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**COMMISSION STAFF WORKING PAPER**

**Part I**

**EXECUTIVE SUMMARY OF THE 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) 1289 final}

## EXECUTIVE SUMMARY

The Accounting Directives (hereafter the "Directives")<sup>1</sup> deal with the annual and consolidated financial statements of limited liability companies in Europe. During the past 30 years, amendments to these Directives have tended to pay insufficient attention to the comparability and user friendliness of the financial statements and have gradually increased complexity and the regulatory burden for companies, especially for the smaller ones.

This impact assessment presents the Commission's proposal to modernise and simplify the financial reporting requirements of EU limited liability companies so as to make them less burdensome and more suited to users' needs.

### 1. PROBLEM DEFINITION

#### 1.1. What are the main problems

The preparation of financial statements has been identified as one of the most burdensome regulatory obligations for companies<sup>2</sup>.

Consultations and analysis indicate that micro / small companies face higher administrative burdens in comparison to medium-sized / large companies. Where a big enterprise spends one Euro *per employee* to comply with a regulatory duty, a medium-sized enterprise might spend four Euros and a small business up to ten Euros per employee.

The financial statements are often not the main source of information used by stakeholders in smaller entities. Yet, the Directives require the smaller companies to prepare extensive financial statements and to comply with a number of other requirements, thus preventing the Member States from designing simpler local solutions. Smaller companies have to prepare financial statements to a level of detail suitable only to larger companies. This is especially the case for the requirements to disclose extensive information in the notes to the financial statements. In addition, with the absence of a general principle of materiality from the Directives, trivial information can be presented in the financial statements for no other reason than complying with regulatory requirements.

Due to the current flexibility offered to Member States in defining company size, companies that are considered as small under the Directives are categorised as medium-sized or even large under national rules in many Member States. This affects the ability of EU companies to compete on a level playing field.

Finally, there are around 80 significant options in the Directive on annual accounts that Member States may adopt or not, and about 40 options in the Directive on

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<sup>1</sup> Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies (78/660/EEC), Seventh Council Directive of 13 June 1983 on consolidated accounts (83/349/EEC)

<sup>2</sup> [http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/priority-areas/index\\_en.htm](http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/priority-areas/index_en.htm)

consolidated accounts. Options generally relate to presentation, recognition, measurement and disclosure in financial statements, and to the overarching "substance over form" principle. This creates problems for users of the financial statements, increasing with company size (medium-sized / large), due to the lack of clarity and comparability this entails for financial reporting across the Member States. It can prevent optimal cross border investment decisions, and results in increased burden for companies with cross border subsidiaries.

## **1.2. What are the drivers of the problems?**

The Directives are one key driver. EU companies also face further local financial reporting requirements, such as tax and statistical reporting, due to national regulations.

## **1.3. Impact of the microeconomic problems on the macro level**

The unnecessary and disproportionate administrative cost imposed on small companies hampers economic activity and is an impediment to growth and employment.

## **1.4. How big is the problem?**

Around 7.3 million companies are within the scope of the Directives, of which 1.1 million are small. It is estimated that the total costs for small companies of complying with the requirements of the Directives amounts to €3.1bn annually, of which €1.7bn constitutes a potential administrative burden.

## **1.5. Subsidiarity**

There is a need to act at EU level, given that the main drivers are the EU Directives. The preferred policy options should be limited to what is necessary in order to attain the objectives and be proportionate.

## **2. OBJECTIVES**

In line with the overarching objective of improving the business environment for EU companies, the review of the Directives aims to (1) reduce administrative burden on companies that are relatively small in size, to free up resources for growth and job creation; (2) increase the effectiveness, relevance and understandability of financial reporting; and (3) protecting the needs of users. The improvements should facilitate the functioning of the EU's Single Market by encouraging cross-border business activities.

## **3. POLICY OPTIONS**

In order to meet the objectives set out above the Commission services have identified and considered a number of policy options, first, through an examination of the broad policy options and second, within the context of the preferred broad approach, through an examination of a subset of options for the revision of the Directives. The options examined in this document should be seen as complementary to the 2009

proposal published on 26 February 2009 aiming to allow the Member States to relieve micro entities from EU level accounting obligations<sup>3</sup>.

### **3.1. Broad policy options for reducing administrative burden and increasing the effectiveness, relevance and understandability of financial reporting.**

Comparing to the baseline scenario (no change), the range of broad policy options and choice of legal instruments includes the following:

- (1) Baseline scenario (no change);
- (2) Better use of existing options in the Directives by Member States;
- (3) Revision and modernisation of selected requirements currently in the Directives in order to reduce administrative burdens on companies in the EU, particularly for SMEs;
- (4) Creating a wholly new EU accounting framework and adopting the "International Financial Reporting Standards for SMEs" for mandatory use within the EU;
- (5) Repealing the Directives and allowing the Member States to put in place whatever basic accounting regime they choose for unlisted companies.

*Having compared the broad policy options above, the preferred option is option 3 consisting in a revision of selected requirements currently in the Accounting Directives through a new Directive replacing the existing Fourth and Seventh Council Directives. This is justified as the most reasonable option to achieve the objectives, having regard to the necessity and proportionality of EU legislation, the timeline, and its acceptability to stakeholders.*

### **3.2. Comparison of options within a review of the Directives**

Various options can be considered within the frame of a review of the existing Directives:

#### ***Options with an overall reach***

- (1) Harmonising the definitions of the size of companies under the Directive ; and/or
- (2) Increasing the different thresholds for the size of company; and/or
- (3) Mandating the preparation of financial statements under an electronic format such as XBRL;

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<sup>3</sup> 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 10 employees, as well as certain limits for the balance sheet total and net turnover.

***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; 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.

The table below provides an overview of the analysis of the above 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
<p>"+" favourable, "++" highly favourable "-" unfavourable, "--" highly unfavourable; "0" neutral; "?" unknown; "N/A" not applicable</p> <p>Source: Commission Services analysis</p>						

*Comparing the options above to the baseline scenario, the Commission services have identified that options 1, 2, 4, 5 and 8 are worth pursuing. These options are not mutually exclusive and have been preferred in view of the objectives mentioned above, the potential impacts, and the potential for general acceptance by stakeholders. These preferred options also fit with the "think small first" approach supported by the European Commission.*

## 4. ANALYSIS OF MAIN IMPACTS

### 4.1.1. *Companies*

The preferred options would provide savings up to a maximum of €1.7bn per year on a recurring basis. The main beneficiaries of this burden reduction would be small companies (around €1.5bn) as a result of a regime that would limit disclosures, harmonise company size definition across the EU, and clarify that the Directives no longer require a statutory audit or consolidation of small groups.

The revision could also have effects on micro-companies. However these savings would be equally 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.

Other benefits expected for companies remaining include the increased clarity of financial statements through clearer principles, and a better comparability stemming from a reduced number of options, especially for medium-sized and large companies.

### 4.1.2. *Users of financial reporting*

For small companies, key information needs of creditors would be kept, or even increased in some Member States as disclosures of "Guarantees and commitments, contingencies, arrangements" and "Related party transactions" would become mandatory for this category of company.

A positive impact on the information provided to the users of financial statements of small, medium-sized and large companies can be expected due to a strongly improved comparability of the financial statements as well as enhanced clarity based on harmonised principles.

### 4.1.3. *Public authorities*

The revision should have no budgetary consequences for public authorities.

### 4.1.4. *Macro-economic and single market*

Cutting "red tape" for smaller companies should contribute to the creation of a business climate that encourages company formation and entrepreneurship, and frees up resources of existing companies that can be reallocated towards productive uses. Fewer options, increasing comparability of the financial statements of larger companies and a focus on information that is really useful in decision-making can result in better investment decisions and a better allocation of capital, thus facilitating cross-border investment, trade and competition.

### 4.1.5. *Third countries and international relations*

The project would improve competitiveness of small EU businesses vis-à-vis companies from other jurisdictions. Better comparability and clarity of the financial statements of EU companies could in addition make the EU more attractive to foreign capital and entrepreneurs.

4.1.6. *Social Impacts*

A business climate that encourages company formation and entrepreneurship, as well as permitting a re-allocation of resources to operations, should be more favourable to jobs creation than it is today.

**5. MONITORING AND EVALUATION**

A detailed monitoring plan will be part of the overall monitoring strategy in relation to the general revision of the Directives.

The evaluation will include an assessment of whether the key objectives have been met, and also possibly allow for further lessons to be learnt.





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**Part II**

**EXECUTIVE SUMMARY OF THE 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  
financial statements and the consolidated financial statements and related reports of  
certain types of undertakings**

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## EXECUTIVE SUMMARY

### 1. INTRODUCTION

Multinationals have worldwide operations supported by many subsidiary companies. 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. CBCR is not a replacement for consolidated accounts, but a complementary scheme of reporting.

### 2. PROBLEM DEFINITION

#### 2.1. What is the problem?

Multinational Corporations (MNCs) operate in many foreign jurisdictions but detailed information on their activities in the countries in which they operate is often not within the public domain. This lack of transparency in country-by-country financial data stands in the way of greater government accountability, in particular, in some resource-rich developing countries for the income received from exploiting natural resources such as oil, gas, minerals and forests. Proponents of CBCR state that if payments 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 in turn can foster economic growth and help to reduce poverty, corruption and internal conflict.

#### 2.2. What are the drivers of the problem?

Currently there is no obligation to provide financial information on a country-by-country basis.

MNCs could publish country-by-country information voluntarily, but few do so. Furthermore, there is an Extractive Industry Transparency Initiative (EITI) which a national government can voluntarily adopt and is relevant to extractive industry participants, but out of the 50 countries considered to be hydrocarbon or mineral rich by the IMF only 9 are currently EITI compliant. Only one country reports payments to governments in respect of forest activities.

#### 2.3. How big is the problem?

In the absence of a CBCR requirement there is no reliable information available on the current level of payments made by extractive and forestry operators to host governments.

In a survey of 11 country reports, the EITI reported that the surveyed host governments annually received collectively US\$43.5 billion from the oil and gas, mining and timber

industries<sup>1</sup>. To put this figure in context the payments represent, on average, 11.5% of these countries' GDP.

The Commission Services estimated that listed EU oil and gas companies could collectively have made payments (including taxes, bonuses and royalties) to governments worldwide of €62 billions in 2009. In its 2009 EITI report Liberia reported payments to government of US\$ 1.9 millions derived from forestry, which represented 5.7% of the government's revenues from exploiting natural resource wealth.

#### **2.4. Subsidiarity**

It is preferable to legislate through EU law to ensure that all EU MNCs exploiting hydrocarbons, minerals and primary forests<sup>2</sup> are treated equally across the EU.

### **3. OBJECTIVES**

The primary objective is to bring increased transparency to the operations of MNCs by increasing the disclosures they make on a country-by-country basis. This should provide relevant information to civil society in order for it to hold governments accountable for their receipts from allowing the exploitation of natural resources.

### **4. POLICY OPTIONS**

In order to meet the objective set out above the Commission Services have identified and considered a number of policy options:

- (1) No change;
- (2) 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;
- (3) Require disclosure of payments to government on a country-by-country basis by EU MNCs in the extractive and logging of primary forest sectors;
- (4) Require disclosure of payments to government on a country- and project-basis by EU MNCs in the extractive and logging of primary forest sectors;
- (5) Require full CBCR by EU MNCs in the extractive and logging of primary forest sectors (payments to governments, revenues, costs, profits, tax charges and taxes paid, assets held and intra-group transactions).

The tables below provide an overview of the analysis of the policy options.

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<sup>1</sup> 2009 EITI overview of country reports, <http://eiti.org/files/Overview%20EITI%20Reports.pdf>.

<sup>2</sup> 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."

Table 1: Assessment of the policy options:

Option	Impact on transparency	Impact on competitiveness and level playing field	Potential impact on costs	Estimates of year one compliance cost
0. No change	0	0	0	0
1. International Action	+	++	-	See note
2. Require CBCR of payments to government by extractive and primary logging EU MNCs	+	-	-	€573 millions
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 millions
4. Require full CBCR by EU MNCs in the extractive and primary logging sectors	++	--	--	€2,887 millions

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

Note: The costs of this option would ultimately depend on the precise nature of the scheme of CBCR agreed upon internationally.

"Primary logging" refers to logging of primary forests.

Source: Commission Services analysis

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. International Action	++	+	+	+	+
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	--	++	--	-	+
<p>"+" favourable, "++" highly favourable "-" unfavourable, "--" highly unfavourable; "0" neutral</p> <p>Preparers: MNCs, other companies, associations of companies;                      Users: Non-governmental organisations (NGOs), investors;                      Public authorities: accounting standard setters or National Ministries.                      Other: political party, law institute, private persons.</p> <p>"Primary logging" refers to logging of primary forests.</p> <p>Source: <i>Commission Services analysis</i></p>					

Having compared the broad policy options above, the best alternative on grounds of competitiveness, transparency and acceptability to stakeholders is action to support a worldwide initiative to foster the disclosure of payments to governments by the extractive industry and loggers of primary forests. However, there is no certainty that an international agreement on CBCR of payments to governments can be achieved.

The preferred policy option is therefore to require EU MNCs active in the extractive and logging of primary forest sectors to disclose payments to governments on a country- and project- basis. The policy would be to target MNCs listed on EU regulated stock markets and EU unlisted large companies active in the extractive and logging of primary forests sectors, to ensure a level playing field between these categories of companies.

The development of and support of an international initiative on CBCR remains crucial as EU action alone on CBCR will not result in a full picture of government receipts from the exploitation of natural resources being shown. In particular EU action alone will not capture the activities of the national oil companies which globally control the largest share of oil and gas reserves and production.

## 5. ANALYSIS OF MAIN IMPACTS OF THE PREFERRED POLICY OPTION

### 5.1.1. Increased transparency

In general terms, CBCR of payments to government on a country- and a project- basis by the extractive industry and loggers of primary forests should provide investors and civil society with significantly more information than today, on what is paid by EU MNCs to host governments in exchange for the right to exploit the relevant countries' natural resources. Publicising this information should have the effect of making governments more accountable. With a project approach, civil society local to a mine, oil field, forest etc. would know what government receives for exploiting such local resources.

### 5.1.2. Potential strengthening of the Extractive Industries Transparency Initiatives (EITI)

With increased levels of data on payments to host governments entering the public domain, there will be increased pressure on national governments from civil society to account for how the revenues derived from extractive and loggers of primary forest MNCs have been spent. Some governments may respond to such calls by implementing EITI locally. This would mean that potentially more countries would be within the scope of the initiative. Finally, a significant expansion of EITI reporting countries may capture non-EU state-owned companies, thus reducing any negative competitive effects for EU MNCs *vis-à-vis* the competitive situation with state owned companies.

### 5.1.3. Improved operating environment for the 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 MNCs making significant investments locally.

### 5.1.4. Increased administrative costs

There will be increased administrative costs from the preferred policy option. The Commission Services estimated the following costs:

	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
<b>Total</b>	<b>616</b>	<b>1,145</b>	<b>297</b>

These 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

cost estimates are based on the assumption (made by the surveyed companies) that information would be disclosed only if it is material.

#### *5.1.5. Competitive disadvantage*

Whilst disclosing payments to government would not give direct insight into the levels of turnover, costs and profits that a MNC generates in a jurisdiction, there may be instances when confidential business data will be revealed or deduced from CBCR data. EU MNCs exploiting natural resources would also not be on a level playing field in terms of disclosure when compared with non-EU state owned companies and this may affect their ability to complete existing contracts and win new ones.

It is not possible to place a monetary value on the loss of competitive position. However, given that some extractive industry operators have voluntarily decided to disclose some country-by-country information and a majority of extractive industry respondents to the public consultation were in favour of disclosing CBCR of payments to governments as a means to improve government accountability it has been judged that the loss of competitive position from this policy would be limited. Furthermore, a number of factors affect the competitive position of EU MNCs in the extractive industry especially, namely the level of engineering know-how and technical efficiency.

The strengthening of the EITI 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.

#### *5.1.6. Public authorities*

The revision should have no budgetary consequences for public authorities. .

#### *5.1.7. International relations*

Where an EU MNC would have to disclose payment information, the disclosure of which is prohibited by the domestic law of a foreign country, the relevant governments could perceive there to be a breach of their national sovereignty. This point is not clear-cut and industry and NGOs dispute the point.

#### *5.1.8. Energy security*

Where a country opposes reporting of payments to government, EU extractive operators may find it harder to operate locally which might have consequent effect on oil and gas resourcing. In practice, however, this has not been the case as some companies already disclose payments to governments on a country basis without impediments to their activities.

#### *5.1.9. 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.

## **6. MONITORING AND EVALUATION**

The Commission will monitor the implementation of the CBCR requirement in cooperation with the Member States. An evaluation of the effects of the preferred policy will be carried out to see to what extent the anticipated impacts (increased payments' transparency, strengthened EITI, improved business environment, increased administrative costs, and increased competitive pressure) materialise.