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The Role and Current Status of IFRS in the Completion of National Accounting Rules – Evidence on Cyprus

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ABSTRACT The case of Cyprus with respect to the adoption of International Financial Reporting Standards (IFRS) is unique given the country's strong reliance on international business and accounting-related services. As such, Cyprus has required the use of IFRS since 1981 not only for publicly listed firms but also for private companies regardless of their size. Cyprus' reluctance to fully transpose Directive 2013/34/EU into national law cannot be unrelated to its long-standing requirement of financial statements that are not only prepared under IFRS but are also audited for all types of corporations registered in the Republic. We conclude that transposing the new Accounting Directive in its entirety into national law could have adverse effects on the Government tax revenue, the GDP of the services sector and the credibility of Cyprus as an international business and financial services center.

Keywords: IFRS, Cyprus, European Union, Accounting Directive 2013/34/EU

1. Introduction

1.1. Regulation (European Commission) No. 1606/2002 (IAS Regulation)

The case of Cyprus in terms of the adoption of IFRS is unique for a number of reasons. First, with the exception of Malta, Cyprus is the only European Union (EU) country that required the use of IFRS in the preparation of financial statements before their adoption was made mandatory in the EU; in fact, Cyprus required the use of IFRS (formerly known as International Accounting Standards (IAS)) as early as 1981 through the regulations of the Institute of Certified Public Accountants of Cyprus (ICPAC). The use of IFRS then became a requirement of the Cyprus Stock Exchange in 1996. Subsequently, in 2003, it became the official statutory requirement through a specific reference in the Cyprus Stock Exchange legislation and the Cyprus Companies Law Cap.113 (Companies Law), under which IFRS form the basis of preparation for the individual and consolidated financial statements of all firms. Secondly, and perhaps more importantly, the requirement for the use of IFRS in 1981 also required all financial statements to be audited. Until 16 September 2016, the only available exemption from the audit requirement, in accordance with the Companies Law, was for small firms, as locally defined.[1] However, this exemption to the

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audit requirement was never actually utilized as Cyprus tax laws require a full scope audit for all firms, regardless of size. As a result, the financial reporting of listed, unlisted public and private firms is based on audited financial statements prepared under IFRS. The above-mentioned audit exemption is now withdrawn to rectify this legislative inconsistency.

The 2005 mandatory adoption of IFRS in the EU through Regulation (European Commission (EC)) No. 1606/2002 was hence uneventfully applied in Cyprus, while the country at the same time chose to also invoke the right to extend the requirement beyond the consolidated financial statements of publicly traded firms, by continuing to require the use of IFRS for the individual and consolidated financial statements of all firms regardless of size. The 2005 mandatory adoption of IFRS in the EU did not, therefore, have the strong impact it had for the rest of Europe.

1.2. Directive 2013/34/EU (New Accounting Directive)

As easy as it were for Cyprus to quickly apply the IAS Regulation, the transposition of EU Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of firms, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directive 78/660/EEC and 83/349/EEC, has proved to be a real headache for both Cyprus and the EU. Cyprus not only missed the deadline to transpose the New Accounting Directive (NAD) by 20 July 2015, but was significantly late in implementing the necessary measures. In September 2015 Cyprus received the first warning by the EU and in June 2016 the EU granted Cyprus (and Ireland for that matter) another two months before initiating legal proceedings against both countries.[2] The delay was purely on account of administrative reasons, and the relevant transposition laws were finally passed on 16 September 2016, but as explained in the following section only certain aspects of NAD were transposed in order to keep the financial reporting environment practically unchanged.

2. Regulatory Environment

2.1. The Cyprus Socio-economic Environment

The application of IFRS for unlisted companies of all sizes as well as listed companies in Cyprus was to a great extent affected by some key country events of the recent history. Cyprus was a Crown colony until 1960, when it became an independent republic. Thus, the British influence to the country's socio-economic environment was apparent, as for example in the adoption of the Companies Law, which was virtually identical to the UK's former Companies Act of 1948. The several subsequent amendments of the Companies Law were associated to, among other things, the Cyprus Stock Exchange establishment in 1995–1996, and the joining of the EU in 2004. The establishment of the ICPAC in 1961 was a milestone event in the importance of the accountancy profession in the Cyprus' economy. The above-mentioned factors led to the creation of a high quality audit, financial and business services environment, which enhanced the financial reporting quality in the country. The country's heavy reliance on audit services is also shown by the relatively large number of registered auditors – currently 933 in Cyprus[3] compared to 1209 in Greece,[4] a figure that should be considered together with the fact that the population of Greece is more than 10 times greater than that of Cyprus.

2.2. The Cyprus Financial Reporting Environment

During the period of harmonization of the Cyprus legislation with EU Directives and Regulations prior to the accession of Cyprus to the EU in 2004, discussions took place over the extent of transposition of the EU Fourth and Seventh Accounting Directives, into national law. With the consent of Brussels, these predecessors of NAD were not transposed into national law in their entirety, on the ground that Cyprus would continue requiring the use of IFRS for the individual and consolidated financial statements of all firms, invoking the option allowed by Article 5 of the IAS Regulation. The specific clause states that Member States may permit or require firms, other than those which are publicly traded, to prepare their consolidated accounts and/or their annual accounts in conformity with international accounting standards adopted by the EU. The Cyprus Companies Law, therefore, requires all firms to prepare their annual (individual) and consolidated financial statements in accordance with IFRS.

The transposition of NAD into national law in Cyprus was finally implemented on 16 September 2016, almost 14 months after the transposition deadline of 20 July 2015, even though NAD was not adopted in its entirety. In fact, most of the clauses that Cyprus did not adopt are exactly the ones that most closely abide by the Directive's objective to reduce the administrative burden for small companies.

The implementing measures were prepared on the basis of the existing Cyprus financial reporting and audit regime. The transposition approach followed by Cyprus was supported by a document issued by the EC in November of 2003, entitled *Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting*,[5] which among other matters provided clarifications on the interaction between the IAS Regulation and the accounting directives in force at the time of issue of the document (Fourth and Seventh Accounting Directives). According to this EC document, a firm which is required to prepare annual or consolidated financial statements, and falls within the scope of the IAS Regulation as a result of the application of Article 5 of the said regulation (i.e. Cyprus legislation), must also comply with the provisions of national law transposing the articles of the accounting directives, which are outside the scope of the international accounting standards, and relate to audit, the annual report and certain publication requirements. This implies, as also noted in the above-mentioned EC document, that if a firm is required to apply IFRS as adopted by the EU for the preparation of its consolidated and/or annual financial statements, no provision of the accounting directives transposed to national legislation may restrict or impede its compliance with this requirement. Furthermore, on the basis of recital 7 of NAD, the provisions of NAD should apply only to the extent that they are not inconsistent with, or contradicted by, IFRS as adopted by the EU framework.

Invoking Article 5 of the IAS Regulation allowed Cyprus to retain its requirements relating to the preparation of audited financial statements under IFRS by all firms. As a result, for the purposes of harmonization with NAD under the Cyprus regime explained above, the transposition of NAD involved only the provisions of NAD which deal with matters outside the scope of IFRS as adopted by the EU framework, and which are the following:

- The definition of a public interest entity.
- Other definitions identified as necessary (e.g. net turnover).
- Categorization of firms and groups of firms:
  - Small- and medium-sized firms and groups.
  - Large firms and groups.
- Disclosure requirements in the notes to the financial statements:
  - Analysis of staff costs only for medium and large firms.
  - Analysis of audit fees only for large firms.
- Additional disclosures in the notes to the financial statements:

  - Name and place of establishment of the immediate and the ultimate holding company, and information about where one can obtain consolidated financial statements – for medium-sized and large firms.
- Limitations on distributable reserves in relation to capitalized development costs or formation expenses.
- Additional information in the management report:
  Information on the acquisition of own shares.
  Information on the use of financial instruments.
- Exemptions in relation to the management report:
  - Exemption of non-listed small firms from the obligation to prepare a management report.
  - Exemption of small- and medium-sized groups from the obligation to prepare a consolidated management report.
  - Exemption in relation to non-financial reporting for medium-sized firms.
- Inclusion of a corporate governance statement, with a defined content, in the management report of publicly traded firms.
- Formulation of an audit opinion in relation to the management report, as to whether it has been prepared in accordance with applicable requirements, whether it is consistent with the financial statements and whether it contains material misstatements.
- Wording of the opinion of the auditors, in line with the relevant International Standards on Auditing.
- Preparation of a report and a consolidated report for payments to governments, and its inclusion in the annual report.

Overall, the provisions of the Directive that were not transposed are either the ones that deal with matters within the scope of IFRS, or those that would restrict or hinder a firm's compliance with IFRS. Specifically, the transposition of NAD did not involve the provisions of the NAD relating to the presentation, content, disclosures and accounting policies to be used in the preparation of individual and consolidated accounts by different sizes of firms. The optional micro regime provisions of the NAD were also not transposed as they would render the audit exemption mandatory for all micro-entities.

In addition, the formerly available exemption from the audit requirement for small firms was removed, to overcome the prior legislative inconsistency and bring the Companies Law in line with the stricter Cyprus tax laws that require a full scope audit for all firms, regardless of size. Thus under the now implemented transposition of NAD, Cyprus retains the requirement for IFRS financial statements for all designated firm sizes, along with the requirement for these to be audited.

3. Why Has Cyprus Not Transposed NAD in Its Entirety?

Cyprus' reluctance to transpose NAD in its entirety into national law cannot be unrelated to its long-standing requirement of IFRS reporting by all types of corporations registered in the country. Given NAD's assertion that requiring smaller firms to abide by IFRS is burdensome, Cyprus' insistence on the current requirements can be deemed rational only if Cyprus perceives that the benefits of IFRS reporting outweigh the costs.

Data on 86 publicly traded Cyprus firms show that one out of four Cyprus firms has approximately 25 million of total assets and around 3 million of total revenues, suggesting that about 25% of Cyprus *listed* firms would be classified as medium-sized under NAD.[6] This in turn also suggests that the overwhelming majority of private firms (for which data are not available) should consist of firms in the small and micro categories. The full implementation of NAD, therefore, would have a significant and adverse impact on the reporting obligations of these firms, shrinking the overall size of the services sector, and negatively affecting the country's GDP. Statistics from the World Bank suggest that services (the sum of both imported and exported services) contributed to 70.3% of Cyprus GDP in 2014, a figure which is two to three times greater than the corresponding number for Portugal (20.5%), Italy (10.7%) and Greece (24.7%). Moreover, according to Eurostat, almost 6.4% of Cyprus GDP comes from corporate tax income. Even if Cyprus' corporate tax percentage is one the lowest in the EU,[7] interestingly, the country's reliance on corporate tax income is 1.6, 2.3 and 2.9 times the reliance of Greece (3.9%), Portugal (2.8%) and Italy (2.2%), respectively.

A second possible benefit that Cyprus derives from the current auditing requirement is that the cost of verifying tax liabilities is borne by the firm itself rather than being assumed by the government. This is because under local tax legislation it is audited financial statements that form the basis for the computation of taxable income. Conditioning the audit requirement on firm size could, therefore, impair the reliability of company tax returns which in turn, could have an adverse impact on the country's tax revenue. In addition, this possibility could also increase government expenditures as the responsibility for and the cost of verifying corporate tax liabilities would have to be assumed by the Government tax department. This cost can be enormous given that number of private companies registered and operating in Cyprus. According to the Registrar of Companies, there were 227,840 companies registered in Cyprus as of the end of 2015, with 173,878 of these filing annual financial statements. Lifting the requirement of audited financial statements for tax purposes would create an enormous need for additional resources to allow tax audits, something that could quickly erode a sizable percentage of the tax benefits derived from the operation of these firms.

Third, even with its seemingly burdensome financial reporting and auditing requirements Cyprus managed to attract a significant number of firms representing foreign interests. This implies that these firms actually *chose* to be registered in Cyprus knowing of and fully agreeing with the substantial financial reporting disclosure and audit requirements. One question that of course arises is why foreign organizations choose to incorporate in Cyprus given the additional disclosure hassle. Apart from the widely known tax benefit that firms enjoy, a major argument for not adopting NAD in its entirety is that foreign firms are attracted to Cyprus exactly because of the more strenuous financial reporting and audit regime. In academic terms, foreign firms that choose to be incorporated in Cyprus, signal authorities, investors, creditors and clients that they are not engaging in any sort of questionable financial or reporting practices. For them preparing financial statements based on a highly demanding accounting regime, and in addition allowing these financial statements to be audited, provides a strong message to all stakeholders that the company adheres to strong ethical standards. In addition, preparing financial statements under IFRS which are also audited, reduces the cost international groups have to bear for using, analyzing and consolidating, the financial statements of their Cyprus subsidiaries. Relaxing these reporting requirements therefore could actually result in a number of these firms moving their registered offices from Cyprus.

Finally, lifting the stricter financial reporting and auditing requirements may also impair the profile of Cyprus as a reputable international business and financial services center, an adverse effect which would not be politically desirable. Cyprus has long been regarded as EU's black sheep, caught in great controversies regarding the enforcement of anti-money laundering legislation. The strict financial reporting and audit regime, however, has provided the country with a solid argument to brush off such accusations but has also deterred poorly governed organizations from registering in Cyprus. Relaxing these requirements could thus actually put Cyprus at the risk of being again considered as a country of questionable financial standards. Cyprus' intensive efforts to promote the financial and legal environment as one that strictly adheres to widely acceptable ethical standards seem to have paid off in the last few years. Specifically, in 2015 the Organization for Economic Cooperation and Development officially rendered Cyprus as compliant with standards promulgated by the Global Forum on Transparency and Exchange of Information for Tax Purposes, with its rating not being different from the one assigned to the United States of America or Germany. In addition, the evaluation performed in 2013 by Deloitte and the Committee of Experts of the Council of Europe on the evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, of the effectiveness of Cyprus in implementing customer due diligence revealed that the level of compliance in Cyprus is not only strong but even more rigorous than in many other EU countries (Aristotelous & Kollatou, 2013). The stakes are therefore high, and Cyprus will do anything in its power to ensure that its credibility and hence its economy, are safeguarded and promoted.

4. Conclusion

The case of Cyprus with respect to the adoption of IFRS is indeed unique given its economy's strong reliance on international business and accounting-related services. As such, Cyprus has required the use of IFRS since 1981. Thus, the EU's decision to require the adoption of IFRS for consolidated financial statements of all publicly listed firms in Europe had no impact on the reporting environment of the country.

Given that all Cyprus firms are required to apply IFRS as adopted by the EU for the preparation of their consolidated and/or annual financial statements, no provision of the NAD transposed to national legislation should restrict or impede their compliance with this requirement. For this reason, the transposition of NAD involved only provisions that deal with matters outside the scope of IFRS, and which are not inconsistent with, or contradicted by IFRS. In addition, Cyprus tax laws have always required a full scope audit of the financial statements of all firms, regardless of size. Even after transposing NAD, Cyprus retained the requirement for IFRS financial statements for all designated firm sizes, along with the requirement for these to be audited.

Due to the country specific environment, we posit that a potential decision by Cyprus to transpose NAD in its entirety into national law would have adverse effects on the Government tax revenue, the GDP of the services sector and the credibility of Cyprus as an international business and financial services center.

Disclosure statement

No potential conflict of interest was reported by the authors.

Notes

[1]Until 16 September 2016, the Companies Law did not require audited financial statements for firms that on their balance sheet date did not exceed two of the following criteria: (a) Gross assets of €3.400.000, (b) Net turnover (revenue) of €7.000.000 and (c) 50 employees.

[2]http://europa.eu/rapid/press-release_MEMO-16-2097_EN.htm.

[3]http://www.icpac.org.cy/selk/individualsauditors.aspx.

[4]http://dbapplication.elte.org.gr:8080/el/accountantsList/?order=ELTEID&page=24.

[5]http://ec.europa.eu/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf.

[6]This conclusion is based on analysing Compustat data on total assets and total income for 86 publicly listed firms in Cyprus.

[7]https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html.

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