

TURKEY

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

ACCOUNTING AND AUDITING

October, 2006

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Acknowledgements

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Turkey in May 2005. The staff team was led by Frederic Gielen and comprised of Ayse Seda Aroymak, Georgine Ann-Marie Newman-Alawode, and Zeynep Lalik Mete (ECSPS), as well as a team of experts from relevant institutions in EU Member States. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

EXECUTIVE SUMMARY

As work on the economics of information—the role of information in a well-functioning economy—demonstrates, enhancing the reliability and availability of financial reporting is conducive to economic growth and mitigating the risk of financial system instability. In that context, this report provides an assessment of accounting and auditing standards and practices in Turkey. It uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on good practices in the field of accounting and audit regulation to assess the quality of financial information and make policy recommendations. For European Union (EU) candidate countries, such as Turkey, the assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*).

There has been significant progress in recent years in improving the environment and framework for financial reporting in Turkey and further widescale reforms are in progress. In particular, a new draft commercial code will modernize statutory regulation of company financial reporting and will set a major challenge to the accounting and auditing professions in Turkey through the requirement to apply Turkish Accounting Standards based on IFRS and audits based in international Standards of Auditing (ISA).

Corporate Sector Accounting and Auditing are at a Crossroads

The role and regulation of corporate sector accounting and auditing are shaped by the economic context in which they take place, and by the structure of the market they serve. Until recently, private enterprises in Turkey were predominantly family-controlled, relying on private sources of finance (including family-owned banks) rather than capital markets, and financial information was not considered a public good provided to meet the needs of market participants generally, but rather a resource to which access was restricted, available only to those having the power to require its provision. Despite banking regulations that require that banks receive financial statements from companies as a pre-requisite to lending, in practice, bank lending decisions were primarily based on collateral and other sources of information about the enterprise with limited reliance on a borrower's financial statements. These considerations, among others, do much to explain the current arrangements for accounting and auditing in Turkey, to give insight into the causes of existing tensions, and to point the way to reforms required to meet the new needs of an economy undergoing radical transformation.

The economic context resulted in an environment where each agency (e.g., the tax authorities) developed its own accounting and auditing requirements. With the exception of regulated entities, including publicly-held companies, there were minimal general requirements for the publication of financial information and the concept of published, general purpose financial statements meeting the needs of several user groups was effectively unknown. Consequently, there was little demand for an independent financial statement audit performed by qualified professionals to lend credibility to the financial information provided to the marketplace. In recent years, progress has been made in the accounting and auditing environment but much remains to be done for Turkey to achieve compliance with international good practices.

Aligning the Statutory Framework with the Acquis Communautaire and International Standards

This report highlights certain shortcomings in the legal and regulatory framework and stresses that addressing those should be a priority for Turkey in order to create a robust legal foundation for the provision of reliable financial information to market participants. Three issues stand out:

- The accounting regulations established by the Ministry of Finance take precedence over all other regulations with limited exceptions for banks and insurance companies. As a consequence, entities falling within multiple jurisdictions are required to prepare multiple sets of financial statements from their single set of underlying accounting records. In addition, the management information system of many medium and large enterprises is based on tax accounting, which may not provide management with adequate information to manage their enterprises efficiently.
- Fragmented approaches based on a multiplicity of stand-alone special-purpose accounting and auditing systems for confidential use need to be replaced by a single robust general purpose system, which treats disclosure and transparency as public goods available to all market participants.¹ Current approaches result in inefficient use of scarce resources and lack of publicly available financial information conducive to efficient resource allocation by market participants¹.
- Financial reporting and auditing requirements applicable to banks, insurance companies, and publicly-held companies have been more stringent than for other companies but, while generally “based on” IFRS and ISA, they have fallen short of these standards and have not always provided users of financial information, including regulators, with financial information reliable enough for decision-making purposes. The Turkish Accounting Standards Board, Turkish Auditing Standards Board (TUDESK), Revenues Administration, the General Directorate of Insurance of the Undersecretariat of Treasury, Capital Markets Board and the Banking Regulation and Supervision Agency are currently addressing this issue.

A draft new Commercial Code has been prepared, which will address these matters. This report endorses the objective of the draft Commercial Code to broadly model Turkey’s legal framework after the *acquis*. The draft Commercial Code requires:

- All companies other than small and medium-sized entities (SMEs) to present their legal and consolidated financial statements in accordance with Turkish Accounting Standards as adopted by the Turkish Accounting Standards Board (TASB). TAS are based on, and correspond to, IFRS
- That SMEs, as defined in the Code, be allowed to apply simplified accounting standards issued by the TASB.
- That all companies have an annual audit by an independent auditor licensed in accordance with the Code. These audits must be carried out in accordance with International Standards of Auditing (ISA).
- That all companies file their annual financial statements with the Ministry of Trade and Industry (where they will be publicly available) and publish the financial statements on the company website, in the Trade Registry Gazette and in 2 newspapers with national circulation.

The draft Code will significantly improve the statutory framework for financial reporting but will also create new challenges for the accounting and auditing professions in Turkey. This report believes that the following issues should be considered:

¹ Various laws give each regulatory authority, the Ministry of Finance, the Capital Markets Board (CMB), the Banking Regulation and Supervision Agency (BRSA), and the General Directorate of Insurance (GDI), the authority to set and enforce accounting and auditing requirements for the various entities that fall under their jurisdictions.

- This report recommends that exemptions from the audit requirement may be allowed for certain companies such as dormant companies and those with very low turnover.
- Those persons and firms authorized to carry out the independent financial statement audit in accordance with ISA described under the draft Code and the Independent Accountants, Independent Accountants and Financial Advisors, and Sworn-In Financial Advisors (Law 3568) should be required to meet appropriate education, training and experience requirements such as those detailed in International Education Standard 8 and the requirements set out in the EU's Eighth Company Law Directive.
- As it would be impractical to publish the full financial statements including the notes in national newspapers, publishing a summary set of financial statements would be more appropriate. However, it is important that the full set of financial statements, including the notes, are available to the public either via a registry or directly (e.g. via a website) as the notes contain much information that is crucial to the understanding of the financial statements, such as related party and contingent liability information.

Enforcing Financial Reporting Requirements

International investors and credit rating agencies assess the overall transparency and disclosure levels of Turkey's top companies as "unsatisfactory" and, in general, bankers do not feel they can "trust" the financial statements presented by prospective borrowers due to rampant "informality problems." While "informality" is an issue that goes beyond the proper remit of this report (i.e., it is more linked to macroeconomic, fiscal and social issues), there are some actions that could help in this direction from the financial reporting side. These include a combination of market (i.e., positive) and deterrent incentives.

In this context, the report suggests that a three-pillar approach to enforcement would be beneficial:

- Revamp the corporate governance framework to ensure that company directors are responsible for the probity of financial statements not only in law but also in practice.
- Further develop a well governed audit profession responsible for reporting on compliance with accounting standards where audits are mandated by law. In addition to mandating statutory audits as suggested above, the report recommends that TURMOB should continue to develop the effectiveness of its statutorily delegated regulation of certified auditors, i.e. those TURMOB members responsible for financial statement audit in accordance with "full ISA." Among other things, TURMOB should continue to exercise quality assurance over the audit activities of its members; exercise disciplinary authority over its members; and issue audit licenses to both individuals and audit firms. This delegated regulation of auditors should be reinforced by a public oversight system for the audit profession to ensure that quality assurance and other functions mentioned above are, in fact and appearance, exercised with sufficient public integrity. This system of public oversight must be governed by "non-practitioners" and be independent of the profession.
- Further develop institutionalized financial information enforcement mechanisms. The repeated instances of non-compliance with existing accounting requirements identified in this report suggest that there could be unrevealed discrepancies in financial statements with possible significant impact, which may not have been adequately flagged by the auditors of these financial statements. This report recommends that regulators continue to play a more active role in the enforcement of accounting standards in the general purpose financial statements of public interest entities. While the report endorses an approach through cooperation among existing regulators or through a unified financial information enforcement

institution, it raises concerns about enforcement by prudential supervisors, since current monitoring and enforcement practices suggest that compliance with reporting requirements appears to be a secondary consideration where the instance of non-compliance has no impact on prudential interest. Since Article 50(a) of the Capital Market Law exempts listed insurance companies from financial reporting requirements set forth by the Capital Markets Board, the current reporting requirements for insurance companies may not be perceived as adequate by the shareholders and investors of these listed financial institutions, in particular as full consolidated financial statements are not prepared at present.

Enhancing Academic Education, Professional Training, and “Retooling” Accountants

In parallel to these improvements, there is a strong need to improve the capacity of the accounting and audit profession in order to enhance the quality audited financial statements and promote public trust. The genuine understanding and adoption of these new accounting and auditing requirements requires related education and training for preparers, auditors, and regulators. There must be a greater focus towards the needs of general purpose financial reporting. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants. This report makes a number of recommendations to address capacity issues, including:

- Assisting vocational and academic education with the development of IFRS and ISA compliant training materials and enhancing the relationships between the business community, including the accounting profession, and universities.
- That TURMOB continue to review, on an ongoing basis, their professional qualifications to ensure that they more effectively meet the needs of Turkish accountants and auditors, taking into account developments in the requirements of the EU 8th Company Law Directive and IFAC’s International Education Standards.
- That TURMOB continue to develop their compulsory Continuing Professional Development (CPD) requirement, including mandating a minimum amount of CPD in line with IES 7 and ensuring completion of CPD requirements is enforced.
- Targeting the significant retooling needs of accountants in industry. Several stakeholders articulated their concerns that there is a lack of up-to-date accounting knowledge within industry. The report recommends a policy mix of positive incentives (e.g., education tax credit) and deterrent incentives (e.g., through corporate governance mechanisms) to foster the retooling of accountants.

From Diagnostic to Reform

The recommendations of this report are mutually supportive in some obvious ways and require a holistic, multi-disciplinary approach to implementation. Also, the report only sketches the policy recommendations to enhance the quality of corporate financial reporting. Upon commencement of this assessment, Turkey established a multidisciplinary National Steering Committee (NSC) for accounting and auditing reform to participate in the assessment and to advise policymakers, regulators, and other stakeholders regarding the implementation of the recommendations. Based on the successful experience of other countries, the report recommends that the NSC develops a Country Strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Turkey. In this context, the report recommends that the institutions which are members of the NSC ensure that they are represented at a senior level on the NSC with adequate support staff to follow through on the substantial agenda ahead.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Turkey is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)² and International Standards on Auditing (ISA)³ as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation. For European Union (EU) candidate countries, such as Turkey, the assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*⁴). The report sometimes takes a position that goes beyond what is present practice in most EU Member States (e.g., it recommends the use of IFRS for *public interest entities*⁵ and ISA for all statutory audits, and relies on the international initiatives currently underway at the international level to ensure that these standards and the related standard setting processes will be further enhanced). These positions are clearly identified in the report.

2. Turkey has a population of 67.8 million and gross domestic product (GDP) per capita of US\$ 7,500 as of end-2004.⁶ Turkey is steadily recovering from the economic and financial crises of 2001. After significantly shrinking in 2001, the Turkish economy has grown at a rapid pace in the last three years with single-digit inflation in 2004.⁷ Many reforms have been introduced in a number of areas, including in the financial sector, in response to the 2001 banking crisis. However, further reforms are needed for the financial sector to fulfill its role in making the economy more productive. In December 2004, the EU extended a formal invitation to Turkey to start membership negotiations. This report makes recommendations to assist Turkey in aligning its regulatory environment with that of the *acquis*.

² Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee (IFRIC).

³ Within this report, ISA refer to the International Standards on Auditing and related practice statements developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

⁴ EU harmonization of Member State private sector accounting and auditing requirements has, to date, formed part of the program of company law harmonization. This had led to the adoption of a number of accountancy-related Company Law Directives, including the Fourth (1978) on the annual accounts of individual companies, the Seventh (1983) on the consolidated accounts of groups of companies, and the Eighth (1984) on the licensing requirements for the auditors of these annual and consolidated accounts. These are supplemented by specialized Directives for banks and insurance undertakings, and Regulation 1606 on the use of IFRS in listed companies.

⁵ Within this report, *public interest entities* are those in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples may include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises, including large state-owned enterprises.

⁶ Gross domestic product based on purchasing-power-parity per capita, International Monetary Fund, World Economic Outlook Database, April 2005.

⁷ A hyperinflationary economy, as Turkey had been considered for many years, requires specific accounting techniques, since reporting the operating results and financial position of an enterprise in local currency without restatement would not be useful. The financial statements reviewed for this report were prepared using hyperinflationary accounting. Paragraph 53 discusses this issue.

3. **The private sector accounts for approximately 80% of Turkey's economy, including a significant contribution from small and medium-sized enterprises (SMEs).**⁸ Progress in privatization remains limited and currently there is a significant number of public interest entities, which are state-owned (e.g., banks, telecommunication, airline, electricity), some of which are listed. Assessing state-owned enterprise financial reporting requirements and practices was deemed important in the context of this report and consistent with the Government's objective to improve the governance of these enterprises. Also, this report assessed the quality of SME financial reporting with a view to enhancing SME access to finance.⁹

4. **Financial intermediation in the banking sector is improving but still lags with respect to medium to long term investment lending to the real sector.** The size of the Turkish financial sector is relatively small and is dominated by the banking sector, whose assets are equivalent to an estimated 84% of GDP. At the end of 2005, there were 51 banks comprising 34 deposit banks, 13 investment banks and 4 participation banks. The largest five banks account for 61% of total banking assets and the largest 10 banks account for 83% of total banking assets, with a 33% share for the three state-owned banks. Many of the important private banks are part of family-owned conglomerates and as a result of complex ownership structures, compliance of those companies with prudential and transparency standards is sometimes difficult to assess.

5. **The role of the non-banking financial sector is somewhat limited.** The non-banking financial sector assets account for approximately four percent of GDP. The insurance sector, currently comprising 45 insurance companies and one reinsurance company, expanded significantly in recent years. At the end of 2004, there were 81 leasing companies. The Istanbul Stock Exchange (ISE) trades the stocks of 308 companies and started to rise after the 2001 crisis. This trend continued during 2004 and 2005.

6. **This report takes these factors into consideration in examining the arrangements for private sector accounting and auditing in Turkey and in making recommendations to address the needs of an economy undergoing radical transformation.** For example, while lending to the private sector remains limited, recent increases in loans to this sector in a context of declining interest rates will require enhanced financial reporting by borrowers and loan accounting by lenders. Also, it is important for financial system stability that accounting adequately measures foreign currency risk exposure at both the borrower and lender level in an environment where foreign exchange positions are significant (as at the end of 2004, loans in foreign currencies amounted to US\$26 billion, i.e., 35% of total loans).^{10, 11} Finally, conglomerates and groups are quite important in Turkey, with a strong historical tradition related to family owned businesses. As a consequence, consolidation and related party information are essential to depict the financial position and performance of a group.

⁸ In Turkey, there are several definitions of SMEs used by various organizations depending on the framework within which they operate.

⁹ Access to finance is a perennial problem experienced by SMEs. Financing constraints include poor risk assessment by financial institutions, requiring the widespread use of asset-based rather than cash flow-based credit analysis partially due to a lack of financial information on potential borrowers. Therefore, enhancing SME financial reporting is important in a multifaceted approach to enhancing access to finance.

¹⁰ Source: BRSA Provisional Data on "Loans of Banking Sector (including SDIF)" as at December 2004.

¹¹ In this context, it is very reassuring that accounting requirements in Turkey require all loans in foreign currencies to be revalued at the current foreign exchange rate and unrealized foreign exchange losses to be recorded in the income statement.

7. **In this context, this report sketches policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private sector growth, and financial system stability.** It is expected that the National Steering Committee (NSC) will develop a Country Strategy and a detailed Country Action Plan (CAP) based on the recommendations outlined in this report (refer to Section VI) as an initial step in the reform process.¹²

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework¹³

8. **The Commercial Code, effective January 1, 1957 (henceforth, the “Commercial Code (1957)”) outlines the basic accounting, auditing, and financial reporting requirements for the five main types of business entities:**

- *The general partnership (Kollektif Sirket)* is established with the purpose of engaging in commercial activities under a common trade name. Partners have joint unlimited liability for the debts of the partnership.
- *The limited partnership (Komandit Sirket)*, where some of the partners, called silent partners, are liable for the partnership’s debts in the amount of capital which they contributed, while the other partners, called active partners, have unlimited liability.
- *The cooperative association (Kooperatif Sirket)* is established based on the principle of mutual help and guarantees.
- *The limited liability company (Limited Sirket)*, the shares of which are not publicly tradable. Limited liability companies generally have a few shareholders (minimum two and maximum 50) and a minimum capital of YTL 5,000¹⁴ (equivalent to approximately US\$ 3,700). Limited liability companies do not have a board structure and are managed by managers who have the right to administer and represent the company.
- *The joint stock company (Anonim Sirket)*, the shares of which may be publicly tradable. Joint stock companies generally have many shareholders (minimum five) and a minimum capital of YTL 50,000 (approximately US\$ 37,000). Joint stock companies have a unitary board structure (management board, or *Idare Meclisi*). Publicly-held joint stock companies, i.e. listed companies and companies with more than 250 shareholders, are monitored by the Capital Markets Board (CMB). As of October 2006 there were 614 publicly-held companies of which 330 were traded on the ISE.

¹² At the beginning of the assessment the Treasury established a National Steering Committee, composed of representatives of the Turkish Accounting Standards Board (TASB), Union of Certified Public Accountants of Turkey (TURMOB), Capital Markets Board (CMB), Banking Regulation and Supervision Agency (BRSA), Central Bank of Turkey (TCMB), Ministry of Finance, Ministry of Justice, the Union of Chambers and Commodity Exchanges of Turkey (TOBB), Undersecretariat of Treasury, General Directorate of Insurance, and General Directorate of Foreign Economic Relations to review the assessment and act on the recommendations.

¹³ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

¹⁴ Law 5083 on the Monetary Unit of the Republic of Turkey was effective from January 1, 2005 and deleted six zeroes from the former currency of the Turkish Republic, the Turkish Lira (TL), to form a new currency the New Turkish Lira (YTL). Thus, 1YTL = 1,000,000 TL.

For the period January 1995 to April 2005, 447,296 new companies were formed in Turkey,¹⁵ of which 89.3% were limited liability companies and 6.8% were joint stock companies.

While the Commercial Code (1957) sets out certain minimum bookkeeping requirements, these do not govern the preparation or publication of financial statements. It contains provisions with respect to “auditors” (*murakip*) of joint stock companies who cannot be more than five in number, and if there is more than one, they form the Board of Auditors (*Denetim Kurulu*). Limited liability companies are required to have one “auditor” if the number of shareholders is greater than 20. Since their task is to oversee the affairs of the company by checking its transactions and accounts, their functions do not correspond to the independent audit of financial statements as this is understood elsewhere (e.g., under the EU Company Law Directives). In addition, there are no licensing, qualification, or education requirements for appointment.

9. The Commercial Code (1957) establishes that members of the board of directors are collectively responsible for the probity of financial statements unless they can prove that they are faultless or the shareholders ratify the financial statements as correct. Directors have civil and penal liability.

10. In line with what is currently prevailing in most EU Member States, shareholders are required to approve the financial statements of a company. The Commercial Code (1957) adequately requires that the meeting of shareholders approve the financial statements of the company and the distribution of profits within three months of the year end.

11. A new draft Commercial Code (the “draft Code”), which will significantly improve corporate law and will also introduce new financial reporting requirements, is currently being considered by Parliament. In 2000, a Commission of 40 experts appointed by the Ministry of Justice started preparing a new Commercial Code. The draft Code was released in February 2005 for comments. The main improvements proposed by the draft Code are summarized below.

12. Financial Reporting Requirements: Article 64 of the draft Code requires all companies other than SMEs to prepare financial statements in accordance with Turkish Accounting Standards (TAS) adopted by the Turkish Accounting Standards Board (TASB). These TAS are based on, and correspond to, IFRS. SMEs are allowed to use simplified accounting standards published by the TASB, though they may also use TAS if they choose to. From a policy point of view, exempting SMEs from too complex a set of financial reporting requirements (such as IFRS) is good practice and is consistent with existing practices in most EU countries, where it is not common to require the use of IFRS by all companies.

13. Statutory Audit Requirements: Articles 397 and 398 of the Draft Code require all companies to have an independent audit conducted according to ISA by auditors or audit firms authorized according to the code. Medium and large joint stock companies would be required to use an independent audit firm whereas small joint stock companies may appoint two sole practitioners, YMMs or SMMMs (refer to definitions in Paragraph 29 below), as independent auditors. Audit firms would be subject to rotation every five years and would be prohibited from providing certain services, including legal and financial consulting services to audit clients. This

¹⁵ The State Statistical Institute did not have readily available information on the number of new companies formed since the enactment of the Commercial Code in 1957. The ROSC team felt that looking at the information for the last decade would be most relevant in assessing the dynamics of new company formation.

universal audit requirement would lead to over 700,000 companies requiring an ISA-compliant audit.

14. The determination of the scope of audit requirements, i.e. the entities which will be subject to statutory audit, may require further consideration. As with IFRS, the application of ISA to excessive numbers and/or inappropriate types of entities may lead to problems of general compliance, even on those engagements where compliance should be possible. Requiring a larger number of audits than the audit profession is currently able to provide would necessitate extensive training to eliminate the risk of poor quality audits and therefore protecting the public perception of the quality of the audit profession. These training programs should be in compliance with International Education Standard 8.

15. **Filing and Publishing Requirements:** The draft Code requires that all companies must file their annual financial statements with the Ministry of Trade and Industry (where they will be publicly available) and publish the financial statements on the company website, in the Trade Registry Gazette and in 2 newspapers with national circulation.

16. As it would be impractical to publish the full financial statements including the notes in national newspapers, publishing a summary set of financial statements would be more appropriate. However, it is important that the full set of financial statements, including the notes, are available to the public either via a registry or directly (e.g. via a website) as the notes contain much information that is crucial to the understanding of the financial statements, such as related party and contingent liability information.

17. **Currently, and until the new draft Code is adopted, various laws and regulations govern financial reporting in a fragmented way, which leads to a multiplicity of stand-alone special purpose accounting requirements.** The application of corporate financial reporting requirements to different enterprises is summarized in Table 1, which should be read in conjunction with Paragraphs 18 to 21:

Financial statements Entities	Legal Entity Financial Statements	Consolidated Financial Statements
Joint stock and limited liability companies		
Large and medium	Tax Procedural Law and UCA	No requirement
Small entities and sole proprietors	Basic Concepts of Accounting set out in the ASIR	No requirement
Publicly-held companies	Tax Procedural Law, UCA and <i>Communiqués</i> issued by the CMB	<i>Communiqués</i> issued by the CMB
Banks	Specific accounting requirements within the Regulations and <i>Communiqués</i> issued by the Banking Regulatory and Supervisory Agency (BSRA), as established by the Banks Act	
Insurance companies	Specific accounting requirements within the Regulations and <i>Communiqués</i> issued by the GDI	No requirement

Figure 1: Corporate financial reporting requirements

18. **The Tax Procedural Law of 1950—which has since been consolidated into the Tax Procedures Code—introduced detailed bookkeeping requirements.** Under the powers granted to it by the Tax Procedures Code, the Ministry of Finance (MoF) introduced the Accounting System Implementation Regulation (ASIR), with effect from January 1, 1994. The ASIR prescribes certain fundamental accounting concepts, a chart of accounts, and a format for the presentation of financial statements and is commonly referred to as the Uniform Chart of Accounts (UCA). The stated purpose of these requirements is to provide information to the taxation authorities as well as establish an accounting system in line with International Accounting Standards (refer to Paragraph 53 below for an analysis of the differences between the ASIR and IFRS). The UCA is applicable to all companies and sole proprietors with varying exemptions to certain business organizations. For example, of the five areas covered by the ASIR¹⁶ small entities and sole proprietors are only required to comply with the Basic Concepts of Accounting, i.e. simplified reporting requirements. Also, financial institutions, including banks, insurance companies, private institutions, and financial leasing companies, that are subject to different accounting requirements as required by their respective regulatory agencies, must also comply with the Basic Concepts of Accounting, Explanations of Accounting Policies, and Principles of Financial Statements in accordance with the Tax Procedural Law.

19. **The Capital Markets Law of 1981 established the Capital Markets Board with powers to regulate companies listed on the ISE, other companies which have more than 250 shareholders, mutual and investment funds, and financial intermediaries.** The Capital Markets Law gives CMB responsibility for monitoring and enforcing compliance with reporting requirements of market participants, except banks, insurance companies, leasing, factoring, and consumer finance companies.¹⁷ CMB is empowered to determine, monitor and enforce the content, standards and principles governing the publication of financial information by listed and other publicly-held companies and the principles related to their audit. These requirements are in addition to those laid down in the UCA and the Tax Procedural Law.

20. **Banks and leasing, factoring and consumer finance companies are required to prepare and present their financial statements in accordance with the accounting requirements set out by the Banking Regulation and Supervision Agency (BRSA).** The BRSA issued new regulations in November 2006 which require banks to comply with Turkish Accounting Standards set by the TASB. Moreover, through corporate governance principles, the BRSA requires that banks prepare financial statements that fully comply with TAS in addition to the statements that the BRSA require for regulatory purposes.

21. **The General Directorate of Insurance (GDI) of the Undersecretariat of Treasury is responsible for regulating and overseeing insurance and reinsurance companies and for establishing their financial reporting regime.** The preparation and introduction of EU compliant requirements in respect of insurance companies has not proceeded at the same rate as other regulated entities. Recent *Communiqués* published by the Treasury aim to update the accounting requirements and financial structure regulations including capital adequacy consistent with the EU Insurance Accounts Directive. It is only now that financial reporting standards, largely “based on” IFRS, are being developed. In particular, the *Communiqué* on “the Insurance

¹⁶ These include: (1) Basic Concepts of Accounting; (2) Explanation of Accounting Policies; (3) Principles of Financial Statements; (4) Preparation and Presentation of Financial Statements, and (5) Framework of Uniform Chart of Accounts and its Functions.

¹⁷ Article 50 of the Capital Markets Law provides for banks and insurance companies to be subject to specific requirements regarding audit supervision, accounting and other requirements in respect of financial statements and which are issued by other regulatory institutions.

Accounting System and its Definitions,” was adopted and published in the Official Gazette in 2004. The GDI draws on the Regulations published by the CMB in 2004, which introduced “IFRS-based” accounting standards for capital market participants. Since amendments are envisaged to these standards, the GDI will need to review these amendments in order to avoid conflicts or inconsistencies.

22. **The Law gives each regulator the authority to determine in secondary legislation how an audit firm should conduct an audit of an entity in their jurisdiction, which results in similar but distinct auditing procedures for banks, insurers and publicly-held companies. This leads to a fragmented approach to audit regulation.** The audit requirements established by the various regulators differ considerably from the requirements in the *acquis communautaire* with respect to their objective and scope. Such differences need to be considered when placing reliance on audited financial statements. Audit requirements in Turkey fall into two broad categories, tax and accounting audits of financial statements prepared according to the UCA and the Tax Procedural Law, and audits of regulated entities.

- ***Authorization to perform tax audits is determined according to the Law on “Independent Accountants, Independent Accountants and Financial Advisors, and Sworn-In Financial Advisors,” which was enacted in 1989 (henceforth, Law 3568).***

Tax audits are:

- *Heavily relied upon by the Revenues Administration (RA) when conducted by Sworn-In Financial Advisors (YMMs).* This conclusion is supported by the fact that YMMs are the only professionals who can certify financial statements prepared according to the UCA and the Tax Procedural Law, for large companies. While companies audited by a YMM are not exempt from tax inspections, there has been no precedent of inspections of such firms to date.
- *Substantially different from the audits required by the Fourth and Seventh EU Company Law Directives* as shown in Section II.B below. Tax audits relate to the revision of the audited financial statements for tax purposes in conformity with the UCA and Tax Procedural Law. TURMOB regulations describing the working principles of YMMs provide a description for the auditing requirements before the financial statements are revised for taxation purposes.¹⁸

The Tax Procedural Code requires tax-based financial statements to be audited by a YMM if the company exceeds one of the two following size thresholds: a total balance sheet of YTL 3 million (approximately US\$ 2.2 million), and net annual turnover of YTL 6 million (US\$ 4.4 million). Upon discovery of an error or fraud in the financial statements, the YMM is required to recommend that the error or fraud be corrected. If the company refuses to correct the error or fraud, the YMM is required to inform the relevant Governmental agency(ies).

- ***Each regulator in the financial sector sets distinct requirements and rules on how audits of the financial statements of entities in their jurisdiction should be conducted. The BRSA sets audit requirements for banks, leasing, factoring and consumer finance companies while the audit requirements for publicly-held companies are established by the CMB. The Treasury determines the audit requirements for insurance companies.***¹⁹

These audits can be characterized as follows:

- *Article 16 of the Capital Markets Law (CML) requires that an independent audit firm approved by the CMB should audit the financial statements of publicly-held*

¹⁸ Regulation 20391 January 3, 1990 Section 3

¹⁹ Other regulated entities were not specifically analyzed for this report.

companies. The CML sets out in Article 22 (d) that the CMB must approve all auditors of publicly-held companies. All CMB registered audit firms must be registered with the Union of Independent Accountants, Certified Public Accountants and Sworn-In Certified Public Accountants (TURMOB). The criteria for such approval are outlined in the *Communiqué* on “Principles of Auditing in Capital Markets.” Among others, partners, managers and independent auditors of approved audit firms must declare that they have not worked in an audit firm whose right to conduct such audits has been revoked. As of October 2006, 93 firms are approved to conduct such audits. In June 2006, CMB issued a new regulation requiring that auditors pass a further examination set by the CMB in order to be approved to audit CMB-regulated companies. This examination should not replace the existing audit licensing of SMMs and YMMs by TURMOB, rather it should be in addition to TURMOB’s audit licensing in accordance with the draft Code and Law 3568.

- *Articles 15, 33 and 39 of the Banking Law (2005) requires that the financial statements submitted to the shareholders should be audited by an independent audit firm approved by the BRSA.* The BRSA requires independent auditors and audit partners to declare that their license to perform external audit of companies has not been revoked by Turkish or foreign supervisory authorities and that they have not taken part in audit activities that has caused such revocation. The BRSA, in consultation with the Central Bank and TURMOB, is responsible for establishing the criteria an audit firm must meet to be authorized to audit banks.²⁰ At present, 41 firms are authorized to audit banks, but a group of four to five firms dominates the sector.
- *Article 39 of the Insurance Audit Law No. 7397 states that practitioners, individuals and firms are required to be approved by the Treasury in order to audit insurance companies.* The detailed requirements for approval to conduct independent audits of insurance companies are outlined in the Regulation on “Conduct of Independent Audit in Insurance and Reinsurance Companies” and in the Regulation on “Principles Applicable to Independent Audit of Insurance Companies” dated September 2003. At present, 40 firms are authorized to audit insurance companies.²¹

This fragmented approach results in overlap and inefficient use of resources and has further consequences for enforcement related to availability and technical capacity of skilled individuals. In addition, the audit firm approval process as currently conducted exposes regulators to significant risk in the case of an audit failure. The audit firm approval process focuses on structural composition rather than technical capacity. For example, the approval process entails a review of an audit firm’s application file and a short site visit with staff members from the regulatory body. The scope of the review and the expertise of the reviewers fall short of emerging practices in this area.

23. The BRSA and the Treasury have implemented some of the internationally recognized good practices regarding the relationship between regulators and external auditors. There is evidence that regulators leverage the work of external auditors to varying degrees. For example, auditors are required to report on internal control and risk management; issues that would affect the going concern of a bank or insurance company. As part of the prudential supervision of banks, the BRSA verifies that the figures in the audited financial statements reconcile with those in the

²⁰ The audit firm must be registered with TURMOB.

²¹ There is significant overlap between the audit firms, which are authorized to audit banks and insurance companies. Specifically, firms applying for authorization to audit insurance companies must prove that their approval to audit banks and/or companies has not been revoked by the BRSA and/or the CMB.

uniform reporting package which is submitted by banks for prudential purposes. In addition, the BRSA holds regular meetings with audit firms to discuss various items in the audited financial statements. However, the ROSC team sees that there are opportunities for leveraging more effectively the work of the external auditors, in a properly governed framework, given the move to adopt IFRS. The Basel Committee on Banking Supervision and the International Auditing and Assurance Standards Board (IAASB) have given some joint guidance governing the relationship between banking supervisors and banks' external auditors, which may be used as a framework by the BRSA and the Treasury.²²

24. **With the exception of regulated entities, stakeholders in Turkey do not have access to company financial statements.** There is no general requirement for companies to file audited legal entity and consolidated financial statements in order to make them publicly available. This does not comply with the *acquis communautaire*, which requires a company to file its financial statements, together with the auditor's report (where applicable) with a "registrar," which in turn is required to make the information publicly available.²³ This hinders decision-making ability of users and consequently may distort resource allocation. As detailed above, this will be addressed in the draft Commercial Code.

25. **Financial statements of regulated entities are required to be published:**

- Banks are required to file their printed and electronic versions of annual financial statements and auditor's report with the BRSA and the Banks Association of Turkey within four months of the year end.²⁴ Banks must also file non-consolidated interim financial statements within 45 days and consolidated interim financial statements within 75 days. These statements must also be published in the Trade Registry Gazette with full disclosures and an abridged version must be published in the Official Gazette. The Banks Association of Turkey also makes them available on its web-site. Finally, banks are encouraged to publish their financial statements on their web-site.

Financial Statements of Banks	Annual (Audited)	Interim (Audited)	
		Consolidated	Separate
Balance Sheet Income Statement Cash Flow Statement Statement of Changes in Equity	Within 4 months of the year end	Within 75 days of the period end	Within 45 days of the period end
Profit Distribution Statement		Not applicable	

Figure 2: Filing deadlines for banks

- Insurance and re-insurance companies are required to publish their balance sheet and income statement in two daily papers within one month of approval by the general meeting.
- Publicly-held companies are required to file quarterly, semi-annual and annual financial statements with the CMB. The CMB is developing a system using electronic signatures

²² Basel Committee on Banking Supervision (BCBS), 2002, *The relationship between banking supervisors and banks' external auditors*. This was also issued by the IAASB under International Auditing Practice Statement (IAPS) 1004.

²³ Refer to Article 47 of the Fourth EU Company Law Directive and Article 38 of the Seventh EU Company Law Directive, as well as Article 3 of the First EU Company Law Directive.

²⁴ Banks are also required to file quarterly and semi-annual financial statements.

which will increase the efficiency of the submission of financial information. The financial statements are also published in Stock Exchange Bulletins. In addition, companies are encouraged to publish their financial statements on their web-sites. Filing deadlines imposed by the CMB are as follows:

Financial statements	Annual	First-time implementation	Interim
Legal entity			
- audited/reviewed	Within <u>10</u> weeks of the year end	Within <u>12</u> weeks of the year end	Within <u>six</u> weeks of the period end
- unaudited	Not applicable	Not applicable	Within <u>four</u> weeks of the period end
Consolidated			
- audited/reviewed	Within <u>14</u> weeks of the year end	Within <u>16</u> weeks of the year end	Within <u>10</u> weeks of the period end
- unaudited	Not applicable	Not applicable	Within <u>8</u> weeks of the period end

Figure 3: Filing deadlines for publicly-held companies

26. **Many of the inconsistencies and fragmented approaches detailed above will be addressed through the implementation of the draft Commercial Code and through the adoption by many of the regulators of TAS and ISA.** However, the draft Code is not yet enacted; any delay in its enactment would prolong the confused state of fragmented requirements for financial reporting currently in place. The rapid enactment of the Code should be a high priority for legislators in Turkey.

27. **Once the draft Code and other regulatory changes requiring the use of TAS and ISA are enacted there will be a significant challenge in successfully implementing the new regulations.** This will represent a challenge for the accounting and auditing professions and also for the regulators in monitoring and enforcing the implementation. Meeting the challenge will require determined efforts by all stakeholders; education and training will be key to successful and sustainable implementation.

B. The Profession

28. **There is a well established accountancy profession with a clearly defined organizational structure in Turkey, which dates back to the nineteenth century.** Therefore, the provision of accountancy services predates the formation of the Expert Accountants Association of Turkey (EAAT) in 1942. This voluntary private organization has no formal legal recognition or legal powers and is a member of the International Federation of Accountants (IFAC). Other than the delivery of some training in IFRS and ISA, EAAT is not active in any of the key areas covered by this ROSC. In 1989, Law 3568 gave legal recognition to the accountancy profession, established qualification requirements, and regulated the organizational structure of the profession. The organizational structure is supported by two distinct Chambers, the Chamber of Independent Accountants and Certified Public Accountants, and the Chamber of Sworn-In Certified Public Accountants, which together form TURMOB. TURMOB is the national umbrella for the local Chambers, and it alone is authorized to issue professional audit

licenses, issue licenses to SMs (see below) and to set professional standards. TURMOB is a member of IFAC and a well-resourced professional organization.²⁵

29. **Accountancy services are a regulated activity in Turkey.** Law 3568 stratified the profession in Turkey into three groups with different educational requirements for licensing and specific allowed activities for each group:

- SMs, of which there are currently 30,000, may provide bookkeeping services, prepare financial statements and tax declarations. They cannot conduct any audits.
- SMMMs, numbering 31,000, may conduct general audits but not tax audits and provide consulting services in addition to all the services provided by SMs.
- YMMs, numbering 3,500, may conduct tax audits and “certify” the tax financial statements and tax returns in addition to all the services provided by SMMMs except bookkeeping. YMMs have joint responsibility with the audited company for errors and misstatements in the financial statements they have certified.

In addition, the MoF determines the minimum mandatory audit fee levels with input from TURMOB.

30. **There are many differences between an audit required for tax purposes and a general purpose audit performed according to ISA.** The new Commercial Code, when enacted, will increase the demand for general purpose audits from TURMOB members. A clear understanding of the differences and required skills, knowledge and activities under these two approaches is essential in re-organizing the profession to meet the needs of the market for high quality financial reporting. The profession will need strengthening and development to meet increased demand for independently audited general purpose financial statements in the economy.

31. **TURMOB needs to keep pace with the growing technical and complex demands on the profession.** The banking and other technical committees of the Independent Auditors’ Association (IAA), a focus group comprised of audit firms which conduct external auditing, is used by the profession for liaison with the regulatory bodies on practical matters related to IFRS and ISA. The IAA lacks legal recognition and authority but has recently articulated the professions’ opinions to various regulatory bodies regarding the issue of whether hyperinflationary accounting should still be required in Turkey for calendar year 2005 IFRS financial statements. Whilst such dialogue between regulators and practitioners is a positive feature and is supplemented by client specific discussions, there is an opportunity to enhance the standing of TURMOB if TURMOB were to focus more on external auditing.

32. **The profession in Turkey is in some aspects self-regulatory. The audit of banks, insurance companies, and publicly-held companies is regulated, and monitored to varying degrees – see Section IIE on enforcing accounting and auditing standards below.** For example, the regulators have the authority to approve the external auditors as described in 22 above,). **A recent IFAC self-evaluation assessed TURMOB to be in compliance with IFAC**

²⁵ TURMOB’s President, Vice President, General Secretary and Treasurer are all members of the Executive Board. They are complemented by 90 full-time staff working in large, modern, well furnished premises. TURMOB had income in 2004 of approximately TRL 15 million (equivalent to approximately US\$ 11 million), which was derived from a percentage income-based fee on the individual chambers and from the issuing of licenses, training courses, and publications.

Statements of Membership Obligations (SMOs)²⁶. However, this fragmented approach falls short of the new Eighth EU Company Law Directive, which requires that the audit profession be subject to public oversight in order to protect the public interest. An independent public oversight system should oversee TURMOB's activities where they carry out the approval and registration of statutory auditors and audit firms; the adoption of standards on ethics, internal quality control of audit firms and auditing practices; continuing education; quality assurance; and investigative and disciplinary systems. The establishment of such oversight system in Turkey is currently under consideration.

C. Professional Education and Training

33. **Turkey has a strong tradition of accountancy education and training. However, given the complexities of IFRS, ISA, and the requirements of the *acquis communautaire* the profession will need to undergo expanded education and training.** TURMOB's education syllabus, in large part, was originally designed to cater to the needs of traditional Turkish tax reporting notwithstanding TURMOB's commitment to the adoption of IFRS and ISA. This is understandable given that there has been no general legal requirement for companies to use TAS/IFRS or to have ISA compliant audits in the past; this will change with the adoption of the new Commercial Code. Therefore, the current syllabus may need to be reviewed to meet the challenges of the new Code; in particular in the areas of Turkish Accounting Standards, International Financial Reporting Standards and International Standards on Auditing.

34. **The business community, preparers and auditors, stated that the education of university accountants has not kept pace with the demands of the changing business environment.** The Turkish Higher Education Council regulates university undergraduate and graduate programs. Preparers and auditors indicated that university graduates had limited knowledge of IFRS, ISA or professional ethics. While some universities have included subject matters on IFRS in their curriculum and audit firms consistently draw on the graduates from these universities, most university and vocational schools will need to modernize the contents of their accountancy syllabus in order to provide graduates with the basic knowledge for entering the profession.

35. **The seven-person TURMOB Examination Commission manages and controls the examination program for trainee accountants in Turkey.** Two members represent the MoF, three members are selected from five candidates proposed by the Turkish Higher Education Council, and the MoF selects the remaining two from among four candidates proposed by TURMOB. TURMOB currently has approximately 12,000 registered trainees attached to chambers spread throughout Turkey.

36. **There are three levels of education requirements for professional licensing. However, they may not currently achieve all the objectives outlined under the new Eighth EU Company Law Directive regarding the development of professionals to conduct the statutory audit of general purpose financial statements.** The following entrance requirements relate to the three distinct TURMOB professional accounting qualifications:

- An SM license requires candidates to successfully complete a practical trainee period under the direct supervision of a member of the profession. The period of required traineeship is six years for the graduates of vocational colleges, four years for the

²⁶ IFAC SMOs are benchmarks used for assisting IFAC members in ensuring high quality performance of their individual members. They include SMO 1, *Quality Assurance*.

graduates of two-year high schools, and two years for holders of Bachelor of Arts (BA) degrees in Economics, Law and Management. Practical training must cover the requirements of Law 3568, related accounting regulations under the UCA and the Tax Procedural Law, social security law, etc.

- An SMMM license requires that candidates (i) have at least a BA or post-graduate degree in Law, Economics, Business Administration, Accounting, Banking, Public Administration or Political Science; (ii) pass the initial entry exam for the SMMM program; (iii) have two years' practical experience under supervision or control of either an SMMM or a YMM in public practice or industry; practical training must cover IFRS, ISA, the requirements of Law 3568, related accounting regulations under the UCA and the Tax Procedural Law, social security law, etc ; (iv) pass the professional SMMM exams; and (v) finally are certified as an SMMM by TURMOB.
- The YMM license requirements are (i) 10 years of work experience as an SMMM, (ii) successful completion of a further set of exams conducted by TURMOB, and (iii) certification as a YMM by TURMOB.

The SMMM qualification has similar requirements to those detailed in the Eighth Directive, but is only partially aligned – for example the EU requires three years of suitable practical training. TURMOB have reviewed their examination against the Eighth Directive's list of subject areas that should be covered to ensure all subjects are included. TURMOB should continue to review their qualification against the Eighth Directive requirements and the requirements of IFAC's IESs, to ensure the most effective implementation of the requirements and standards.

There are currently grandfathering policies for civil servants of the MoF and academics that are not in-line with the requirements of the Eighth Directive. TURMOB's practice of exempting individuals with a minimum of eight years of service working as a tax inspector or as an academic from sitting professional exams in order to qualify as auditors would need to be reexamined.

TURMOB provides both new training members and existing members with training in IFRS and ISA. However, the ROSC team found that there was a perception amongst some members of the business community, preparers and auditors that completion of the TURMOB educational and training requirements does not provide new accountants with the ability to prepare or audit financial statements in accordance with IFRS and ISA. In the short-term, audit trainees of the large and established firms conducting external auditing are given in-house IFRS and ISA training.

37. **There is a clear need for accountants and auditors to undertake formal continuing professional development to maintain sufficient theoretical knowledge, professional skills and values in line with the new Eighth EU Company Law Directive.** This requirement for a commitment of life-long learning is mirrored in IFAC's IES 7, *Continuing Professional Development* (CPD). TURMOB members are subject to a mandatory CPD requirement and TESMER, a division of TURMOB responsible for basic education and training, organizes and offers a range of courses to members throughout the year. The complexities and in-depth knowledge required for certain IFRS and ISA will necessitate a more consistent and effective requirement for CPD. TURMOB recognizes this need and will offer extensive CPD training opportunities in IFRS and ISA to its members.

D. Setting Accounting and Auditing Standards

38. **The Tax Procedures Code is currently the basis of authority for accounting regulations for all entities in Turkey with some exemptions for financial institutions, including listed companies and banks.** The Revenues Administration designs legally mandated accounting requirements to meet the needs of the state as a tax collector. These requirements do not necessarily meet the needs of several other user groups, locally and internationally, which use general purpose financial statements for decision-making purposes.

39. **The Capital Markets Law provides the CMB with the authority to determine accounting and auditing requirements in respect of companies with shares listed on the ISE, companies having more than 250 shareholders, mutual funds, investment funds and financial intermediary companies except for banks and insurance companies.** In the past, the CMB has promulgated accounting requirements based on a perceived need in the market – draft regulations are prepared taking into account the views of all relevant stakeholders and are posted on the internet for comment prior to promulgation. Regulations are published in the form of *Communiqués* and the most recent *Communiqué* on accounting requirements, issued as Series X1/25 applicable from 1 January 2005, aimed to raise the accounting requirements of market participants to be “equivalent” to IFRS (refer to Paragraph 54 below). CMB also permits adoption of “full IFRS” for financial periods ended December 31, 2003 onwards. CMB is currently undertaking a study on the compliance of its accounting requirements with IFRS.

40. **The Banking Law (2005) provides the BRSA with the authority to determine accounting and auditing requirements applicable to all banks under its supervision.** The BRSA introduced new regulations in November 2006, which require banks to comply with Turkish Accounting Standards set by the TASB. For regulatory purposes, banks are required to consolidate financial statements of participations which are credit institutions and financial institutions. Moreover, via corporate governance principles the BRSA requires that banks prepare financial statements that fully comply with TAS, in addition to the statements that the BRSA require for regulatory purposes..

41. **The General Directorate of Insurance, in cooperation with the Turkish Association of Insurance and Reinsurance Companies, an industry association, sets accounting requirements for insurance companies.** The conclusions reached under Paragraphs 40 and 40 above also apply to the GDI.

42. **The TASB began operations in 2002 as a public legal entity, with administrative and financial autonomy, to develop national accounting standards.** These will supersede the standards developed by the BRSA, the CMB, and the Treasury (GDI). The CMB and Treasury, all of whom are represented on the TASB, will adopt the standards so that there is consistent and comparable financial reporting among regulated entities. The BRSA has adopted the TAS in November 2006. Please refer to paragraph 55 below for the new regulations issued.

43. The TASB board comprises nine members representing (1) the Ministry of Finance, (2) the Ministry of Industry and Commerce, (3) the Council of Higher Education, (4) the Undersecretariat of Treasury, (5) the CMB, (6) the BRSA, (7) TOBB, (8) a self-employed accountant, and (9) a certified financial consultant from TURMOB. The Board has members drawn across the range of institutions and authorities with a common interest in raising the quality of financial reporting in Turkey. The last two members listed above should represent users and preparers of financial statements, whose practical experience is critical to the development and implementation of standards likely to be accepted, adopted and understood by the financial reporting community. The TASB also has a number of preparers and users of accounts on its committees which review the accounting standards prior to adoption.

44. The TASB is financed in part by budget from the Ministry of Finance and in part by two per cent of the income of TURMOB. It currently lacks a robust legislative legal underpinning setting out its remit and responsibilities, functions and aims and it is currently supported by only one supplementary article in the Capital Markets Law. Following the implementation of the draft Code, the TASB will become the recognized single body for the setting of accounting standards in Turkey. The TASB has recently published a full set of TAS with standards corresponding to all extant IFRS and IAS. TAS corresponding to IAS 32 and 39 were initially published in draft and have recently been adopted formally by the TASB.

45. **The TASBs coherent approach to setting accounting standards is not currently replicated in the promulgation of auditing standards, over which a number of regulatory institutions have authority in respect of particular types of entities.** This fragmented approach to auditing standard setting is inefficient and is not conducive to the creation of a common platform, which treats disclosure and transparency as public goods available to all market participants. The regulatory approach to private sector auditing in Turkey is one in which specialized agencies each devise different obligations. This hinders the agencies' efforts to develop their staff expertise, which is further curtailed by the lack of seconding mechanisms, and results in inefficient duplication of tasks.

- *For publicly-held companies and other capital market institutions the CMB is authorized under Article 22 of the Capital Markets Law to determine the principles related to independent audit requirements.* CMB, requires the application of independent audit standards that are fully convergent with International Standards of Audit.
- *Under Articles 15, 33, and 39 of the Banking Law (2005) the BRSA sets audit requirements for banks.* The BRSA prepared a regulation which requires audits to be performed to standards 'parallel to ISA'.
- *Requirements relating to the auditing of insurance companies are established through Regulations issued by Treasury.*

Also, the respective departments of the BRSA, CMB, and Treasury, which deal with matters relating to audit have little practical experience in ISA. The recruitment process is such that staff are recruited after college and undergo the regulators' high quality training. However, failure to complement in-house-developed expertise with mid-career staff from the sector and/or the accounting industry does not allow staff to develop subsequently. In line with current international practice, an easily implementable approach would be to have fellowships and secondments to and from the regulatory sector and the accounting industry, both locally and internationally.

46. **An effort to unify the auditing standard setting has been made with the formation of the Turkish Audit Standards Board (TUDESK), which has a mandate of setting national auditing standards,** TUDESK has translated ISA in compliance with an IFAC licensing agreement and are translating the IFAC Code of Ethics. The 2004 updates had been reflected to the ISA 2002 translations; TUDESK is currently in the process of updating the translations as of 2006. The 15-member board of TUDESK has established a number of committees to ensure that the national auditing standards produced will be "convergent" to ISA.

E. Enforcing Accounting and Auditing Standards

47. **Reflecting the fragmented nature of regulatory responsibility of accounting standards, each of the institutions authorized to set accounting standards also monitors their compliance and oversees their enforcement.** The regulators responsible for the enforcement of applicable accounting standards in their jurisdictions are the Revenues Administration within the Ministry of Finance for the Tax Procedures Code; the BRSA for banking and other financial companies; the CMB with respect to publicly-held companies; and the Treasury with respect to insurance companies. TÜRMOB, through its professional ethics standards, requires its members to check compliance with applicable accounting standards in the companies they audit.

48. **The regulation and enforcement of accounting and auditing standards as they relate to the Tax Procedures Code is carried out by one of the two departments in the Revenues Administration (RA) within the MoF.** The implementation of the auditing requirements, under Law 3568, and the accounting requirements outlined in the UCA and the Tax Procedural Law, is done by the RA. This department employs 25 people, who are distinct from Tax Inspectors, and is financed by the state budget. Compliance with the procedures and principles in the regulation is compulsory. If this is not adhered to by the preparers and auditors the Tax Procedure Code and Law 3568 grant authority to the MoF and TÜRMOB to impose penalties.

49. **This report uses Standard No 1, *Enforcement of Standards on Financial Information*, issued by the Committee of European Securities Regulators (CESR) as a benchmark to assess accounting standards enforcement in publicly-held companies.**²⁷ In order to measure, on an accepted basis, the quality of the enforcement regime (as demonstrated by CMB in respect of listed issuers – the prime enforcer) the principles of Standard No 1 are adopted as a stable and recognized guideline against which to assess fundamental aspects of the enforcement regime, notwithstanding that CMB is not yet enforcing the EU reporting framework as envisaged by Standard No. 1.²⁸

- ***Principle 3 – Competent independent administrative authorities set up by Member States should have the ultimate responsibility for enforcement of compliance of the financial information provided by the issuers identified by Principle 9²⁹ with the reporting framework.***

The Standard does not define a “competent independent administrative authority” but it does introduce a limited number of key characteristics. The authority should not be capable of undue influence from issuers, their auditors, intermediaries, the government or other stakeholders. It should have minimum powers to:

- monitor financial information,
- require additional information from issuers and their auditors, and
- take measures consistent with the purposes of enforcing the reporting framework of financial information (Principles 6 and 7).

The CMB is a regulatory public agency responsible for the reliable, transparent and stable operation of the capital market; it has administrative and financial autonomy. The CMB’s Corporate Finance Department is primarily responsible for the

²⁷ The report also has regards to these principles when assessing accounting standards enforcement in the general purpose financial statements of listed banks and insurance undertakings.

²⁸ This report only focuses on those principles, which were deemed of significant importance to further enhance existing practices in Turkey.

²⁹ Principle 9 – The principles for enforcement (...) should apply to financial information provided by issuers: (a) whose securities are admitted to trading on a regulated market; (b) that applied for admission to trading of their securities on a regulated market.

enforcement of reporting requirements and is authorized to take “all kinds of measures” in order to secure an orderly market. Issuers have no formal relationship with CMB that might impact on its monitoring or enforcement activities, nor how they are conducted. Under the due process of enforcement, the Executive Board of CMB considers and determines cases put to it by the Department of Enforcement and decides on the enforcement action to be taken.

- ***Principle 4 – Other bodies might carry out enforcement on behalf of the competent administrative authorities, provided that these bodies are supervised by and responsible to the relevant competent administrative authority.*** The CMB has not delegated any of its functions or powers given to it by the Capital Markets Law, except that the ISE may suspend shares of companies from trading in case of non-publication of financial statements in a timely manner. The BRSA and the Treasury have their own authority to act in respect of other entities – they do not carry out enforcement activities on the part of any other regulator.
- ***Principle 5 – Irrespective of who carries out enforcement any standard on enforcement established by CESR should be complied with.*** As appointed regulators of the accounting requirements of banks and insurance companies, the BRSA and the Treasury would also need to cooperate with the CMB in its role as the securities regulator. There is a need for clarification of the CMB’s role with regard to the supervision of the securities of banks and other financial companies. Having regard to the banking sector,
 - By implication, as banks are exempt from most of the reporting requirements of the Capital Markets Law and the BRSA has authority to set the accounting framework, the BRSA enforces the accounting framework as envisaged by Standard No 1. Compliance with the CESR Standard however must be considered in the light of BRSA’s activities as an enforcer of financial information, not as a prudential supervisor. The BRSA’s activity should be looked at as a matter of fact, i.e. the extent to which it does require financial information to comply with relevant financial reporting requirements (irrespective of any consequential impact on matters of prudential interest) and the nature of the corrections it requires.
 - Banks, their management and auditors are obliged by law to provide the BRSA with explanations and access to documents in order to satisfy the BRSA’s enquiries with regard to compliance with the financial reporting requirements. The Banking Law provides for the BRSA to require any document or explanation it considers necessary. Failure to comply can lead to fines and/or imprisonment.
 - The BRSA has appropriate sanctions and actions it can impose to correct breaches in respect of that framework – i.e. not merely financial penalties. The Banking Law (Article 37) gives the BRSA the power to take action deemed appropriate where any published financial statement is found to be inaccurate. That no corrections have been made nor fines imposed in recent times could indicate either that minor matters are settled informally (i.e., include missing information in future sets of financial statements) or that they are not raised with the banks in the first instance.

Having regard to the insurance sector,

- The functions of regulation and supervision of insurance companies are divided between two units of the Treasury. As discussed in Paragraph 41

above, the GDI has responsibility for the drafting of legislation and regulations, for offsite supervision, and for approval of premiums and coverage levels. The onsite supervision of companies is handled by the Insurance Supervisory Board (ISB) within the Treasury. The areas for improvement relating to accounting standards' enforcement in listed banks (see above) apply similarly to listed insurance undertakings.

- ***Principle 6 – Competent administrative authorities shall have adequate independence from government, and market participants, possessing the necessary powers and having sufficient resources.*** The CMB is a public legal entity with administrative and financial autonomy. The seven person Board is appointed by the Council of Ministers and comprises representatives from the Related Ministry (2), Ministry of Finance, Industry and Commerce, BRSA, the Union of Chambers and Commodity Exchanges of Turkey and the Association of Capital Markets Intermediary Institutions. Members serve for six years. The Council of Ministers determines the compensation of Board members. The CMB is, in substance, financially independent of Government. It is funded by fees raised upon issuers equivalent to 3/1000 of the issue value of traded securities. The Ministry of Finance is obliged to cover any shortfall. This last occurred in 1994. The CMB has approximately 100 capital market experts involved in monitoring compliance with CMB reporting, accounting and auditing requirements. Each has a university degree in social sciences. CMB staff implied that 50 were committed to corporate finance activity, which has a very wide brief. Intensive training is provided in the first six months of employment but there is limited subsequent formal training program beyond practical on the job training that is provided through the next 2.5 years of working with a qualified expert. There are also overseas graduate studies and certificate programs. The broad nature of the CMB graduate entrants and the lack of a formal IFRS training program pose a risk in the IFRS environment that staff may not be appropriately versed in the detailed accounting requirements of IFRS to be confident in the monitoring of IFRS compliant financial statements. Whilst the CMB has hosted several educational programs on the application of IFRS, further IFRS training should be a priority for CMB staff if they are to be able to properly detect and enforce noncompliant financial information.
- ***Principle 7 – The necessary powers – which may be delegated to those acting on behalf of the competent independent administrative authority – should at least include power to monitor financial information, require supplementary information from issuers and auditors, and take measures consistent with the purposes of enforcement.*** The Capital Markets Law, Article 22, provides CMB with the necessary powers – including the specific authority to require publication of corrected financial information.
- ***Principle 8 – The competent administrative authorities should be responsible for the setting up of an appropriate due process of enforcement consistent with the application of the principles hereby stated; and the implementation of that due process.*** There is a clear and published due process in respect of CMB's enforcement of financial information (i.e., a flowchart of the decision process and the actions and sanctions available under it is included in the CMB Annual Report). Cases for enforcement draw on a range of proactive and reactive prompts – including complaints, internal referrals, published comments, and planned enforcement activities.

The ongoing monitoring function of the CMB focuses initially on determining whether the relevant reports have been submitted within the filing deadlines. It appears that 506 such reviews were conducted in 2003. The initial reviews are carried out on the basis of a standard form, but subsequent follow-up review does not appear to be according to a consistent procedure in all cases. The CMB relies initially on the auditor's report to highlight potential matters of interest – qualified audit opinions always attract a more detailed review as do other unusual comments. Staff also looks at the primary statements for evidence of unusual or unexpected items and transactions, which may warrant enquiry of the company. The extent of the further review is not clear – in particular, whether the “quick-scan” approach adopted above would then give rise to a full compliance review of the financial statements to ensure that all potential breaches are raised with a company. The lack of a standard approach to the initial review of financial statements raises the following risks:

- Lack of consistency – the quality of the review is dependent on the skills of the individual CMB experts.
- The review is restricted to a reading of the primary statements, which will not highlight potentially inappropriate accounting policies or disclosure issues, which are more likely to arise in 2005 with the transition to IFRS or “IFRS-based” requirements.
- Failure to identify potential areas of significant non-compliance.

The CMB is aware of the greater potential for non-compliance in the transition period to IFRS or “IFRS-based” requirements. Staff accepted that a checklist of key risk areas, supplemented by a detailed checklist, would assist in the consistency of their reviews and their ability to focus on known areas of difficulty, which may differ within industry groups. With little specific provision in the law regarding the review of financial information staff understood the need for an operational framework to support the enforcement process. If structured to focus on recognized risk areas of potential non-compliance, the initial review could function as a “quick scan” tool to contribute to a risk-based selection of financial statements for a full review in accordance with a consistent checklist.

- ***Principle 10 – The principles for enforcement here identified should apply to financial information provided by all harmonized documents, including annual and interim financial statements and reports, prepared on individual and consolidated basis as well as prospectuses and equivalent documents.*** The CMB is responsible for the monitoring of annual financial statements, periodic financial statements and prospectuses required of issuers.
- ***Principle 11 – For financial information other than prospectuses ex-post enforcement is the normal procedure, even if pre-clearance is not precluded.*** The CMB reviews prospectuses on an ex-ante basis and other harmonized financial information ex-post. The CMB also provides issuers with oral or written opinions on the applicability of specific accounting treatments but this is not considered by CMB to constitute pre-clearance of accounting treatments to be included in annual or periodic reports. There is no indication that issuers are entitled to rely on responses given by staff. Particularly in the transition period to IFRS or “IFRS-based” requirements, such enquiries by companies are likely to increase in number and complexity. Care needs to be taken that the advice given – even if on an informal basis – is internally consistent and compliant with IFRS but without encroaching on the proper domain of IFRIC.

- ***Principle 13 – Enforcement of all financial information is normally based on selection of issuers and documents to be examined. However, an approach based solely on risk may be an acceptable selection method.*** CESRfin (SCE) is currently developing guidance on how financial information is to be selected for review. A primarily risk-based approach is envisaged, which combines an assessment of the probability of error and the impact that any such error would have on the market and investor confidence. The risk-based approach can be supplemented with rotation or sampling techniques.

The current CMB approach to ongoing monitoring would constitute an acceptable first step – i.e. the “quick scan” approach to highlight areas of potential risk of non-compliance. As noted above however, a greater degree of formality could be introduced to the “quick-scan” to increase its effectiveness and the consistency with which financial statements are reviewed. The inclusion of other industry and company specific factors – see below – could improve the chance of detecting information where there is a higher risk of material non-compliance.

- ***Principle 14 – In order to allow enforcers to adopt gradually the selection methods provided for by Principle 13, a mixed selection technique based on a combination of a random selection and rotation is considered a workable transitional step. However, such a methodology should be designed to give an adequate level of detection risk.*** The CMB is proactive in its monitoring function although it also responds to specific complaints about financial information and matters drawn to its attention in the press. Prior to 2003, CMB reviews were often promoted by complaints – leaving less resource to perform the continuous monitoring function. There have been substantially fewer complaints in the intervening period – arguably because investors are not well versed in “IFRS-based” requirements.

Historically, the CMB has paid particular interest to potential fraudulent activity rather than prima facie non-compliance with reporting requirements. Selection of financial statements for further review is not systematic, but dependent upon a quick review of key items in the primary statements. As noted above, if properly formulated and expanded to include risk areas of potential material non-compliance, such reviews could be conducted as a “quick-scan” tool to determine financial statements with a higher risk of non-compliance for a full compliance review.

“Quick scan” reviews may be conducted on all financial information where the number of market participants is limited to extract information to feed a detailed risk approach to selection. Liquidity ratios, and other changes in accounting policies, a high level of acquisitions, significant bucks to trends in profit or turnover all feature in most such approaches. The quality of corporate governance could also play a role in the process, particularly in light of CMB’s adoption of a “comply or explain” approach to corporate governance principles in annual financial statements.³⁰

Alternatively, depending on the shape and characteristics of the overall market, particular focus could be placed on those issuers with a high market capitalization where, if there were an error in the financial statements, the impact would have a more significant effect on the markets and investor confidence generally, the maintenance of which is a stated aim of the CMB.

³⁰ The CMB adopted a code of corporate governance principles in June 2003 (amended in February 2005). Adoption of the code by issuers is optional.

- ***Principle 15 – Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive in-nature checking. The level of risk should normally determine the intensity of the review to be performed by the enforcers. The type of document to be examined and the level of information available on the issuer are also to be taken into consideration.*** As noted above, the extent to which financial information is reviewed is not wholly clear once the “quick-scan” review is completed. There are no formal documented procedures. Enquiries are made of the company by e-mail, telephone or formal letter depending on the materiality and potential seriousness of the issue raised. Auditors may also be approached for further information and their working papers may be reviewed.
- ***Principle 16 to 19 – Where a material misstatement in the financial information is detected enforcers should take appropriate actions to achieve an appropriate disclosure and where relevant, public correction of misstatement (in line with the requirements of the reporting framework). Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve an action as well. Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation. Actions should be effective, timely enacted and proportional to the impact of the detected infringement. A consistent policy of actions should be developed, whereby similar actions are adopted where similar infringements are detected***

Material decisions in respect of enforcement cases are considered by the Executive Board which has a range of actions and sanctions at its disposal, including the requirement to publish information omitted from the financial statements, correction of the financial statements, fines and prohibition of trading. In determining appropriate action the Board considers previous findings to ensure consistency in the action taken in respect of similar breaches.

- ***Principle 21 – Enforcers should periodically report to the public on their activities at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters.*** The decisions of the Executive Board in respect of enforcement decisions are announced to the public through CMB’s weekly bulletin. In addition, where the CMB discovers “generic” issues not specific to the financial information of a particular company it can issue Bulletins to give advice on the application of an accounting requirement.

50. **There is currently no program of audit practice quality review undertaken by the auditors’ professional body (TURMOB) to review the work of the 1,239 member firms in accordance with IFAC SMO No.1, *Quality Assurance*, or in line with the new Eighth EU Company Law Directive (which requires external quality control of all auditors registered for statutory audit at least every 6 years, or every 3 years for auditors of public interest entities).** Reliance is placed on the quality review activity of the regulating bodies as well as audit firm’s own internal quality review procedures. No specific annual returns have to be made by member firms in this context. The TURMOB chambers presently act however whenever specific complaints are made against members by the public or the regulators, but this is reactive as opposed to proactive. If a case is found following investigation, the file will be referred to the chamber’s Disciplinary Board. Members can appeal against chamber decisions, to the TURMOB Disciplinary Board within one month, of the decision. Final decisions are forwarded to the MoF, which will publish details in the Official Gazette. For example, the Chamber of Certified Public Accountants of Istanbul dismissed 150 members in 2003/4 and 62 licenses were removed by the

equivalent Ankara chamber in 2003. TURMOB have stated their intention to implement such a program of quality control.³¹

51. The CMB operate audit quality inspection of the auditors which are approved by them to audit CMB-regulated companies. This inspection includes on-site review of audit working papers by staff from the CMB. The CMB performed 6 such inspections in the last year (out of 90 audit firms approved by the CMB). The CMB is aware of the requirement in the EU 8th Directive that all auditors of public interest entities should be inspected every 3 years; CMB intends to increase its capacity for inspections to meet this requirement over time.

52. The BRSA do not perform regular on-site inspections of BRSA-approved auditors but have the authority to do so³². They rely on audit firms' own internal quality control and desk-top reviews of audit opinions. The BRSA could work together with the CMB in this area, as most if not all of the BRSA-approved auditors will also be approved by the CMB.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

53. **Significant differences arise between the financial position and performance of an enterprise prepared in accordance with the UCA and Tax Procedure Law as opposed to IFRS.** Since the Tax Procedure Law has precedence over all other accounting regulations, most Turkish companies only prepare financial statements in accordance with the UCA and the Tax Procedural Law. The needs of the users of financial statements prepared by medium-sized and large entities are not being met given the limited scope of this basis of preparation. The required disclosures are limited hence further reducing the transparency of financial statements in general. Dissimilarities between the UCA and IFRS are wide-ranging and illustrative differences and their implications are outlined as follows:

- IAS 1, *Presentation of Financial Statements*, has not been adopted and so requirements for the Statement of Changes in Equity, the Cash Flow Statements, and some accounting policies and explanatory notes are omitted. While the tax regulation has disclosure requirements, these are less comprehensive than "full IFRS." The absence of extensive accounting policies, explanatory notes and other disclosure requirements prevents users of the financial statements and enforcers from determining the complete basis of preparation of the financial statements, including assumptions made and departures from standards, if any. While users may be able to make economic decisions using the current UCA-based financial statements in small enterprises, the lack of disclosures is likely to hinder the decision-making process in larger and more complex enterprises where such decisions require an evaluation of the ability of an enterprise to generate cash and of the timing and certainty of its generation.³³
- IAS 16, *Property, Plant and Equipment (PPE)*, requires that the depreciable amount of an asset be depreciated over its useful life.³⁴ The UCA requires application of the depreciation rates outlined in the tax laws, which may not necessarily reflect the

³¹ TURMOB will start the application of mandatory quality assurance system starting from January 1, 2007 in line with the decision taken by the Board of Directors.

³² BRSA Regulation on Operations and Authorization of Independent Audit Firms.

³³ Also, the UCA does not include a "true and fair view override" requirement, which is required under both IAS 1 and the Fourth and Seventh EU Company Law Directives.

³⁴ Under IAS 16, an entity should choose either the cost model (cost less accumulated depreciation) or the revaluation model (fair value less any subsequent accumulated depreciation) as its accounting policy and apply that policy to an entire class of PPE.

useful life of the asset. Also, under Turkish law, capitalization of subsequent costs (e.g. day-to-day servicing) is allowed at all times, whereas IFRS only allows capitalization if the recognition criteria of IAS 16 are met (e.g. a major inspection of an aircraft).

- IAS 17, *Leases*, distinguishes between finance and operational leases. Under the UCA, assets subject to finance leasing contracts after July 2003 are accounted in accordance with IAS 17 requirements. However, assets subject to finance leasing contracts prior to July 2003 are not reflected in the lessee's balance sheet. This means that accounting treatments across these two periods are not comparable. In addition, the economic resources and the level of obligations of the lessee may be understated resulting in distorted financial ratios.
- IAS 19, *Employee Benefits*, requires that an entity recognizes a liability when an employee has provided service in exchange for employee benefits to be paid in the future (e.g., a pension plan that provides a pension of 2% of final salary for each year of service). Under the UCA, an entity is not allowed to recognize a liability for such post-employment benefits. Consequently, accounting under the UCA does not provide a clear understanding of liabilities that a company will face, which could be substantial and thus significant information that would aid users of the financial statements in assessing the economic reality facing the company in the future is absent. At a macroeconomic level there may be a significant amount of "hidden liabilities" since existing social legislation in Turkey requires employers to make a lump-sum termination payment to employees who complete at least one year of service.
- IAS 24, *Related Party Disclosures*, has not been adopted and related party activities are not adequately disclosed under the UCA. This may facilitate the diversion of company resources for private benefit. While listed companies, banks, etc. are subject to more stringent requirements (refer to Paragraphs 54 to 56 below), the UCA falls short of good practices in EU Member States as recognized by the recent proposal by the European Commission to amend the Fourth and Seventh EU Company Law Directive in this regard.
- IAS 27, *Consolidated Financial Statements and Separate Financial Statements*, has no equivalent under the UCA. Hence, consolidated financial statements are not presented. Given the complex relationships of companies in Turkey, this represents a significant obstacle for third parties to gain a full understanding of the economic relationships that exist between companies and the resulting consequences for the group.
- IAS 29, *Financial Reporting in Hyperinflationary Economies*, was only partially taken into account by the UCA. As discussed above, the objective of financial reporting is to assist users in making economic decisions. In times of hyperinflation, IAS 29 seeks to eliminate the effects of price changes to allow comparability. For example, if a machine had been purchased for TRL 100 in December 1994, its "value" at the end of 2003 would have been TRL 3,309.³⁵ Until 2003, the UCA did not require hyperinflationary accounting. In 2004 the Ministry of Finance introduced a new set of regulations detailing the principles for the application of inflation accounting for financial statements beginning with the year ended December 31, 2004.

³⁵ Example adapted from *Principle of Financial Accounting*, Prof. Can Simga-Mugan, Nazli Hosal-Akman, page 638, 2nd edition, Ankara, 2005.

- The UCA does not embrace “fair value” as an acceptable or required valuation basis for assets and liabilities. The valuation approach that the IASB is rapidly introducing “fair value” as the primary basis of asset/liability measurement.³⁶ As a result, a substantial portion of a reporting entity’s assets and liabilities under IFRS are stated in the balance sheet at “fair value,” including pension assets and liabilities, derivative financial instruments, certain other financial assets, financial liabilities held for trading, tangible and intangible fixed assets that have been acquired in a business combination, impaired or revalued, assets held for disposal, share-based payment liabilities, investment properties, provisions and biological assets. In most instance, the UCA generally endorses “historical cost” as the measurement basis for assets and liabilities.

54. **The Turkish requirements which are closest in purpose to IFRS are the accounting standards issued by the CMB, although it is recognized that these apply only to the 600 or so companies which are subject to CMB’s regulations.** Until January 1, 2003, the fundamental difference between CMB accounting requirements and IFRS was the lack of hyperinflationary accounting. Although Turkey had been experiencing hyperinflation in the last three decades (refer to Paragraph 2 above) the only requirement was the annual revaluation of PPE. Furthermore, long-term investments were carried at cost. Other differences related to consolidated financial statement, investments in associates, etc. On November 15, 2003, the CMB issued *Communiqué X1/25*, effective from January 1, 2005, which is intended to cover all extant IAS, IFRS and IFRIC interpretations and to close the existing differences between CMB requirements and IFRS. *Communiqué X1/25* is required in respect of all listed companies, intermediaries, and their subsidiaries and associates. Other publicly-held companies are not subject to *Communiqué X1/25*. While the CMB is firm that the financial statements of listed companies provide equal relevance and reliability as they are presented in accordance with IFRS, the ROSC team noted that differences with “full IFRS” remain. These stem from two major issues:

- ***Delays in keeping the body of translated and “gazetted” IFRS-based requirements up-to-date.*** Turkey has a tradition of reliance on laws and regulations (rather than standards) for the fixing of accounting and auditing requirements. Rather than giving authority to a continuing process of standard-setting, new statutory measures are required whenever a new international standard is enacted, or an existing international standard is amended (between 2003 and 2004 alone, five new IFRSs were adopted by the IASB, 15 IASs were amended, and one IAS was withdrawn). Most amendments and new standards enacted by the IASB since November 15, 2003 are not reflected in CMB accounting requirements. Consequently, foreign users of listed company financial statements may face difficulty in analyzing financial statements due to lack of international comparability.
- ***Regulatory intervention in the implementation of the standards:*** As discussed in Paragraph 53 above, the Ministry of Finance (in coordination with other regulatory agencies) has indicated that hyperinflationary accounting will no longer apply for financial statements for the year ending December 31, 2005. Consequently, this will introduce a major difference between CMB accounting requirements and IFRS if Turkey still qualifies as a hyperinflationary economy based on the characteristics outlined in IAS 29. As a consequence, some companies may elect to voluntarily prepare additional financial statements in which full compliance with IFRS can be achieved (e.g. for their foreign investors, credit rating agencies, etc.). This has

³⁶ The IASB has adopted what is essentially a market value definition of fair value, and expresses it in most of its standards as follows: “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

negative cost implications and also raises uncertainties among users as to which are the “real” figures. In addition, financial statements prepared and audited on a voluntary basis will fall outside the scope of domestic regulatory regimes, thereby often reducing the reliance users can place on them.

55. **There are specific differences between IFRS and BRSA accounting requirements.** As discussed in Paragraph 20 above banks are required to prepare financial statements in compliance with BRSA accounting requirements. The BRSA introduced new regulations which will require banks to comply with Turkish Accounting Standards set by the TASB. For regulatory purposes, banks have to consolidate financial statements of participations which are credit institutions and financial institutions. In addition, through corporate governance principles, the BRSA will require that banks and other financial companies prepare financial statements that fully comply with TAS in addition to the statements that the BRSA require for regulatory purposes. Differences between TAS/IFRS and current BRSA accounting requirements mainly relate to:

- **The scope of consolidation.** As discussed in Paragraph 20 above, the BRSA requires banks to prepare consolidated financial statements, but these include financial subsidiaries only. However, banks are also required to prepare fully consolidated financial statements in accordance with TAS which is in line with IAS 27.
- **The measurement of loan losses.** The BRSA requires that banks perform a review of loan exposures and classify them into risk categories (i.e. standard, closely monitored, with limited collectibility, doubtful, and loss). The classification is largely based on timeliness of repayments of loans and the economic and financial condition of the borrower. The BRSA requires banks to establish a general provision relating to the first two categories and specific provisions for the last three categories. Specific provisions are determined on the basis of a provisioning matrix that specifies a range of fixed minimum provisioning rates for each category (e.g., 20% for the “with limited collectibility” category). This methodology may not comply with IAS 39, which requires impairment or loan losses to be calculated as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate. Although this methodology differs from IAS 39 with respect to calculating provisions for bank originated loans, the BRSA indicated that the regulation was prepared in accordance with the requirements of Basel Capital Accord.

The Turkish financial sector consists in large part of financial-industrial conglomerates, having commercial banks at the center of the groups, surrounded by both financial and non-financial subsidiaries. As with other publicly held companies, if the ultimate parent company is publicly held, it has to prepare consolidated financial statements in accordance with the CMB regulations. The “Regulation on Financial Holding Companies” was published in November 2006 by BRSA. According to this regulation, if a parent company is a financial holding company, it has to prepare consolidated financial statements.

56. **The GDI has indicated its commitment to the phased-in adoption of “full IFRS” in the insurance sector.** Currently, as discussed in Paragraph 21 above insurance companies are required to prepare financial statements in compliance with the accounting requirements issued by the General Directorate of Insurance of the Undersecretariat of Treasury. Since the applicable standards adopted by the Treasury are similar to those adopted by the BRSA and CMB, the ROSC team anticipates that the issues relating to the difference between Turkish accounting requirements and IFRS will be similar to those in Paragraphs 54 and 55 above.

57. **The ROSC team made assessments of the compliance gap sampling 12 sets of financial statements, which purport to be prepared in accordance with IFRS, and 12 sets that purport to be prepared in accordance with Turkish accounting requirements.** For the sample review, the ROSC team selected 17 enterprise sector companies (listed and unlisted), three banks, and one insurance company (the financial statements were as of December 31, 2003)³⁷. The team noted that the quality of the IFRS financial statements is inconsistent and there is non-compliance with specific standards by a number of companies, even where the audit opinions were unqualified. This non-compliance could be due to a lack of understanding on how to implement IFRS and is further evidenced by the use of “boilerplate language” in the accompanying required disclosures. The quality of the financial statements prepared according to Turkish accounting requirements, which purport to be significantly compliant with IFRS, was variable with a number of significant issues.³⁸ The multiplicity of accounting regulations over a relatively short period of time, occasionally with an early adoption option may have contributed to confusion and affected preparers’ ability to properly implement the new requirements.

With respect to IFRS financial statements, the ROSC team noted the following non-compliance issues:

- **Assets and profits may be overstated in a number of public interest entities.** Several companies have capitalized borrowing costs in accordance with IAS 23 in spite of the fact that IAS 29 states that it is inappropriate to do so in a hyperinflationary economy. The capitalization of borrowing costs in such circumstances leads to double counting, as actual interest rates reflect the rate of inflation dealt with by indexation. All the financial statements were unqualified in respect of this matter.
- **Incorrect valuation of financial assets at cost and not at fair value, which could result in the overvaluing of assets and consequent understating of losses in a reporting period.** The unqualified audit opinion on a company’s 2003 consolidated financial statements includes an emphasis of matter paragraph, which indicates that the opinion on the 2002 financial statements was qualified because available-for-sale investments were carried at cost instead of fair value in contravention of IAS 39. The company sold the available-for-sale investments during 2003 at a loss of TRL 35 million (equivalent to approximately US\$ 26 million) to a subsidiary, which carries the investments at fair value. The loss, which represents about 15% of net income, would have been reported in 2002 or earlier if IAS 39 had been applied correctly and as a result the 2003 financial statements were materially incorrect. This transaction is also in contravention of IAS 27.28, which, states “consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances,” and IAS 27.24, which, states “intragroup balances, transactions, income and expenses shall be eliminated in full.”

³⁷ Among these 24 sets of financial statements, two were audited by local audit firms and 17 by local member firms of international audit firm networks. Due to a confidentiality agreement with the MoF, we are unable to ascertain the auditors of the financial statements prepared according to the UCA. 10 of the 12 IFRS financial statements had unqualified opinions (three reports included emphasis of matter paragraphs) while the other two were qualified (both with emphasis of matter paragraphs). Of the 12 financial statements prepared according to Turkish accounting requirements, four had unqualified opinions, three were qualified, and five were unaudited.

³⁸ The ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample’s small size, it cannot be considered to be representative of all listed companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings are not meant to reflect systemic problems that would apply to all companies.

- **Provisions for employment benefits may be understated.** There are significant omissions with respect to post-employment benefits (pensions and employee termination benefits), including non-disclosure of the actuarial valuation method, lack of segregation of the charge for the period between current service cost and interest, the present value of the defined benefit obligation, the fair value of plan assets and other assumptions.
- **Use of boilerplate disclosures.** The wording used in each case to describe the reasons and procedures in the application of IAS 29, *Financial Reporting in Hyperinflationary Economies*, is virtually identical. The procedures followed are correct (with one exception) although there are several references to corrections of the indexation of assets in prior periods, which suggest that there are some practical implementation issues.
- **Lack of comparability of operating performance of companies due to incorrect cash flow statement classifications.** Two of the banks in the sample show loans to customers as investing activities and deposits from customers as financing activities. They should be classified as operating activities in the cash flow statement in accordance with IAS 7.15, which states "...cash advances and loans made by financial institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that entity." This breach of compliance is also in contravention of BRSA regulations (*Communiqué* No. 16 on "Recognition of Cash Flow Statements" and *Communiqué* No. 17, which dealt with the presentation of the Cash Flow Statements were prepared for compliance with IAS 7 and have been revoked since banks started to implement the TAS).

With respect to financial statements prepared in conformity with BRSA accounting requirements, the ROSC team noted the following non-compliance issues:

- **Lack of transparency related to provisions could lead to manipulation of earnings.** A bank with an unqualified opinion has provided for "Other Provisions" without providing a detailed explanation of the nature or content of the provision. The BRSA does not allow the setting of provisions without specific correlation to loans or assets. This non-compliance with BRSA regulations, which was considered against the backdrop of a lack of transparency in provisions, may conceal an attempt to smooth earnings.
- **Inconsistently applied loan loss provisioning in consolidated financial statements could restrict third parties' ability to assess credit quality in bank's financial statements.** There were two cases where the loan loss provision policy of subsidiaries in another country was not in compliance with BRSA regulations but with the other country's rules.

With respect to financial statements prepared in conformity with CMB accounting requirements, the ROSC team noted the following non-compliance issues:

- **Possible misleading financial statements as a result of inadequate disclosures.** A number of disclosures were missing from the financial statements that were reviewed. The missing disclosures concerned items in the balance sheet and income statement and related to fair values, classification of investments and valuation methods related to discounting of financial assets and others. Disclosures are important in informing users as to the measurement basis and assumptions that underlie the financial statements.
- **Possible aggressive accounting policy.** A company with financial statements prepared according to *Communiqué* X1/25 had a relatively low profit in 2003 and a

significant loss in 2004. No corporate tax liability arose due to significant losses (almost 20 times 2003 profit) that were carried forward from prior years. A material deferred tax asset has been calculated and reflected in the financial statements although *Communiqué X1/25* permits recognizing the deferred tax assets only if it is probable that the deferred tax assets can be realized. Given the current profit levels it is unlikely that the company will realize the entire deferred tax assets and therefore the company's action could be viewed as aggressive accounting policy.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

58. **There is no single standard governing the audits of the financial statements of companies generally.** TURMOB, through internal regulations, has prepared guidelines on conducting audits.³⁹ In addition, as discussed in Paragraph 22 above, the law gives each regulator the authority to determine in secondary legislation (e.g., *Communiqués*) how an audit firm should conduct an audit of an entity in their jurisdiction, which results in distinct auditing procedures for “tax audits,” banks, insurance and publicly-held companies.

59. **Most audits conducted in Turkey are based on asserting that the statutory books are in compliance with the UCA and the Tax Procedural Law.** While some audits of large companies are conducted according to ISA (especially those with foreign interests), audits of the statutory books are generally not conducted in accordance with ISA but instead in accordance with special purpose auditing regulations set by the Ministry of Finance and by TURMOB. Therefore, most audits are distinct from the general understanding of an audit as required by the Fourth, Seventh, Insurance Accounts and Banking Accounts Directives.

60. **Turkish Auditing Standards governing regulated entities are effectively an abbreviated version of ISA. Practicing auditors generally comply with the strict wording of written Turkish Auditing Standards and a lack of ISA-compatible requirements in certain areas may adversely impact audit quality.** Since the requirements adopted by the regulators are very succinct as compared to ISA, the ROSC team determined that a detailed list of the standard gap would be overwhelming and not necessarily conclusive. Instead, the team sought to highlight a few areas where the lack of ISA-compatible requirements may impact audit quality.

61. **There is conflicting evidence about the quality of audits which purport to be conducted in accordance with ISA.** From the review of a sample of audited financial statements (see Paragraph 57 above) and discussions with sole practitioners, small and large audit firms, TURMOB, and regulators, specific issues surfaced that adversely impact the average quality of auditing practices:

- **Confusing/misleading audit opinions** – The review indicated a number of instances where the opinion given by the auditor should have been different given other information in the audit opinion and the financial statements. For example, there were several reports with emphasis of matter paragraphs that appear to be unnecessary and were related to the adoption of IFRS and corrections to the indexation of assets. Overuse of the emphasis of matter paragraph may lead to a use of the paragraph to avoid compliance and it then becomes less certain as to the precise nature of the auditor's opinion thus increasing the risk of misleading users of the financial statements.

³⁹ See TURMOB's Regulation on “the Working Principles and Procedures of Certified Public Accountants and Sworn-In CPAs” and the auditing standards issued by TUDESK

- **Use of emphasis of a matter where a qualification may have been more appropriate** – The audit report of a listed company contained an emphasis of matter paragraph related to a qualified opinion on the 2002 financial statements because available-for-sale investments were classified at cost instead of fair value (refer to Paragraph 57 above). In addition, an emphasis of matter paragraph was used in the case of non-compliance with IAS 28, *Investments in Associates*, where a qualification may have been more appropriate based on the information provided in the financial statements. The use of emphases of matter paragraphs as opposed to qualifications is potentially misleading to investors and could raise doubts as to the auditors' independence and objectivity.
- **Inadequate implementation of ISA 600, *Using the Work of Another Auditor*** – The auditors of a listed company have relied entirely on the reports of other auditors who have audited 18% of total assets and 23% of net profit. ISA 600.18 allows such an approach only “where local regulations of some countries permit a principal auditor to base the audit opinion on the financial statements taken as a whole solely upon the report of another audit regarding the audit of one or more components.” No evidence has been found in the auditing regulations in Turkey that this is permitted and in order to comply with ISA 600.18, the auditors were expected to “perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor’s purposes, in the context of the specific assignment.”
- **Possible misleading audit opinions could affect reliance on audited financial statements** – The 2003 audited financial statement of a listed company stated that in the 2002 financial statements, which were audited by another auditor, goodwill acquired in 2001 was written off because the merged operation had been fully integrated. The auditors of the 2003 audited financial statements do not indicate whether they agree with the treatment and do not qualify their opinion in this respect. If the auditors agree with the treatment then the explanatory paragraph is unnecessary. However, in 2002 the goodwill should have been included in the balance sheet as an asset and amortized over its useful life in accordance with IAS 22, *Business Combinations*. This departure from IAS 22 should have resulted in a qualification. The auditor’s failure to qualify the opinion could mislead investors comparing the performance of this company with others in the same sector.

62. **Auditors are sometimes expected to prepare financial statements or at a minimum make adjustments prior to conducting the audit.**⁴⁰ The supply of technically competent professionals with the ability to prepare financial statements in accordance with increasingly technical and complex accounting requirements has not kept pace with demand. This has created a situation where the staff in many companies is unable to fully prepare the financial statements according to IFRS. Accounting staff in one of the companies involved in preparing IFRS statements for the past 10 years stated that standards are difficult to implement and that the auditors were relied upon to prepare the consolidated financial statements⁴¹ and audit them. This has implications for auditor independence and the ability of the market to rely on such audited

⁴⁰ This issue was also raised in “Convergence to IFRS: The case of Turkey,” Can Simga-Mugan, Nazli Hosal-Akman, draft paper, Ankara, 2005, page 11.

⁴¹ In repeated instances, preparers and auditors indicated that the audit firms, including the local member firms of international audit firm networks, do the consolidation and prepare the financial statements. In addition, the ROSC team noted that the electronic file of the IFRS financial statements (selected for purposes of the review under Section III of this report) had been prepared on the computers of the audit firms.

financial statements. Given, the skills gap, which is expected to remain at current level in the near future, training of highly educated accounting professionals is a priority.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

63. **The overall transparency and disclosure level of Turkey's top companies is assessed as "unsatisfactory."** In an April 2005 press release assessing financial disclosure by the top 52 Turkish companies, Standard & Poor's pointed to the limited level of voluntary disclosure and a problem of transparency of groups.⁴² For "accounting-literate" users of companies' financial statements with no supplementary access to internal financial and management information, published financial statements prepared in accordance with current legal and regulatory requirements suffer from the following major shortcomings:

- **Failure to adequately and consistently adjust for the effects of hyperinflation.** Efforts can be made to compensate for this by means of the process of "dollarization", but this is considered to be too approximate to result in sufficiently reliable information.
- **Absence of full consolidated financial statements for groups of companies as a whole, including for banks.** Concerns are expressed about the lack of information on transactions between group companies (including the basis for transfer pricing, intra-group transfers of assets, and the elimination of intra-group transactions). Combined with certain weaknesses in the protection of minority shareholders, this undermines investor confidence.
- **Absence of related party disclosures.** This raises many of the same issues as the absence of full consolidation.

64. **There is a perception that different types of user groups have access to information that others do not.** In response to user pressures, certain groups/companies now prepare IFRS financial statements on a voluntary basis, but there is dissatisfaction with this approach. Firstly, the number of companies/groups involved is small. Secondly, such voluntary financial statements are not disclosed to the market, and there is a perception that not all shareholders are treated equally in terms of access to them. Domestic minority shareholders, in particular, are concerned that more information may be provided to foreign institutional investors. Thirdly, these financial statements are prepared outside any regulatory or enforcement framework (e.g. they are not reviewed by the CMB) and there are concerns about their reliability. Such public perception is very detrimental to Turkey as highlighted in a Financial Times article on the listing of Turk Telekom which stated: "Public financial disclosure is poor. Regulation and permissible redundancy levels remain opaque... If Turkey wants to attract quality investors to its privatizations it will have to raise its game."⁴³

VI. POLICY RECOMMENDATIONS

65. **The National Steering Committee should develop a detailed action plan based on the recommendations of this report.** Without attempting to provide a detailed tactical design for reform, this report sketches the policy recommendations to enhance the quality of corporate

⁴² *Corporate Governance: Turkish Transparency and Disclosure Survey*, Standard & Poor's Governance Services, London, April, 22, 2005.

⁴³ "Turk Telekom" in Financial Times Europe, Saturday May 14 and Sunday May 15, 2005, page 22.

financial reporting. Upon commencement of this assessment, Turkey established a multidisciplinary National Steering Committee (NSC) for accounting and auditing reform to participate in the assessment and to advise policymakers, regulators, and other stakeholders regarding the implementation of the recommendations. Based on the successful experience of other countries the report recommends that the NSC develops a Country Strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Turkey.

66. Implementing the proposed recommendations will enhance the reliability and availability of financial reporting. As work on the economics of information, this will be conducive to:

- Strengthening Turkey’s financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of *public interest entities*;
- Contributing to foreign direct and portfolio investment;
- Helping mobilize domestic savings;
- Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions, which are based on the financial performance of the prospective borrower;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is a building block of a market-based monitoring of companies); and
- Assisting the authorities to adopt, monitor, and enforce compliance with the relevant portions of the *acquis communautaire*.

The policy recommendations set forth in this report are predicated on the notion that full compliance with the *acquis communautaire*, which represents a high-quality regulatory and institutional framework for accounting and auditing, is the long-term objective of Turkey. As set forth in this report, such an objective requires extensive reforms to Turkey’s legal framework, institutions, and accounting profession, as well as changes in its accounting, auditing and business culture.

67. The membership of the NSC would need to be expanded to include academics, users and preparers of financial statements in order to reflect as many stakeholders in the accounting reform process. The NSC will be essential to the reform process, given the diversity of legislation, regulatory authorities, and the fragmentation of the financial reporting framework. It is critical that the members possess demonstrated technical competency and knowledge of accounting, auditing and financial reporting (including knowledge of IFRS, prudential regulation, ISA, and IFAC’s International Education Standards and Code of Ethics); high level analytical skills; integrity, objectivity and discipline; and commitment to accounting and auditing reform and the public interest.

68. Measures are needed to address the wide-scale “informality” problem in Turkey. Such informality is linked to a range of macroeconomic, fiscal and social issues, and progress

should be made in each of these areas; however, there are some actions that could help relating to financial reporting. The challenge for Turkey is to encourage a culture of compliance and disclosure where, in the past, such compliance has been seen to lead to higher taxes and a greater regulatory burden. The timely enactment of the new draft Commercial Code together with coordinated regulatory requirements to use TAS and ISA in preparing and auditing financial statements should help the authorities in this regard, but these measures will only work if they are effectively implemented and if the macroeconomic, fiscal and social drivers complement these reforms. Measures to aid this implementation include:

- Helping preparers, users and auditors of financial statements to understand a clear difference between financial reports and tax reports; ideally tax reporting should be based on making the necessary adjustments to financial reports.
- Implementing and enforcing specific actions linked to regulated activities which reinforce the use of audited financial statements, such as in banking, where the BRSA should require banks to ask their loan customers for audited financial statements for their business. Banks should keep the statements on their credit files and, crucially, should make their lending decisions based on the statements, whether on a subjective or on an objective, model oriented, basis. Such activity is envisaged by a current banking regulation [INSERT REF] but is not widely practiced by banks.
- Developing auditors' ability to perform ISA-compliant audits through training and education and through the provision and implementation of a standards ISA-compliant audit methodology with associated training..

69. Fragmented approaches based on a multiplicity of stand-alone special purpose accounting and auditing requirements should be replaced by a single, coordinated, robust general purpose system, which treats disclosure and transparency as public goods available to all market participants. The revision of the statutory framework, led by the revision of the Commercial Code (1957) currently underway in Turkey will address this but it is crucial that this revision is completed urgently and that it is not unduly delayed or its effectiveness and scope reduced by the political process. This report supports the reform to corporate financial reporting proposed in the draft Commercial Code. However, it makes the following recommendations in regard to the draft Code:

- That very limited exemptions to the audit requirement be made for dormant companies and possibly for those with very low turnover.
- That the Code clearly requires that companies file their full financial statements, including all notes, with a registering entity where they will be publicly available.

70. In addition this report recommends that:

- Remaining **conflicting or ambiguous financial reporting requirements should be amended.** The legal and regulatory framework should be revised so that regulatory requirements do not impede compliance with TAS in general purpose financial statements. If regulators need additional (unpublished) information for prudential supervision or statistical purposes, this should be done only by supplementing, not departing from, IFRS. This would have the added benefit of mobilizing regulators to assist in the enforcement of the requirements for general purpose financial statements, since the regulators would have a keen interest in ensuring that the fundamental TAS/IFRS-based financial statements are correct (as their reports would be built on that foundation).

- **Corporate governance arrangements should be modernized in line with emerging practices in OECD countries.** The recommendations of the recent OECD report on corporate governance in Turkey should be implemented. Confidence in the financial statements is linked to those who have responsibility for preparing and making them publicly available. In line with what is currently prevailing in EU Member States, the responsibility should rest collectively with all board members both in law and in practice.
- **In order to meet the challenge to the auditing profession that the audit requirement in the draft Code will pose, TURMOB must continue to develop the effectiveness of its regulation of certified auditors, i.e. those TURMOB members who are authorized to conduct audits in accordance with ISA under the Code and Law 3568 (SMMs and YMMs).** This regulation should include the following tasks: (i) ensuring timely updates to the translation of ISA and IFAC Code of Ethics for Professional Accountants into Turkish (refer to Paragraph 71 below); (ii) issuing implementation guidance on the application of ISA; (iii) exercising quality assurance over the auditing activities of its members, by way of monitoring of their work; (iv) exercising disciplinary authority over its members; (v) issuing audit licenses to both individuals and audit firms on the basis of education, experience, and examination requirements consistent with IFAC IESs and the *acquis communautaire*; adverse findings of either the quality assurance system or the disciplinary system should result in suspension or removal of this license; and (vi) working closely with the BRSA, CMB and the Treasury in the development of specific additional approval, auditing, quality assurance or reporting requirements applicable to the statutory auditors of entities subject to their supervision. These arrangements should be established in accordance with the requirements of the new Eighth EU Company Law Directive.
- **A public oversight system for the audit profession should be established to oversee the operation of the above audit regulation.** The purpose of the oversight system is to ensure that quality assurance is, in fact and appearance, an exercise with sufficient public integrity; it should also instill public confidence in the profession and demonstrate to regulators and the public the adequate discharge of self-regulating responsibilities. The public oversight system should have the ultimate responsibility for the oversight of (i) the approval and registration of statutory auditors and audit firms, (ii) the adoption of standards on ethics, internal quality control of audit firms and auditing, and (iii) continuous education, quality assurance and investigative and disciplinary systems.

In addition, the oversight system of public oversight should have the right, where necessary, to conduct its own investigations of statutory auditors and audit firms and to take appropriate action.

Importantly, the system of public oversight must be governed by “non-practitioners.”⁴⁴ While Turkey may allow a minority of practitioners to be involved in the governance of the public oversight system, the oversight system should be clearly independent of the profession.

⁴⁴ Under the new Eighth EU Company Law Directive, a “non-practitioners” is defined as a “natural person who for at least three years prior to his or her involvement in the governance of the public oversight system has not carried out statutory audits, has not held voting rights in an audit firm, has not been a member of the administrative or management body of an audit firm and has not been employed by or otherwise associated with an audit firm.”

Given the growing presence of large Turkish companies on international equity and debt markets (e.g. through issuing Eurobonds), these measures will help underpin the confidence in the functioning of the Turkish capital market and help prevent unnecessary international regulatory overlap through reciprocal cooperation with other countries.

71. **The current framework has some of the institutional infrastructure necessary to foster an accounting and auditing environment which facilitates the preparation of high quality financial statements.** Specific recommendations that would utilize aspects of the current infrastructure while incorporating new features where necessary are as follows:

- **Accounting and auditing standard setting activities should provide for a common platform, which ensures efficient use of expert resources:**
 - *The TASB should become solely responsible for accounting standard setting activities subject to a review of its remit, membership and resources.* For the TASB to become the recognized single accounting standard setter in Turkey, a legislative framework needs to be developed with a clear set of accepted and understood aims and objectives and remit. The draft Turkish Commercial Code gives this mandate to TASB; other regulatory regulations may need to be further amended to confirm this.
 - TUDESK, the auditing standard setter within TURMOB, should gain similar responsibility for adopting auditing standards for the audit profession which would conform to ISA.

The TASB and TUDESK should have adequate resources to continue to translate updates to IFRS and ISA on a timely basis in line with the official translation process set out by the IASCF and the IFAC Translation Policy.

- **Institutionalized accounting standard enforcement mechanisms should be reviewed to ensure compliance with reporting requirements.** This report's recommendations aim to strengthen two enforcement pillars: (a) preparers, through requiring collective responsibility of board members, requiring the application of TAS, retraining of accountants in industry, and enhancing academic education; and (b) auditors, through the adoption of ISA, quality assurance system, and public oversight. However, it is essential to also address the third enforcement pillar, i.e. regulators. While different models exist, this report recommends that regulators play an active role at least in the enforcement of accounting standards in the general purpose financial statements of *public interest entities*. This may be done either through the establishment of a new body (e.g., one with a similar role a remit to that of the Financial Reporting Review Panel in the United Kingdom), or extending the enforcement role and capacity of existing regulators (BRSA, CMB, and Treasury).

While there are clear advantages to a regulatory system which gives authority to a single central regulator, a fragmented approach where responsibility is shared amongst enforcers is an accepted alternative. Such a model presents risks of overlap or, more significantly, areas where there are gaps between the powers or remits of those concerned. Particularly as the enforcers strive to enforce IFRS there is arguably a greater need for consistent application of similar requirements. The relationship between the various enforcers could be strengthened by Memoranda of Understanding, which set out clearly the manner in which they may seek to co-operate and demonstrate a unified approach to enforcement. Going forward, this could include prior discussion before release of generic bulletins or advice that may

have implications across the various regimes if issued in respect of an accounting requirement common to all preparers.

72. **There is also a strong need to develop the capacity of the accounting and audit profession.** The genuine understanding and adoption of these new accounting and auditing requirements require related education and training for preparers, auditors, and regulators. In this context, there will need to be a greater focus towards the needs of general purpose financial reporting. The following recommendations would enhance the capacity of existing accountants as well as ensure the capacity of future accountants:

- **Vocational and academic education.** Vocational schools and universities will require further assistance with the development of, training materials that are compliant with and adequately cover IFRS, ISA and the IFAC Code of Professional Ethics. Training of syllabus preparers and lecturers, including practical work experience, in these specialized areas would also be highly beneficial.

A liaison group should be established between the universities and TURMOB. This will assist with the dissemination of knowledge and help keep universities aware of the training needs of the profession.

- **The professional examination syllabus should continue to be reviewed periodically to ensure that it effectively meets the needs of the audit and accounting professions and that is aligned with the requirements of the new Eighth EU Company Law Directive and the IFAC International Education Standards (IES).**
- **The Continuing Professional Development requirement for auditors and accountants should continue to be developed to meet the needs of practicing auditors and accountants and to meet the requirements of the new Eighth EU Company Law Directive and IFAC IES 7.** TURMOB should actively control completion of the required CPD hours by members and ensure that appropriate course are offered, especially in the areas of ISA and TAS/IFRS.
- **Accountants in industry:** As discussed in Section II.C above, several stakeholders articulated their concerns that there is a lack of up-to-date accounting knowledge within industry. In order that accountants in industry obtain a deeper understanding of the issues concerned, a program should be developed to specifically target the significant retooling needs of accountants in industry. A number of approaches exist, and can be broadly categorized as direct regulation or incentive-based policies, which are further described below. The “right” policy will likely draw upon both types to include a mix of positive incentives, compliance monitoring and sanctions.
 - Direct regulation involves statutory requirements that are monitored and enforced by a regulatory body, and non-compliance is punishable by sanctions. However, it is important to note that in EU Member States, there has been a clear trend away from direct regulation of accounting services, other than audit. With regard to the accounting profession, direct regulation generally takes one of the following three forms: required licensing, protection of an accounting title, or qualification for external accountants.
 - While direct regulation mandates a certain type of behavior through rules, enforcement and sanctions, incentive-based measures encourage certain behaviors through rewards, which are usually market-based. The Government can play an active role in promoting the improvement of the quality of accounting profession through the use of incentives. These include an array of options, such as setting a good example through applying international good

practice in accounting and auditing within state-owned enterprises, so that these may serve as a model for the rest of the corporate sector; and providing seed money or tax credits for the establishment of retooling programs of accountants in enterprises.