both areas.

4. PROBLEM DEFINITION

This section outlines the problems associated with the lack of transparency in the operating activities of multinational companies (MNCs), which have led to calls for CBCR. It then explores the causes of this lack of transparency, which will inform the policy alternatives discussion following later in this impact assessment.

MNCs, by definition, operate in many foreign jurisdictions but detailed information on their activities in the countries in which they operate is not within the public domain. MNCs include both listed and non-listed companies as non-listed companies also have cross-border activities and operate in countries other than their country of registration through subsidiaries, associates, joint ventures or branches. Interested parties[50] promoting development argue that this lack of transparency in country by country financial data stands in the way of greater Government accountability in some resource-rich countries for the income received from exploiting natural resources. Proponents of CBCR state that if payments in aggregate made to a particular Government by MNCs were known, citizens and other interested parties would be better able to demand that the Government accounts for how these incomes have been spent, which reduces the potential for corruption and therefore increases government revenues and can in turn foster economic growth, help to reduce poverty and internal conflict[51].

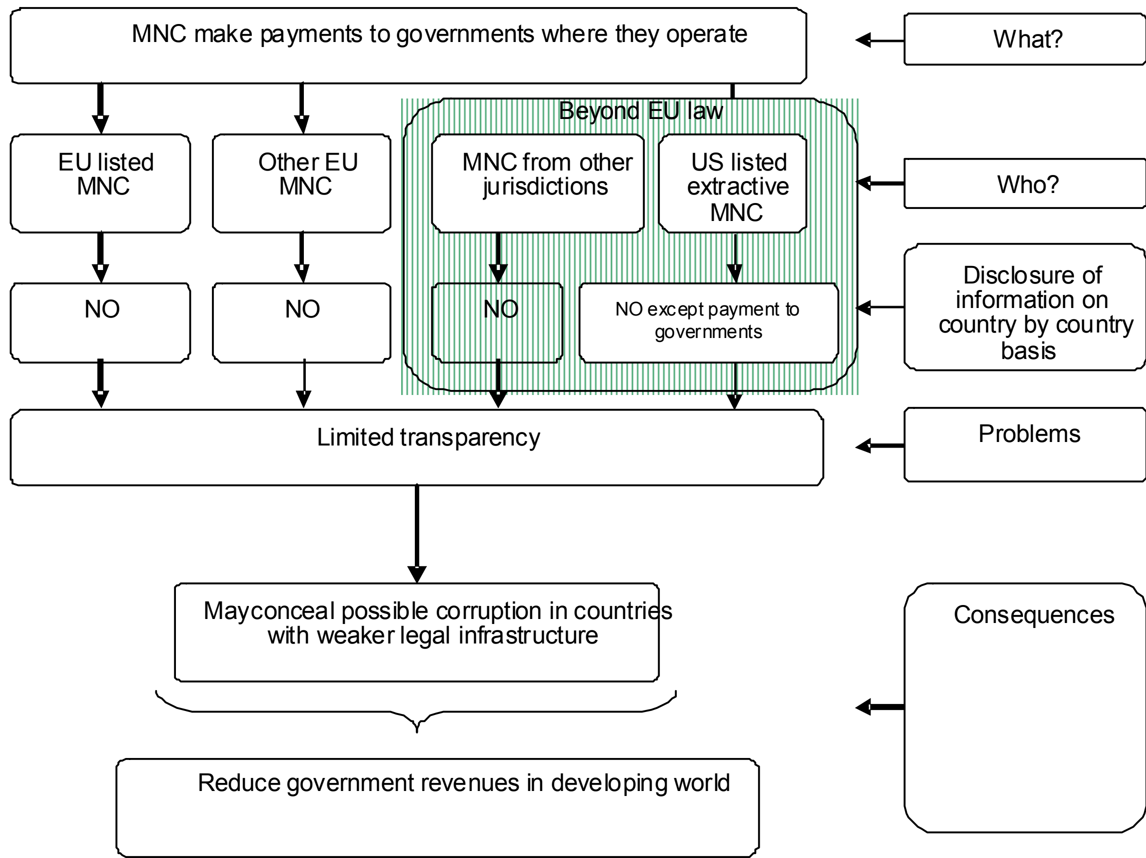
---

[49] Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010. Companies that import wood products under EU voluntary agreements will be exempt from this requirement.

[50] Different categories of stakeholders are concerned: civil society, public authorities, the EITI which gathers all partners inc. governments of resource-rich countries and MNCs.

[51] See EITI fact sheet of 25 November 2010; and 30 March 2011

The problems are depicted visually in the following problem tree.



The weakness with current statutory reporting requirements

Both listed and non-listed EU MNCs have an obligation, coming from the EU Accounting Directives, to publish yearly financial statements reporting worldwide revenues, profits and assets. Whilst there is an obligation to identify subsidiaries, associates and joint ventures and their country of residence there is no obligation to provide other information on a country by country basis within the Accounting Directives.

Companies listed on EU regulated markets are required to prepare their consolidated financial statements in accordance with IFRSs which require the reporting of revenues, profits etc. on a segmental basis (IFRS 8). In practice this means that reporting segments are typically identified on the basis of different products or services, or different regulatory environments. Segmental reporting on a strict country by country basis would only happen where a MNC manages its operations globally on such a basis – which is not the experience of MNCs reporting under IFRS 8[52].

---

52 The European Securities and Markets Authority (ESMA) reviewed the accounts of 33 issuers who represent 90% of the EU extractive industry stock market capitalization. It found that whilst in all but 3 cases geographical areas of operation were disclosed there were divergent categories covering parts of countries, countries, sub-continents and continents. ESMA reported that "*none of the issuers*

4.1. Voluntary initiatives

The EITI (see section 3.6) can provide, in those jurisdictions where it is in force, a considerable amount of information to stakeholders on the various types of payments MNCs operating in the extractive industry make to host governments. EITI encompasses all companies operating in the country, creating a level playing field between all companies active in that country. Further, it respects foreign governments' sovereignty.

However, the EITI is a voluntary scheme and as long as a country chooses to remain outside the scheme, EITI can offer no improvement in local transparency. Furthermore, until now the EITI has focused on the extractive sector although some countries have decided to extend the scope of such reporting to other sectors which they consider to be relevant to their economy[53].

MNCs could also voluntarily publish CBCR financial data, but this has only happened in a few cases. Statoil, Rio Tinto plc and Anglo American plc voluntarily publish some CbyC financial but not to the same level of detail as under EITI but none of the EU-listed forestry companies voluntarily publish CbyC information.

4.2. How large is the problem?

There have been calls for CBCR in respect of all jurisdictions where MNCs operate, however they have been especially strong with regard to MNCs operations in resource-rich countries (whether listed or non-listed). The World Trade Organisation reports that total exports of all natural resources in Africa were worth roughly US$390 billion in 2008, nearly 9 times the value of international aid to the continent (US$44 billion), and over 10 times the value of exports of agricultural produce (US$38 billion)[54]. Exports of natural resources represented 71% of Africa's total goods' exports in that year.

Targeting the extractive and loggers of primary forest sectors is justified on the grounds that these sectors are engaged in primary exploitation of natural resources that are considered to belong to society at large and are often associated with a great source of wealth in resource-rich countries[55]. An initiative in the extractive and logging of primary forest sectors is also seen as complimentary with other EU initiatives in those sectors (see Section 3.7).

---

reviewed provided country-by-country information in their financial statements". ESMA "The European extractive industry: Country-by-country reporting and segment reporting". (February 2011)

[53] Summary of LEITI First Report, 1 July 2007 - 30June 2008; Final report of the administrators of the second LEITI reconciliation, 1 July 2008 - June 2009

[54] World Trade Organisation - International Trade Statistics 2009 - Merchandise trade by product (table II.2)

[55] In its *Guide on Resource Revenue Transparency (2007),* the International Monetary Fund (IMF) defines a resource-rich country as a country in which the total average fiscal revenues, or the total average export proceeds from the oil, gas, and/or mining sectors, has been at least 25 % during the previous three years. According to the same report during 2000-05, the average annual hydrocarbon revenues accounted for 79.8% of total fiscal revenues in Angola, 78.9% in Nigeria, 60% in Gabon, 85.2% in Equatorial Guinea, 69.6% in Rep.Congo (p.62) http://www.imf.org/external/np/pp/2007/eng/051507g.pdf

Revenues derived from the extractive and logging of primary forest sectors result from countries' natural resource wealth. They are managed by governments on behalf of citizens for the benefit of the country's citizens however there is no mechanism to provide the public with an understanding of governments' revenues from the exploitation of such resources despite the importance of these two sectors to the economies of many developing countries.

In many resource-rich developing countries extractive industry and loggers of primary forest payments to host governments indeed represent a significant proportion of total government income. The IMF revenue transparency report states that oil, gas and mineral resources account for over 50% of government revenue or export proceeds in many low- and middle-income resource-rich countries[56]. In some developing countries, forestry accounts for between 8 and 12% of GDP (including Guinea-Bissau, Chad, and Liberia). In a survey of 11 country reports, the EITI reported that the 11 surveyed host governments annually received collectively US$43.5billion from the oil and gas, mining and timber industries[57]. To put this figure in context the payments represent, on average, 11.5% of these countries' GDP[58]. Measures addressing the oil, gas, mining and logging of primary forest sectors would therefore seem to be of considerable importance.

A minority of resource-rich countries are currently compliant with the EITI. The IMF designates more than 50 countries as rich in hydrocarbons[59] (they control 91% of world oil reserves and 85% of world gas reserves) and mineral resources[60]. Whilst 23 of the designated countries are EITI compliant or EITI candidate countries[61], not all of them currently publish a yearly report under the EITI scheme. Moreover, whilst some developing countries feature among the top exporters of hydrocarbons they do not belong to EITI compliant or candidate countries (e.g. Algeria, Angola and Venezuela).

In the absence of a CBCR requirement there is no reliable industry information available on the current level of payments made by extractive operators to host governments. Statoil (operating in the oil and gas sector) does voluntarily disclose payments in its Annual Report. For the three years to 31 December 2009, 30% of its revenues were paid to host governments in the form of indirect and direct taxes (excluding VAT), profit oil in kind (production entitlement) and signature bonuses. Extrapolating this ratio of payments to government to revenue to all listed EU oil and gas companies would suggest that

---

56 IMF: Guide to resource transparency (2007)

57 2009 EITI overview of country reports, http://eiti.org/files/Overview%20EITI%20Reports.pdf.

58 Commission services analysis

59 Hydrocarbon-rich countries (2000-05): Algeria, Angola, Azerbaijan, Bahrain, Brunei Darussalam, Cameroon, Colombia, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Iran, Iraq, Kazakhstan, Kuwait, Libya, Mexico, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, Turkmenistan, United Arab Emirates, Uzbekistan, Venezuela, Yemen. Countries with potentially large medium-and long-term hydrocarbon revenue: Bolivia, Chad, Mauritania, Sao Tome and Principe, Timor-Leste.

60 Mineral (2000-05): Botswana, Chile, Dem. Republic of Congo, Ghana, Guinea, Indonesia, Jordan, Kyrgyz Republic, Liberia, Mauritania, Mongolia, Namibia, Peru, Papua New Guinea, Sierra Leone, South Africa, Uzbekistan, Zambia.

61 23 countries made of 9 EITI compliant countries and 14 candidate countries

collectively payments to government worldwide by the sector in 2009 would have been €362 billion[62].

As far as the Commission Services are aware, no logging companies voluntarily report payments made to governments in respect of their logging activities. In its 2009 EITI report Liberia reported payments to government of US$ 1.9 millions derived from forestry. Whilst this amount does not appear to be significant in absolute terms it does represent 5.7% of the revenues made from natural resources wealth by the Liberian Government.

4.3. How will the problem evolve without action?

Without coordinated EU action it is unclear whether there will be any significant improvement in government or company accountability:

- There are currently no mandatory CBCR requirements except for the limited disclosures requested by the Hong Kong Stock Exchange and the AIM which only apply to new applicants in the extractive sector.
- In April 2005, the IASB held its first discussions on the extractive activities project. The Board considered a CBC regime for extractive companies. However there are indications that the implementation of a global CBC regime for the extractive industry will not be achieved through the IASB in the foreseeable future. Firstly, the IASB concluded that such a disclosure requirement was not within the scope of accounting regulation. Secondly, the IASB decided to postpone the development of the accounting standard for extractive industries.
- In 2003 the EITI was launched. There are now 11 compliant countries and 24 candidate countries. 23 of them feature among the 50 developing countries which are considered to be resource-rich by the IMF. EITI is an innovative scheme which foresees a validation process for prospective countries (on average the validation process takes 2 years). It is therefore understandable that participation is progressive and the number of compliant countries in 2011 is still limited. To date major EU listed extractive MNCs active in the 11 EITI compliant countries and preparing country reports under EITI include Anglo American, Areva, BG Group, BHP Billiton, BP, Eni, Gaz de France, Lukoil, Repsol, Rio Tinto, Shell, Statoil, Total and Vale. EU non-listed extractive companies include Central African Gold (AIM)[63], Cluff Gold (AIM)[64], Perenco[65], Sterling (AIM)[66]. Only one non-listed EU timber-logging MNC (EuroLogging) reports payments to government in Liberia, the only country where EITI reports are also prepared for the forestry sector. The EITI is widely known in resource-rich countries but governments choosing to remain outside it until now appear willing to resist pressure for greater transparency around their receipts from extractive operators.

---

[62] Source: Commission Services analysis. Extrapolation based upon Statoil Overview of activities by country statement in 2009 Annual Report. Revenues of listed oil and gas listed companies for the 2009 accounting period drawn from ESMA analysis of listed extractive companies – total revenues for oil and gas companies were €1,208 billion.

[63] Ghana EITI report 2008

[64] Sierra Leone EITI report 2006-2007; Burkino Faso EITI report 2008-2009

[65] Democratic Republic of Congo EITI report 2007; Gabon EITI report 2006

[66] Gabon EITI report 2004

– Section 1504 of the Dodd-Frank Act was adopted in July 2010. In April 2011, the SEC postponed the initial due date for the final implementing rules (15 April 2011) to the second half of 2011. Also, under the Dodd Frank Act only 15 EU dual-listed companies would be required to disclose payments to governments on a country- and project- basis. Moreover the Dodd-Frank Act would only cover the extractive sector.

– Finally, MNCs are aware of the interest that some stakeholders have in the payments that extractive or forestry operators make to host governments. Despite this interest, as pointed out by the ESMA study[52], there are as far as they are aware no explicit CBCR disclosures to the level of detail foreseen by the EITI in the annual reports of listed companies which usually divulgate more information than non-listed companies. Companies operating in EITI compliant countries are disclosing payments data in respect of payments to the local host government, but no MNC has chosen to voluntarily go further and disclose equivalent data in respect of non-EITI countries that they operate in.

The EITI has had some success but there appears to be a need for action to accelerate the process by which payments to governments in developing resource-rich countries fall into the public domain.

4.4. Subsidiarity and proportionality

According to the subsidiarity principle the EU should act only where it can provide better results than intervention at Member State level. In addition, the preferred options identified in this document should be limited to what is necessary in order to attain the objectives laid down in Section 5, and comply with the principle of proportionality.

Several policy options have been considered in this document (see section 6). They mainly differ in terms of additional information requested on a country basis. In all cases, in order to ensure that all companies are treated equally across the EU, it appears preferable to legislate through EU law rather than at Member State level.

Local regulations on country by country disclosures have already been put in place (see section 3.5). Some Member States recently expressed support for EU binding rules on payments to governments by the extractive industry[67], but want coordinated EU action. There is the risk that national initiatives lead to differences in terms of targeted companies or type of disclosures, which would undermine the ability of civil society to compare data. EU instruments appear to be more suitable in assuring consistency than individual action by the Member States.

Without coordinated EU action there is also the risk that Member States action alone could lead to distortions in the internal market in Securities. For instance, a Member State unilaterally introducing regulations to bring greater transparency for securities issued

---

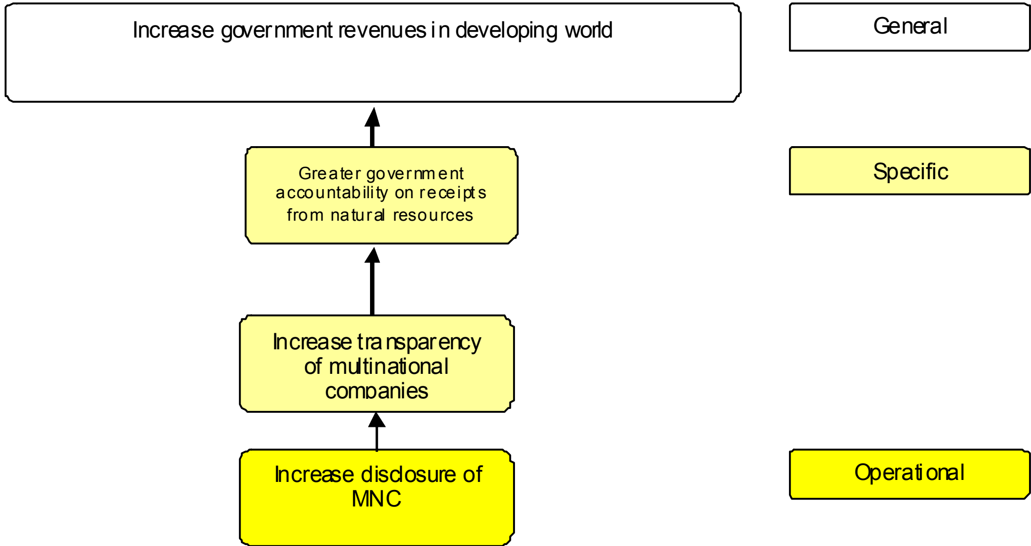
[67] On 19 July 2011 in Nigeria UK Prime Minister David Cameron said: "… Alongside this the US has gone a step further, introducing legally binding measures to require oil, gas and mining companies to publish key financial information for each country and project they work on. And I'm calling on Europe to do the same. We want to disclose the payments our companies make to your governments so you can hold your governments to account for the money they receive…"

within its jurisdiction could see local issuers migrating to a Member State without equivalent regulation. EU action is justified to maintain a level playing field for all EU MNCs.

5. OBJECTIVES

The operational policy objective is to bring increased transparency to the operations of MNCs in the extractive industry and loggers of primary forests by increasing the disclosures they make. The extractive industry covers all companies with activities which involve exploring for and finding minerals, oil and natural gas deposits, and extracting them[68]. The loggers of primary forests cover those activities of companies which involve the clear-cutting, selective logging or thinning of timber from primary forests[69]. The specific objectives are to provide relevant information to civil society in order for them to hold government and business to account on receipts from MNCs for exploiting natural resources (oil and gas, minerals and primary forests). This specific objective would in turn increase government revenues.

These objectives are summarised in the following objectives tree:



The disclosures which would be relevant for the purpose of making governments accountable for the revenues derived from the exploitation of oil, gas, mines and primary forests would be the payments made to governments by companies on a country basis. Other disclosures, in particular payments to government on project basis, may also be very relevant as they would increase the granularity and usefulness of the information at local

---

68 Like the EITI, the focus is on upstream activity because it is exclusively extractive activity. Payments to governments associated with so-called "midstream" and "downstream" operations (transport, refining and storage) would not be reported as such activities do not necessarily have to take place in the same country, and their value added has less to do with the intrinsic value of the raw material.

69 Defined in Directive 2009/28/EC as "naturally regenerated forest of native species, where there are no clearly visible indications of human activities and the ecological processes are not significantly disturbed."

level. The publication of payments to governments should create transparency in the management of the natural resources which have been at the centre of conflicts in some countries and should also allow civil society to engage in dialogue with their governments. If payments to government were disclosed on a project basis, local communities would be able to question how the monies received are subsequently spent, and whether a fair return was received in respect of the exploitation of the relevant natural resources.

CbC information could be limited to payments to government but could also be extended to a broader set of data (e.g. full accounts on a country basis). All costs and revenues generated by the activities of a MNC would then be allocated to each country where the MNC operates. Whilst such disclosures provide more information it needs to be considered as to whether such information would better help achieve the objectives depicted in the objectives tree above.

It is acknowledged that other policy options in the field of development could achieve some of the above objective, for instance making aid conditional upon improved governance and transparency – including national governments signing-up to EITI. However this Impact Assessment concentrates on the possible role that financial reporting by requiring country by country disclosures has in achieving the objectives of enhancing governance in resource-rich developing countries. It summarises the possible forms of CBCR and assesses their effectiveness, benefits and the costs.

6. POLICY OPTIONS – DESCRIPTION AND ANALYSIS

A wide range of possible voluntary or mandatory policy options can be considered relevant when contemplating a requirement for CBCR. The Commission Services have considered a broad range of different policy options (5 policy options), initially considering the "no change policy option", which would leave the decision to disclose CbyC information to MNCs (therefore, it would in effect be a voluntary scheme) (**policy option 0**).

The Commission Services next examined possible schemes that would result in a global agreement for CbyC reporting for EU and non-EU MNCs (here below referred to as "an international action"). Different schemes are considered under **policy option 1** – in particular existing international initiatives such as the EITI - which would oblige EU and non-EU MNCs to disclose CBC information. Instead of concentrating on the merits of particular CBCR schemes *per se* the analysis is on the merits of the EU acting in concert with international partners, instead of unilaterally. This reflects the reality that a reporting scheme agreed internationally would be the result of negotiation and compromise between the EU and its international partners, and the outcome of such negotiations would be difficult to foresee.

Finally, the Commission Services assessed several policy options that would oblige only EU companies to disclose CbyC information (hereinafter referred to as "an EU action") (**policy options 2 to 4**). These policy options vary in the type of disclosures which extractive companies and loggers of primary forests would have to provide. Possible disclosures could range from payments to governments to a full set of financial data on a country basis. Policy options 2 and 3 mainly require the disclosure of payments to governments from the extractive and logging of primary forest sectors. Policy option 2 requires the disclosure of payments to governments on a country basis, whilst policy option 3 requires the disclosure of such information on a country- and project- basis. Policy option 4 requires the disclosure of a much broader set of data. In addition to a report on payments

to government, policy option 4 requires a complete set of CbyC accounts to be prepared by companies active in the extractive and logging of primary forest sectors. The targeted companies include listed and non-listed MNCs[70] in the extractive and logging of primary forest sectors. The policy options are summarised below:

- Option 0: no change
- Option 1: support an international initiative to require country by country disclosures by MNCs in the extractive industry and loggers of primary forests. Under this policy option all MNCs (EU and non-EU) would be subject to new disclosure requirements.
- Option 2: require disclosure of payments to government on a country by country basis by EU MNCs in the extractive and logging of primary forest sectors
- Option 3: require disclosure of payments to government on a country- and project- basis by EU MNCs in the extractive and logging of primary forest sectors
- Option 4: require full CBCR by EU MNCs in the extractive and logging of primary forest sectors (disclosure of payments to governments, revenues, costs, profits, tax charges and taxes paid, assets held and intra-group transactions)

The policy options are assessed on their effectiveness in meeting the objective of increased transparency by MNCs and limiting factors, including their acceptability to stakeholders; the effect on competitiveness and the level playing field, and their compliance costs. Whilst enhanced transparency is seen as generally desirable, there needs to be recognition that providing additional information to stakeholders has a cost. Costs include the resources that MNCs would need to devote to collecting data (redesigning accounting and IT systems, training staff, etc.) and potentially having it audited, but also the potential loss of competitive or commercial positions. Such costs are discussed in this section for each policy option.

6.1. Analysis

Option 0. No change

This policy option constitutes the business as usual scenario. Under this option, no specific initiative is taken by the EU.

Transparency This policy option is unlikely to trigger the public disclosure of additional information and enhance transparency. The operations of extractive and forestry MNCs have been the subject of considerable interest from civil society for many years, and it has always been possible for them to voluntarily disclose information on their activities according to or beyond what is required by the

[70] This scope includes all MNCs registered in the EEA and all listed companies in the EEA. The latter would include non-EEA registered companies listed on EEA markets.

Transparency Directive, the Accounting Directives and IFRS. Some extractive companies do disclose already some financial information on a per-country basis[71] but only a few have chosen to do so, but not to the level of detail foreseen by the EITI. As far as the Commission Services are aware no loggers of primary forests disclose such information on a voluntary basis. If companies were to voluntarily provide more information there is unlikely to be consistent and comparable disclosure as requested by users in the Commission's public consultation. Increased transparency in the trading of diamonds and timber has been achieved with the adoption of KPCS and the EU timber regulation however they do not make mandatory the publication of payments to government. Finally, although the EITI has achieved significant steps, the impact of the initiative is still rather limited (see section 4.3).

Competitiveness and level playing field — EU business would remain on a level playing field, as transparency requirements elsewhere in the world are limited[72]. However, disclosures requirements are foreseen under the Dodd Frank Act. Therefore the current regime would not allow for a level playing field between EU companies themselves as some EU companies active in the extractive sector are listed in the US, and would have to comply with the US rules.

Compliance costs — Companies would not be forced to incur additional administrative burden or costs.

Acceptability to stakeholders — The result of the public consultation carried out by the Commission Services (see Annex 6) have demonstrated that whilst preparers seem most satisfied with the current rules on disclosure requirements, users (especially NGOs) are strongly in favour of mandatory country by country reporting. The European Parliament and some Member States have also called for mandatory CBCR for the extractive industry. Even though this policy option would not be acceptable to stakeholders calling for additional disclosures, it would be acceptable to preparers.

Option 1. An International Action: Support an international initiative

This policy option relates to narrower initiatives requiring the disclosures of payments to governments only, or broader ones looking at full CBCR. It would require coordinated international action through, for example, the IASB or G20 to implement at a global level the policies examined (in an EU context) under options 2 to 4 below.

Transparency — The overall effect on transparency would depend upon the policy choice followed. A policy of full CBCR adopted at international level would provide more transparency than a narrower form of reporting payments to government in the extractive and logging of primary forest sectors. Overall a positive international action would result in improved transparency.

71 Such as Norway's Statoil Hydro, Canada's Talisman Energy, US-based Newmont Mining Corporation, UK-based Anglo-American, and UK-based Rio Tinto.

72 On the Hong Kong Stock Exchange new extractive issuers are required to report payments to government on first listing. There is, however, no annual reporting requirement.

Competitiveness and level playing field

The advantage of an international initiative is that it would overcome the distortions in competition between trading blocs, as all MNCs wherever they were listed or headquartered would be within the scope. In their responses to the Commission consultation preparers expressed the concerns that mandatory disclosures for EU MNCs active in the extractive sector could place the EU industry at a disadvantage vis-à-vis National Oil Companies (NOCs) in the global competition for resources and this could ultimately impact energy security.

An EU regulation requiring the disclosures of payments made to host governments would give an incomplete picture of payments made to resource-rich countries (even if complementing the US requirements) because the obligations would apply only to companies registered in the EU. Many NOCs could continue to operate without making equivalent disclosure either because they are listed outside the EU (and the US) or because they are not listed at all. In terms of production and reserves these are amongst the largest oil producers in the world[73].

In their responses to the Commission consultation preparers also expressed the views that the level of payments to government could give indirect insight into the levels of turnover, costs and profits that a MNC generates in a jurisdiction; there could be instances when confidential business dealings will be revealed; and companies having to disclose payments will not be able to operate in countries where public disclosure of the terms of commercial agreements would be prohibited.

As regards the loggers of primary forests the major international competition for EU MNCs, especially in Africa, comes from Chinese companies. Therefore, it would be essential to have, at least, China as part of an international approach.

Compliance costs

There will be increased administrative burdens in line with the scope of the policy. The disclosure of a full set of accounts on CbyC basis would be more costly than reporting only payments to government.

Acceptability to stakeholders

International coordinated action is a preferred policy option, especially for preparers as it would maintain a level playing field. However, the timescale in which action could be achieved would be of concern to users, especially NGOs.

Practically, the IASB is the only body that could deliver a coercive instrument dealing with the disclosure of financial information whilst maintaining a level playing field, but no development from the IASB in the short to medium term can be expected. As noted in 3.3 above it is only in the recent past that the IASB has completed its project on company segmental reporting (IFRS 8), in which it decided against any scheme of CBCR despite clear requests from NGOs to the contrary. Given that CbyC is not on the IASB's current work

73 For instance Transparency International states that Saudi Aramco, the National Iranian Oil company, Petroleos Venezuela and Petroleos Mexicanos all produced over 1,000 million barrels of oil equivalent (MMBOE) in 2006. To put this in context only 2 EU oil producers (BP and Shell) produced over 1,000 MMBOE in the same year.

programme, any initiative on the part of the IASB is likely to take several years to reach the status of a final standard and there would be a further implementation period of at least two years beyond that. Whilst the Commission would support worldwide harmonisation, there is no certainty that a global consensus on the issue would be found, and the expected timeframe for such action is long.

Within the extractive industry (with a potential for extension to the forestry sector) the EITI is the only recognised scheme of reporting currently with worldwide applicability. EITI brings together all partners, including NOCs and sovereign host governments. The Commission financially supports and has endorsed the objectives of the Initiative[74]. However ultimately it is the decision of nation states to join EITI and whilst the Commission and other EU institutions could further encourage more countries to join and obtain EITI compliant status it is unclear whether this would have any noticeable impact in bringing more countries into the Initiative.

Option 2. An EU Action: Require CBCR of payments to government by EU multinational companies (MNCs) in the extractive and logging of primary forest sectors

This policy option would require disclosure of payments to governments (as defined by EITI - see Annex 4) by the extractive industry and loggers of primary forests in view of making governments (in particular in developing resource-rich countries) more accountable for the revenues received from exploiting natural resources. The simplest way to achieve the policy option is to require companies to publish data on payments made to host governments in accordance with the EITI framework. Under this policy option MNCs would have to disclose the payments made to governments by country (see Annexes 3, 4 and 5 for further detail on the EITI framework).

Transparency

This policy option would have the effect of putting into the public domain the information that would be available in respect of EU MNCs payments' to government if there was complete and unanimous signup to the EITI by all oil, gas, mineral producing and timber logging countries where EU MNCs operate. Using the EITI framework will produce information that users will find useful, as a number of civil society organisations, foreign governments and EU MNCs participate in the EITI initiative and assisted in designing the reporting framework.

Competitiveness and level playing field

In terms of competitiveness, the policy would offer competitors only limited insight into financial performance and profitability of the company in the host country, as payments to government only represent one element of the operating cost base. Total revenues, profits, and production levels would not be known, although those with knowledge of how the various payments to government locally are computed may be able to extrapolate the data to arrive at estimates for revenues etc. This is especially the case where a company has

[74] In 2010 the Commission co-financed two EITI expert and high-level meetings (€200,000), and in 2011 it has foreseen to further finance EITI capacity building seminars to strengthen the implementing capacities of EITI stakeholders.

only one project (e.g. one mine) in a particular country. In terms of worldwide competitive position the measure would be seen to bring more in line EU listed extractive MNCs with those listed in the US (except for the requirement for project based accounting). Though it is acknowledged that non-EU MNCs listed outside the EU or the US (and state-owned companies) would not have to comply. EU MNCs in the logging of primary forest sector would have to comply though non-EU logging companies would not be subject to such requirements. Preparers have expressed concerns regarding the potential risk of losing contracts or not being invited to tender for new contracts if new rules were to force them to disclose information that is regarded as confidential by host governments of resource-rich countries.

Compliance costs

For companies not already operating in an EITI compliant country such a policy may involve accounting systems and procedure changes at Head Office level and at host country level to collate and report the data on relevant payments to government. However this would be the least burdensome way to implement the policy, as those MNCs currently providing CBCRs who are already reporting under the EITI scheme could replicate the systems' and procedure changes they have implemented locally in EITI compliant or candidate countries to their worldwide operations[75]. The year one cost of this option is estimated to be €573 millions, with subsequent years' costs estimated to be €149 millions (see Annex 8 for further detail).

Acceptability to stakeholders

The results of the public consultation have shown that preparers are in general opposed to country by country reporting requirements, however a detailed analysis shows that the extractive industry (in particular, oil and gas companies) considers CBCR to be conducive to improving domestic accountability and governance in resource-rich countries (see Annex 6). Where industry provided comments on the practicalities of a reporting regime, a preference was also expressed for one aligned with EITI, rather than one based on project by project accounting as required by the Dodd Frank Act in the USA. Though NGOs would prefer a broader approach (such as policy option 4 considered below) some already acknowledge that this would be a first significant step.

Option 3. An EU Action: Require CBCR of payments to government on a country- and project- basis by EU MNCs in the extractive and logging of primary forest sectors

This policy would see extractive and logging companies reporting payments to governments on a country- and project- basis. Compared with policy option 2 this option requires disclosure by project (and not only by country). It is argued that disclosure of payments on a project basis should be required as it is foreseen in other jurisdictions (see for instance section 1504 of the Dodd Frank Act). A project would be defined as the level at which the company prepares regular internal management reports to operate and monitor its activities. This could be at the level of a particular geological basin in the extractive industry or geographical province for loggers of primary forests, or by reference to legal rights such as a concession or licence.

---

[75] Major EU listed extractive MNCs active in the 11 EITI compliant countries and preparing reports under EITI include Anglo American, Areva, BG Group, BHP Billiton, BP, Eni, Gaz de France, Lukoil, Repsol, Rio Tinto, Shell, Statoil, Total, Vale

Transparency	This policy would achieve a greater level of transparency than option 2 as information would be disclosed on a country- and project- basis. This would mean that civil society local to a mine, oil field, and forest etc. would have information on the payments being made to government in respect of the extraction of local resources. Disclosing payments to governments on a project basis would also provide more detailed information, allow for reconciliation of sub-totals (projects) with totals (countries) and therefore support the reliability of the information published.
Competitiveness and level playing field	A disclosure requirement on a project by project basis would mean that companies have to disclose a greater level of business sensitive information than with option 2 above. For instance, where signature or discovery bonuses were paid in respect of particular oil fields competitors may be given insight into the pricing or profit structure that a company is willing to accommodate. This option however creates a near identical regime to the Dodd Frank regime and in doing so avoids any competitive distortion between EU only listed companies and EU/US dual-listed companies.
Compliance costs	At a company level this option would be more costly than option 2, as payment information would need to be presented at project level in addition to a country level. However, a reporting threshold or materiality level below which the disclosure of information on a project basis would not be mandatory would mitigate the increased level of costs. The year one cost of this option is estimated to be €1,145 millions, with subsequent years' costs estimated to be €297 millions (see Section 7 and Annex 8 for further details).
Acceptability to stakeholders	Preparers would prefer option 2 as it would result in less commercially sensitive information entering the public domain, and in terms of preparation effort would be more straightforward and hence less costly. NGOs would generally prefer this option to option 2 as it would provide information to civil society at a local level.

Option 4. An EU Action: Require full CBCR by EU MNCs in the extractive and logging of primary forest sectors

This policy option would provide more information than the options to disclose payments to governments made by extractive industry and loggers of primary forests (options 2 and 3), and require, in addition to a report on payments to government, for all extractive and logger of primary forests MNCs a disclosure on a CbyC basis of a set of accounts (revenues, costs, profits, tax charges and taxes paid, and assets held). Revenues and costs would be split to identify those arising on transactions with third parties and those with other group companies (see Annex 2). Advocates of this policy option believe such a CbC regime would also help tackle tax avoidance as they argue the lack of financial data on country by country basis makes it possible for MNCs to conceal tax avoidance and/or transfer pricing abuse.

Transparency	Some NGOs support this approach which would provide a greater insight into precisely where a MNC operates, its profitability in different countries and the assets deployed there as well as the impact of its activities on local

employment, output and taxes paid to host governments. For capital providers, this would allow a better assessment of geo-political risk, and relative performance and return on capital within the MNC. This being said, investors and capital providers have not expressed strong support for the disclosure of such detailed information. Responses to the IASB's consultation on IFRS 8 demonstrated that they did not consider CbyC reporting useful in the financial statements of companies. The IASB therefore decided that only segmental reporting would be required (and not country by country reporting).

It has also been argued that the publication of a potentially enormous amount of data may make it harder to analyse a MNC's financial report whilst many claim that annual financial statements should be shorter not longer[76]. Additionally, respondents to the EFRAG study on the costs of implementing CbyC reporting (see Section 7) raised a concern that a requirement to provide information about *all* countries could result in overly detailed and voluminous reports where a MNC operates in numerous countries, which would obscure rather than provide any useful information to users.

A majority of the respondents to the Commission consultation expressed the view that CBCR would not be useful to improve tax governance at a global level. To tackle tax avoidance more effective and proportionate measures should be deployed, involving capacity building in developing countries' tax administrations, greater worldwide cooperation on tax rules and information sharing by national governments[77].

Competitiveness and level playing field

The Commission conducted a series of interviews with different categories of stakeholders (users, preparers and public authorities) where the view was expressed that this policy option would place EU MNCs at a significant competitive disadvantage relative to their peers in the rest of the world, as non-EU competitors would have significant insight into their operations and would not bear the costs of such extensive disclosures.

Compliance costs

EU MNCs would have an obligation to disclose a very large amount of data, which would be more costly than other options. Some respondents to the Commission public consultation referred to costs of US$10 million or more if new systems were required; one company referred to US$100 million for a company not organised on a geographical basis. Although these estimates were very different, they were subsequently borne out by the EFRAG study on the costs of implementing CbC reporting. Companies whose reporting systems are not configured on geographic lines would face significant costs in making the changes in order to report on a CBCR basis. Using EFRAG data the Commission Services estimated the year one cost of this option to be €2,887 millions, with subsequent years' costs estimated to be €877 millions (see Annex 9 for further detail). These estimates are approximately $2^1/_2$ the estimated costs per company of implementing CBCR on the basis of payments to government

[76] Louder than Words (in Short) (2009) Financial Reporting Council

[77] See also COM (2010)163 "Tax and Development: Cooperating with Developing Countries on Promoting Good Governance in Tax Matters"

(see Section 7.1.3 and Annex 8). They are based upon the survey respondents' comments and cannot be assumed to be representative for all extractive MNCs. The companies surveyed were also amongst Europe's largest, and the costs for smaller companies may be less than these averages.

Such a level of cost could result in an unwillingness on the part of extractive or loggers of primary forests MNCs to locate Head Office functions, and issue securities in the EU, which would have a negative long term effect on EU employment and investment prospects. At a time that the discussion about the competitiveness of European industry is high on the agenda, a decision to implement such a policy would be very costly for European industry and not proportionate in meeting the targeted objectives.

Some supporters of policy option 4 have suggested to limit the disclosures on a CbC basis to a *summary* set of accounts comprising payments to governments, revenues (distinguishing intra-group transactions from others), and pre- and post-tax profits in order to make the compliance costs more bearable for the industry as they argue this information could be readily available. The Commission conducted a series of consultations with different categories of stakeholders where the view was expressed that publishing information on a country by country basis even if limited to a set of key financial data would also result in significant additional costs because such disclosures would necessitate the detailed allocation of all items of income and expenditures to arrive at pre/post tax profits on a country basis. Therefore the financial reporting systems would have to be improved and the costs incurred for such improvements would be as high as those for producing a full set of accounts on a country basis. In effect it is almost as costly to present a full profit and loss account, as it is to present only revenues and profits or losses - the cost burden lies in calculations, not presentation. This concern was confirmed by the EFRAG study undertaken on the costs of implementing CbC reporting (see Section 7). One participant in the study whose reporting system is not set up on geographic lines reported a year 1 cost of €46 millions for this method of CBCR, which would be nearly three times more costly than the average cost of reporting payments to government under option 3. Additionally, some participants to this study indicated that although some of the required information might be available in the individual entity's accounting system, these accounting systems generally maintain information in accordance with the local accounting regulation, and that information might not necessarily be compliant with international accounting standards, and therefore not be comparable or meaningful for users.

Acceptability to stakeholders

The results of the public consultation have shown that this policy option is strongly opposed by a number of stakeholders (inc. preparers, accountants and auditors, see Annex 6) because there seems to be limits to the additional benefits that can be expected from such a policy option, whilst the costs would be high. Users in the same public consultation expressed a supportive view.

6.2. Summary comparison of broad policy options

Policy option 0 does not appear to be a realistic one for dealing with the problem. Current reporting practices by MNCs demonstrate that there is a need for action in order to enhance disclosure practices. Whilst the preferred approach would be policy option 1 there is no certainty that an international agreement can be achieved in the foreseeable future. Policy option 3 is preferred to policy option 2 because it would produce more payments information; information will be produced at a local level for civil society; whilst a matrix presentation by country and by project will enhance the reliability of the data. The disclosure of payments to government on a country- and project- basis would better satisfy the demands of stakeholders calling for enhanced disclosures whilst the costs of such policy option (compared to policy option 2) would remain acceptable if an appropriate materiality threshold (below which detailed disclosure at project level would not be mandatory) is introduced. In addition, an obligation for companies to disclose all payments on a project-by-project basis may raise issues of proportionality. A possible sub-option to address this issue would be to slightly amend Policy option 3 so that only information on payments by project which is already available within a given company would be disclosed. While this would somewhat reduce the effectiveness of option 3, it may not diminish its efficiency as costs would also be reduced. Policy option 4 would meet the demands of NGOs calling for greater transparency around the worldwide operations of MNCs, however the potential benefits associated with such enhanced transparency cannot be seen to be outweighing the loss of competitive position and the considerable administrative burden for EU multinationals, even with the lower granularity of data envisaged by some supporters of such policy. Having compared the broad policy options above the best alternative on grounds of competitiveness, transparency and acceptability to stakeholders is therefore "support for an international initiative". However there is no certainty that EU action will deliver an international agreement on enhanced transparency measures, so the policy option to be followed is to require the disclosure of payments to government on a country- *and* project- basis by EU MNCs in the extractive and logging of primary forest sectors (policy option 3). This approach would strike a balance between more transparency without overburdening companies, and without excessively putting EU companies at a competitive disadvantage. It would not compromise future efforts by the EU to obtain international agreement, and could assist in negotiations if international partners agree that there should be a worldwide level playing field.

The table below summarises how each policy option is assessed against the attributes of increased transparency; the effect on competitiveness and the level playing field; and compliance costs.

Table 1: Assessment of the Policy Options				
Option	**Impact on transparency**	**Impact on competitiveness and level playing field**	**Potential impact on costs**	**Estimates of the compliance costs (year one cost)**
0. No change	0	0	0	0
1. Support an international initiative	+	++	-	See note below
2. Require CBCR of payments to government by extractive and primary logging EU MNCs	+	-	-	€573million (see annex 8)
3. Require CBCR of payments to government on a country- and project-basis by EU MNCs in the extractive and primary logging sectors	++	-	-	€1,145 million (see 7.1.3 and annex 8)
4. Require full CBCR by EU MNCs in the extractive and primary logging sectors	++	--	--	€2,887 million (see annex 9)

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral

Note: The costs of the international option would depend on the precise nature of the scheme (see commentary for option 1).

"Primary logging" refers to logging of primary forests.

Source: Commission Services analysis

The table below summarises how each category of stakeholder would view each of the policy alternatives.

Table 2: Acceptability to stakeholders					
Option	**CATEGORY OF STAKEHOLDERS**				
	Preparers	**Users**	**Auditing/ accounting firms**	**Public Authorities**	**Other**
0. No change	0	0	0	0	0
1. Support an international initiative	++	+	+	+	+
2. Require CBCR of payments to government by extractive and primary logging EU MNCs	+	+	-	++	++
3. Require CBCR of payments to government on a country- and project-basis by EU MNCs in the extractive and primary logging sectors	+	++	-	+	++
4. Require full CBCR by EU MNCs in the extractive and primary logging sectors	--	++	--	-	+

"+" favourable, "++" highly favourable"-" unfavourable, "--" highly unfavourable; "0" neutral

Preparers: MNCs, other companies, associations of companies;
Users: NGOs, investors;
Public authorities: accounting standard setters or National Ministries.
Other: political party, law institute, private persons.
Source: ***Commission Services analysis***

"Primary logging" refers to logging of primary forests.

Preparers: In contacts with the Commission Services, preparers firmly expressed the view that they would prefer an international agreement on CBCR to avoid the impacts of an EU unilateral approach on competitiveness and the level playing field (option 1). Nevertheless, they had a constructive approach and demonstrated their readiness to accept a mandatory CBCR set at EU level if an international agreement was difficult to achieve. They also considered that a CBCR requirement should not be unduly burdensome for companies. Therefore, companies strongly opposed option 4. Consequently, for preparers, option 1 receives "++", options 2 to 3 "+" and option 4 "--".

Users: users (mainly represented by NGOs) expressed their preference for a broader approach (policy option 4) though some already acknowledged that the implementation of policy options 2 or 3 (with a preference for policy option 3 as it provides for the disclosure of information on a project basis) would be a first significant step. Investors have shown interest in the disclosures of CBCR but consider that policy option 4 would be extremely burdensome for companies.

Auditing/accounting firms: auditing/accounting firms strongly opposed policy option 4 and expressed some concerns regarding policy options 2 and 3 if audit requirements were to be imposed.

Public authorities: Public authorities expressed their preference for an EU initiative limited to payments to governments in the extractive industry (policy option 2).

6.3. Choice of instrument

The available legal instruments would be a Directive or a Regulation.

The following points are relevant when considering the case for a Directive – the Transparency Directive (TD)[78] or the Accounting Directive (AD)[79]:

- The scope of the TD covers *all* companies listed on EU regulated markets (including companies incorporated outside the EEA but listed on EU regulated markets such as Gazprom and Glencore. These constitute about 15% of the extractive issuers identified by ESMA).
- The scope of the AD is EU registered companies both listed and non-listed.
  - The TD has previously addressed the subject matter by means of a recital (recital 14).
  - A revision of the TD is planned for the second half of 2011.
  - A revision of the AD is ongoing whose primary objective is to reduce the administrative burden for small and medium-sized entities (SMEs).

An alternative would be drafting a Regulation, which would have the advantage of being directly applicable and so would not need to be transposed into national law. However the creation of a separate Regulation to deal with this <u>single</u> policy objective alone does not appear proportionate, when the policy could be legislated for within separate sections of the AD and TD.

Self-regulation is not considered as an option because this information has been of interest to many NGOs throughout the years, but very few companies have actually disclosed this type of information.

In the light of the above considerations the inclusion of a series of provisions within the Transparency Directive and the Accounting Directive is the preferred choice in order to cover all large companies which are listed and registered in the EU. In order to avoid undue administrative burden on small and medium sized companies (in the context of the simplification objective of the AD revision) only large extractive companies and loggers of primary forests would be targeted, using the existing AD definition of large company, that is a company that exceeds two of the three following criteria in two successive years: turnover in excess of €40 millions; assets in excess of €20 millions; in excess of 250 employees.

7. CUMULATIVE IMPACTS OF THE PREFERRED OPTION

The preferred policy option of disclosure of payments to governments on a country- and project- basis by the extractive industry and loggers of primary forests is inspired by the

[78] Directive 2004/109/EC

[79] Directive 78/660/EEC

EITI, which has a proven record and would avoid the duplication of numerous different disclosure requirements. The preferred option is also seen as an EU initiative which would contribute to reinforcing the existing EITI scheme.

The Commission believes that only companies of a certain size with activities in the extractive industry and logging of primary forests should be targeted by the new rules, therefore the scope of the reporting requirements will include companies listed on EU regulated stock exchanges and large unlisted companies. Several arguments support the inclusion of non-listed companies: first, large non-listed companies could potentially make significant payments to governments in developing countries; second, imposing a CBCR regime on listed and non-listed companies would maintain a level playing field in the EU. These two categories of companies (EU listed and large unlisted companies) would normally pay the largest amounts to governments. Requiring small and medium-sized companies to provide disclosures would not be in line with the Commission's current policy of making administrative burdens proportionate – smaller businesses proportionately spend more time and resource dealing with administrative tasks than their larger counterparts. The size criteria used to define large companies in the Accounting Directive would be used.

As mentioned earlier, the Commission supports the definition of payments to governments as defined by the EITI revenue streams (see Annex 4). The Commission recommends that the disclosure of payments to governments should be reported by companies in a separate and non-audited report on an annual basis (see Annex 5). Stakeholders in the public consultation referred to auditing costs as one of the major costs of possible disclosure requirements, a point confirmed in the study carried out by EFRAG. By not requiring the auditing of payments to governments, transparency can be improved while keeping the costs at a reasonable level. Under the preferred policy option, payments would be disclosed on a project basis which would also support the reliability of the data provided by the targeted companies.

7.1. Expected primary impacts of the preferred policy option

7.1.1. Increased transparency

In general terms, CBCR of payments to government by the extractive industry and loggers of primary forests should provide investors and civil society with significantly more information on what specifically is paid by EU companies to host governments in exchange for the right to extract the relevant countries' natural resources.

In 2010, the EITI reported on the benefits of its initiative where it has been implemented[80]. Whilst acknowledging that measuring the impact of the EITI is a difficult task[81] it reported that its activities had contributed to reducing corruption, improving public financial management and the business operating environment because EITI generates data on revenues that are otherwise not available to the public. Publicising this information should have the effect of making governments more accountable. Citizens and NGOs will have a

[80] EITI: Impact of EITI in Africa. Stories from the ground (2010), http://eiti.org/files/EITI%20Impact%20in%20Africa.pdf

[81] The report recounts one case where public monies have been recovered: an estimated US$ 4.7 bn owed to the government by the state-owned Nigerian National Petroleum Corporation for payments of domestic crude.

better (but incomplete) picture of the revenues local governments receive from extractive operators and will be better able to demand that governments explain how the revenues have been spent. In its 2009 report into its adoption in Liberia, the EITI quotes the country's President as saying[82]: "*LEITI (*the national scheme*) represents an important step in advancing our efforts to engage with stakeholders, to talk about our resources, and to build trust in our communities*".

By requiring disclosure of payments at a project level, where material, local communities would have insight into what governments are being paid by MNCs for exploiting local oil/gas fields, mineral deposits and forests, and allow these communities to better demand that government account for how the monies have been spent locally. A degree of MNC accountability would also be created, as over the life of a project the total payments to government would be known so that civil society would be in a position to question whether the contracts entered into between the government and extractive and loggers of primary forests delivered adequate value to society and government.

7.1.2. Potential strengthening of the EITI

Due to the limitations in present information availability it cannot be estimated precisely how much more government revenue will be subject to increased scrutiny, but in its overview of country reports[83], the EITI reported that US$43.5 billion of payments (representing on average 11.5% of those countries' GDPs)[58] annually were made by oil, gas, mining and forestry companies in 11 countries it surveyed. Given that the EITI report concerned 11 resource-rich countries, whilst the IMF designates more than 50 countries as rich in hydrocarbon and mineral resources[84], significantly more information would be within the public domain if a policy of disclosing all payments to host governments was implemented.

23 countries which are designated "resource-rich" by the IMF are currently compliant or candidate countries under the EITI scheme. Whilst this could be seen as rather significant (about 40% of payments to governments being disclosed) not all "candidate" countries already publish EITI reports. Also, whilst it is acknowledged that a EU/US CBCR regime on large extractive companies would not provide a complete picture of payments to government per country, as EU and US-listed companies control 29% of worldwide oil reserves and production and 12% of worldwide gas reserves and production[85], the level of data on payments to host governments entering the public domain following the EU and US requirements would be significantly increased.

More importantly, the EU and US requirements would affect countries which have until now decided to remain out of the EITI scheme. In those countries there will be increased pressure on national governments from civil society to account for how the revenues derived from extractive and logging of primary forests MNCs have been spent. Some governments may respond to such calls by implementing EITI locally e.g. Algeria, Botswana or Venezuela which feature among the main exporters of crude oil, gas and minerals. In 2009, 60% of government revenues and 30% of GDP stem from oil, gas and

---

82 http://eiti.org/document/case-study-liberia

83 2009 EITI overview of country reports, http://eiti.org/files/Overview%20EITI%20Reports.pdf

84 IMF: Guide to resource transparency (2007)

85 The Energy Intelligence Top 100: Ranking the World's Oil Companies. Energy Intelligence Research

mineral rents in Algeria; with the equivalent figures respectively 50% and 33% in Botswana, and 90% and 33% in Venezuela[86].

The major EU MNCs which would be subject to the EU requirement to disclose payments to governments are active in many countries (beyond the 50 resource-rich countries as designated by the IMF): Shell operates in 90 countries, Total in 130 countries. This means that potentially there would be pressure to disclose such information in many more than 50 countries. A significant expansion of EITI reporting countries would capture non-EU state-owned unlisted companies, thus reducing any negative competitive effects for EU companies *vis-à-vis* the competitive situation with non-EU state owned companies.

7.1.3. Improved operating environment for extractive industry and loggers of primary forests

More accountable governance in resource-rich countries would bring increased political stability which creates a more stable business environment for companies making significant investments locally[87]. The extractive industry and loggers of primary forests are typically capital intensive with long project cycles (with upfront investment, and profits and revenues at the end of the cycle). Increased political stability gives greater assurance about being able to see a project through from start to finish without having to face political turmoil. Transparency of payments made to a government can also help to demonstrate the contribution that their investment makes to a country, and reduce the demand for business to contribute to local infrastructure projects. Creating a business environment where less bribery and corruption takes place creates a more level playing field for companies that do not engage in such practices, and an absolute reduction in the level of bribes and corrupt payments would increase the level of profits available to be paid as dividends to MNCs' shareholders.

7.1.4. Increased administrative costs

There will be increased administrative costs from the preferred policy option. The Commission Services, using and following-up on initial questionnaire and interview data obtained by the European Financial Reporting Advisory Group from four listed MNCs operating in the (oil, gas and minerals) extractive sector (all of whom have either prepared country reports under the EITI or voluntary disclosed some CbyC information), estimates that for the four surveyed MNCs the average group global set-up cost would be €10.4 millions, with average annual recurring costs of €3.6 millions.

Extrapolating these findings to cover the 171 EU listed companies identified by ESMA in the extractive industry, indicates that the one-off costs/set-up costs for the EU listed sector would total €672 millions, with annual recurring costs of €236 millions. The "year one" costs of the policy would therefore be €908 millions, with costs in subsequent years falling to €236 millions. To put the "year one" figure in context, it would represent 0.05% of annual revenues for the 171 companies concerned.

[86] Max Khamis, Abdelhak Senhadji, Maher Hasan, Francis Kumah, Ananthakrishnan Prasad, and Gabriel Sensenbrenner, Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead, International Monetary Fund, 2010 & Central Intelligence Agency (CIA) , The World Factbook 2010

[87] See: http://eiti.org/eiti/benefits

Extrapolation has been conducted on the basis of the number of subsidiary companies. It is assumed that the use of this number is relevant as it indicates the number of countries where companies operate and therefore the volume of additional information/disclosures they would have to prepare and publish under a CRCR regime. The number of subsidiaries also reflects the size and the complexity of the organisational structure of the company, which have an impact on the costs of enhancing and maintaining IT and reporting systems to track and compile information.

Whilst costs estimates were provided by only a few companies, the surveyed companies already report some CbyC information, which gives more confidence in the costs that businesses would have to incur under the preferred option. However, none of the companies surveyed report on a project basis, nor to the level of detail required by EITI in respect of their entire global operations, so there will be significant implementation costs for these companies with the CBCR requirement. It was therefore considered appropriate to extrapolate the sampled companies' figures to all listed and large EU companies (which do not report CbC information at present). There may be a degree of over estimation in the overall cost to the sectors as large companies usually have simpler accounting systems given that they have fewer subsidiaries and a narrower range of global operations; so the costs burden for an unlisted company may be lower than that of a listed company.

The costs assume the information will be unaudited. A requirement to audit would be estimated to increase annual recurring costs by approximately €90 millions.

Furthermore, the costs estimates are based on the assumption (made by the surveyed companies) that information would be disclosed if it is material[88]. Surveyed companies provided data on information that they considered material. Whilst the surveyed MNCs were asked to consider all the incremental costs they may face, until the policy is implemented it is difficult to calculate precisely what costs will be incurred. For example, companies may face an increased level of press and NGOs questioning about the disclosures they make which would result in increased levels of spending on press and public relations activities. They may also face an increased level of interaction with foreign governments and NOCs to explain why disclosures were being made. The estimates given above are based upon respondents' comments and cannot be assumed to be representative for the extractive industry as a whole.

It should also be noted that 15 of the 171 companies identified by ESMA have a listing in the USA, and will be required to report payments to government in accordance with SEC rules. As such it is therefore considered that not all the increased administrative costs faced by these companies can be attributed to EU action alone. Approximately 18% of the estimated set-up and annual recurring costs estimated above can be attributed to these 15 companies (see Annex 8).

On the assumption that dual-listed companies face no additional reporting obligations from an EU reporting requirement beyond those imposed by Dodd Frank Act the estimated year one costs for the EU listed extractive sector would be €740 millions, and annual recurring costs thereafter would be €192 millions.

---

[88] Materiality is a financial reporting/audit concept. Information is considered material when its omission would distort the understanding of the annual reports – International Auditing Standard 320.

Using data drawn from national company registries the Commission Services estimate there to be 419 large unlisted (which are not members of EU listed groups) extractive companies in the EU. It was not possible to establish how many of these would be MNCs so for the purposes of producing an estimate an assumption has been made that all these companies would be within the scope of the preferred policy. Applying the same methodology and the same entity set-up and annual recurring costs obtained from the surveyed companies gives an estimated year one cost for the unlisted extractive sector of €397 millions, with subsequent years' costs falling to €103 millions.

In terms of the number of companies the EU forestry sector is much smaller than the extractive sector. The Commission Services identified six listed companies and 20 large unlisted companies. Applying the same entity set-up and annual recurring costs obtained from the surveyed extractive MNCs gives a year one cost for the combined listed and large unlisted forestry companies of €8 millions, with subsequent years' costs of €2 millions.

In summary the administrative cost to EU business of the proposed policy would be:

Table 3: Administrative costs of proposed policy

	Estimated Number of companies	**Year one cost (€ millions)**	**Subsequent years' costs (€ millions)**
Listed extractive MNCs	171	740	192
Unlisted large extractive MNCs	419	397	103
Forestry (listed and unlisted large MNCs)	26	8	2
Total	*616*	*1,145*	*297*

Further details on how these estimates have been arrived at are provided in Annex 8.

7.1.5. Competitive disadvantage

Whilst disclosing the level of payments to government would not give direct insight into the levels of turnover, costs and profits that a MNC generates in a jurisdiction, there will be instances when confidential business data will be revealed or can be deduced from such data[89], especially when project level disclosure would result in information being provided in respect of individual mines, oil fields, etc.

Preparers have argued that EU MNCs would not be on a level playing field when compared with non-EU state owned companies, many of which have foreign operations (see section 6.1). The example of BP in Angola has been cited as an example. In 2002 BP disclosed a signature bonus of US$111 millions in a US SEC filing. The Angolan state oil company, reacting to press coverage, threatened to take "appropriate action" if "material damage" was caused by the disclosure. This was seen as a threat to curtail BP's activities in the country by the business community. However, BP has remained operational in the country since and considers itself one of the largest investors in the economy. Furthermore, BP advised that they continue to make such filings at the US SEC and with UK authorities and this has

[89] http://www.sec.gov/comments/s7-42-10/s74210-12.pdf

not caused problems with the Angolan authorities. However, the company advised that in 2006 the Angolan Ministry of Petroleum issued Directive (Despacho) 385/06 which states in the most relevant part that: “Companies active [in the petroleum industry] in the country are prohibited from divulging any information without formal authorisation of the Ministry of Petroleum.”

Statoil which is majority owned by the Norwegian State (with ample Norwegian resources) but listed in the European Economic Area (and hence would be subject to any requirement to disclose) currently discloses certain country by country payments voluntarily, and did not report a loss of competitive position as an issue in its response to the public consultation.

Rio Tinto publishes a country by country tax report where the payments made to governments in each of the country in which it operates are detailed[90].

EU legislation has previously recognised the confidential nature of the oil and gas industries, and the risk to business from publishing business sensitive information. In Directive 94/22/EC on granting and authorising prospection, exploration and production of hydrocarbons there is a requirement for Member States to publish an annual report on geographical areas opened up for exploration etc. However, there is *no requirement* for the Member States to publish information of a commercially confidential nature. The industry would argue that the preferred policy option should foresee a similar exemption from disclosing commercially confidential payments information.

It is not possible to place a monetary value on the loss of competitive position. However, given that some extractive industry MNCs have voluntarily decided to disclose some CbyC payments and a majority of extractive industry respondents to the public consultation were in favour of disclosing CBCR of payments as a means to improve government accountability it is judged that the loss of competitive position from this policy would be limited. The strengthening of the EITI (see 7.1.2) would also militate against any possible short-term loss of competitive position, as it may lead to a more global application and enhanced reputation of compliant companies.

The point was made in some bilateral meetings that many factors are involved in successfully winning or negotiating a new contract with a host government. In the extractive industry technological expertise can be very important, and this is an area in which some major EU MNCs have an advantage due to their engineering know-how. In a ranking of relative technical efficiency of major oil companies (2002-2004), EU and US privately owned companies were far ahead of their international competitors: Exxon Mobil (efficiency score: 0.84), BP (0.75), Conoco Phillips (0.71), Shell (0.67), Chevron (0.67), Total (0.39), Saudi Aramco (0.36), Petroleos de Venezuela (0.32), Pemex (0.16), National Iranian Oil Company (0.05), PetroChina (0.03)[91]. In this respect, investment efforts are a critical area, yet one in which EU and US privately-held businesses also clearly outweigh state-owned companies. In 2006, the top companies for upstream capital expenditures comprised Exxon Mobil (14.470 billions of dollars), Shell (12.046), BP (10.237),

---

90 Rio Tinto, Taxes paid in 2010. A report on the economic contribution made by Rio Tinto to public finances

91 The rentier state national oil companies: an economic and political perspective; Essay of the Middle East Journal, June 22 2010

PetroChina (10.160), Total (10.040), Conoco Phillips (8.844), Chevron (8.389) Petrobras (7.194), EnCana (6.650) and Statoil (6.423)[92]. Conversely operators from other trading blocs are more inclined to fund major infrastructure works in return for being awarded a contract. To summarise, there are many factors relevant in assessing the competitive position of EU MNCs and giving greater transparency on payments to government would be one factor amongst others to be considered.

7.2. Other impacts

7.2.1. International relations and public authorities

International relations: the policy might be considered within the administrations of certain foreign governments as impinging domestic law making powers. Where an EU MNC also has to disclose payment information whose disclosure is prohibited by the domestic law, foreign governments could perceive there to be a breach of their national sovereignty. However this is a contested point – one respondent to the Commission consultation reports that it has received legal advice that disclosure would be illegal in certain countries whilst an academic at Columbia Law School, reports that in a global survey of mining and hydrocarbons laws' confidentiality and disclosure provisions, no examples were uncovered of an explicit prohibition of disclosure of payments[93]. The Commission considers that once a critical mass of MNCs and countries apply this system, it is less likely that countries claim infringements on their domestic laws, however an exemption is foreseen within the proposed legislation to exempt companies from disclosing payments to governments, where such a disclosure would result in the company or its employees being considered to have committed a crime under host government law.

Government opposition parties, and NGOs active in resource rich developing world countries are, however, likely to welcome the policy. For instance the Ugandan shadow Finance Minister, Albert Oduman, has called[94] for EU legislation to require the disclosure of payments by oil companies as Uganda is not a member of EITI, and the companies involved in exploiting recently found oil reserves are all EU listed.

Public authorities: the revision will not have budgetary consequences for public authorities. Nor will there be consequences for the EU budget.

7.2.2. Energy security and environmental impacts

Energy security: The security of EU energy supply figures high on the EU's agenda for several reasons inter alia because energy generated in EU member states does not cover current demand[95]. In 2006, 54 % of energy consumption was sourced from imports. According to estimates, this share may rise to 70 % by 2030. The majority of Europe’s

---

92 The rentier state national oil companies: an economic and political perspective; Essay of the Middle East Journal, June 22 2010

93 Royal Dutch Shell plc, in its submission of 28 January 2011 to the SEC, states that it had received legal advice that disclosure of payments to governments in Cameroon, China and Qatar would be illegal. See also Susan Maples JD (an academic at Columbia University) letter of 2 March 2011 to the US SEC.

94 http://www.one.org/blog/2011/01/18/albert-charles-okello-oduman-on-transparency/

95 The Treaty of Lisbon contains such objectives, from energy supply security through efficiency to renewable sources.

energy import is made-up of oil (60 %) and natural gas (26 %). At present, renewable energies constitute 16 % in the Union's own energy production, while oil (14.2 %) and natural gas (19.5 %), are still dominant. In addition, DG Energy reports that the EU is currently heavily dependent on a few suppliers both for crude oil and gas. Among these countries the position of Russia should be noted as it currently provides 35% of crude oil and 40% of gas imports; by comparison, current EITI candidate and compliant countries provide 33% of crude oil and 43% of gas imports[96].

Where a country opposes reporting of payments to government (see above), EU extractive operators may find it harder to operate locally which could have a consequent effect on security of oil and gas supplies to Europe. However, as is the case for the competitiveness of EU MNCs, as explained in section 7.1.5 above, disclosing payments to government would be one factor to be considered in assessing overall security of energy supply.

Environmental impacts: Whilst specific environmental concerns are an important issue within the extractive and logging of primary forest sectors ordinarily, no environmental impacts were identified from bilateral contacts with stakeholders, nor did any respondents to the public consultation suggest any.

7.2.3. Social Impacts and fundamental rights

Social impacts: Within the EU there will be limited social impacts as EU governments publish national accounts which provide information on government revenues. However, in other parts of the world, citizens may have limited information on government revenues. The main social impacts would therefore be outside the EU.

In 2007, the total number of employees in the energy sector was 1.6 million, representing 1.3% of the EU economy[97]. These often represent highly qualified jobs (average personnel costs per employee in the energy sector were 40% above the EU average). However bilateral contacts and responses to the public consultation did not identify a risk that EU extractive companies would seek to move their operations or Headquarters outside the EU in response to new regulation in this field. But the risk cannot be excluded that some MNCs may choose to relocate or list outside the EU in response to new disclosure requirements.

Fundamental rights: There will be no impacts on fundamental rights of EU citizens.

8. MONITORING AND EVALUATION

In light of the policy objectives set out in Section 5, the following arrangements are proposed in order to set up an appropriate monitoring and evaluation framework.

8.1. Monitoring

The Commission will monitor the implementation of the revised Directives in cooperation with the Member States throughout the implementation period which is expected to last possibly until the end of 2014. In compliance with the principle of subsidiarity, the relevant

[96] Eurostat 2010
[97] Source: Eurostat 2011

information should be gathered primarily by the Member States through Securities Markets' Regulators, and the Accounting Regulatory Committee (ARC). It is expected that the costs of such activity would be met from existing operational budgets, and would not be significant. Monitoring activity should involve sample reviews of CbyC reports, to ensure compliance with the requirement of the revised Accounting and Transparency Directives and a comparison between issuers with similar operations to ensure they are reporting in a consistent manner.

During this time, implementation workshops can be organised by the Commission and/or ESMA to deal with questions/issues that might arise in the course of the implementation period. Where questions are common to the whole extractive and logging of primary forest sectors guidance on how to deal with the issue could be issued by the Commission/ESMA.

8.2. Evaluation

The evaluation of effects of the preferred policy will be carried out to see to what extent the anticipated impacts (increased payments' transparency, improved business environment, increased administrative costs, availability of information on payments by project, increased competitive pressure, and strengthened EITI) and possible impacts such as threats to security of energy supply materialise. Improved disclosures by governments of resource-rich countries on their sources of revenues would be an indicator of better transparency. A significant increase in the number of EITI compliant countries from the current 11 would be an indication that the policy has been successful. Full compliance with the EITI can take a number of years to achieve, as specific rules need to be agreed between stakeholders in each country applying the initiative, and Government accounting systems may need to be improved to allow full reconciliation of receipts to payments. Therefore, a significant increase in the number of candidate countries from the current 24 would also be an indication of success.

In terms of possible downsides it will be necessary to assess whether any non-EU registered MNCs have chosen to de-list from EU regulated stock exchanges as a consequence of the policy. Equally if non-EU stock markets experience more listing activity for extractive issuers that would be indicative of negative consequences for the EU. The ability of EU MNCs to compete in third countries for exploration/production contracts will be evaluated via bilateral contact. The number of new contracts awarded or continued will be followed through bilateral contacts. The share of EU MNCs within global production will also be monitored. If MNCs point to specific problems a review will be undertaken to see if the policy would need refinement.

Evaluation could be carried out by the relevant Commission Services (DGs Internal Market and Services, Development, Energy and Enterprise) and/or ESMA, as a follow up to the 2011 study by ESMA on CBCR. The evaluation should be carried out within five years of the entry into force of the Directives, and it will form the basis of the report to the EP and Council, foreseen within the proposed legislation, on the implementation and effectiveness of CBCR. The report should also consider international developments in the intervening period, and consider broadly the overall scope of CBCR.

Annex 1: Payments to government on a country- and project- basis by all EU listed and EU registered large extractive industry and loggers of primary forests

This policy option would apply to all companies engaged in oil, gas or minerals extraction and those engaged in logging of primary forests which are either listed on EU regulated stock markets or EU registered large companies. Therefore both listed and unlisted companies would be within the scope.

The payments to be reported would be the EITI revenue streams listed in Annex 4, on a country- and project- basis. Where particular payments (such as certain profits taxes and dividends) cannot be allocated to a specific project they would be reported in respect of the country alone. A reporting format in the following form is envisaged:

Country A	Project Y	Project Z	Total payments to government
Royalties	X	x	x
Licence fees	X	x	x
Dividends	--	--	x
Profits taxes	--	--	x
Total	*X*	*X*	*X*

A materiality criterion would be necessary as the largest extractive operators in the EU can have thousands of projects and related payments, and reporting payments in respect of all of them would result in reports of unmanageable proportions, where the key information could easily be obscured.

IAS 1 on the Presentation of Financial Statements requires a preparer to consider the characteristics of the users of financial information in assessing what is material. Given that civil society and NGOs will be taking a particular interest in the content of CbyC reports the Commission Services consider that materiality thresholds set by a company when preparing the annual financial statements may not necessarily be appropriate when preparing a CbyC report, and the materiality of the payment to the host government will need to be considered.

Annex 2: Full CBCR for all listed MNCs

As mentioned in section 6.1 (option 4) full CBCR would require a summary financial statement being presented for the consolidated activity in every country that a company operates in. Revenues, costs, taxes paid, assets and liabilities would be reported on a country by country basis, with disclosures split to identify transactions with third parties and those with other group companies.

An example of such a scheme was included in the Task Force on Financial Integrity and Economic Development 2009 paper "Holding multinational corporations to account wherever they are"[98]. The suggested scheme would require the disclosure of the following information in respect of all a MNC's operations in a given country.

1. The name of the country;
2. The names of all group entities operating within the country;
3. Its financial performance in the country, without exception, including:
   - Sales, both third party and to other group entities;
   - Purchases, split between third parties and intra-group;
   - Labour costs and employee numbers;
   - Financing costs split between those paid to third parties and to other group members;
   - Pre-tax profit;
4. The tax charge split as noted in more detail below;
5. Details of the cost and net book value of physical fixed assets located in the country;
6. Details of gross and net assets in total in the country.

Tax information would need to be analysed between:

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;

[98] http://www.financialtaskforce.org/2009/06/17/country-by-country-reporting-holding-multinational-corporations-to-account-wherever-they-are/

4. Deferred taxation liabilities for the country at the start and close of each accounting period.

Other advocates of full CBCR would call for further information including details of finance income, dividends paid, intangible assets and third party/intra-group liabilities. The provision of this additional information, if desirable, would not pose further burden as the information would have been collated in order to present the information otherwise disclosed.

The summary financial statement would be prepared using IFRS recognition and measurement criteria (with the exception of actual tax payments) which would allow reconciliation of the aggregate CBCRs to the group consolidated income statement and statement of financial position (actual tax payments could be reconciled to cash flow statement disclosure of "taxes on income", as required by paragraph 35 of IAS 7). The scope would extend to subsidiaries, associates and joint ventures whose results would be included in the consolidated financial statements

To give the same confirmatory value as the consolidated accounts, the summary financial statement would be subject to audit, in accordance with the auditing standards applied to the group consolidated financial statements. Likewise the materiality criteria used in preparing the group consolidated financial statements would be used to give financial information with the same degree of precision as that included in the group accounts.

In terms of publication, given the possibility that information disclosed could be extensive for groups with operations in many countries, electronic means of publication would be encouraged (for example XBRL), and where electronic filing at the Company Register is permitted within a Member State it would be expressly provided that there would be no need for any other form of public filing required.

Annex 3: Comparative table of types of payments to governments

	Types of revenue streams	EITI	US DODD-FRANK *(proposed)*	EU *(preferred)*
Payments to government	**Production entitlements: Host governments & National State owned company**	√	√	√
	Profits tax	√	√	√
	Royalties	√	√	√
	Dividends	√	X	√
	Production, signatory, discovery and other Bonuses	√	√	√
	License fees (and other consideration for licenses and concessions)	√	√	√
	Other significant benefits to government	√	√	√
Other	**Reserves**	X	X	X
	Production volumes	X	X	X
	Production revenues	X	X	X
	Production and development costs	X	X	X
	Names and location of each key subsidiary and property	X	X	√[2]

Source: Commission Services Analysis (2011)

Notes:

1. In IASB Discussion paper DP/20active Activities", pp 146-147
2. Already required by the EU Accounting Directives

Annex 4: EITI revenue streams (payments to governments)

Revenue stream	Further description
Host government's production entitlement	This is the host government's share of the total production. This production entitlement can either be transferred directly to the host government or to the national state-owned company. Also, this stream can either be in kind and/or in cash.
National state-owned company production entitlement	This is the national state-owned company's share of the total production. This production entitlement is derived from the national state-owned company's equity interest. This stream can either be in kind and/or in cash.
Profits taxes	Taxes levied on the profits of a company's upstream activities.
Royalties	Royalty arrangements will differ between host government regimes. Royalty arrangements can include a company's obligation to dispose of all production and pay over a proportion of the sales proceeds. On other occasions, the host government has a more direct interest in the underlying production and makes sales arrangements independently of the concession holder. These "royalties" are more akin to a host government's production entitlement.
Dividends	Dividends paid to the host government as shareholder of the national state-owned company in respect of shares and any profit distributions in respect of any form of capital other than debt or loan capital.
Bonuses (such as signature, discovery, production)	Payments related to bonuses for and in consideration of: • Awards, grants and transfers of the extraction rights; • Achievement of certain production levels or certain targets; and • Discovery of additional mineral reserves/deposits.
License fees, rental fees, entry fees and other considerations for licenses and/or concessions	Payments to the host government and/or national state-owned company for: • Receiving and/or commencing exploration and/or for the retention of a license or concession (license/concession fees); • Performing exploration work and/or collecting data (entry fees). These are likely to be made in the pre-production phase. • Leasing or renting the concession or license area.
Other significant benefits to host governments	These benefit streams include tax that is levied on the income, production or profits of companies. These exclude tax that is levied on consumption, such as value-added taxes, personal income taxes or sales taxes.

Source: EITI: Source Book (2005), pp. 27-28.

Annex 5: Comparison of CBCR disclosure approaches

		Country-based	Company-based	
		EITI	**US DODD-FRANK** *(proposed)*	**EU** *(preferred)*
WHO	**Type of company**	All extractives	All extractives registered on the SEC	Extractive and primary logging [1]
	Type of activities	Upstream	Upstream - downstream	Upstream
WHAT	**Payments to government**	See Annex 4	See Annex 4	See Annex 4
	Materiality of payments	All material	*Not de minimis*	Material
	Reporting basis	Cash not accrual basis	Cash not accrual basis	Cash not accrual basis
WHERE	**Location**	EITI reports, publicly available	Separate annual, electronic format (along with reports filed with the SEC)	Separate annual report
	Audit requirements	Where companies audited, no further audit requirement	None	None
	Reporting level	*Country decides:* Aggregated or company by company	*Company:* Country by Country & by project	*Company:* Country by Country & by project
	Timeframe	Countries decide	Fiscal year	Annually

Source: Commission Services Analysis (2011)

Notes:

1. All extractive companies and loggers of primary forests that are issuers in EU regulated markets, and large non-listed companies with activities in the extractive and logging of primary forest sectors.

Annex 6: Outcome of the Public Consultation [99]

The Commission conducted a public consultation on country by country financial reporting by multinational companies between 26 October 2010 and 9 January 2011[100] in order to obtain stakeholders' views on possible additional disclosure requirements.

During the 10 week consultation period the Commission received 73[101] responses from various stakeholders, almost half of them coming from the UK and DE (36) and seven from pan-European organisations.

Most of the responses (43) came from preparers (23 companies and 20 associations of companies), 17 responses came from users (13 NGOs promoting development and/or tax justice, three investors and one taxation institute), five responses came from public authorities (LU, UK, DK, HU, BE; three accounting standard setters and two national Economy Ministries), five came from accountants and auditors and three came from "other groups" (a political party, a law institute, a private person). As regards preparers contributing to the consultation, they came from financial institutions (banks and insurance companies: 18.5%), the extractive industry (oil companies: 10%, mining companies: 7%), the chemical and pharmaceutical industry (11%), other energy industries (4.5%). Miscellaneous preparers made up the rest. All companies that contributed to the public consultation have operations in third countries, and 91% are listed companies which prepare reports according to IFRS.

The overall result of the consultation shows a rather diverse pattern of opinions, reflecting the opinions of several categories of respondents: where preparers, accountants and auditors were in general opposed to requirements to report on a country by country basis, users and other respondents were in favour. The opinions of public authorities were split and half of them expressed "no opinion" in response to several of the questions. A majority of the respondents were preparers (43 companies and industry associations out of 73 contributions) who expressed a rather dismissive view on most of the questions. However, a detailed analysis shows that the industry most directly concerned – the extractive industry, in particular oil and gas – expressed in general a constructive view as they consider this to be conducive to improving domestic accountability and governance in resource-rich countries. The NGOs were of a similar view. As regards the type of companies which should fall under the scope of any future instrument, among the respondents who considered that some companies should be targeted a majority considered listed companies to be the appropriate group.

---

99 The complete summary report of the public consultation can be found at : http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm

100 The consultation document can be found at: http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm

101 There were actually 76 responses, but four responses came from the same organisation (and in one case the same person) so they were counted as one sole contribution in the statistics. However, all contributions have been published on the website. For more information see the methodology section.

Annex 7: Meetings with stakeholders

1. ActionAid
2. AFEP (Association Françaises des Enterprises Privées)
3. Anglo American
4. ArcelorMittal
5. Association Technique Internationale des Bois Tropicaux (ATIBT)
6. BHP Billiton
7. BP
8. Business Europe
9. Canada Mining Council
10. CBI (Confederation of British Industry)
11. CCFD Terre Solidaire (a development NGO)
12. CEPI (Confederation of European Paper Industries)
13. CICERO
14. CIDSE
15. Christian Aid
16. Cookson
17. Citigroup
18. ENI
19. ENI Norway
20. Eurodad (a network of development NGOs)
21. Euromines
22. European Timber Trade Federation (ETTF)
23. EITI Secretariat (Extractive Industries Transparency Initiative)
24. Financial Centre Forum (IFC)
25. General Electric

26. German Institute for International and Security Affairs
27. Gplus
28. Global Witness
29. ICAEW (Institute of Chartered Accountants in England & Wales)
30. International Chamber of Commerce (ICC)
31. IBM
32. Maples and Calder Law Firm
33. OGP (International Association of Oil & Gas Producers)
34. ONE (a development NGO)
35. Open Society Foundations
36. OSCE (Organisation for Security and Co-operation in Europe)
37. Oxfam
38. Philips
39. Publish What You Pay (PWYP)
40. Revenue Watch
41. Rio Tinto
42. Shell
43. Statoil
44. Tax Justice Network
45. Total
46. Transparency International
47. Unilever
48. Vale
49. Vodafone
50. Xstrata

Annex 8: Compliance cost of the preferred option

Four listed MNCs in the extractive industry provided detailed estimates on the group set-up costs and annual recurring costs they would expect to incur with a requirement to report payments to host governments on a CbyC, as well as on an un-audited basis. Follow-up discussions with the companies indicated that a requirement to additionally report in respect of material projects could result in up to a 100 % uplift in costs. The estimates below are on the basis of reporting payments to host governments on a country- and project- basis.

The information provided is business sensitive, and the MNCs participated in the cost estimation exercise on the basis that their individual estimates would remain confidential. Hence the information below is anonymised.

	Group set-up costs (€ millions)	Group Annual recurring costs (€millions)
Company A	17.2	1.8
Company B	3	0.6
Company C	14	7
Company D	7.4	5.2
Total	*41.6*	*14.6*
Average	*10.4*	*3.6*

According to ESMA data these four companies collectively had 192 subsidiary companies, giving a total number of entities in the four groups of 196 (4+192). The cumulative set-up and recurring costs for the four groups of €41.6 millions and €14.6 millions were divided amongst the number of group entities to give an estimated cost per group entity:

Set-up costs per group entity	Annual recurring costs per group entity
€212,244	€74,490

ESMA reported that there were 171 companies extractive companies with shares listed (depository receipts are not included) in the EU (as at 30 September 2010), which between them had 2,999 subsidiary companies (i.e. 3,170 group entities).

Extrapolating the estimates across the listed extractive sector, on the basis of the number of group companies (parent and subsidiary companies), gives the following estimated costs for EU business:

Year one (€millions)			Year two and successive years (€ millions)	
Set-up costs	Recurring costs	Total	Recurring costs	Total

672	236	908	236	236

If dual-listed companies (*15 companies with 570 subsidiaries i.e. 585 group entities*) were to face no reporting obligation from an EU reporting requirement over and beyond that stemming from the Dodd Frank Act, the estimated costs for EU business would be:

Year one (€millions)			Year two and successive years (€ millions)	
Set-up costs	Recurring costs	Total	Recurring costs	Total
548	192	740	192	192

The data takes into account the fact that some EU MNCs already report under EITI, as the surveyed companies included those with and without direct experience of reporting under EITI. However, MNCs reporting information under EITI do not report all payments made to government in all the countries where they operate. They provide this information only in relation to EITI compliant countries, so they will incur additional cost with a requirement along the lines of the preferred policy option.

419 unlisted large EU companies active in the extractive industry were identified by the Commission Services. These constituted 85 parent companies (which collectively had 968 subsidiaries) and 334 "solus" companies. To arrive at a cost estimate for this sector the entity costs referred to above have therefore been extrapolated over 1,387 entities (85+968+334) to give the following estimated costs for the sector:

Year one (€millions)			Year two and successive years (€ millions)	
Set-up costs	Recurring costs	Total	Recurring costs	Total
294	103	397	103	103

The Commission Services identified 26 EU forestry companies (listed and large unlisted companies) potentially within the scope of the proposed rules. Applying the same level of estimated costs to these companies gives the following estimated costs for the sector:

Year one (€millions)			Year two and successive years (€ millions)	
Set-up costs	Recurring costs	Total	Recurring costs	Total
6	2	8	2	2

The costs of reporting only payments to government are estimated to be 50% of the anticipated cost of reporting on both a country- and project- basis. This would mean that the estimated cost for option 2 – reporting payments to government in the extractive industry only (see section 6.1) would be:

Administrative costs of extractive and forestry industry MNCs reporting payments to government only		
	Year one cost (€millions) (50% of the estimates provided above)	Subsequent years' costs (€ millions) (50% of the estimates provided above)
Listed extractive MNCs	370	96
Unlisted large extractive MNCs	199	52
Forestry MNCs	4	1
Total	573	149

Annex 9: Compliance cost of full CBCR and payments to government for MNCs in the extractive and forestry industries

The four MNCs in the extractive sector referred to in Annex 8 provided estimates to EFRAG of the group set-up costs and annual recurring costs they would expect to incur with a requirement for full CBCR, together with a requirement to report payments to government.

	Group set-up costs (€ millions)	Group Annual recurring costs (€millions)
Company A	46.6	18.8
Company B	17.9	4.7
Company C	14.0	8.5
Company D	7.5	5.5
Total	*86.0*	*37.5*
Average	*21.5*	*9.4*

Company D provided its estimates on the basis that disclosures would only be required for a limited number of countries, those being most material to the company. Given that materiality criteria will need to consider the materiality of operations from the country perspective, it is possible that the costs it foresees have been under-estimated.

Following the same methodology as in Annex 8, the set-up and recurring costs per group entity of this option are estimated to be:

Set-up costs per group entity	Annual recurring costs per group entity
€438,776	€191,327

Extrapolating these estimates to the number of companies within the targeted sector, as identified in Annex 8, gives the following estimated costs for the policy option.

Administrative costs of full CBCR and reporting payments to government (on a project basis) for extractive and forestry industry MNCs		
	Year one cost (€millions)	Year two and subsequent years' costs (€millions)
Listed extractive MNCs (171 companies)	1,997	607

Unlisted large extractive MNCs (419 companies)	874	265
Forestry MNCs (26 listed and large unlisted companies)	16	5
Total	*2,887*	*877*

Annex 10: Acronyms

AD: Accounting Directive

AIM: Alternative Investment Market

ARC: Accounting Regulatory Committee

BRIC: Brazil, Russia, India and China

CBC / CbyC: Country by Country

CBCR: Country by Country Reporting

EFRAG: European Financial Reporting Advisory Group

EP: European Parliament

EITI: Extractive Industries Transparency Initiative

ESMA: European Securities Market Authority

FAO: Food and Agriculture Organisation

FLEGT: Forest Law, Governance and Trade Program

GDP: Gross Domestic Product

IAS: International Accounting Standards

IASB: International Accounting Standards Board

IEA: International Energy Agency

IFRS: International Financial Reporting Standard

IMF: International Monetary Fund

ISC: Inter Services Steering Group

KPCS: Kimberley Process Certification Scheme

MNC: Multinational Corporation

MMBOE: Million Barrels of Oil Equivalent

NGOs: Non-Governmental Organisations

NOCs: National Oil Companies

PWYP: Publish What You Pay

SEC: Securities Exchange Commission

TD: Transparency Directive

UN: United Nations

VAT: Value Added Tax

VPA: Voluntary Partnership Agreement

XBRL: eXtensible Business Reporting Language