

IV

Assurances of Integrity

120. The need for effective mechanisms to provide assurances of integrity is especially important in the case of resource revenue flows. The magnitude of these transactions and their technical complexity provide a high exposure to risks of malpractice. In developing countries, this situation is often combined with a lack of technical capacity and political failure to address risks adequately. The inherent risks¹⁰⁷ associated with resource sectors require that governments place special emphasis on data quality, internal controls, and independent external audit. This chapter of the Guide examines some key requirements for establishing good practice in this area of the Code. The role of the EITI validation process is highlighted again in this context.

A. Internal Control and Audit of Resource Revenues 4.2.5

Internal control and audit procedures for handling resource revenue receipts through government accounts or special fund arrangements, and any spending of such receipts through special funds, should be clearly described and disclosed to the public.

121. The special risks and complexity of resource transactions require that procedures of internal control and audit of resource revenue flows go beyond standard government rules and procedures in a number of respects. As noted above, tax administration for resource revenue flows is complex and requires specialist skills, which are generally in short supply in developing country administrations. Internal controls should be clearly defined and subject to periodic external review that is accessible to the public. In advanced countries, the national audit office can provide adequate assurance that such controls are in place. In the United Kingdom, for instance, the National Audit Office periodically reviews high-risk government processes to establish that internal controls are adequate. Its 2000 report on the petroleum revenue tax examined key areas of risk (such as misstated production volume or value, misstated claims for allowable expenditure, or nonsettlement of tax liabilities) and gave assurance that Inland Revenue is adequately managing the risks asso-

¹⁰⁷Inherent risks and the potential for corruption in the petroleum sector are described in McPherson and MacSearraigh (2007). Inherent risk factors include volume of transactions, rents arising from its oligopolistic nature, concentration of revenue flows, complexity, and the strategic significance of the sector.

ciated with this tax.¹⁰⁸ For developing countries, weakness in both government internal audit and the national audit office may require that an independent external source provide the necessary assurance. Nigeria, as a pilot exercise under the Nigerian EITI, has recently followed this path and engaged an independent company to carry out a comprehensive, financial, physical, and process audit of its oil and gas revenue administration. The report, completed in April 2006, is available on the Internet. It reveals significant weaknesses in revenue administration, but it represents an important step toward transparency and the establishment of effective internal controls.¹⁰⁹

122. Standard control and audit procedures should be applied to spending of resource-related revenue (including through resource stabilization and savings funds) in the same manner as they apply to ministries and other government bodies.

B. Tax Administration Openness

4.2.6/1.2.1

Tax administration should be conducted to ensure that resource companies understand their obligations, entitlements, and rights. The scope for discretionary action by tax officials should be clearly defined in laws and regulations, and the adequacy of sector skills and standard or sector-specific procedures should be open to review.

123. General transparency considerations suggest the need for a tax administration framework that is clear and understandable and covers all procedures related to taxpayers' rights and obligations, revenue administration powers, and adequate dispute resolution processes. Within this general framework, tax administration for resource companies is often best centralized in a large taxpayer unit; specialized sectors within such a unit would usually be organized along clear functional lines and with a sector-based audit program emphasizing field audits.

124. Staff in such specialized units should be well qualified to deal with complex sector-specific issues, including, for example, transfer pricing and petroleum cost accounting, and should work closely with industry representatives to identify and resolve uncertainties in the application of relevant tax laws, which may also involve explaining the administration's views through public rulings or education programs. Although some scope for discretionary action by tax administrators is necessary given the complex environment of major resource development,¹¹⁰ this should be clearly defined in laws and regulations to avoid corruption initiated by companies or government on the one hand and unduly aggressive assessments of resource companies by tax officials on the other. Strengthening dispute resolution mechanisms, both at the administrative level and through the courts, is necessary to address the latter problem. Finally, tax administration staff should be able to offer professional service, advice, and assistance to help taxpayers understand their rights, obligations, and entitlements under the tax laws. Service and other standards that taxpayers can expect the administration to meet should be published.

¹⁰⁸See http://www.nao.org.uk/publications/nao_reports/00-01/00015.pdf.

¹⁰⁹As part of the financial audit, the *Nigeria* report covers control and information flow issues in government financial systems (<http://www.neiti.org/FARFinIssues%20in%20Govt.pdf>). It recommends a wide review of the information and management systems of the key sources of revenue (sale of equity crude by the Crude Oil Marketing Department, management of petroleum resources by the Department of Petroleum Resources, and the management of taxation).

¹¹⁰For example, many tax laws base provisional tax payments on the previous year's assessment. However, this is irrelevant in the start-up phase of a mining or petroleum project. The tax legal framework should include provisions allowing the tax administration to determine when the previous year's assessment should be used and when a forward estimate of income should be used.

125. Tax information systems need to be in place and maintained centrally to allow tax officials and others (for example, under EITI) to reconcile tax office data on company resource revenue and costs with data from other sources.¹¹¹ Moreover, it is important to ensure a regular flow of relevant data and information on resource revenue from other organizations to the tax office (and vice versa) to keep all relevant government offices promptly and comprehensively informed about recent developments. At the same time, the tax administration should keep information it holds about a taxpayer confidential in accordance with the law, although under certain limited circumstances the law may permit the tax administration to disclose taxpayer information to other government agencies (e.g., for law enforcement or statistical purposes).

126. The tax administration's work plans and performance indicators, including those for the specialized unit dealing with resource revenue companies, should be published *ex ante*, and *ex post* annual reports should be provided to the legislature on performance during the year. Both *ex ante* and *ex post* reports should be available to the public. Tax administration and other agencies receiving resource revenue payments also need to be made subject to the standard external auditing requirements, and these audit reports should be published.

127. The standard requirements for assurance of integrity described in the Manual apply to resource-related transactions: data should meet accepted quality criteria and there should be adequate oversight mechanisms in place. The need for adequate oversight of accounts of NRCs and other relevant companies, as well as government accounts, is of specific importance to resource-related transactions. Oversight of these transactions is particularly emphasized under the EITI.

C. Oversight of Companies

4.3.1/1.1.5

International and national resource companies should comply fully with internationally accepted standards for accounting, auditing, and publication of accounts.

128. International companies can be expected to observe the audit-related transparency and disclosure requirements under the OECD's Principles of Corporate Governance. These suggest that annual audits should be conducted by an independent, competent, and qualified auditor to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.¹¹² Also, these companies are obliged to comply with internationally accepted accounting and audit standards, including, for example, the recommendations of the Statement of Recommended Practice of the Oil Industry Accounting Committee (2001). Although these requirements are outside the scope of the Code, adherence to relevant company and auditing standards by both international and domestic private sector companies in the resource sectors is a critical element of effective resource

¹¹¹Where elements of tax administration are split between the finance minister and a resource minister (for PSCs), it is particularly important that all revenue flows be accessible through a centralized information system.

¹¹²See OECD (2004, p. 22). See also the *OECD Guidelines for Multinational Enterprises* (OECD, 2000).

revenue management. Application of such standards is therefore supported by the Guide. International resource companies generally do comply with International Financial Reporting Standards (IFRS), but this is often not the case for NRCs in low- and middle-income countries.¹¹³ Therefore, one of the first requirements for NRCs is that they need to apply IFRS, including to the consolidated accounts that cover all of their subsidiaries.

129. The international dimension of company operations, however, requires coordinated action to ensure that internal and national oversight mechanisms are effective. Increasing concern with corruption in international business dealings has led to the development of national laws and international agreements to help oversee and control such practices. The U.S. Foreign Corrupt Practices Act (US Code 15, 78 dd et seq.), passed by the U.S. Congress in 1977, was the first major piece of legislation of this kind. The 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions represents a widely supported effort (with 35 signatories) to establish similar legislation as a standard feature for developed countries. The 2004 Transparency International global corruption report, however, notes that although all of the signatories have passed laws making foreign bribery a crime, few national governments have enforced the new laws, with the United States being a notable exception.¹¹⁴ The OECD Working Group on Bribery monitors implementation of the convention, and, since 2001, phase II monitoring has been concerned with effectiveness of national enforcement.¹¹⁵

130. NRCs, as well as any domestic private sector companies involved in the resource sectors, should be made subject to standard company audit requirements, and there may also be a case for oversight by the national audit office (the government external auditor), particularly where the national audit office has a mandate and capacity to audit state-owned enterprises. There may be cases that require special audits of NRCs. Auditing of NRCs, however, is often a critical weakness, which in a number of countries has led IMF-supported programs to require that such audits be undertaken.¹¹⁶ In this context, the selection of independent auditing companies should be based on a transparent tendering and selection process. Audit reports should be published. Tax administration and other agencies receiving resource revenue payments also need to be made subject to the standard external auditing requirements. External audit of government agencies and state-owned enterprises is often found to be a particularly weak area of fiscal transparency in developing countries. Special efforts to improve resource revenue transparency could usefully be combined with training and technical assistance.

¹¹³Note also that IFRS do not require reporting of country-specific data. Improvement in this respect will be an important element of EITI implementation. Where NRCs have international operations, similar considerations may be relevant.

¹¹⁴See <http://www.globalcorruptionreport.org/>.

¹¹⁵Progress to date is reviewed at <http://www.oecd.org/dataoecd/19/39/36872226.pdf>.

¹¹⁶The *Republic of Congo* is a case in point. In *Azerbaijan*, the NRC (called SOCAR) will be required to prepare, as part of a wider financial restructuring plan, annual consolidated financial statements in accordance with IFRS starting in 2008.

D. Oversight of Company/Government Revenue Flows

4.3.1

A national audit office or other independent organization should report regularly to the legislature on the revenue flows between international and national companies and the government, and on any discrepancies between different sets of data on these flows.

131. It normally falls within the mandate of the national audit office to ensure the integrity of government revenue flows. The general provisions of the Code should apply equally to resource revenues. However, in many cases, the national audit office lacks the mandate or expertise to audit such revenues, particularly when a significant portion of revenues flow through NRCs/NOCs. Establishing effective internal management and control systems (following practices outlined elsewhere in this Guide) will facilitate the task of the national audit office. The traditional transactions-based audit practiced in most developed countries often fails to address the key systemic issues that are prevalent in resource-rich countries. Risk-based approaches (as illustrated by the U.K. and Nigerian examples cited above) need to be applied more widely and given full political support for the underlying problems to be addressed and credible assurance of integrity given.¹¹⁷

132. The validation mechanism under the EITI represents an important step toward establishing credible assurance of revenue flows, which in turn should help promote longer-term institutional change. The mechanism requires an independent validator to verify the procedures adopted to assess, compare, and report on both the aggregate payments to government reported by companies (including state-owned resource companies) and the aggregate payments received by government from companies. The validation process is not a financial audit, and it does not remove the need to establish an effective government audit process. Commercial auditors and national audit offices would continue to carry out these functions. However, the validation report can comment on the adequacy of such processes in relation to EITI validation principles. This approach is of central importance to EITI implementation. It also provides a starting point for national agencies to build their own capacity and participate effectively in the assurance process. Country development partners can help augment the capacity of national audit bodies, possibly by supporting systemic recommendations made by EITI validators.

133. Local CSOs can also play a vital role in providing independent assurance of integrity of processes and data. At a general level, the Manual advocates independent scrutiny of macroeconomic forecasts, and in some countries CSOs have taken on such a role (for instance, in Ukraine). The EITI has given much more emphasis to the potential role of CSOs in providing assurance of integrity of resource revenue data. Active participation of CSOs is seen as one of the key criteria by which effective implementation of the EITI is to be judged. One promising example of effective engagement of CSOs in promoting transparency is the Memorandum of Understanding (see http://www.eitransparency.org/section/countries/_azerbaijan/_mou) signed by Azerbaijan's State Commission, aimed at guaranteeing a fundamental role for local CSOs in the design and monitoring of EITI implementation.

¹¹⁷See also Daniel (2002b), who emphasizes the importance of flow of funds analysis as a check that the "fiscal system delivers what it should."