



Chapter 12 **Accounting principles and practices**

Investor considerations

- There is no requirement to publish financial statements except for listed companies, banks and insurance companies.
- Comprehensive accounting standards issued by the Capital Markets Board are applicable with effect from the first interim financial statements starting from 1 January 2005. These accounting regulations are identical with International Financial Reporting Standards.
- An independent audit does not preclude the right of the tax authorities to examine the books themselves.

Accounting principles

Turkish commercial law does not specify accounting principles, and so practical application is in accordance with the tax law. Since the commercial financial statements are required to agree with the books, they generally omit provisions and accruals not permitted for tax purposes, such as doubtful debts, inventory obsolescence and earned employment termination benefits. In more recent years, subsidiaries of international companies have recorded provisions and accruals in accordance with International Financial Reporting Standards but, as recording these in the books reduces flexibility for dividends, the practice is not widespread, and is more often used in joint venture situations to minimize the risk of distributions effectively out of capital.

In January 1989 the Capital Markets Board issued comprehensive accounting regulations that have been applicable to capital market companies with effect from fiscal year 1989. In November 2001, the Capital Markets Board of Turkey ("CMB") issued 2 new significant communiqués in order to harmonize with the International Financial Reporting Standards. Communiqué XI/20, "Principles for Restatement of Financial Statements in Periods of Hyperinflation" ("Communiqué for Inflation") and Communiqué XI/21, "Principles of Consolidated Financial Statements and Accounting of Investments" ("Communiqué for Consolidation") issued by the CMB, are effective for financial statements for the financial years ending after 1 January 2003 and for the interim financial statements for the first financial period following the year-end in question. Effective from the first interim financial statements starting from 1 January 2005, CMB has also issued a new Communiqué XI-25 which includes the standards identical with International Financial Reporting Standards. The listed companies will prepare and issue their financial statements starting from 1 January 2005 in accordance with Communiqué XI-25 which will make the financial statements more comparable and similar with IFRS.

A statutory standard Chart of Accounts (CoA) became effective as of January 1, 1994. The application of the CoA is mandatory for real persons and legal entities other than financial institutions (including banks) that prepare balance sheets. Financial institutions are subject to a special regime.

The statutory CoA introduces two different types of cost accounting regimes. The regime referred to as 7/A represents a more detailed and complex regime designed for larger companies, whereas regime 7/B provides a simpler alternative for small and medium-size businesses. Under 7/A, expenses are recorded in the ledger according to the "function principle" and in sub-ledgers according to the "types of expense" principle. Under 7/B, expenses are recorded according to the "type" principle only.

Form and content of financial statements

The requirements for the financial statements of non-capital market and capital market companies are described below.

Non-capital market companies

◦ Basic financial statements

Under the Turkish Commercial Code, the board of directors is required to submit the following financial information to the annual general meeting of the shareholders.

1. Balance sheet
2. Income statement
3. Activity report (indicating the commercial, financial and economic situation of the company)
4. Dividend distribution table

There is no general publication requirement (See Appendix VIII for sample financial statements.)

Under the statutory CoA, national codes are entered directly to the ledger at transaction level, and the accounts in the statutory CoA are transferred directly to the income statement directly as well as the balance sheet.

◦ Income statement

A format for income statement is described in the statutory CoA and is the same as the one given by the Capital Markets Board for capital market companies. For an outline of these prescribed income statements, see Appendix VIII.

◦ Capital

Shareholders' equity is grouped together as the third item on the credit side of the balance sheet. The position is subdivided into nominal capital (including both paid-up capital and unpaid capital), legal reserves (profit reserves) and capital reserves (, profit and loss for the period, accumulated profit, and loss for previous periods). Reserves for bad debts and employment termination benefits are included in the external sources groups. Depreciation is shown under related fixed assets groups on the debit side of the balance sheet.

Companies are not permitted to purchase their own shares (treasury stock), because this would be a reduction in capital. Share premiums are shown under capital reserves. Stock dividends may be created from retained earnings or profit for the year, on a resolution of the

shareholders, and are recorded, after completion of registration formalities, by a single transfer between accounts.

- Legal reserves

Under the Turkish Commercial Code, Turkish companies are required to set aside first and second level legal reserves out of their profits. Please note that a branch is not subject to the legal reserve requirements.

Joint stock and limited companies are required to set aside 5% of their net profits each year as a first level legal reserve. The ceiling on the first level legal reserves is 20% of the paid-up capital. The reserve requirement ends when the 20% of paid-up capital level has been reached.

The second level reserves correspond to 10% of profits actually distributed after the deduction of the first level legal reserves and minimum obligatory dividend payout (5% of the paid-up capital). The second level legal reserves amount to approximately 1/11 of the profit to be distributed. There is no ceiling for the second legal reserves and it is accumulated every year.

- Valuation of assets

For tax purposes, fixed assets are valued at cost less depreciation and adjusted against inflation by using monthly Wholesale Price Indices, if the conditions for inflationary accounting exist.

- Marketable securities

Marketable securities are in principle valued at fair market value.

- Inventory

The inventories, either purchased or produced, are valued at their cost value and adjusted against inflation, if the conditions for inflationary accounting exist. Under the regulations of the Tax Procedural Law, for goods produced the cost value includes direct and indirect production costs. It is optional to allocate general administration expenses into the cost of goods produced.

The inventory shall be valued by using the following valuation methods:

- Actual or moving weighted average
- FIFO

- Real property

Real property is segregated into land, land improvements and buildings. Land is recorded at original cost (including direct expenses) and cannot be depreciated. Land improvements and buildings are recorded at cost and depreciated based on useful life method. Please refer to Chapter 15 for further explanations on depreciation. The cost values are adjusted against inflation, if the conditions for inflationary accounting exist.

- Movable fixed assets

Movable fixed assets are recorded at cost and depreciated for tax purposes (see Chapter 15 for further details). The cost values are adjusted against inflation, if the conditions for inflationary accounting exist.

- Consolidation

Consolidation of the accounts of group companies for tax purposes is not allowed in Turkey since each company is regarded as a separate taxpayer.

- Provisions and reserves

Apart from accruals of exchange gains and losses mandatory for tax purposes, recording is generally made only on the basis of actual invoices. Invoices are generally be recorded in the year of issuance for tax purposes, irrespective of when the service is rendered. Accordingly, it is not usual to set up reserves for earned employee severance benefits or for bad debts or other assets not collectible at full value (provisions for bad debt can only be set aside for tax purposes if certain conditions are met).

According to the statutory CoA, net profit or loss for the period, along with provisions for tax and other legal liabilities on this profit, are to be shown in the financial statements.

- Accounts disclosure

According to the statutory CoA, footnote disclosure is required for non-listed market companies, in line with disclosures for listed companies. The balance sheet may be extended on both the assets and liabilities sides by so-called “contingencies and commitment accounts” that in-

clude contingent liabilities, securities and guarantees, but the figures do not need to be broken down.

- Recording of income

Income is recorded on the basis of the actual invoice date. Nevertheless, accrual of income is normally not a problem because it increases taxable income, although the tax authorities might challenge recording of an accrual clearly made to ensure the recovery of tax losses before the expiration date. In general, this facilitates manipulation of cut-off.

Listed companies

- Basic financial statements

The Capital Markets Board regulations applicable as of 1 January 2005 specify the format of the balance sheet, income statement, statement of changes in financial position and the presentation of notes to the financial statements, including accounting principles, explanation of items in the financial statements, contingent liabilities, and subsequent events. Listed companies are required to publish their balance sheet, income statement and legal auditors' report in the Trade Registry Gazette and in at least two daily newspapers. Variations for non-listed market companies (see above) are summarized below.

- Income statement

A very detailed income statement by revenue and cost type is required (see Appendix VIII for a summary), including provision for taxes on income and proposed distribution of the profit.

- Capital and retained earnings

Shareholders' equity, including all categories (unpaid capital, losses), is analyzed as the third item on the liabilities side of the balance sheet (see Appendix VIII). Listed companies are required to keep their books in accordance with the statutory CoA, under which national codes are entered directly on the general ledger at the transaction level.

- Marketable securities

Marketable securities are recorded with their costs. In addition, a provision is booked as well if the cost value of the marketable securities is at least 10% lower than its market value.

- Inventory

Inventories are stated at cost less provision to lower net realizable value if this is more than 10% below cost. Cost must be based on consistent valuation principles between categories and must exclude interest, financial expenses and administrative overheads.

- Trade investments

Investments are recorded at their acquisition costs plus the nominal values of the bonus shares obtained from the capital increases financed with the internal sources of the related corporations.

Investments are valued with the market price in cases where the decrease in the value of the investments is material in the total amount of the financial statements and where no reasonable and objective justification exists that the decrease in value will be eliminated in the near future.

- Foreign Currency Transactions

Transactions in foreign currencies are translated into Turkish lira at the exchange rates prevailing at the dates of such transactions. Foreign currency denominated receivables in the balance sheet are translated at the CBT buying rate, and foreign currency denominated payables in the balance sheet are translated at the CBT selling rate prevailing at the balance sheet dates. Currency differences arising on foreign currency transactions are incorporated in the determination of period income/loss.

- Property, plant and equipment

Foreign exchange losses or gains on long-term loans related to the acquisition of property, plant and equipment may be capitalized and depreciated in parallel with the assets concerned.

Depreciations are calculated based on economic useful lives

- Purchase of another business

Goodwill arising on the acquisition of a business is written off within the period not exceeding 20 years. A new standard “Standard for Mergers and Acquisitions” has become effective for the periods after 1 July 2003; the accounting treatment for purchase of another business will be made in accordance with this new standard.

- Consolidation

Under tax regulations, consolidation of the accounts of group companies for tax purposes is not allowed in Turkey since each company is regarded as a separate taxpayer. However, Communiqué XI/25, is effective for interim financial statements for the financial year starting from 1 January 2005. The accounting principles for consolidation are in line with the International Financial Reporting Standards.

- Provisions and reserves

Full provision must be made for all anticipated liabilities and losses, including doubtful debts, earned employment termination benefits, expenses, and accrued interest. The new Communiqué, include the accounting principles for deferred taxes.

The CMB encourages companies to calculate deferred tax liability by applying the relevant International Financial Reporting Standards in the meantime.

- Accounts disclosure

Footnote disclosure is required for a variety of topics, the most significant of which are listed below.

1. Accounting principles and valuation methods applied
2. Changes in accounting principles and the effects of changes in valuation methods on financial statements.
3. Events subsequent to the balance sheet date.
4. Contingent liabilities and gains.
5. Prior-year items.
6. Extraordinary items.
7. Sales to affiliates (if in excess of 20% of total).
8. Insurance values of assets.
9. Market value of marketable securities.
10. Mortgages or restrictions on assets given for loans.
11. Employment termination benefits not provided for (earned benefits at December 31, 1988 may be provided for in equal instalments over five to ten years).

- Recording of income

Sales revenue is recorded when the invoice is issued. Income and expenses for the period are accounted for on an accrual basis.

Book and tax differences

Non-listed companies

Because of the principle of identity between book and tax accounting treatment, major differences between book and tax income normally only arise where more sophisticated companies have made provisions that are disallowable for tax purposes. These do not have to be disclosed in detail.

Listed companies

With the issuance of the new Communiqué which is identical with International Financial Reporting Standards, the Capital Markets Board regulations require the books to be kept on a tax basis. Adjustments made to conform to the regulations are to be posted in disallowable expense accounts.

Trends in the development of accounting

The Capital Markets Board regulations represent a major breakthrough in accounting concepts for capital markets companies in Turkey. The Capital Markets Board of Turkey ("CMB") has issued 2 new significant communiqués to harmonize with the International Financial Reporting Standards. Communiqué XI/20, "Principles for Restatement of Financial Statements in Periods of Hyperinflation" ("Communiqué for Inflation") and Communiqué XI/21, "Principles of Consolidated Financial Statements and Accounting of Investments" ("Communiqué for Consolidation"), issued by the CMB in 2001, are effective for financial statements for the financial years ending after 1 January 2003 and for the interim financial statements for the first financial period following the year-end in question.

In November 2003, the CMB has issued a new Communiqué concerning the standards identical to IFRS. These standards are effective with the first interim financial statements starting from 1 January 2005. Early adaptation of the standards were encouraged for the financial years 2003 and 2004

Foreign investors

Foreign investors should be well aware of the accounting principles and practices in the event of acquisitions, whether of minority or majority

shareholdings. A pre-acquisition audit by an internationally recognized firm of accountants is usually necessary to ensure negotiations are conducted on the basis of proper financial information. Where the foreign investor participates in a company with a significant local shareholder, it is strongly advisable to provide for the preparation of financial statements on the basis of International Financial Reporting Standards or other accounting principles, and for these to be audited by an internationally recognized firm of accountants. For subsidiaries, the development of an appropriate system to comply with parent company requirements is important. To this end, training of local accounting staff should be planned and the responsibility of the general manager and chief financial officer in this regard clearly identified.