Extractive Companies Should Act Now To Meet New Transparency Requirements

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Oil and gas and mining companies operating in Canada may have to act quickly to meet rigorous new financial and tax transparency reporting standards that could be in place as early as next year. Natural Resources Canada recently released a consultation paper on proposed mandatory reporting standards for Canadian extractive companies. Under these new reporting requirements, which Canada has committed to establishing by June 2015, these companies would be required to publish annual reports containing details of specific financial and tax related cash payments to all levels of domestic and foreign governments, including Aboriginal entities. These new reporting standards may require significant systems and process changes to track reportable payments.

The consultation paper, “Establishing Mandatory Reporting Standards for the Extractive Sector”, notes that, while Canada is intending to look to provincial and territorial securities regulators to implement these standards, it will enact federal legislation by April 1, 2015 in the absence of such standards. According to Natural Resources Canada, the consultation is intended to provide information on the proposed reporting standards and to receive feedback on key reporting requirements, the proposed reporting process and other implementation issues.

Affected extractive companies could find it challenging to make needed systems and process modifications by Canada’s intended implementation date of June 2015, including meeting the proposed requirement to post the required information in eXtensible Business Reporting Language (XBRL) on their public websites.

Background

Canada announced in June 2013 that it will establish mandatory reporting standards for Canadian extractive companies. This commitment builds on a global trend promoting transparency reporting for extractive industries. Mandatory reporting for the extractive sector is being implemented in the United States through the U.S. Dodd-Frank Act and in the European Union (EU) through its Transparency and Accounting Directive. Canada intends to align its reporting requirements with other jurisdictions to eliminate duplicative reporting and reduce the filing burden.

The consultation paper is based on Natural Resources Canada’s spring 2013 consultations with provinces and territories, industry, business and Aboriginal groups.
Who has to report?

According to the paper, reporting will be required by publicly-listed companies and medium and large private extractive companies operating in Canada that are involved in the commercial development of oil, natural gas, and minerals (i.e., exploration, extraction, processing (primary), and export (transport out of country)). Companies only involved with the transport of resources within Canada would not be required to report.

Under this approach, which is consistent with the EU’s Transparency Directive, medium and large private companies operating in Canada would be required to report if they meet or exceed two of the three following thresholds:

- CAD $20 million in assets
- CAD $40 million in net turnover
- 250 employees.

In cases of joint ownership or subsidiaries, foreign and domestic companies (public as well as medium and large private firms) operating in Canada will have to report if they have a controlling interest in any project in Canada or abroad. Canada is proposing to use the International Financial Reporting Standards (IFRS) definition of “control” for these purposes.

Note that, in the U.S., the proposed mandatory reporting requirements only apply to extractive companies that are required to file an annual report with the Securities and Exchange Commission. This would include not only publicly listed companies but other companies that have other forms of securities (i.e. debt instruments etc) which give rise to SEC reporting obligations.

KPMG observations

In a recent industry consultation session attended by KPMG, Natural Resources Canada confirmed that a foreign entity that has Canadian operations caught by the private company thresholds noted above will have to report on their global operations and not just the Canadian portion of their operations. For multinationals not otherwise subject to mandatory reporting, this change could result in a significant additional compliance cost and such entities will need to adapt their global reporting systems accordingly.

What has to be reported?

Under the requirements, extractive companies will have to report payments of $100,000 or more (either cumulative over the year or one-time payments) to all levels of government, domestically and internationally in respect of defined categories. Note the $100,000 de minimus is not aggregated among the categories (i.e., no reporting is required if there are no payments over $100,000 within a category even if the aggregate payments otherwise included in the categories exceed $100,000). Payments to Aboriginal entities would also be captured, including relevant payments in Impact Benefit Agreements. Canada is proposing
that the following types of payments be reported:

- Taxes levied on the income, production or profits of companies, excluding consumption taxes
- Royalties
- Fees, including licence fees, rental fees, entry fees and other considerations for licences and/or concessions;
- Production entitlements;
- Bonuses, such as signature, discovery and production bonuses;
- Dividends paid in lieu of production entitlements or royalties (excluding dividends paid to governments as ordinary shareholders)
- Payments for infrastructure improvements (e.g., roads, electricity).

Consistent with the U.S. and EU rules, extractive companies would need to report each payment type at the government and project level. A “project” is generally considered to be an operational activity performed by an extractive company according to its particular industry and business context. (e.g., an oil field, individual well, mining site). The name of the government or government controlled body would also need to be published. Canadian companies would not have to report social and community payments (e.g., for community centres, schools, training).

Companies may also voluntarily choose to disclose smaller payments (e.g., at a threshold of $10,000).

**KPMG observations**

Companies will need to adjust their financial reporting systems in light of the $100,000 reporting payment threshold, and gather the necessary information to verify that they are below the reporting payment threshold.

The types of taxes reported do not include the full array of taxes paid by resource companies and will therefore understate the true economic impact of the project to the community and the relevant governments. For example, employment taxes, value added taxes, custom duties and property taxes are not included, notwithstanding that they represent significant contributions to the various taxation authorities. Companies may wish to consider adopting more detailed reporting, which can be cross-referenced to the required Canadian reporting.

At the industry consultation session, Natural Resources Canada said that, in considering its validation approach, it is looking at an external audit report or possibly in having a third party sign off on the process and controls around the reporting process. Natural Resources Canada remains open to suggestions. Currently, this validation approach is unique to the Canadian rules.

Natural Resources Canada noted that it is still considering how the reporting would be impacted by recoveries of payments through the application of tax credits and tax loss
For payments made to Aboriginal groups, it appears there may not be grandfathering for existing agreements, and that these reporting requirements will override confidentiality agreements with Aboriginal bands. It is not yet clear how Canada will define “Aboriginal entity”, particularly as it applies to non-Canadian groups.

What is the reporting process?

Canada is proposing to allow companies to use a common reporting template that would be consistent with other jurisdictions (e.g., the U.S. and EU). Should federal legislation be enacted, companies would have to inform Canada that they have posted an annual public report on their corporate websites (in XBRL format) and issue a public notice confirming that they have complied with this reporting. Companies would also have to ensure this information is verified by a third party, according to recognized accounting standards. Canada would also conduct annual audits of selected companies, and implement a compliance mechanism for non-reporting and misrepresentations.

To minimize the administrative and cost burden, Canada intends to enable companies operating in multiple jurisdictions to produce a single report. As such, Canada will work with the U.S. and European Commission to ensure that the reporting template is similar. The reporting standards would be drafted to allow equivalency with the Dodd-Frank Act and the EU Transparency Directive, or an equivalent standard introduced by provinces and territories.

The consultation paper proposes that there should be no reporting exemptions including for companies when national or contractual laws prohibit the disclosure of certain information.

KPMG observations
The introduction of a new annual compliance reporting process on a cash and in-kind valuation basis represents a significant challenge for companies from a scoping, process, controls and technology standpoint. The rules contain many grey areas that will require companies to analyze their facts and circumstances, including deciding on what payments to governments and government-controlled bodies fall under the definition of “commercial development of oil, natural gas or minerals” for the predefined payment types. Companies must also define elements such as projects on a globally consistent basis and analyze in-kind payments to provide a valuation for reporting.

To add further complexity, companies will have to assess the risk of publicly disclosing information which is potentially prohibited under national and commercial laws, as the new rules do not propose any exemptions.

Due to the effort needed to gather the information, companies may want to consider voluntarily reporting such payments or, at a minimum, reporting that no payments are
required to be reported based on the reporting guidelines established.

A company’s ability to efficiently comply with these obligations and reduce the long-term financial burden will depend on properly adapting accounting systems and controls to automatically gather and report on the data. Typically, ERP systems like SAP and Oracle are not geared to capture the information on a cash basis, and therefore must be modified. In many instances, companies will need to find a method of consolidating the data from various legacy systems. Collecting consolidated information from joint ventures, minority shareholdings, and entity acquisitions and dispositions will also be a challenge.

The proposal to have companies post an annual public report on their corporate website will allow a company greater ability to provide context to the amounts reported, which is a significant benefit over the proposed Dodd-Frank Act reporting system. For example, reporting of nominal corporate income taxes in a period of substantial financial statement earnings on its own could lead to a false impression and unwarranted criticism. Where a company can explain that the reason for the reduced income tax was the claiming of deductions for a recent substantial capital investment in the project, this will add much greater context to the amounts reported. However, the XBRL reporting format also represents a new technology challenge to Canadian companies as currently no other submissions are made in XBRL format in Canada.

Questions for consultation

Natural Resources Canada’s consultation paper also includes a series of questions on the following topics to stimulate discussion:

• General considerations
• Companies required to report
• Types of payments
• Potential for a conflict of laws
• Equivalency
• Penalties
• Reporting process
• Verification process

Next steps

To have the mandatory reporting standards in place by June 2015, Natural Resources Canada notes that it will conduct face-to-face and teleconference stakeholder consultations in March and April 2014. Consultation materials and summaries of consultations on mandatory reporting will be posted on the Treasury Board site and Canada will accept stakeholder comments until May 9, 2014.

KPMG observations
As a result of these upcoming changes, oil and gas and mining companies operating in
Canada will want to follow the developments of this change as the standards are implemented. Due to the short timeframe, these companies will want to start preparing as early as possible to ensure they have adequate resources to comply. Companies will need to scope out the data required to meet the reporting standards, determine how to obtain information from existing accounting systems and technology and embed new process and controls into the business. As well, teams will have to be educated and trained to meet the rigorous new financial and tax transparency reporting standards.

We can help

Your KPMG adviser can help you assess the potential impact of the mandatory reporting standards on your extractive company. For more details on this decision and its potential impact, contact Iain MacIntosh (National Leader, Tax Transparency) at iainmacintosh@kpmg.ca.

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