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Changing Ukraine's Accounting and Reporting System: Economic Necessity and Practical Reform Steps

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Executive Summary

The cost of paying corporate taxes is a major determinant of the business climate in any country. In the case of Ukraine corporate tax rates are not excessive, but the administrative burden of paying taxes is extremely high, due to a very complicated and inefficient tax accounting and reporting system. As a result, Ukraine ranks 181 out of 183 countries in the sub-indicator "paying-taxes" of the publication "Doing Business" by the World Bank. Similar shortcomings concern the system of commercial accounting, which is still to some extent subordinated to tax accounting and thus very burdensome to apply by companies.

This situation has wide-ranging economic implications. The current system of accounting and reporting provides a very weak basis for informing managers, creditors, potential investors and tax authorities. As a result, banks are often not ready to provide loans based on the analysis of financial reports, but prefer to stick to "collateral lending", thus restricting the access to finance by business. But also foreign investors find it difficult to deal with the existing system. Last, it is questionable whether the current system provides a good basis for stable and high public revenues.

For all that reasons, it is of paramount importance to reform the accounting and reporting system. In particular, tax and commercial accounting should be re-aligned, in order to avoid the current practice of "double double-entry accounting", which increases the administrative burden for companies considerably. Furthermore, the current accounting and reporting system is based on the idea of "Form over Substance". This should be changed towards a principle that reflects the true underlying economic situation of the company. Besides, the frequency of tax and commercial reporting should be decreased from currently four to one time per year, as is the case in most developed countries. But also the auditing of companies should be tightened.

In order to implement these reforms, we suggest raising the organisational status of the accounting methodology division in the Ministry of Finance. Furthermore, a working group should be created, with the aim of drafting a new system of accounting and reporting. Finally, a fixed timetable should be established. In our view, the adoption of the new system should be obligatory for joint stock companies already in 2011. Other companies should have an option to join the new system in 2011 and an obligation to do so in 2012.

Reforming the system would create huge benefits at a very low cost. Besides, it would send very positive signals to foreign investors. Furthermore, the reforms would be highly popular with business and the population. Thus, the reform of the system of accounting and reporting would be an ideal first step in the reform agenda of the new government.

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1. Introduction

While Ukraine has moved after the break-up of the Soviet Union on a transition path from a centrally planned economy towards a market economy, the institutional framework in which economic activities take place has not always kept pace with market reforms. In particular, the accounting and reporting regulatory process, which is the focus of this paper, has mirrored this change only partially.

This comes as no surprise: In the Soviet Union, reporting to the authorities was an instrument of economic administration and more important than the management's own informational needs. The very nature of the Soviet economic system required thus a set of accounting principles, which gave completely different information than those that market-oriented commercial management requires. In modern market economies, a consistent system of commercial and tax accounting and reporting supports economic growth and development by facilitating the availability of finance, the attraction of foreign investments, the development of small and medium-sized enterprises and a stable tax base.

The present paper analyses the current state of commercial and tax accounting and reporting in Ukraine with respect to above mentioned objectives and derives concrete policy recommendations. We focus on accounting and reporting regulations for enterprises (privately-owned and state-owned alike), but not on the state sector (budgetary entities), which is a separate topic.

The structure of the paper is as follows: In the second chapter, we provide a short overview of the system of accounting and reporting currently in place in Ukraine. We discuss the legislative and regulatory basis for both commercial and tax accounting, and highlight the shortcomings of the current system. In chapter three, we undertake a short analysis of the economic effects of the current regulations. Here, we focus on the implications for both, the enterprise sector and the economy as a whole. The chapter four contains a number of concrete proposals how the current system could be improved. In the last chapter we conclude.

2. The current system of accounting and reporting in Ukraine

The previous Ukrainian accounting and reporting system was established by "Cabinet of Minister" regulations as of April 1993 and has been influenced by the Soviet model for a long time. It focused on reporting for tax purposes and did not provide relevant information to capital markets, management and creditors.

In July 1999 the Parliament passed and in August 1999 President Kuchma signed a new law "On Accounting and Financial Reporting in Ukraine". The law states that the financial accounting system is to be based on *National Standards of Accounting in Ukraine (NSAU)*[1], which **should not contradict** international standards (hereinafter: International Financial Reporting Standards (IFRS)[2]). Most of the old accounting methodology was eliminated. However, in practice there are gaps between NSAU and IFRS.

It is important to mention in addition, that tax calculation is not based on NSAU. Over the past several years, Parliament has enacted numerous tax accounting rules that operate quite independently of accepted accounting principles. Following this, tax accounting in

[1] Sometimes also referred to as *Ukrainian Accounting Standards (UAS)*.

[2] Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS). IAS were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). On 1 April 2001, the new International Accounting Standards Board (IASB) took over from the IASC the responsibility for setting International Accounting Standards. During its first meeting the new Board adopted existing IAS and SICs. The IASB has continued to develop standards calling the new standards IFRS.

Ukraine is separate from financial accounting and often requires duplication of recordings, which leads in practice to a "double double-entry accounting".

2.1 Legislative and Regulatory Basis

2.1.1 Commercial accounting (NSAU)

The regulation of questions of methodology of commercial accounting and financial reporting is carried out by the Ministry of Finance of Ukraine. It develops and approves national standards of accounting and other regulatory legal acts concerning accounting and financial reporting[3].

Under the developed NSAU, potential investors and creditors found it difficult to fully embrace financial statements prepared by national enterprises. Both investors and creditors had to transfer financial statements based on NSAU into financial statements following IFRS or US-GAAP (U.S. Generally Accepted Accounting Principles).

Starting in 2003 banks in Ukraine were required to follow IFRS. Enterprises with foreign investments usually operate with two accounting systems[4], one in accordance with Ukrainian requirements and the other one in accordance with international requirements, in order to meet the reporting obligations of their parent companies.

Currently all Ukrainian entities, as well as representative offices of foreign entities, ***must*** maintain accounting records and financial statements in accordance with NSAU (except for banks which have been required to use IFRSs since 2003).

The use of the legislatively set Chart of Accounts[5] is also obligatory for Ukrainian legal entities, while additional sub-accounts can be added by the accounting department if needed. Within this chart, every account is given a title and a numerical symbol and is assigned to a specific class or group. However, small businesses, non-profit non-government organizations, and foreign business entities may apply a simplified set of accounting rules.

The program of integration of Ukraine with the European Union[6] provided to introduce a package of 25 prime National Standards of Accounting until 2002. By now 34 NSAUs have been adopted, which, as stipulated in the 2000 "Law on Accounting and Financial Reporting", should not contradict IFRSs.

NSAU are generally based on IFRS, but they are not identical. There are still areas for which no local standards have been introduced (e.g., Accounting for Government Grants and Disclosure of Government Assistance, Interim Financial Reporting, Investment Property).

2.1.2 Tax accounting

The period of formation and functioning of the tax accounting system in Ukraine is characterized by the

- absence of a clearly defined and realised concept,
- inconsequence of steps in changing of the tax legislation and
- exclusive orientation on interests of state structures.

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[3] The order of accounting and financial reporting in banks is established by the National Bank of Ukraine according to national standards of accounting.

[4] With respect to the before mentioned "double double-entry accounting" one could even say three accounting systems.

[5] Decree №291 of the Ministry of Finance.

[6] Approved by the Decree № 1072/2000 from September 14, 2000.

Inconsistence and rashness in decisions concerning tax procedures change led to distrust to the tax report and significantly decreased its importance in management decisions.

Tax accounting is regulated by numerous tax laws, often contradicting each other. No Tax Code has been adopted.

Though commercial and tax accounting have several ***similar features*** like:

- Operating with the same primary documents
- Fixing and reflecting the same facts of economic activities
- Always confirmed documentary
- Uniform money equivalent
- Continuousness of accounting,

the final results of tax and commercial accounting differ significantly.

The main reason of the ***difference*** of commercial and tax accounting lies in the divergence between:

- recognition and an estimation of incomes and expenses for definition of an object of taxation by the profit tax and the value added tax and
- accounting standards concerning determination of the financial result,

which makes it impossible to constitute profit tax declarations based on commercial accounting figures.

Some differences between tax and commercial accounting can be found in the following table:

Table 1

Tax and Commercial Accounting Differences

Features /Conceptions	Tax Accounting	Commercial Accounting
Purpose	Base for taxation	Offering to decision-makers the complete, truthful and objective information about financial situation, cash flow and results of companies activities
Regulation Organs	State Tax Administration of Ukraine	Ministry of Finance of Ukraine, Committee of Standardisation of Ukraine
Main users	Tax inspectors	Managers (directors), shareholders and external users
Reporting form	VAT declaration, profit tax declaration (no balance!)	Balance, Financial Statement, Cash flow statement, Equity capital statement, Notes to Financial Statement
Rules	Regulated by numerous tax Laws and rules equal for all taxpayers	Every company uses its own accounting policy, that should not contradict NSAU
Fixed Assets Accounting		
Classification and accounting	For the needs of tax accounting tangible fixed assets are divided into four groups. Group 1 is accounted after each object, the accounting of groups 2, 3 and 4 is conducted without separate objects detachment	Fixed assets in the commercial accounting are booked according to the chart of accounts of Ukraine verifying each object.
Depreciation method	The Company can **only** use the amortisation method foreseen by the Law about profit taxation (tax method).	The company uses one of the amortization methods foreseen by the internal accounting standards (e.g. linear, tax etc.). The company chooses which method to use.
Terms of Depreciation	Accounted quarterly, the start of depreciation accounting is the subsequent quarter after putting the fixed asset into operation (different to date of acquisition!)	Accounted monthly, the start of depreciation accounting is the subsequent month after putting the fixed asset into operation
Accounting of Incomes and Expenses	Including of incomes and expenses for definition of an object of taxation (net profit) foreseen by the Law about Profit tax; ***received prepayments are income***	Including of incomes and expenses for definition of financial result foreseen by the internal accounting standards (NSA 15 "Incomes" and NSA 16 "Expenses")

Source: Own display

For the reason that tax and commercial accounting are having different purposes, rules and evaluation procedures of assets, obligations, incomes, expenses, and, as a consequence, - different results, the work of accountants and controlling units becomes more complicated.

This causes the necessity of a simplification of tax accounting and maximum convergence with commercial accounting for the purposes of increasing accounting effectiveness.

2.2 Shortcomings of the current accounting and reporting regulations

The most obvious shortcoming is a ***not existing Tax Code*** and the ***missing principle of correlation of NSAU with tax accounting***, which results in the above outlined differences between commercial and tax accounting.

In addition, we see the following shortcomings of the current standards:

- Required documentation leads to "Form over Substance" (for commercial accounting as well) and following this, often does not reflect the given economical situation. Furthermore, it requires significant manpower. For example:
  - In order to be able to account a received service, a so-called "Act" of acceptance has to be signed by both parties. Is this document missing or even only a stamp or signature of one of the contractors is missing, the underlying service cannot be accounted as such. In case payments were made, but this act is missing, the transaction will be accounted as received/made prepayments, which usually leads to outstanding amounts in the balance at the position advances paid/received.
  - A VAT-credit can only be accounted as such, in case the Ukrainian provider of respective service/goods has issued a so called VAT-special document.[7]
- A lack of legal consequences for non-proper commercial accounting leads to neglecting NSAU and a focus on tax accounting, which again is not sufficient for the management and creditors. Although official audits of the commercial accounting of a LLC are foreseen by law, there follows no legal consequence if they are not carried out.
- Four reporting periods per year for commercial and for tax accounting require significant manpower.
- NSAU have less interpretative guidance, explanations and illustrations than IFRS, which inevitably leads to some confusion in the application of local standards. This undermines the comparability and quality of financial statements in Ukraine.

3. The economic effects of the current accounting and reporting regulations

A relatively simple and straightforward economic analysis of the implications of the current accounting and reporting regulations in Ukraine reveals a number of negative effects for the enterprise sector, the government, and the economy as a whole.

1. <u>High costs of the current accounting and reporting regulations</u>

The current accounting system in Ukraine is very complex for enterprises, as many reports are to be prepared. Tax accounting operates independently (and unpredictably) from commercial accounting principles, which makes further duplication of recordings necessary. Many companies employ tax accountants in addition to commercial accountants in order to be on the safe side.

These claims are substantially supported by empirical evidence collected in the well-known "Doing Business" report by the World Bank. This annual report collects and compares different quantitative indicators in terms of business regulation and the protection of property rights for currently 183 countries. In the 2010 edition, the sub-

[7] „Nalogavaya Nakladnaya" in Ukrainian.

indicator "Paying taxes" shows for Ukraine an extremely negative picture: the country ranks No. 181 out of 183 countries[8]!

The table below gives more details on the immense administrative burden related to tax payments for a hypothetical medium-size Ukrainian company, also relative to other countries.

Table 2

Paying Taxes in Ukraine (2010)

Indicator	Ukraine	Eastern Europe & Central Asia	OECD Average
Payments (number per year)	147	46.3	12.8
Time (hours per year)	736	336.3	194.1

Source: World Bank "Doing Business 2010"[9]

Note: The sub-indicator "Paying taxes" takes also tax rates into account, i.e. refers to more aspects of company taxation. We focus here only on the administrative burden of tax payments.

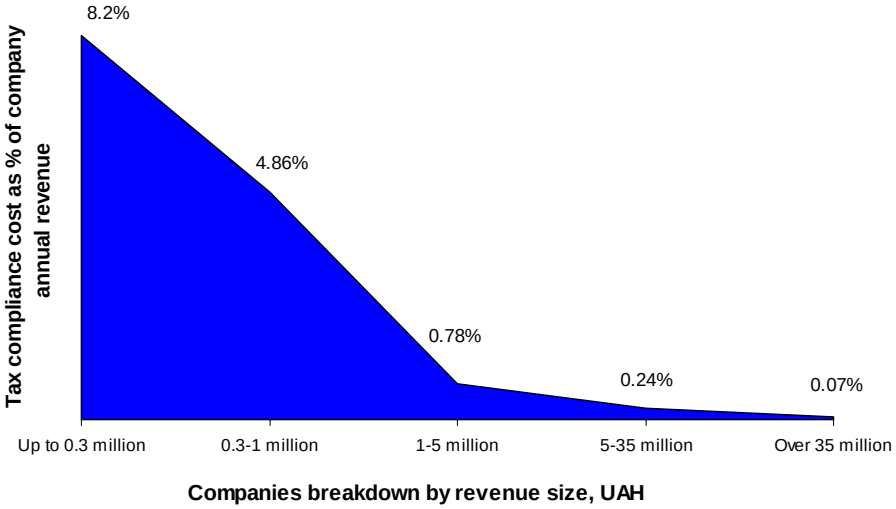
In economic terms, all this translates into higher costs for doing business for companies. But this is also highly inefficient from an economy-wide point of view: Such (forced) behaviour is a waste of productive economic resources, which could be better employed elsewhere in the economy.

2. Adverse structural economic implications

The high costs due to the existing accounting system affect principally all companies, i.e. the total enterprise sector. However, the impact of this administrative burden is not independent of firm size, as Figure 1 clearly demonstrates:

Figure 1

Tax compliance cost as a share of annual company revenue in Ukraine (2008)



Source: Ukraine Tax Compliance Cost survey (World Bank)

[8] Overall, Ukraine ranks No. 142 out of 183 countries in the report. Since in total only 10 sub-indicators are considered for the overall ranking, one can also see the importance of positive changes to one sub-indicator (i.e. "Paying taxes") for the overall rank.

[9] Download from http://www.doingbusiness.org/ExploreEconomies/? economyid=194#PayingTaxes

While larger firms normally have the ability to deal with such costs, small and medium-sized (SME) firms find it very hard to comply with regulations due to the considerable costs involved. Thus, the current system is an impediment especially for SME development, as smaller companies are hit relatively more severely by such costs. This translates into a negative structural economic effect.

As a reaction to such problems, a system of simplified taxation (including simplified accounting) for the SME sector has been established in Ukraine. Clearly, the general system needed a valve for the survival of small business in the official economy. But the establishment of special systems create as a rule additional problems, especially if such systems are of a permanent character. In the case of Ukraine, the system of simplified taxation has led to a massive tax evasion and thus to very large fiscal losses for the government. Thus, indirectly, the extremely complicated general system of taxation and accounting contributes to huge fiscal losses.

3. Questionable basis for the provision of bank lending

Lending decisions by banks, as well as corporate finance decisions more broadly, require the presentation of financial reports that give a complete, fair and unbiased view on the financial situation of the company. The current accounting system with its methodological flaws is fulfilling this purpose only to a very limited degree. One direct implication of this is the dominance of collateralised lending in the financing of companies by banks.

These shortcomings restrict access to finance for individual companies, a fact which has economy-wide negative implications for economic growth and development.

4. Impediment for the attraction of foreign investments

As we argued in the second chapter, in theory national accounting standards (NSAU) should be based on international standards (IFRS). However, as also became clear in the second chapter, in practise there are several gaps between the systems, requiring foreign investors to operate two accounting systems[10] – one in accordance with national regulations, the other one for reporting obligations with respect to the parent company.

For foreign investors already operating in Ukraine, this implies higher costs, since complying with local accounting standards and preparing financial statements according to international standards involves considerable resources. But also potential new foreign investors in local companies are negatively affected. The low informational content of financial statements according to local standards in terms of comparability and quality makes decisions regarding acquisitions, take-overs, etc. more difficult and more expensive (by adjusting reporting under local standards into international standards).

The negative economic effects for current and potential foreign investors of such "double" or "triple accounting" are straightforward to see. This is a clear impediment for the attraction of foreign direct investment, which serves as a major engine for economic growth and employment.

5. Questionable if the system correctly establishes the tax base

The previous chapter highlighted the fact that tax accounting in Ukraine is not based on commercial accounting, but operates rather independently of the former. Furthermore, it is not a well-designed and realised, comprehensive system, but rather a selection of individual rules, which often lack internal consistency.

Company taxation based on such a "system" which neglects the true economic situation is likely to be inferior from a public finance point of view. This also implies that government revenue is in such a scenario likely to be lower than what it could be under a new and comprehensive system. In our view, any future company taxation reform should start with the economically sound calculation of the tax base. For this, tax accounting need to be reformed. Furthermore, the adoption of a simple and coherent accounting and taxation system would facilitate the necessary reform or abolition of the simplified

[10] Three, if one takes into account tax accounting separately.

taxation system. In such a way, adopting proper booking standards would further broaden the tax base and clearly increase tax revenues.

Summing up the short discussion above, the following two conclusions can be made regarding the economic implications of the current accounting standards:

Conclusion 1: Current accounting and reporting regulations exhibit high economic costs for the enterprise sector in several areas. They impede an improvement in the business climate, and lead to a dismal enterprise performance, especially with a view on the important SME sector.

Conclusion 2: Current accounting and reporting regulations are also a burden for the whole economy. They imply a waste of economic resources which could be employed with a higher productivity in other parts of the economy. Furthermore, by changing the accounting standards, the country could most likely gain more from foreign investments and achieve a higher and more stable tax base

4. A reform strategy to change the current system of accounting and reporting

Based on the previous discussion, it is obvious that the current accounting and reporting system is badly in need for reform, both for enterprise-specific and general economic reasons. In the following section we develop a reform strategy for changing the current system. This consists of concrete recommendations on how the system should be changed, as well as proposals on how the reform process should be implemented.

4.1 Key elements of the reform strategy

Recommendation 1: Move towards the "principle of correlation", i.e. the alignment of commercial and tax accounting in the new Tax Code to be adapted soon.

While Ukraine has lacked a single Tax Code since independence in 1991, key policymakers have recently confirmed that such a legal act should be adapted soon. The new Tax Code should be based on NSAU, which means tax accounting should comply with commercial accounting. To NSAU should be added interpretative guidance, explanations and illustrations following IFRS. This would - in case the new Tax Code will be based on NSAU - specify the base for taxation[11]. Such an approach could translate into concrete advantages for the state budget in terms of higher tax revenue, e.g. by changing depreciation modalities towards economically justified levels[12].

Recommendation 2: Move away from the "Form over Substance" motivation in accounting and reporting.

Financial information that correctly reflects economic reality is a key input for many business decisions and thus without alternative. The accounting and reporting system needs to set a framework in which information mirrors this reality rather than is only in compliance with formal standards.

At the same time, significant resource savings and thus efficiency gains are possible by moving from a system that is centred on formal compliance to a more flexible system which concentrates on the substance of economic transactions.

Recommendation 3: Decrease the frequency of tax and commercial reporting

The high administrative burden on business, especially SMEs (see Figure 1), can be eased by a shift to an annual rather than the existing quarterly tax and commercial reporting frequency. This would generate considerable resource savings and improve the business climate significantly. The tax authorities could establish regular tax pre-payments based on the financial results of the companies' previous year, as is common in many other countries of the world.

Recommendation 4: Intensify auditing duty (auditor's opinion).

The application of international standards in accounting and auditing guarantees reliable and credible financial information, which helps in turn to secure access to cheaper finance for investments. While an auditing duty already exists, audits are often not carried out due to a lack of credible sanctions. We recommend tightening the respective auditing duties for LLC which are above a certain size threshold, via establishing firm sanctions if the company in question violates the rules.

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[11] It should be mentioned, that there will be – as in every country - still differences between commercial and tax accounting, but far out not to that extend as currently in Ukraine.

[12] A concrete example for such changes towards more realistic depreciation rules can be found in information technology (IT)-equipment, where currently tax legislation allows a depreciation which is not in line with the economically useful life of such equipment.

4.2 Implementation of the reform strategy

The proposals above need to be implemented over a certain period of time. In order to facilitate their implementation, we make a number of proposals on how this process could be structured.

Recommendation 5: Raise the organisational status of the accounting methodology division in the Ministry of Finance.

As of now, the relevant body that is responsible for setting accounting standards in the Ministry of Finance has the status of a division. We recommend an upgrade to departmental status, in order to raise its importance and to give it the necessary political backing for the implementation of the reform strategy.

Recommendation 6: Establish a working group for consultation and coordination with the relevant industry bodies.

The relevant industry bodies (e.g. the Chamber of Auditors of Ukraine (UCA), the Professional Public Union of Auditors of Ukraine or the Ukrainian Federation of Professional Accountants and Auditors (UFPAA)) need to be integrated into all steps of the reform process, providing a constant stream of feedback to government plans and bringing in own suggestions. Thus, we suggest the establishment of a working group, which brings together all concerned parties, at the earliest possible stage.

Recommendation 7: Commitment to a fixed timetable for the reform process.

For the reform to be credible, a firm date for the start of the new system is needed, which serves as a point of orientation for all concerned parties. Furthermore, a timetable for a gradual implementation towards this objective is required, in order for both enterprises and tax officials to get used to the new norms.

We would suggest that in the 3rd quarter of 2010, the relevant norms shall be passed, so that the training of tax officials can start in 4th quarter of 2010. In 2011, for companies in the legal form of joint-stock companies (JSC) it would be mandatory to apply the new rules, while for limited liability companies (LLC), its adoption would be voluntarily[13].

From the beginning of 2012 onwards, all commercial entities should report according to the new rules. We choose 2012 as the starting point of the new system, as this would coincide with the implementation of the government's accounting reform for public sector entities, which is part of the wider "Public Finance Modernization Project"

5. Summary and conclusions

Ukraine's new parliamentary coalition, which carries the programmatic name "Stability and Reform", has clearly committed itself to a new strategy of economic reforms. At the same time, while there is no serious alternative to such reforms for the benefit of the country, one hears usually a number of objections related to such reform efforts. While being beneficial in the long term, such measures are often perceived as unpopular, at least in the short term. Furthermore, most reforms take a lot of time to implement, and involve considerable amounts of public funding. In short, implementing reforms makes sense from an economic, but unfortunately not always from a political point of view.

Behind this difficult background, the reform of Ukraine's accounting and reporting system should be considered as an ideal starting point for the new administration. From an

[13] However, these considerations are subject to further analysis and refinement and thus should be handled flexibly. Equally, one could apply different criteria, e.g. make the introduction dependent on enterprise size. Companies with more than 250 employees and/or turnover of more than UAH 100 m could be required to use the new rules already in 2011.

economic perspective, the establishment of a modern and consistent system of tax and commercial accounting and reporting would improve the investment climate, boost economic growth and efficiency, and raise the government's tax revenues. This reform would clearly serve as a "first best"-solution in terms of a general accounting and reporting system, which is just and applies to all entities. At the same time, such a reform would make it less important to strive for "second-best" solutions (like simplified taxation and accounting), which may make partially sense as a valve in a complex and inefficient system, but which are inferior to a "first best" solution. The problems frequently associated with simplified taxation (tax evasion, pseudo self-employment, corruption, etc.) could also be better addressed.

From a political point of view, our proposals to reform the current accounting and reporting system would also be largely immune against these frequently heard objections to reforms mentioned above. Such a reform would require little public funds, it could be implemented relatively quickly, and would not be perceived as unpopular. On the contrary, this reform would be an important psychological signal for foreign and domestic investors, showing a clear break with Soviet legacy, which comes exactly at the right time.

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