STANDARDS OF FINANCIAL REPORTING

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Abstract: A long time ago many financially developed countries adopted accounting standards for financial reporting. It may be strongly argued that standardization in financial reporting is one of the fundamental elements of improving financial markets. Turkey first adopted standards for bank reporting in 1986. However, financial reporting standards for nonfinancial firms have been established only in very recent years (1995). Yet, in spite of the improvements, it is hardly possible to say that newly adopted standards are sufficient for accurate comparisons of financial reports. That is to say, the treatment of new financing tools (e.g. leasing, factoring, forfeiting) and off-balance sheet activities (e.g. forwards, futures, swaps, assurances, guarantees) are still not completely standardized. Having understood the needs, improvements in the standards of accounting will help improve the Turkish financial markets and eventually economic growth.

Key words: *Standards of Financial Reporting, GAAP, IAS, TAS*

Özet: Finansal yapıları gelişmiş ülkeler uzun zaman önce finansal raporlama için gerekli muhasebe standartlarını oluşturmuşlardır. Buna bağlı olarak, finansal raporlamada sağlanacak standardizasyonun, finansal piyasaları geliştireceği söylenebilir. Türkiye ilk defa banka raporlarında bu standartları uygulamaya 1986 yılında başladı. Fakat finansal sektör dışında bu standartların uygulamaya konması 1995 yılında oldu. Raporlama standardizasyonunda sağlanan bu gelişmelere rağmen, günümüzde finansal raporların tam olarak karşılaştırılabilir olduğunu söylemek zordur. Leasing, faktoring ve forfaiting gibi yeni kullanılmaya başlanan finansman tekniklerinin ve bilanço dışı aktivitelerin nasıl muhasebeleştirileceği net değildir. Bu ihtiyaçları gözönünde tutarak muhasebe standartlarının geliştirilmesi hem Türk finansal piyasalarının gelişmesine katkıda bulunacak hem de ekonomik gelişmeye hız katacaktır.

Anahtar sözcükler: *Finansal Raporlama Standartları, Amerikan Muhasebe Standartları, Uluslararası Muhasebe Standartları, Türk Muhasebe Standartları*

INTRODUCTION

A long time ago many financially developed countries adopted accounting standards for financial reporting. It may be strongly argued that standardization in financial reporting is one of the fundamental elements of improving financial markets. What investors ask for is a fair and reliable representation of financial position of the firms because they need to compare firms'performances in determining their investment strategies.

Turkey first adopted standards for bank reporting in 1986. Since then the standards for bank reporting have considerably widened and improved. However, financial reporting standards for nonfinancial firms have been established in very recent years (1995). Until recent years the Turkish government has viewed financial reporting as a tool to collect taxes rather than a reflection of the true financial position of the firms. However, with the adoption of accounting standards for nonfinancial firms, the Turkish government looks to be changing its view about the fundamentals of financial reporting.

Yet, in spite of the improvements, it is hardly possible to say that newly adopted standards are sufficient for accurate comparisons of financial reports. That is to say, the treatment of new financing tools (e.g. leasing, factoring, forfeiting) and off- balance sheet activities (e.g. forwards, futures, swaps, assurances, guarantees) are still not completely standardized. Besides, the treatment of the effects of inflation on financial reports is still not clear.

Having understood the needs, ways and rooms to improve the accounting standards will help improve the Turkish financial markets and eventually economic growth. This paper will discuss some hot issues for accounting treatments of some economic events in Turkish accounting standards (TAS) and compare it to the U.S. accounting standards (GAAP) and the international accounting standards (IAS).

STANDARDIZATION OF FINANCIAL REPORTING

The purpose of financial reporting is to transfer financial information (quantitative and qualitative) about the entity to others who have interest in the entity. Realizing this goal the following fundamental question needs to be asked: how reliable is the financial reporting even if we have the standards for treatment of economic events, record keeping and financial reporting ?

Accounting treatments of economic events differ among the countries and so do accounting standards. The same economic event (a transaction) may be recorded at different accounts with different amounts. Therefore, two entities having very similar aspects (operations, market power, industry, sales, risk taking, etc.) may present two very different ways of financial reporting and they maybe valued differently by the interest holding parties. Assuming that the markets are efficient (all investors are rational, no assymetric information, etc.),two entities should be valued exactly the same by investors. However, we know that the markets are not perfectly efficient although we accept the efficiency partly, timely and locally. Not all investors have the same level of education, background and facilities to reach of information.

Unification of accounting and financial reporting standards serve to improve market efficiency. If the accounting treatment of economic events is set to be the same in all markets and countries, the information assymetry will mostly be eliminated among the investors and across markets. This may provide a basis to promote the mobility of capital and information assymetry among the investors and across the markets, and also this supports economic growth by unifying all financial markets in the world.

The differences of accounting standards in financial reporting may be categorized under the following areas: annual reporting, property, plant and equipment, consolidation, joint ventures, foreign currency translation, investment in debt and equity securities, leases, intangible assets, goodwill, research and development cost, advertising cost, contingencies, disclosures of financial instruments. The comparative accounting treatments under IAS, GAAP and TAS are discussed in the next section.

Annual Reporting

In IAS financial statements including balance sheets, income statements and cash flows and related footnotes need to be presented in annual reports in a comparable manner.

The GAAP requires that the information package given in US annual reports consists of:

- audited financial statements consisting of two year's balance sheets and three years'statements of income and cash flows and related footnotes.
- management's discussion and analysis of financial condition and results of operations for those three years.
- selected financial data for five years.

Information provided in the management's discussion and analysis must focus on the three key aspects of liquidity, capital resources and results of operations.

In TAS the public firms only require to present their financial statements including balance sheet and income statements. Presentation of all other financial statements is optional. In addition, any information related to balance sheet and income statements needs to be included in footnotes. However, management's discussions on related financial issues are also optional.

Property, Plant & Equipment (PP&P)

According to IAS, PP&E should be recognized when their future benefits are probable and their costs can be measured reliably. Initial measurement should be at cost. PP&E may be revalued:

- If an item of PP&E has been revalued, the entire class must be revalued.
- Revaluations should be credited to equity (revaluation surplus) unless reversing a previous charge to income.
- Decreases in valuation should be charged to income unless reversing aprevious credit to equity.

If the revalued asset is sold or disposed of, any remaining revaluation surplus is transferred directly to retained earnings (not through income statement). Gains or losses on retirement or disposal of an asset should be calculated by reference to the carrying amount.

The US GAAP generally requires strict adherence to the historical cost convention. It is not possible to revalue upwards property, plant and equipment.

In TAS revaluation of plant and equipment is possible, however, restricted to the predetermined revaluation rates by the Ministry of Finance. The increases through revaluation are reserved in a fund under equity section.

Consolidation

In IAS a subsidiary is defined as a company controlled by another firm (the parent). If a parent has one or more subsidiaries, consolidated financial statements are required. All subsidiaries must be included, unless control is temporary or if there are severe long-term restrictions on the transfer of funds from the subsidiary to the parent. Intragroup balances and transactions and resulting unrealized profits must be eliminated.

For consolidation of subsidiaries monetary balances should be translated at the closing rate, and non-monetary balances at the rate that relates to the valuation basis. Differences on monetary items should be taken to income, unless the amount is related to a net investment in a foreign entity, in which case they are reported in equity until the asset or liability is disposed of.

For the consolidation of investments in foreign firms, financial statements of foreign entity should be translated using closing rates for balance sheets and transactions rates for income and expenses. Differences should be taken directly to equity.

Due to GAAPif a company has one or more majority-owned subsidiaries, US GAAP requires consolidated financial statements. A majority owned subsidiary is defined as one in which the parent company has a controlling financial interest through direct or indirect ownership of a majority voting interest. A subsidiary is not to be consolidated If control by the parent is likely to be temporary or control doesn't rest with the majority owner. For example, if the subsidiary is in legal reorganization, or bankruptcy, or operates under foreign exchange restrictions so severe as to restrict the parent's ability to control the subsidiary is not to be consolidated.

By TAS consolidation for majority and minority-owned subsidiaries are not required.

Joint Ventures

In IAS joint venture is a contractual arrangement subject to joint control. IAS treats joint ventures in three different ways:

- jointly controlled ventures should be recognized by the venturer by including the assets and liabilities, expenses and incomes of the venture.

- jointly controlled assets should be recognized on a proportional basis.
- iointly controlled entities should be recognized in consolidated financial statements.

However, interest held for resale under severe long-term restrictions should be treated as investments.

According to GAAP an investment in a corporate joint venture is generally accounted for the equity method (recognizing as a separate item in the investor company's income statement its proportionate share of the investee's income or loss for the year). When the investment represents more than %50 of the voting stock of the corporate joint venture, the investment should be consolidated.

In TAS there is no specific accounting treatment for joint ventures.

Foreign Currency Translation

IAS treats that all accounts are classified as monetary and non-monetary accounts. Monetary items are translated at the current exchange rate while non-monetary items are translated at a rate of acquisition.

GAAP requires that if the parent company's currency is adapted as the functional currency, then it is necessary to re-measure the local currency into the functional currency using historical rates of exchange for non-monetary balance sheet items and the related income statement items (e.g. depreciation). The current (year-end) rate is used for monetary items. This approach is also necessary with highly inflationary economies, which the standard defines as those with "a cumulative inflation of approximately 100 % or more over 3 year period".

If the local currency is used as the functional currency, the financial statements are translated as follows:

Assets and Liabilities	⟹	Current (year-end) rate
Revenues, Expenses	⟹	Historical rate
Gains, Losses	⟹	(weighted average for the period)
Equity Accounts	⟹	Date of translation

The difference arising from translating the net assets is separately disclosed in the stockholders' equity section. When an investment in a foreign entity is wholly or partially sold, the appropriate amount in the translation adjustment relations to that investment is transferred to net income and included in the determination of gain or loss on the sale of the investment.

Exchange gains or losses on foreign currency transactions are required to be included in net income exceptions to this rule, which allows deferral of the difference, are:

- a forward exchange or other type of contract which effectively hedges a net investment in a foreign entity or a foreign currency commitment such as

forward purchase contracts.

- gains or losses attributable to inter-company balances that are of a long-term investment nature.

In TAS although the accounting treatment for translation of foreign currency is blurry, the current practice is to translate all items using the current rate.

Investment in Debt and Equity Securities

By IAS current investments should be valued at market or at the lower of cost and market. Long-term investments should be valued at cost, at revalued amount, or for marketable equity securities at the lower cost or market on a portfolio basis. Investments reclassified from current to long-term should be transferred at the lower of cost or market, or at market if they were previously stated at that value.

GAAP requires that the accounting treatment depends on the classification of the securities as held to maturity, trading or available for sale; the classification is based on the intent of management.

If securities classified as held to maturity, debt securities are carried at amortized cost. The cost basis of an individual security is written down to recognize any decline to fair value that is other than temporary. The amount of any write-down is charged against income, any recovery in value is not reserved.

Securities held principally for resale in the near term are classified as trading securities, and should be carried of fair value. Changes in fair value and realized gains and losses are included in the income statement.

According to TAS revaluation is possible for short-term security investments if carried at market. The revaluation increases and decreases are reserved in revaluation surplus (deficit) under equity section.

Leases

In IAS capital leases are those that transfer substantially all risks and rewards to the lessee. Lessee should capitalize a finance lease at the lower of the fair value and the present value of the minimum lease payment. Rental payments should be split into a reduction of liability and a finance charge designed to reduce in line with liability. Lessee should expense operating lease payments. For lessors, finance leases should be recorded as receivables.

The US GAAP imposes conditions in determining whether leases are classified as capital (finance) or operating leases. Capital leases include any leases which meet any one of the following four criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term.

- The lease contains an option to purchase the leased property at a bargain price.

- The lease term is equal to or greater than 75 % of the estimated economic life of the leased property.

- The present value of rental and other minimum lease payments equals or exceeds 90 % of the fair value of the leased property.

The third and fourth criteria are not applicable If the lease term commences in the final 25 % of the property's total estimated economic life. All other leases from the standpoint of the lessee are classified as operating leases.

Capital leases are recorded as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term subject to a fair value ceiling. The interest rate to be used for present value computations is the lower of the lessor's implicit rate used in the lease, if known to the lessee, and the lessee's incremental borrowing rates. The asset is amortized in accordance with the lessee's normal depreciation policies or over the lease term if shorter.

Rental payments on operating leases are charged to expense over the lease term as it is payable. Other disclosures by lessees regarding leasing include a general description of leasing arrangements, basis for contingent rentals, particulars of renewals or purchase options, escalation clauses, and restrictions imposed by leasing agreements such as dividends, additional debts and further leasing.

In TAS leasing agreements are not differentiated as capital and finance leasing. Therefore, leasing agreements are treated as off-balance sheet financing and the periodic lease payments are expensed.

Intangible Assets

According to IAS an intangible asset should be recognized initially, at cost, in financial statements if;

- The asset meets the definition of an intangible asset (there should be an identifiable asset that is controlled and clearly distinguishable from a firm's goodwill).

- It is probable that the future economic benefits that are attributable to the asset will flow to the firm.

- The cost of the asset can be measured reliably.

If an intangible does not meet the definition and the criteria, it must be expensed when it is incurred. After initial recognition in the financial statements, an intangible asset should be measured by:

- Historical cost less any amortization and impairment losses or

- Revalued amount less any subsequent amortization and impairment losses.

Revaluation of intangible assets are permitted only if value can be determined by reference to an active market though active markets are expected to be rare for intangible assets.

GAAPrequires that intangible assets acquired from others are recorded as assets. The costs to develop intangible assets are expensed if not specifically identifiable. The cost of all intangible assets must be amortized by systematic charge to income over the period estimated to be benefited, not exceeding 40 years.

In TAS intangible assets acquired form others are recorded as assets. Intangible assets are not subject to revaluation, carried at historical cost and amortized over 5 years.

Goodwill

By IAS any goodwill recognized must be amortized over its useful life but not more than 5 years unless longer (up to 20 years) can be justified.

In GAAP the excess of the purchase price over the values of the net assets acquired is defined to be goodwill, and must be capitalized as an intangible asset and must be amortized to the income statement over its estimated useful life but not more than 40 years. It is not permissible in US GAAP to write-off goodwill directly to reserves.

Any excess of the fair value of net assets acquired over cost is allocated to reduce proportionately the values assigned (negative goodwill.) to non-current assets expect long-term investments in marketable securities and any other long-term assets expected to be liquidated in the near term. After reduction of non-current assets to zero, any remaining excess value is classified as a deferred credit and systematically amortized to income over the period benefited but not exceeding 40 years.

In TAS goodwill may only be recognized in acquisitions and amortized in a period of maximum 5 years.

Research and Development Costs

In IAS all expenditures on research costs should be recognized as an expense. However, if some development expenditures (e.g. internally developed computer software) may result in the recognition of an intangible asset.

Development costs are expensed until the project is deemed technically and economically feasible and also the firm intends to proceed, then the following costs should be capitalized. Capitalized development costs should be amortized on a systematic basis reflecting the pattern of recognition of benefits. The balance should be written down when no longer recoverable.

GAAP requires that research and development costs are charged to expense as incurred unless those are related to activities conducted for others. The costs of intangibles purchased from others for use in research and development activities, which have alternative future uses, are on exception to the immediate write-of rule. Such costs are capitalized and amortized as intangible assets not exceeding 40 years.

In TAS research and development costs are expensed in the current period. If the benefits of the research & development are expected to last in coming years, the cost may be capitalized.

Advertising Costs

According to IAS all expenditures on advertising costs should be recognized as an expense.

In GAAP the cost of advertising should be expensed either as incurred or the first-time the advertising takes place except for certain direct-response advertising. For example, The cost of the first public showing of a television commercial and the first appearance of a magazine advertisement should be expensed. The accounting policy selected from the two alternatives should be consistently applied to similar kinds of advertising activities. The cost of direct-response advertising (e.g. catalogues, telemarketing and direct mail) should be capitalized as assets where the primary purpose is to elicit sales to customers who could be shown to have responded specifically advertisement, and the advertising results in probable future economic benefits (e.g. probable future revenue exceeds future costs). The costs are amortized over the period during which the future benefits are expected to be received.

By TAS all costs on advertising may be expensed in the current period. If the benefits of advertising are expected to last in coming years, the cost may be capitalized.

Contingencies

In IAS footnote disclosures are required for contingencies . According to GAAPloss contingencies must be categorized as probable, reasonably possible or remote. If probable, then provision must be made and charged in the income statement of the year in which the loss contingency becomes probable if the amount of loss can be reasonably determined. If it cannot be reasonably determined, note disclosure is required. If the loss contingency is reasonably possible, provision should not be made but note disclosure should be given including estimation of amounts or range of possible amounts. If the loss contingency is remote, then no disclosure needs be made.

In TAS contingencies which possibly affect the financial position of the entity need to be disclosed in footnotes.

Disclosures of Financial Instruments

By IAS information related to financial instruments need to be disclosed in financial statements concerning interest rate risk (repricing, maturity dates, fixed and floating interest rates), credit risk (maximum exposure and significant concentration), fair values, hedges of anticipated transactions, terms and conditions.

The US GAAP focuses on information about the extent, nature and terms of financial instruments with off balance sheet risk of accounting loss and on information about concentrations of credit risk for all financial instruments.

All entities are required to disclose the following information for financial instruments with off-balance sheet risk.

- The face or contract amount.

- The nature and terms of the instruments including a discussion of the credit and market risk, the cash requirements and the accounting policy used.
- The accounting loss the entity would incur if any counterparty to the financial instrument failed completely to perform according to the terms of the contract.
- The entity's policy for reducing collateral on financial instruments it accepts and a brief description of collateral on instruments presently held.

The second part of the disclosure on financial instruments focuses primarily on disclosures about fair values and includes:

- Fair value of all financial instruments for which it is practicable to estimate the value
- Methods and significant assumptions used to estimate fair value
- When fair value is not disclosed, the reasons why it is not practicable to estimate fair value together with certain information pertinent to estimating fair value such as effective interest rate and maturity rate.

In TAS footnote disclosures are required for financial instruments whether revalued or carried at cost. If carried at cost, the current market values and amounts of securities are displayed. If carried at market, the revaluation differences, reference for market value and amounts of securities need to be presented. Credit, interest and market risk discussions are not required.

CONCLUSION

The preparation of financial statements under different accounting standards creates information asymmetry among the investors and it eventually handicaps the development of financial markets and economic growth. The unification of accounting treatments for the same economic events and reporting of the true financial position of entities will serve as an useful tool to increase market efficiency.

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