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Our ref: WJID/JP/RG/SJJ

Dear Sir

Capital Requirements Directive 4: consultation on country-by-country reporting Draft guidance and legislation

We refer to the draft guidance and legislation issued on 19 November 2013 and entitled "Capital Requirements (country-by-country reporting) Regulations 2013". We welcome the opportunity to comment. We also reiterate that, as with our previous correspondence, our comments below are designed to assist HM Treasury achieve the implementation of CRD4 policy objectives in a clear and simple way with the minimum of incremental administration.

For ease of review, we have divided our response into three appendices; Appendix 1 concerns the consolidation requirement, Appendix 2 is a hypothetical group structure which we have used to test the application of the draft legislation, and Appendix 3 covers all other aspects of the draft guidance and legislation.

In our view, the areas that still require additional consideration are:

1. **The definition of 'consolidation'** and how it is interpreted in practice. We have identified several situations where an institution's results will be reported in multiple places, and we do not feel that this is helpful to users of CBCR information; indeed it seems to us to be very misleading.

   In addition, we have identified many scenarios where the results of entities outside the scope of CRD4 will be disclosed, which appear to be contrary to the Government's stated intentions at Paragraph 3.10 of the Summary of Responses document.

In our view, both issues could be resolved by expanding Regulation 6 of the draft legislation to include results reported by other UK companies, as well as companies within the EEA.

2. We have concerns with **the inclusion of additional requirements into the statutory audit report**. This concern is not specific to CBCR, but CBCR does seem to us to represent 'the thin end of the wedge', particularly for banks. The statutory audit report is addressed to shareholders, the primary users of financial statements, and we think it inappropriate to establish a precedent for information not directly relevant to the shareholders being included within the audit report.

3. While a **fixed deadline for reporting** of 31st December appears sensible for most (and in particular calendar year end groups), there will be some for whom it will be very difficult to comply (i.e. those with 30th September year ends or later). We propose that the deadline should instead be a set number of months after each institution's year end, consistent with the approach taken to filings with Companies House, the PRA and the FCA.

4. There are a number of areas where the guidance needs to be expanded, most notably in the context of **the meaning of 'tax paid'**.

If you would like to discuss any of these points further please do not hesitate to contact James Polson (jpolson@deloitte.co.uk), Sally Jones (saljones@deloitte.co.uk). or the undersigned.

Yours faithfully

Bill Dodwell

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Appendix 1 – the consolidation requirements

In preparing our response, we have applied the draft legislation to a hypothetical group structure, set out at Appendix 2. Our hypothetical group, as will be the case for virtually every real business, is made up of both CDR4 institutions (I) and non-institutions (NI). The ultimate parent company is a holding company, termed as H in the group structure.

Mixed groups

Applying the draft legislation, it seems to us that the legal entities I1, I2 and I3 each has a primary CBCR obligation under Reg 3(2) in respect of its own activities. In the cases of I2 and I3, as they have no subsidiaries of their own, their CBCR obligation ends there.

I1, however, has subsidiary undertakings which we assume need to be included in its CBCR disclosure (being reported on a 'consolidated basis' in accordance with Reg 3(2)). The fact that one of I1's subsidiaries, NI2, is not itself an institution does not seem to relieve I1 of its obligation to include NI2's results in its CBCR disclosure. Is that HMT's intention?

Including NI2's results in I1's disclosure appears contradictory to the Government's stated position at Paragraph 3.10 of the Summary of Responses document "*However, it is not the Government's intention to capture institutions that are not in scope of CRD4*", hence **our preference would be for the institutions to be permitted to exclude non-institution subsidiaries from their CBCR disclosure if they prefer** (some, with limited numbers of non-institutions, may prefer to report for the whole group).

Paragraph 3.10 goes on to say "*Therefore, the Government intends to require institutions to use an accounting consolidation approach in relation to itself and any subsidiaries/branches it has. This will ensure that groups that only possess a small minority of institutions in scope of CRD4 will not be required to disclose for institutions that are not in scope*" – our hypothetical worked example demonstrates why institutions outside of the scope of CRD4 will indeed be disclosed for if they are themselves owned by an institution. It is clear to us that this area needs additional work before it meets the Government's objectives.

An alternative solution might be look to the definition of a "financial group" within the Financial Conglomerates Directive (FCD). The FCD group is considered to be financial only if at least 40% of its business is "financial sector". The definition of financial sector includes credit institutions, investment firms subject to CRD IV, insurance undertakings, re-insurance undertakings and holding companies and "financial institutions" as defined (unregulated firms carrying on defined financial activities). Following this definition, it may be possible to restrict the application of CBCR for groups below the 40% threshold to report CBCR only in respect of their financial subsidiaries and financial "participations" (i.e. for a wider class of entities than just CRD4 'institutions', but all within what might be expected of a financial group). Groups above the 40% threshold would report in respect of the entire (accounting consolidation) group.

Group reporting

Similarly, the fact that I3 will have separately made its own CBCR disclosure does not seem to relieve I1 of the need to report I3's CBC results. Is that HMT's intention? Our reading is that I2 and I3 have to report their 'solo' data and I1 has to report on its consolidated position. Hence I3's data will be disclosed twice (once at I3 level and again in I1's data). For some institutions there will be multiple levels of reporting. It seems to us that the better answer would be for I3's results to be reported in either its own disclosure or in I1's, but not in both – not least to avoid the users of CBCR inadvertently double-counting.

We note that many groups only produce consolidated financial information at the ultimate parent level (i.e. H in our hypothetical group structure diagram). I1 will not necessarily have IFRS consolidated financial information readily available for its subgroup. We note that the CRD4 CBCR reporting requirements place an additional burden on I1 to consolidate which may not currently exist, with commensurate administrative costs. Preparing this, and in particular IFRS consolidated profit before tax, could involve significant work (e.g. reflecting goodwill/intangibles at the subgroup level). The obligation to prepare this data solely for CBCR reporting purposes may be burdensome.

The guidance says that for mixed groups "institutions may *in addition to* providing the information required under regulation 3(1) aggregate the separate sets of information required for disclosure within the group *to form one disclosure for the whole group* (on a country by country basis)" [our emphasis]. It is not clear that this guidance is helpful, in that it does not seem to relieve I1, I2 or I3 of any reporting obligations (because of the use of the phrase 'in addition to'); nor does it transfer the obligation to Holding company H, because H is not itself an institution.

A similar issue also applies to regulation 5, as currently drafted.. It allows each institution to CBCR for the entire group (including non-institutions, presumably) or for a subgroup. It does not clarify *which* institution within the group should report for the whole group (and certainly does not relieve any of the other institutions from their Reg 3 obligations), nor allow for holding companies that are not themselves institutions to report for the whole group ("Where an institution is a member of a group whose members include entities which are not subject to the obligations of regulations 3(1) or 4(1) **it** [i.e. the *institution*, but not a parent company unless it also happens to be an institution] may meet those obligations….").

We also note that Reg 5 only applies to mixed groups. There does not seem to be any facility within the draft legislation to allow parent-company reporting for groups made up entirely of institutions.

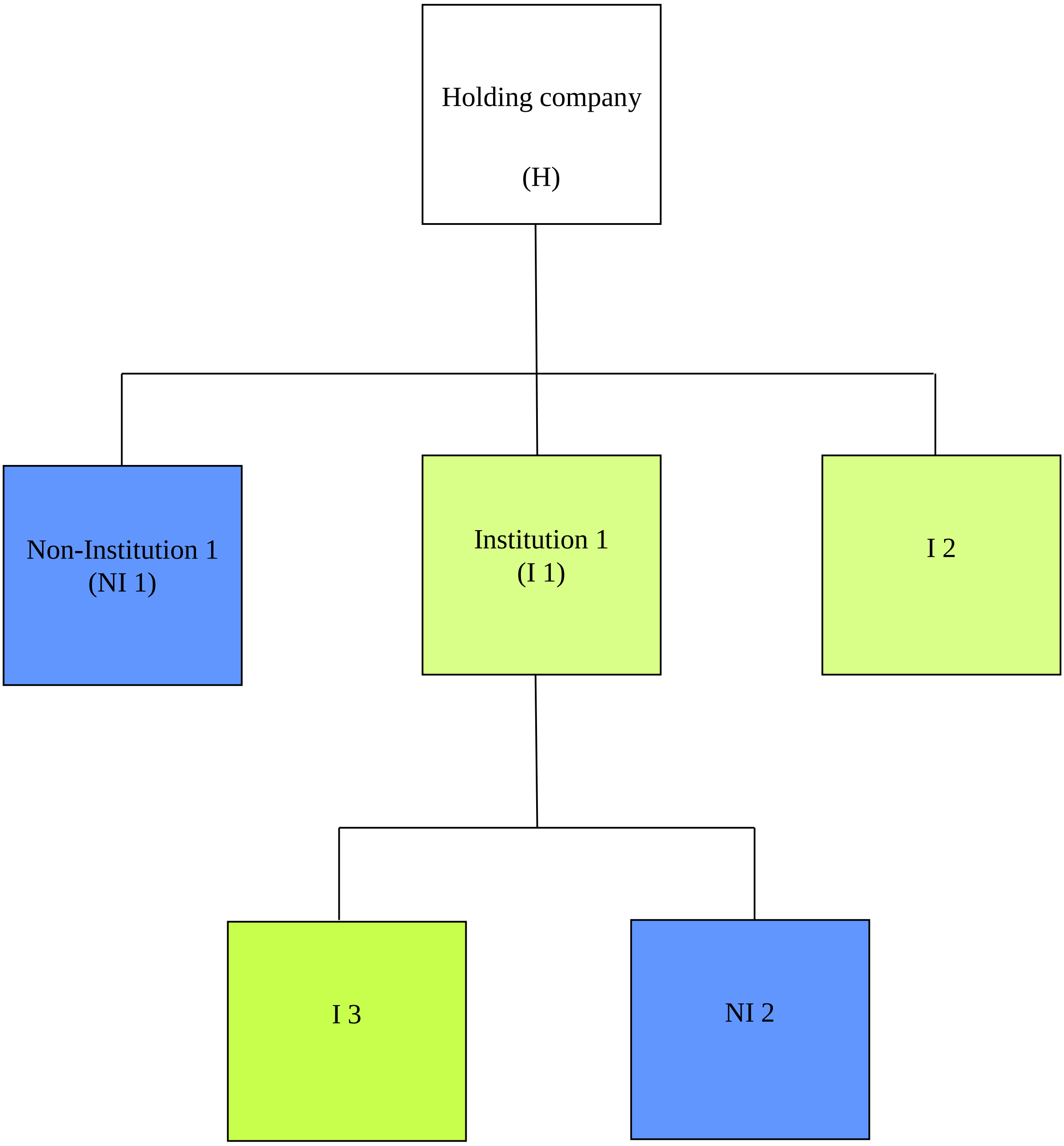
We suggest that a better answer would be to look to whether a company (whether a holding company or an institution or both) is already preparing consolidated financial information, and oblige those consolidated entities to CBCR the results of the institutions (and not the non-institutions, unless the group prefers) whose results are included within its consolidation. Institutions whose results are CBC Reported within that consolidation would be obliged to put a note to that effect in their financial statements. This would apply whether the consolidating company was in the UK or elsewhere in the EEA, and could be achieved in a straightforward manner by amending Reg 6 to remove the need for the reporting entity to be in "elsewhere in the EEA".

Institutions whose results are not CBC Reported elsewhere (we do not anticipate that there will be many – it would seem to be limited to institutions held directly by non-EEA parents) would revert back to the rules in Regulations 3 and 4.

Subgroups in Regulation 5

Reg 5(b) intends to permit reporting by a sub-holding company, providing that all of the group's institutions are within its subgroup. It seems unlikely that this will be a natural fact pattern for many groups. It is possible that groups will restructure to bring all of their institutions into one subgroup (and also, presumably, to move all non-institutions elsewhere within the group).

Appendix 2 – hypothetical group structure diagram



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Appendix 3 – other aspects of the draft guidance and legislation

There are a number of proposals set out within the consultation responses document, the draft guidance and/or the draft legislation which seem to us to be proportionate and appropriate. In particular, we welcome your confirmation that:

- The basis for consolidation should be the accounting consolidation (whether under IFRS or UK GAAP) and not prudential consolidation;

- There will be no requirement for institutions to reconcile their CBCR disclosures, prepared under IFRS or UK GAAP) to their local GAAP records;

- Reporting institutions will be permitted to provide a detailed narrative explanation of their CBCR disclosures, including but not limited to disclosure of taxes other than corporate tax (and foreign equivalents);

- Reporting will be left flexible to allow for the facts and circumstances of each reporting entity, and in particular that there is no intention to require reporters to prepare their disclosures to a standard template;

- 'Public subsidies' will be defined as direct support by government, and thus will exclude central bank operations, schemes found to be in line with the European Commission's State Aid rules, and tax incentives available across the board. It would be helpful if HM Treasury would confirm whether this captures central government only, or other levels of government (e.g. local government), and also whether QUANGOs and the European Commission are included.

  (We do, however, note that the draft guidance refers specifically to tax *deductions* available to all; as you may be aware the enhanced R&D relief for large companies has been amended to create a tax credit, and hence is no longer strictly a tax deduction. We propose that the wording of the guidance should be amended to refer to tax *incentives* available across the board.)

- Institutions will be permitted to report their CBCR disclosure on a group website, with a note to that effect in their financial statements. However, we note that the draft legislation does not reflect this position, calling instead for CBCR disclosures to be included "where possible" in the relevant institution's financial statements. The legislation needs to be amended to reflect that website reporting is an alternative rather than a fall-back.

- Interim reporting does not need to be audited.

- The definitions of 'turnover' and 'profit or loss before tax' will follow each institution's financial statement definitions. We agree that this will make the CBCR more relevant and straightforward for all users.

There are, however, some aspects with which we do not agree, and these are set out below.

- **Audit/assurance obligation**

  As a basic proposition, we have concerns with the inclusion of additional requirements within the statutory audit report. This concern is not specific to CBCR, but CBCR does seem to us to represent 'the thin end of the wedge', particularly for banks. The statutory audit report is addressed to shareholders, the primary users of financial statements, and we think it inappropriate to establish a precedent for information not directly relevant to the shareholders being included within the audit report.

  That said, there will be many institutions for whom CBCR will be a simple disclosure and where its disclosure will most efficiently be done through the financial statements; for that class of institutions it does not seem appropriate to expect them to obtain a standalone assurance report.

  We propose that the choice (i.e. audit report or assurance report) should be removed, and that instead **the legislation should clarify that:**

  - If the reporting is included in the annual report, it should be reported on in the statutory audit report; and

  - If the reporting is published separately on the website, it should be reported on by means of a separate assurance report.

  Finally:

  - Paragraph 2.15 of the draft guidance refers to the fact (correctly) that the IAASB's Framework covers ISAs, ISREs and ISAEs, and paragraph 2.16 goes on to say that the chosen assurance engagement should give a similar level of comfort as a statutory audit. It would be more helpful if the government clarified that they expected this to either be an audit under International Standards on Auditing (UK and Ireland) or a reasonable assurance engagement under ISAE 3000.

  - we note Reg 3(8) proposes that the audit be carried out in accordance with the standards required by Directive 2006/43/EC. To date, no international standards have been endorsed under Article 26; we suggest, therefore, that this should instead refer to standards issued by the Financial Reporting Council and/or International Standard on Assurance Engagements 3000.

- **Deadlines and timing**

  Of these, the most significant relates to the requirement in Reg 3(1) that institutions shall publicly disclose on or before 31st December immediately following each period of account. While a fixed deadline of 31st December appears sensible for most (and in particular calendar year end groups), there will be some for whom it will be impossible to comply. The worst case scenario will for those that draw up 52 week accounts that broadly follow the calendar; it is quite conceivable that such companies will have periods of account ending a handful of days before 31st December, and they will not be able to meet the deadline. There will also be some institutions drawing up accounts to 30th September or later, and they will certainly struggle.

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We propose that the deadline should instead be a set number of months after each institution's year end. We are not aware of any reason why a deadline aligned with Companies House filing requirements could not be adopted, and this would be fairer for all.

This would also help with a separate but related timing issue associated with Reg 6 (prevention of duplication). Reg 6 discharges an institution's obligation for CBCR disclosures if its information *has already* been published in another EEA State (although, as set out in Appendix 1, we think that this should be amended to allow for publication in any EEA State, including the UK). In our view **it should be possible for an institution's obligations to be discharged if the information has to be, and is, published in the EEA within, say, 6 months of the expiration of the UK deadline**.

- **<u>Geographical location for companies</u>**

  We do not agree that the geographical location for companies should be their country of incorporation; **we propose that it should be the jurisdiction of tax residence**. It is not unusual for companies to be incorporated overseas, oftentimes to facilitate commercial transactions such as securitisations or assurance activities, but to be tax resident and tax paying in the UK.

  'Branch' appears to be defined to only mean a branch of an institution - Art 4(1)(7) of CRR. Thus, a non-institution with a taxable presence in a state other than its state of incorporation (either a branch or because the whole non-institution is tax resident in a jurisdiction other than its state of incorporation) is not a 'branch' as defined. So would a Jersey company (not itself an institution, but whose results are included in CBCR consolidation higher up the corporate structure) with a UK presence have its P&L results listed as Jersey but its corporation tax in the UK?

Finally, there is a third category of matters where we feel additional clarifications and/or guidance is required.

- **<u>Definition of 'corporation tax paid'</u>**

  We understand the basis of HMT's decision that 'corporation tax paid' means the corporate tax paid on the profits/losses being CBCR disclosed, although we also note that this will result in a disclosure that will not tie back to either the cash flow statement nor the tax accrual, and would not ourselves have reached the same conclusion. In our view, an accounting measure of taxes levied would have created a greater degree of consistency, and we understand that other Member States (e.g. Germany) have decided to use an accounting measure.

  In that context, our view is that the reference in the legislation to s.2 CTA 2009 is reasonable. It will, however, inevitably increase the additional work needed by institutions in order to comply. Groups will already have identified which taxes equate to 'taxes on income' for accounting purposes (e.g. taxes within the scope of IAS12 for IFRS reporting purposes), so taking an accounting definition of taxes on income should require no further technical analysis of whether a tax is a tax on income. Groups and audit firms have built up an understanding and application of the accounting literature and applied this to the taxes levied in most jurisdictions. The approach adopted in the draft CBCR legislation is new and will therefore require institutions to test all taxes paid by the entity or its subsidiaries against a new definition. Some groups will be subject to many hundreds of different taxes worldwide. Whilst in many cases it will be clear whether a tax is based on profits or otherwise, our experience of applying accounting literature has identified difficulties in application, and differences when applying different GAAPs (such as IFRS, UK GAAP or US GAAP) to a particular tax. There could easily be differences of view in applying this new definition of 'tax', potentially

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leading to inconsistent application by institutions, at least in the early years of operation. We expect the UK definition of 'tax' will also differ from that taken in other Member States.

In addition, there are a number of items where, even so, it is not clear whether they fall within that definition. In practice, we do not think that it matters overly much whether these items are taken to fall within the definition or not, but it does matter that they are treated consistently and therefore we think that **they should be addressed in the guidance**.

These include:

- *CFC apportionments* (we note that both s.2 CTA 2009 and the draft CBCR legislation refer to the tax charged on 'profits of companies' without specifying that the company in question needs to be the institution making the CBCR disclosures. Accordingly it seems that CFC apportionments should be included as 'corporation tax paid'). We would also welcome guidance as to whether the CFC profits on which UK tax arises should be reported as UK profits or foreign profits.

- *Withholding taxes suffered*. Withholding taxes are not taxes levied on profits, but are creditable against corporate tax. Should they be included within the mandatory disclosure?

- *Partnerships*. we assume that a UK LLP with, say, Irish members should report its profits as UK profits even though the corresponding tax would presumably be reported as Irish – is our understanding correct?

- *Bank levy*. We seek your confirmation that bank levy should be excluded from the definition of tax paid, as it is not a tax on profits even though it is collected via the mechanics of corporation tax.

- *Branch tax*. If an UK institution has, say, an Irish branch taxable in Ireland at 12.5% such that additional tax arises in the UK on the branch's results, should the additional UK tax be reported under Ireland, or the UK?

- *Tax booked other than in the P&L*. Are institutions expected to disclose ***total*** tax paid on their income, or restrict their disclosure to tax paid that relates to profit or loss per their income statement? UK corporate tax computations make a number of adjustments to pre-tax profits for amounts booked elsewhere in the accounts. Examples would be amounts booked to the Available For Sale reserve, cash flow hedge reserve, or the cumulative foreign exchange translation reserve, as well as in the profit and loss reserve (pensions, share-based payments, tier 1 capital coupons).

  IFRS accounting requires tax charges/credits to be allocated between income statement and equity; but we are not aware of any existing requirement (or guidance on this topic) to allocate tax payments between income statement and equity, so allocating tax payments could be somewhat arbitrary (and again reduce comparability).

  Given the references to s.2 CTA 2009, we presume that the disclosure should be based on all tax paid on income, irrespective of where the related profits are booked. However, this will inevitably mean that the disclosure will include amounts not recorded in profit before tax, thus making any attempt to compare tax paid and profit before tax a challenge at best.

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- **UK branches of EEA institutions**

  The summary of responses document says "Given the disproportionate burden on third country branches and the fact that branches themselves are not considered 'institutions' under CRD4, the Government believes they should not be included in the scope of CBCR". The first part of that sentence clearly refers to third country branches specifically; the rest seems to refer to all branches. The draft guidance says that "Branches of institutions established in *a third country* are not considered institutions under CRD4 and the Government does not consider them to [be] in the scope of the CBCR requirements of CRD4". **It would be helpful if the guidance could be clarified to make it clear that branches of third country institutions which are based in the UK will fall outside the scope of CBCR, whist UK branches of EEA countries will be within scope (but would be expected to fall under the consolidated disclosures of their parent EEA institution in that EEA home state, and therefore will be exempted from additional reporting in the UK)**.

- **Materiality**

  It is by no means clear to us what the phrase "The Government would expect materiality to be applied in line with the relevant assurance engagement and in the context of country-by-country reporting". As CBCR is an entirely new concept, there is no precedent to say how materiality should be set in this context. **We propose that the materiality level for CBCR should be set at the same materiality level as for the reporting entity's profit and loss statement**.

- **Dormants**

  Is there any proposal that dormant entities can be excluded from CBCR? Although they will have no turnover, profit/loss or tax for the year, they will certainly have names and directors who may well meet the criteria to be 'employees' for the purposes of in Reg 3 (which does not itself offer any definition of employee or employed). Their inclusion seems unnecessary to us. A number of groups have in excess of 1000 group companies and including many hundred dormant subsidiaries.

- **Employee numbers**

  Paragraph 2.11 of the draft guidance states "*Institutions are required to adopt a **similar** approach to calculating this figure as they do for the purposes of section 411 of the Companies Act*" [our emphasis]. It would be helpful if any differences between the two could be made explicit in the guidance or, if they are completely aligned, for the word 'similar' to be substituted for 'the same'.

- **Extent of disclosures**

  If an institution has 20 foreign branches plus 200 subsidiaries (which themselves have another 30 branches) such that the group operates in 50 territories in total, is it most appropriate to reflect expecting 251 lines of disclosure (1+20+200+30)? Or would the Government expect just 50 lines (allowing an aggregation process for each territory)?

  It seems to us that the language of CRD4, the original HMT consultation and the documents issued on 19th November all point to the latter, but that would not allow any information specific to individual subsidiary institutions to be gleaned from the aggregate data. The first method could demonstrably disclose data for any subsidiary institutions, thereby enabling all of a group's disclosure to be set out in just one place, but does not seem as closely aligned to CRD4 as the second method.