

T.C.  
DOKUZ EYLÜL ÜNİVERSİTESİ  
SOSYAL BİLİMLER ENSTİTÜSÜ  
İNGİLİZCE İŞLETME ANABİLİM DALI  
İNGİLİZCE İŞLETME YÖNETİMİ PROGRAMI  
YÜKSEK LİSANS TEZİ

**TAS 23 BORROWING COSTS AND TAS 2  
INVENTORIES: THE COMPARISON OF THE  
STANDARDS WITH THE TURKISH TAX  
PROCEDURAL LAW**

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2010

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## ÖZET

**Yüksek Lisans Tezi**  
**TMS 23 Borçlanma Maliyetleri ve TMS 2 Stoklar: Standartların Türk**  
**Vergi Usul Kanunu ile Karşılaştırılması**  
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Son yıllarda, küreselleşme nedeniyle artan doğrudan yabancı yatırımlar ve sermaye hareketleri, güvenilir ve karşılaştırılabilir finansal tablolara olan ihtiyacı artırdı. Bu ihtiyacı karşılamak amacıyla IASB, yüksek kaliteli ve güvenilir Uluslararası Muhasebe Standartlarını (UMS/UFRS) hazırlayıp, yayınlamaktadır. Türkiye’de, Türkiye Muhasebe Standartları Kurulu, (TMSK) UMS/UFRS ile birebir uyumlu Türkiye Muhasebe Standartlarını (TMS/TFRS) oluşturma stratejisi izlemektedir.

İşletmeler için küreselleşmenin etkilerinden bir tanesi de artan rekabettir. İşletmeler bu sert rekabet ortamının üstesinden gelebilmek için makineler, teçhizatlar veya tesisler gibi yeni yatırımlara ihtiyaç duymaktadır. Bu yatırımların finansmanı genellikle yabancı kaynaklarla sağlanmakta, bu durum ise borçlanma maliyetlerinin muhasebeleştirilmesinin önemini artırmaktadır. Öte yandan stokların değerlendirilmesi; stokların eksik ya da fazla değerlendirilmesinin doğrudan net geliri ve böylece vergilemeyi etkilemesi nedeniyle, her zaman muhasebenin önemli ve tartışmalı konularından biri olmuştur. Borçlanma maliyetlerinin ve stokların değerlendirilme ve vergileme sürecindeki bu önemleri nedeniyle, bu çalışmanın amacı; TMSK tarafından yayımlanan Standartlardan ikisi; TMS 23 Borçlanma Maliyetleri ve TMS 2 Stoklar Standartlarını ve bunların hükümleri ile Vergi Usul Kanunu çerçevesinde Türkiye’de mevcut vergi ve muhasebe uygulamalarını karşılaştırmalı analiz yöntemi izleyerek analiz etmektir.

**Anahtar Kelimeler:** 1)TMS/TFRS 2)Borçlanma Maliyetleri 3)Stoklar 4) Değerleme

## **ABSTRACT**

**Master with Thesis**

**TAS 23 Borrowing Costs and TAS 2 Inventories: The Comparison of  
the Standards with the Turkish Tax Procedural Law**

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**In recent years, with the increasing foreign direct investments and capital movements due to globalization, the need for reliable and comparable financial statements has increased. So as to meet this need, IASB formulated and published high quality and reliable International Accounting Standards (IAS/IFRSs). In Turkey, Turkish Accounting Standards Board (TASB) has followed the strategy of setting Turkish Accounting Standards (TAS/TFRSs) fully compliant with IAS/IFRSs.**

**One of the effects of globalization for entities is increasing competition. The entities need new investments such as machines, plants or facilities to overcome this severe competition. The financing of these investments generally done by external resources and this has increased the importance of accounting of borrowing costs. On the other hand, the valuation of inventory has always been one of the important and controversial issues of accounting because overvaluation or undervaluation of inventories influences directly net income and so taxation. Because of this importance of the borrowing costs and inventories in the valuation and taxation process, this study aims to analyze two of the Standards that are published by TASB; TAS 23 Borrowing Costs and TAS 2 Inventories and the differences between their Articles and present tax and accounting applications in Turkey based on Tax Procedural Law (TPL) by following a comparative analysis method.**

**Key words:** 1) TAS/TFRS 2) Borrowing Costs 3) Inventories 4) Valuation

**TAS 23 BORROWING COSTS AND TAS 2 INVENTORIES: THE  
COMPARISON OF THE STANDARDS WITH THE TURKISH  
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## LIST OF ABBREVIATIONS

<b>BRSA</b>	Banking Regulation and Supervision Agency
<b>CMB</b>	Capital Markets Board
<b>EU</b>	European Union
<b>FASB</b>	Financial Accounting Standards Board
<b>FIFO</b>	First-in, First-out
<b>IAS</b>	International Accounting Standards
<b>IASB</b>	International Accounting Standard Board
<b>IASC</b>	International Accounting Standards Committee
<b>IASF</b>	International Accounting Standards Committee Foundation
<b>IFAC</b>	International Federation of Accountants
<b>IFRIC</b>	International Financial Reporting Interpretations Committee
<b>IFRS</b>	International Financial Reporting Standards
<b>IOSCO</b>	International Organization of Securities Commissions
<b>LIFO</b>	Last-in, Last-out
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>SAC</b>	Standard Advisory Council
<b>SEC</b>	Securities and Exchange Commission
<b>SME</b>	Small and Medium Sized Enterprises
<b>TAASC</b>	Turkish Accounting and Audit Standards Board
<b>TAS</b>	Turkish Accounting Standards
<b>TASB</b>	Turkish Accounting Standards Board
<b>TCC</b>	Turkish Commercial Code
<b>TFRS</b>	Turkish Financial Reporting Standards
<b>TPL</b>	Tax Procedural Law
<b>TÜRMOB</b>	Professional Chambers and Union of Chambers of Certified Public Accountants of Turkey
<b>UN</b>	United Nations
<b>USGAAP</b>	United States Generally Accepted Accounting Principles

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## **INTRODUCTION**

The number of the entities that use accounting information has increased considerably with the globalization of capital markets and rapid evolution of international trade. This has created a need for producing reliable and comparable accounting information systems which has been a catalyst for setting global accounting standards.

In a historical perspective, first, national accounting standards have been developed but in time, stakeholders have understood the fact that these standards are useful when all investment activities take place in national context; however, in a rapidly globalized world where economies are mutually dependent, these national standards are not enough to meet their needs. Therefore, the demand for high quality accounting standards that are based on global accounting rules, has increased recently. This unavoidably led to a campaign to harmonize different national accounting standards all over the world. Several organizations and institutions such as International Accounting Standards Board (IASB), European Union (EU) and United Nations (UN) have involved in this process of harmonization or standardization of accounting standards. However IASB, which has formulated and published high quality, understandable and enforceable global financial accounting standards known as International Accounting Standards (IAS) and recently International Financial Reporting Standards (IFRS), is generally accepted as the most influential actor of this process.

Turkey, as a developing country, which wants to be a full member of EU, in order not to being different to the developments in international accounting environment, has conducted important studies concerning the purposes of developing accounting standards that are in conformity with IAS/IFRSs. The efforts of Capital Markets Board, the establishment of Turkish Accounting and Audit Standards Board and then Turkish Accounting Standards Board (TASB) are some of the important steps in this process. TASB which has public entity, administrative and financial autonomy, aims to develop national accounting standards that are in favor of public



interest to achieve reliable, comparable and understandable financial statements. Two of these Standards that are issued by TASB are “Turkish Accounting Standards 23 Borrowing Costs” (TAS 23) and “Turkish Accounting Standards 2 Inventories” (TAS 2). TAS 23 aims to establish rules for recognizing (accounting of) borrowing costs. TAS 2 aims to prescribe the accounting treatment for inventories. This study aims to analyze deeply these two Standards and to determine the differences between the present tax and accounting applications in Turkey based on Tax Procedural Law (TPL) and the Articles of the Standards by following a comparative analysis method.

Our study consists of four parts. In the first part, a theoretical basis for the evolution of International Accounting Standards and Turkish Accounting Standards is covered. Some important questions such as why harmonization of accounting standards is crucial, should national accounting standards be harmonized to a global level or left alone, should developing countries adopt the same accounting standards as those used in highly developed countries or should small and medium sized enterprises be subject to the same standards with the larger ones, is discussed. The institutions that are effective in the setting of global accounting standards are mentioned. Importantly, obstacles to harmonization of accounting standards and problems in the application of IAS (IFRS) by different countries are analyzed. In addition to these, a comprehensive covering of the development of Financial Reporting Standards in Turkey is provided in this part.

In the second and third parts of our study, a deep analysis of TAS 23 Borrowing Costs and TAS 2 Inventories Standards is made subsequently. In order to provide the reader with a clear understanding of the Paragraphs of the Standards, comprehensive application examples are given in these two parts. Since, Turkey face with the problem of the lack of education and professional training in line with the TAS/TFRSs, the author of this thesis hopes that the study will make a contribution for both literature and accounting professionals.

In the fourth part of the study, the differences between the present tax and accounting applications in Turkey based on Tax Procedural Law (TPL) and the Articles of the TAS 23 and TAS 2 is analyzed by following a comparative analysis method.

## **FIRST PART**

### **THE EVOLUTION OF INTERNATIONAL ACCOUNTING STANDARDS AND TURKISH ACCOUNTING STANDARDS**

#### **1.1. The Definition and Objectives of Accounting Standards**

Accounting is a service activity that provides useful financial information about economic entities to interested parties, such as managers, investors and creditors. (Chasteen, Flaherty and O'Connor, 1998: 2) A business enterprise has an obligation to keep its capital providers informed about the entity's performance, condition and prospects. In other words, the business is accountable to its investors and creditors but in fact it is also accountable to others who provide resources or an environment in which to operate, such as employees, governments and the community at large. (Alfredson et al., 2005: 4) Nowadays academicians use the term of "stakeholders"<sup>1</sup> rather than "stockholders" to reflect this issue.

In recent years with the growing level of global capitalized markets and rapid evolution of international trade, the number of people that use accounting information has unavoidably increased. (Duman, 2007: 1) Indeed, global investors need reliable, understandable and comparable information if they are to make efficient capital allocation decisions. (Brouwer, 2005: 4) This need of producing more reliable and comparable accounting information systems and practices led to setting accounting standards.

Accounting standards that are developed from accounting principles are the rules that manage accounting applications and preparation of the financial statements and financial reports.

Young (2003: 621) describes "accounting standard-setting" as a process, an exercise in sense-making, which constructs (at least temporarily) accounting facts by including and excluding particular matters, transactions and objects within the

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<sup>1</sup> Stakeholders represent any group or individuals who can affect or is affected by the achievement of the organization objectives. (Deaconu, Nistor and Popa, 2009: 39)

financial statements. By the means of inclusion via measurement and disclosure, importance and relevance are assigned to some matters and objects; and through exclusion, immaterial and insignificant issues are determined.

In a historical perspective, the rules for what kind of information should be provided within the financial statements and reports and the format that information should take, have reflected differences among countries but despite the existence of differences, a mechanism for developing and adopting accounting standards had been established in most countries. In some cases, standard setting has been the responsibility of the public accounting profession, with enforcement of the standards often achieved by law or government regulation. For instance, accounting standards are set by the private sector professional accountancy organization in Austria, Brazil, Canada, Sweden, Italy, the Netherlands, New Zealand and South Africa. In other examples, standard setting has been the responsibility of the government. For example, there are government sponsored accounting standards boards in Argentina, China, France, Finland, Malaysia, Poland and Greece. (Alfredson et al., 2005: 4) In some countries such as United States and Germany, a private sector standard setter has been established that is independent of the public accounting profession but these are generally under close investigation of government bodies as in the example of the relationship between Financial Accounting Standards Board (FASB) and Securities and Exchange Commission (SEC) in the United States.

In any way, national accounting standards have been useful for stakeholders when all investment and other related economic activities take place in home countries but as mentioned above, in a rapidly globalized world in which interdependence of the capital markets is unavoidable, stakeholders but especially investment community and accounting profession realized the need for and the importance of an effort in the development of international accounting standards and a common global accounting language.

## 1.2. The Importance of Setting Global (International) Accounting Standards

As Berberoğlu (2002: 4-12) discuss substantial differences can be observed from one country to another in financial accounting and reporting practices due to differences in legal environment, taxation systems, economic and cultural structures and the level of economic development. As Zeghal and Mhedhbi (2006: 376) emphasize, a particular country's choice of a specific set of accounting standards, policies, and practices is the result of an interactive process among a number of environmental factors. They quote from Cooke and Wallace's (1990) study "Financial Disclosure and Regulation and Its Environment" that these factors could be internal as well as external. They could include factors such as economic growth and the level of wealth, the level of inflation, the education level, the legal system<sup>2</sup>, the country's history and geography, the financial system, the size and complexity of business enterprises, the notoriety of the accounting profession, the development of financial markets, sources of investment and financing, accidents of history<sup>3</sup> and the predominant culture and language. They may also include the existence of a colonial link<sup>4</sup>, the presence of multinational enterprises, the significant importance of foreign investment and financing, the degree of openness to foreign markets, the signing of international agreements, and the presence of international accounting firms.

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<sup>2</sup> There exist two main legal systems; common law and code law. In common law countries (these are Anglo-Saxon originated countries; The USA, The UK, Australia..) the aim of financial reporting is a fair representation of the financial situation of the company. In the UK this is translated into "true and fair view" concept. In code law countries (France, Germany and Italy...) financial reporting is focused on compliance with the legal requirements and tax laws. (Alexander, Britton and Jorissen, 2007: 35)

<sup>3</sup> Company failure scandals especially in the USA in the 1920s and 1930s and in the UK in the 1960s and 1980s, had a deep impact on financial reporting in these countries. In the USA the Securities and Exchange Commission was established to control listed companies, with responsibility to ensure adequate disclosure in annual accounts. An increasing control over the form and content of financial statements through improvements in the accounting standard setting process has evolved from the difficulties that arose in the UK. (Elliot B. and Elliot J., 2009: 142)

<sup>4</sup> "For instance in the South Pacific Zone; Fiji, Papua New Guinea and most other South Pacific Island countries legal and accounting systems bear the marks of their colonial experiences. In many cases this legacy is English–Australian–New Zealand in origin (for example, Kiribati, Samoa and Solomon Islands), though French (for example, New Caledonia) and United States (for example, Marshall Islands) influence is also marked in a small number of nations." (Chand and Patel, 2008: 89)

Most countries fall generally into one of two general groups. In countries such as France, Germany and Japan, businesses obtain their financial resources largely from borrowing. In these countries, we generally observe small auditing profession and tax domination of accounting rules. (Nobes and Parker, 2004: 22) In countries such as the United States, the United Kingdom, Australia and the Netherlands, businesses more often obtain financial resources from equity transactions. These countries known as Anglo-Saxon Group are capital market and shareholder oriented. (Delvaille, Ebbers and Chiara, 2005: 138) In these countries accounting practices tend to be less conservative and relatively independent of tax rules; some private sector body usually responsible for standard setting. (Chasteen, Flaherty and O'Connor, 1998: 17)

The differences mentioned above can have dramatic effects on the numbers presented in the financial statements. For instance, the financial crisis in late 1990's in Korea and the accompanying dramatic drop in prices for Korean stocks focused attention on this country's accounting rules. (Libby R., Libby P. and Short, 2001: 23) The Asian Wall Street Journal reported the following: "Had it used the U.S. accounting guidelines, Korea Telecom would have taken a big hit in 1997; recording a loss of 201 Billion won rather than 11 Billion won in net earnings it reported using Korean guidelines. But it would have reported that net earnings bounced back to 388 Billion won in 1998, compared with the gain of 195 billion won it reported using Korean guidelines. The big difference is largely because of foreign currency swings, which are reported differently in the U.S." (The Asian Wall Street Journal, 1999: 13) Two other examples are that in 1993 Hoechst AG revealed 1.212 Million USD of profits under the International Accounting Standards, while its gains calculated in accordance with the US GAAP amounted only to 625 Million USD. According to the French accounting regulations, in 1996 the Euro Disney Company registered a profit of 202 Million FF, whereas according to the US GAAP its profits surged to 1.021 Million FF. (Maliszewska and Maliszewski, 2008: 44)

As seen above, differences in accounting practices among countries can be observed due to political, social, economic and legal bases and can have dramatic impacts. However, the globalization<sup>5</sup> process leads the interdependence of markets and companies and this unavoidably has increased the demand for high quality accounting standards which is based on global accounting rules. As Maliszewska and Maliszewski (2008: 41) states the deepening of international trade and services, the increasing number of cross-border mergers and acquisitions, the liberalization of restrictions imposed on cross-border capital flows are some reflections of this process.

All these developments have led to a growing campaign to harmonize the different accounting standards all over the world and over the last several years the international accounting movement has gained momentum. In 2001, the International Accounting Standards Committee was reorganized into the International Accounting Standards Board. A major step occurred when the European Union adopted a regulation requiring most publicly traded EU companies to use the IFRS starting in 2005. Some non-EU countries have also replaced their national standards with IFRSs, while others like the United States have publicly indicated their intention to converge their standards with IFRSs. (Hines, 2007: 24) As the IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) declares more than 100 countries now require or permit the use of IFRSs or are converging with the International Accounting Standards Board's (IASB) standards. Many smaller countries have stopped developing national standards altogether, relying instead on IAS's as their national GAAP. Examples include Bahrain, Croatia, Cyprus, the Dominican Republic, Ecuador, Egypt (listed companies only); Haiti, Kenya, Malta, Nepal, Oman, Panama, Tajikistan, United Arab Emirates (banks only) and Venezuela. In China, some listed companies must prepare IAS financial statements for investors while still preparing Chinese GAAP statements for government purposes. (Alfredson et al., 2005: 10) Several other intergovernmental, regional or professional organizations too are involved in attempts to harmonize or standardize accounting standards. Market

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<sup>5</sup> Some authors argue that by globalization, the world has become a "global village".

forces also contribute to harmonization the reason of which will be clear in the following paragraphs of this section.

### **1.2.1. The Definitions of Harmonization and Standardization**

Harmonization or standardization has been defined in several studies as:

Murphy (2000: 475) by quoting from (Van Hulle, 1989) states that harmonization is the coordination of pre-existing rules of a different and sometimes conflicting nature.

*“Harmonization is a process of increasing the comparability of accounting practices by setting bounds to their degree of variation. Standardization appears to imply the imposition of a more rigid and narrow set of rules. However, within accounting, these two words have almost become technical terms, and one cannot rely upon the normal difference in their meanings. “Harmonization” is a word that tends to be associated with the transnational legislation emanating from the European Union, “standardization” is a word often associated with the International Accounting Standards Committee.” (Nobes and Parker, 2004: 66)*

*“Standardization advocates the setting out of rules for accounting for similar items in all countries. Harmonization is less radical in that it allows for some different national approaches but provides a common framework so that major issues will be dealt with in similar ways across national borders. As efforts to improve comparability of financial statements have increased, these two approaches have come closer together.” (Elliot B. and Elliot J., 2009: 142)*

*“Standardization generally means the imposition of a rigid and narrow set of rules, and may even apply a single Standard or rule to all situations. Standardization does not accommodate national differences and, therefore is more difficult to implement internationally. Harmonization is much more flexible and open; it does not take a one-size-fits-all approach, but accommodates national differences and has made a great deal of progress internationally in recent years.” (Choi, Frost and Meek, 2002: 291)*



“Harmonization is a process. Harmony is a state, which will also be referred to as a level. When the degree of concentration for an accounting method increases the state of harmony increases and harmonization has occurred.” (Murphy, 2000: 475)

As can be seen above, although there exist some differences with the meanings of standardization and harmonization of accounting standards, most academicians use these words interchangeably as they see the difference slight. Standardization is more related to setting global accounting standards set and a global financial reporting language. Harmonization less radically refers more to a process of increasing the comparability of accounting practices and lower degree of variation internationally. I will also use these terms interchangeably in the following parts of this study.

### **1.3. Who Puts Pressure for Global Accounting Standards**

The pressure for international harmonization comes mainly from -creditors, investors and financial analysts who use the financial statements in their multi-purpose decision making process; -companies operating multinationally (in fact, in a highly globalized world, with increasing competition, almost all companies over the world seek for international trade opportunities); - international accountancy firms and unavoidably -tax authorities (government). The goal is to have a coherent set of accounting standards and practices that provide national and international decision makers with a relatively homogenous information product which is comparable and reliable.

#### **1.3.1. Creditors and Investors**

Creditors and investors have become increasingly frustrated that the financial statements of companies in different countries cannot be compared. (Hines, 2007: 24) Especially, after the Asian Financial Crisis during the late 1990's, investors and creditors have started to emphasize more on the reliability of the financial statements and financial reporting procedures of the countries in which they intend to invest.

(Özkök, 2000: 87) They also need confidence in the soundness of the auditing. (Nobes and Parker, 2004: 74) By the establishment of global accounting standards, increased credibility of domestic capital markets to foreign capital providers and potential foreign merger partners and increased credibility to potential lenders of financial statements from companies in less developed countries will be beneficial to investment community. (Alfredson et al., 2005: 6) Indeed, informed investors are an important ingredient of liquid and stable capital markets. (Lewitt, 1998: 79)

### **1.3.2. International (Transnational) Companies**

In an increasingly interconnected world, the operations of international corporations are transnational. In addition more and more investing takes place on a global level. (Hines, 2007: 4) For these large companies seeking capital worldwide, their location no longer played a significant role in the choice of the accounting rules or principles to be applied in their annual accounts. Much more important was the fact that these companies wanted to make an appeal on the international capital market. (Alexander, Britton and Jorissen, 2007: 35) Although the leading companies still have a strong national home base, for many companies especially from smaller countries like Switzerland or Scandinavia, the importance of the home market is almost negligible. For example, the 1998 net sales of Nokia in its Finland home market have been only 3.5 percent of total sales. (Gebhardt, 2000: 1). As Nobes and Parker (2004: 74) states, for multinational companies the advantages of harmonization is obvious. The great effort of financial accountants to prepare and consolidate financial statements would be much simplified if statements from all around the world were prepared on the same basis. The appraisal of foreign companies for potential takeovers would also be greatly facilitated. Multinational companies would also find it easier to transfer accounting staff from one country to another. Nobes especially stress on the fact that if accounting can be made more comparable and reliable, the cost of capital should be brought down by reducing the risk of investors. As discussed in a research monograph prepared by Street and Gray (2002: 51-72), there are higher levels of compliance for companies based outside United States, for instance Switzerland and China, possibly because of the need to do more to

overcome perceptions relating to their traditional national accounting models and to be viewed as acceptable to the international investment community. For the companies operating in these countries, converting to IFRS is often a costly and time consuming process but many of them are discovering that conversion improves access to capital, reduces the cost of raising capital and increases shareholder relations. (Alp and Üstündağ, 2009: 683, with reference to Hansen, 2007)

### **1.3.3. International Accounting Firms**

Big international accounting firms support and put pressure for harmonization process too, owing to the fact that this will facilitate their work on international basis and reduce their costs especially within the large clients.

### **1.3.4. Tax Authorities**

Internalization of accounting standards takes support from tax authorities too for several reasons. First of all, tax authorities can more easily detect harmful transfer pricing practices of companies that operate transnationally and by the way they can prevent tax evasion. Moreover, the authorities can more easily determine the tax responsibilities of foreign investors.

## **1.4. Criticisms of International Accounting Standards**

Despite, the growing campaign for the establishment of global international accounting standards and a common financial reporting language by the interested parties (stakeholders), which evaluated deeply above paragraphs, I should emphasize that there have existed some criticisms of global accounting standards too. It has been claimed that accounting, as a social science, has built-in-flexibility and that its ability to adapt to widely different situations is one of its more important values. It was doubted that international standards could be flexible enough to handle differences in national backgrounds, traditions and economic environments. In addition to this some observers have argued that international accounting standard setting is essentially a tactic of the large international accounting service firms to

expand their markets. Moreover, several authors stated that adoption of international standards may create “standards overload”. Corporations must respond to an ever-growing array of national, social, political and economic pressures and are hard to put comply with additional complex and costly international requirements. (Choi, Frost and Meek, 2002: 293)

The debate whether the harmonization (standardization or internalization) of accounting standards is necessary may continue in the near future. Some arguments against harmonization have merit. However, increasing evidence shows that the goal of international harmonization of accounting, disclosure, and auditing has been so widely accepted that the trend towards international harmonization will accelerate. Indeed as Choi, Frost and Meek (2002: 295) argue that national differences in the underlying factors that lead to variation in accounting, disclosure and auditing practice are narrowing as capital and product markets become more international. Increasing number of companies is deciding that the use of International Accounting Standards is in their interest even if it is not required. It has been argued that a common set of practices will provide a “level playing field” for all companies worldwide. (Murphy, 2000: 471) Many countries allow companies to base their financial statements on IAS and some require it.

To conclude this title I want to say that efforts to achieve international accounting harmonization have experienced several critical debates. Should national accounting standards be harmonized to a global level or left alone? Should developing countries adopt the same accounting standards as those used in highly developed countries? Should small and medium sized enterprises be subject to the same standards with the larger ones? In the following sections of this part, I will try to focus on some of these debates.

### **1.5. The Debate over the Adoption of IAS/IFRSs by Developing Countries and the Factors Affecting This Process**

The adoption of IAS by developing countries has always been the subject of controversy in accounting literature. According to Zeghal and Mhedhbi (2006: 375)

two schools of thought exist. The first supports the adoption of international standards in the developing countries because harmonization of international accounting enhances the quality of financial information; it improves the comparability of accounting information in the international milieu; it facilitates financial operations on an international scale, and thus contributes to a better globalization of capital markets. Zeghal and Mhedhbi (2006: 375) by quoting from Wolk, Francis, and Tearney (1989) argues that international accounting harmonization is beneficial for developing countries because it provides them with better-prepared standards as well as the best quality accounting framework and principles.

The second school of thought insists that consideration of each country's specific environmental factors is necessary when establishing a national accounting system. Talaga and Ndubizu (1989) stressed that a country's accounting principles must be adapted to its local environmental conditions. In fact, the accounting information produced according to developed countries' accounting systems is not relevant to the decision models of less-developed countries. These arguments, and others, have led some authors to strongly oppose the adoption of IAS by developing countries. (Zeghal and Mhedhbi, 2006: 375)

There exist several studies that emphasize on the factors affecting the adoption of IAS by developing countries. Zeghal and Mhedhbi (2006: 373-386) researched factors that are capable of influencing the adoption of IAS. In applying logistic regression to a sample comprising 64 developing countries, they concluded that education level, existence of a financial market, and cultural membership are factors that are positively and significantly tied to the adoption of IAS. No significant relationships are found, however, for economic growth and external economic openness. According to their results, they concluded that developing countries that enjoy the highest literacy rate, that have a well established capital market and that belong to an Anglo-American culture are the most motivated ones to adopt IAS. In another study, Adhikari and Tondkar (1992: 75-98) adopted a multivariate cross national approach to study the relationship between environmental factors and the

accounting disclosure requirements of stock exchanges in different countries. Among severally selected factors which have generally economic origin, they found a positive relationship between the size of equity market (the level of market capitalization) and the level of disclosure requirements as they expected. According to this result, the greater the size of equity market, the more developed and rigorous disclosure requirements. However, contrary to their expectations, no significant relationship was found between the degree of economic development and the level of disclosure requirements. According to the authors, one reason for the insignificance of this relationship may be that the degree of economic development (and other factors such as cultural, business and regulatory environments) is more useful in explaining variations in disclosure practices and requirements among countries with marked differences in the level of economic development.

## **1.6. International and Regional Institutions Working on Setting of IAS/IFRSs**

Many international bodies are involved in the process of harmonization or standardization of accounting standards. These have included organizations that may not be closely related to accounting such as United Nations and Organization for Economic Cooperation and Development (OECD). However, International Accounting Standard Board (IASB) (previously International Accounting Standards Committee, IASC) and European Union are generally accepted the most influential actors. The contribution of these bodies is described below.

### **1.6.1. International Accounting Standards Committee Foundation (IASCF)**

#### **1.6.1.1. Establishment and Aim**

As the IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) explains The IASC Foundation is an independent, not-for profit private sector organization working in the public interest. Its principal objectives are:

- to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB;
- to promote the use and rigorous application of those standards;
- to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and
- to bring about convergence of national accounting standards and IFRSs to high quality solutions.

The governance and oversight of the activities undertaken by the IASC Foundation and its standard-setting body rests with its Trustees, who are also responsible for safeguarding the independence of the IASB and ensuring the financing of the organization. The Trustees are publicly accountable to a Monitoring Board of public authorities.

#### **1.6.1.2. Organizational Structure**

IASCF consists of four main bodies; Trustees, Board, Standard Advisory Council (SAC) and International Financial Reporting Interpretations Committee (IFRIC).

##### **1.6.1.2.1. Trustees**

As the IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) explains the IASCF comprises twenty-two Trustees who promote the work of the International Accounting Standards Board (IASB) and the rigorous application of IFRSs but are not involved in any technical matters relating to the standards. This responsibility rests solely with the IASB.

Trustees are appointed for a renewable term of three years. Each Trustee is expected to have an understanding of, and be sensitive to, international issues relevant to the success of an international organization responsible for the development of high quality global accounting standards for use in the world's capital markets and by other users.

The main responsibilities of Trustees are to appoint the members of the Board, the Standing Interpretations Committee and the Standards Advisory Council, to monitor IASB's effectiveness, to raise its funds, to approve IASB's budget, to have responsibility for constitutional change. (Alexander, Britton and Jorissen, 2007: 42)

Uysal (2006: 104) criticizes the composition of Trustees as it has no egalitarian or democratic origin, and Trustees' claim of being based on continentally differentiated membership is not fair as the calculation is too simple. Moreover, the claim of having diversity in the background of members does not reflect a composition that deeply questions present applications and supports different point of views.

#### **1.6.1.2.2. International Accounting Standards Board**

Before focusing on the International Accounting Standards Board we shall first say some words about its predecessor; International Accounting Standards committee. (IASC)

Prior to the establishment of the IASB, international accounting standards were set by the IASC. As early as 1966, the professional accountancy bodies in Canada, the United Kingdom and the United States created the Accountants International Study Group (AISG) to develop comparative studies of accounting and auditing practices in the three countries in the hope that their respective accounting standards board would work towards the harmonization of any differences. In 1972, at the tenth World Congress of Accountants in Sydney, with the proposal of AISG countries and with the support of Australia, France, Germany, Japan, the Netherlands and Mexico, together the nine countries agreed to form IASC, and in 1973, the IASC opened its doors in London. (Alfredson et al., 2005: 7) This body existed from 1973 to 2001, and its membership consisted of major professional accounting bodies from around the world.



The IASC'S objectives were (IASC Constitution)

- To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance.
- To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

As Murphy (2000: 472) states by quoting from Epstein and Mirza (1997) the IASC's progress can be seen as taking place within three phases, (1) 1973-1988, development of a common body of standards; (2) 1989-1995, the comparability/improvements project; and (3) 1995-2000, the core standards project. The early development years were devoted to establishing and codifying a set of international standards. The comparability project was the result of criticism regarding the numerous alternatives allowed by the IASC standards. The comparability project resulted in the revision of 10 standards. The core standards project has been encouraged by the IOSCO. The efforts of this program focus on the development of high quality standards, which could be used for cross-border reporting.

Although it was productive, the IASC suffered from a number of shortcomings and the IASC voted to dissolve itself and to be replaced by the International Accounting Standards Board. Some perceived shortcomings of the IASC were: (Alfredson et al., 2005: 7)

- full-time workload but only a part-time board
- lack of convergence of IASs and major national GAAP after 25 years of trying.
- need for broader sponsorship than is provided by the accounting profession.

- shortage of resources, especially budgetary
- weak relationships with national standard setters

Recognizing these problems, in 1998 the committee began a comprehensive review of the IASC's structure and operations. That review was completed in 2000. The main recommendations of the structure review are shown below: (Alfredson et al., 2005: 14)

- The large, part time IASC should be replaced by a smaller and essentially full-time International Accounting Standards Board.
- The new IASB should operate under a broad-based IASC Foundation (IASCF) with trustees representing all regions of the world and all groups interested in financial accounting.
- The new IASB should have a Standards Advisory Council (SAC) to provide counsel to the board.
- The SIC should continue in a slightly modified form as the International Financial Reporting Interpretations Committee. (IFRIC)

After some debate, the proposals received rapid and widespread support. In May 2000, the IFAC unanimously approved the restructuring. The Constitution of the old IASC was revised to reflect the new structure.

The establishment of the IASB addressed and improved upon all the issues mentioned above. Membership was expanded, the budget was increased, more full-time staff members were added and an effort was made to establish better relationships with the different national standard setters. (Hines, 2007: 9)

While it was in existence, the IASC issued 41 standards, called International Accounting Standards (IAS). The International GAAP rules passed by the IASC were incorporated by the IASB. These rules remain in effect unless superseded by subsequent IASB Standards. (Hines, 2007: 9)

Having emphasized on IASC, predecessor of IASB, now we can focus on International Accounting Standards Board.

As the IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) explains the IASB is the independent standard-setting body of the IASC Foundation. Its members (currently 15 full-time members) are responsible for the development and publication of IFRSs including the IFRS for SMEs and for approving Interpretations of IFRSs as developed by the IFRIC. All meetings of the IASB are held in public and webcast. In fulfilling its standard-setting duties the IASB follows a thorough, open and transparent due process of which the publication of consultative documents, such as discussion papers and exposure drafts, for public comment is an important component. The IASB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

Differently from the procedure to be a member in Trustees which is based on geographical representation; the main qualification for appointment to the board is competence in profession and expertise international markets and businesses. (Uysal, 2006: 99)

The Board's main responsibilities are (IASB Constitution)

- to develop, in the public interest, a single set of high quality, understandable and enforceable global financial accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- to promote the use and rigorous application of those standards; and
- to bring about convergence of national accounting standards and International Accounting Standards to high quality solutions

The process of producing a new IFRS is similar to the process of some national accounting standard setters. Once a need for a standard has been identified, a steering committee is set up to identify the relevant issues and draft the standard. Drafts are produced at varying stages and are exposed to public scrutiny. Subsequent drafts take account of comments obtained during the exposure period. The final standard is approved by the Board and an effective date agreed. (Elliot B. and Elliot J., 2009: 142)

Donnelly (2007: 119-121) argues that between 2000 and July 2005, the IASB transformed itself from a collegial, private interest association dominated by accountants in common law countries and with cooperative links to other professional associations to a hierarchical, centralized international organization producing standards sanctioned by a number of securities regulators at the national, regional and international levels. It therefore has a significant and global impact on the way that company information is made public.

We can see some reflections of the increasing importance and influence of the IASB as a leader organization in setting global accounting standards. For instance, in 2002, the IASB and the Financial Accounting Standards Board (FASB) of United States launched the Short-Term Convergence Project as part of the Norwalk Agreement to cooperate on bringing standards closer together. Later, in 2006, the IASB and the FASB agreed a Memorandum of Understanding (MoU) that described a programme to achieve improvements in accounting standards, and substantial convergence between IFRSs and US generally accepted accounting principles (GAAP). The MoU was updated in 2008, and in November 2009 the two boards issued a further statement outlining steps for completing their convergence work by 2011. ([www.iasb.org](http://www.iasb.org), December 15, 2009)

Moreover as IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) states, in 2008, the IASB and the Accounting Standards Board of Japan (ASBJ) published a MoU, known as the Tokyo Agreement, which described work to achieve substantial convergence between IFRSs and Japanese GAAP by June 2011. In 2009 the

Japanese Business Accounting Council (BAC), a key advisory body to the Commissioner of the Japanese Financial Services Agency (FSA), approved a roadmap for the adoption of International Financial Reporting Standards (IFRSs) in Japan.

Most recently, at their September 2009 meeting in Pittsburgh, US, the Group of 20 Leaders (G20) reaffirmed their commitment to global convergence in accounting standards, calling on 'international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011. ([www.iasb.org](http://www.iasb.org), December 15, 2009)

#### **1.6.1.2.3. International Financial Reporting Interpretations Committee (IFRIC)**

As the IASB website ([www.iasb.org](http://www.iasb.org), December 15, 2009) explains, The IFRIC is the interpretative body of the IASB. The IFRIC comprises 14 voting members appointed by the Trustees and drawn from a variety of countries and professional backgrounds.<sup>6</sup> IFRIC meetings are open to the public and webcast. In developing interpretations, the IFRIC works closely with similar national committees and follows a transparent, thorough and open due process.

IFRIC's responsibilities are to: (Alfredson et al., 2005: 17)

- interpret the application of International Financial Reporting Standards (IFRS's) and provide timely guidance on financial reporting issues not specifically addressed in IFRSs or IASs, in the context of IASB framework, undertake other tasks at the request of the board.
- publish draft interpretations for public comment and consider comments made within a reasonable period before finalizing an interpretation

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<sup>6</sup> IFRIC members comprised mostly of technical partners in audit firms but also include preparers and users. (Epstein and Mirza, 2005: 5)

- report to the board and obtain board approval for final interpretations.

#### **1.6.1.2.4. Standards Advisory Council (SAC)**

As the IASB website explains ([www.iasb.org](http://www.iasb.org), December 15, 2009) The Standards Advisory Council (SAC) is the formal advisory body to the IASB and the Trustees of the IASC Foundation. It is comprised of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups that are affected by and interested in the IASB's work. Members of the SAC are appointed by the Trustees.

The members<sup>7</sup> are supposed to serve as a channel for communication between the IASB and its wider group of constituents, to suggest topics for the IASB's agenda, and to discuss IASB proposals. (Epstein and Mirza, 2005: 5)

The Council meets three times a year to advise the IASB on range of issues, including the IASB's agenda and work programme. The SAC also provides advice on single projects with a particular emphasis is on practical application and implementation issues, including matters relating to existing standards that may warrant consideration by the International Financial Reporting Interpretations Committee.

Some authors claim that SAC has no effective influence on the work of IASB. For instance, Donnelly (2007: 119-121) states that weak SAC influence over the Board has disappointed a number of its members. The IASB constitution requires there to be at least 30 members on the council to bring in a variety of viewpoints about the desirability and impact of measures proposed by the Board, and to suggest new ones where this is deemed necessary. Despite this, the SAC lacks institutionalized point of view non-financial reporting issues, such as director statements (also known as management commentaries) covering the company's

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<sup>7</sup> The SAC consists of about 40-50 members, nominated in their personal (not organizational) capacity, but are usually supported by organizations which have an interest in international reporting. (Epstein and Mirza, 2005: 5)

treatment of so-called stakeholder issues relating to employees, the community and the company's long-term strategy. This is considered as surprising by the author given the IASB's aim and intent to move into this area of reporting standards as a means of improving corporate governance through transparency.

### **1.6.2. International Federation of Accountants (IFAC)**

As the IFAC website ([www.ifac.org](http://www.ifac.org), December 18, 2009) explains The International Federation of Accountants was founded on October 7, 1977 in Munich, Germany at the 11th World Congress of Accountants.

The IFAC has a full time secretariat in New York and comprises an assembly of the same accountancy bodies as belong to the IASC. Its work includes the setting of international guidelines for auditing, ethics, education, management accounting and organizing the international congress every five years. (Nobes and Parker, 2004: 81)

IFAC was established to strengthen worldwide accountancy profession in the public interest by:

- developing high quality international standards and supporting their adoption and use;
- facilitating collaboration and cooperation among its member bodies;
- collaborating and cooperating with other international organizations; and
- serving as the international spokesperson for the accountancy profession

The relationship between the IASC and the International Federation of Accountants (IFAC) is one which causes much confusion and some tension. Both these difficulties can be overcome by recognizing that the IASC is an accounting standard setting body and IFAC represents the accountancy profession. The relationship worked well when this difference was understood and sometimes

worked badly when one or other organization attempted to usurp the other's role. (Cairns, 1997: 332-333)

Crucially, in a historical perspective, the IASC and IFAC agreed a set of mutual commitments under which IFAC recognized the IASC as the sole body having the responsibility and authority to issue, in its own name, pronouncements on international accounting standards with full authority. This has been an important step for the IASBs acceptance as the leader of global accounting standards setter.

### **1.6.3. International Organization of Securities Commissions (IOSCO)**

IOSCO is the representative body of the world's securities markets regulators, including the SEC in the US and about 100 similar organizations. As emphasized in different sections of this study high quality financial information is crucial to the operation of an efficient capital market. However, differences in the quality of the accounting policies among countries led to inefficiencies between markets. As regulators of capital markets, IOSCO members have a strong interest in financial reporting that is relevant, reliable, complete and transparent. (Alfredson et al., 2005: 8)

From the early 1990's, IOSCO took an active role in encouraging and promoting the improvement and quality of IAS's. IOSCO rather than establishing financial reporting standards itself followed a policy of support for the IASC efforts to set international accounting standards. In 1995, IOSCO and IASC formally agreed to work on a program of core standards that could be used by publicly listed enterprises when offering securities in foreign jurisdictions. This agreement was described as a milestone. Although there were some deficiencies of the agreement in disfavor of IASC, the one possible success for the IASC was the acknowledgement that the IASC, and not IOSCO, should be responsible for the interpretation of International Accounting Standards. (Cairns, 1997: 345-346)



The substance of the July 1995 agreement between the IASC and the IOSCO is that:

- The IOSCO technical committee had agreed that the IASC work programme will result, upon successful completion, in International Accounting Standards comprising a comprehensive core set of standards;
- Completion of comprehensive core standards that are acceptable to the technical committee will allow it to recommend endorsement of International Accounting Standards for cross border offerings and other foreign listings.

In May 2000, IOSCO recommended that its members permit the use of IASs by multinational issuers for cross-border offerings and listings. This is accepted as a major step for the elimination of the necessity for the multiple reporting. (Elliot B. and Elliot J., 2009: 148)

All these IOSCO'S cooperation efforts with the IASC and then IASB and its endorsement of the IASB's efforts are indicative of the growing support for the establishment of generally accepted International Accounting Standards.

#### **1.6.4. European Union**

The EU's strategy on accounting harmonization mainly based on the accounting directives and the demands of some of Europe's big companies to issue their securities and raise capital on international capital markets. The accounting directives have done much to improve and harmonize financial reporting in the European Union. (Cairns, 1997: 306-307) The main directives were the following ones:

- Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies (78/660/EEC),

- Seventh Council Directive of 13 June 1983 on consolidated accounts (83/349/EEC),
- Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC)
- Council Directive of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (91/674/EEC)

The adoption of these directives was a remarkable step in the process of financial reporting harmonization, as they brought about a certain level of financial statements comparability. However, they had some flaws as a tool of harmonization too. First of all, directives have some technical deficiencies. (Üstündağ, 2000: 51) Moreover, the preparers tried to preserve too many traditional national solutions and they did not come up with common rules for all the countries. (Maliszewska and Maliszewski, 2008: 44-45) A further problem is that compliance with the directives has been insufficient for those larger companies which wish to access international capital markets. (Cairns, 1997: 307) Moreover, the legislation process in the EU is long and complicated; hence, once accepted, the directives were not amended before 2001.

In the 1990's Europe's big companies faced some difficulties in internationalizing their financial reports. There was some disagreement on the accounting standards and other requirements which should be met in such reports. This problem has been experienced especially for companies which wished to list their securities or raise capital in the United States. European companies realized that traditional national approaches to financial reporting is inadequate in the face of demands of globalization and this led the capital markets increase their pressure on national and EU bodies for accounting reforms and for convergence with international financial accounting standards.

With the increasing pressure coming from business environment and capital markets, The EU bodies recognized that the Accounting Directives which provided

accounting rules for limited liability companies were not, in themselves, sufficient to meet the needs of companies raising capital on the international securities markets. There was a need for more detailed standards to meet the needs of business environment. (Elliot B. and Elliot J., 2009, 148)

The European Commission initially sought to persuade the American Securities and Exchange Commission (SEC) to support the mutual recognition of European financial statements prepared in accordance with the directives but the SEC was firmly opposed to such an idea. The only realistic option open to the EU was to lend its full support to the adoption of International Accounting Standards as the mutually acceptable standards of accounting and disclosure. (Cairns, 1997: 309)

In this way, the approach to financial reporting harmonization in the EU has changed. The IAS (and later the IFRS) was approved as the basis of standardization. The Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards was a true landmark in the process of financial reporting standardization. According to this regulation, all the companies, whose securities are traded on a regulated market within the EU, are obliged to prepare their consolidated financial reports in conformity with the IFRS starting from 2005. The directives also regulate matters that are outside the scope of the IFRS, including the management commentary and the audit of financial accounts. (Maliszewska and Maliszewski, 2008: 45-46)

Although the applications and the impacts are different and the processes vary in speed, in the big countries of Europe; France, Germany and Italy; the internalization of financial reporting has accelerated considerably especially as a result of the European Regulation requiring the application of IFRS for consolidated accounts of listed companies in 2005 that mentioned above. (Delvaille, Ebbers and Chiara, 2005: 138)

On the other hand, despite all these encouraging developments toward convergence of accounting standards in European zone, as Chand and Patel (2008:

85) states the EU has encountered a number of difficulties in their drive towards convergence. The major obstacles are the differences in the systems of developing and enforcing compliance with accounting standards, and the various cultural and economic disparities that exist in the respective countries of the European Union. Moreover, there exist uncertainties about the legal consequences of IFRS implementation on different concepts and computations related to enterprises (such as dividends, employee participation and incentives). (Delvaile, Ebbers and Chiara, 2005: 143) Therefore, as McCreevy (2006) stated in IASCF Conference in 6 April 2006:

*“European Union, in the short term, shall focus on two key issues: The first one is to ensure a stable platform for existing IFRS, so the new standards can be down and prove their worth and the second one to solve any problems of application or enforcement to ensure consistency in the standards throughout the EU.”*

#### **1.6.5. United Nations (UN)**

United Nations interested in the accounting developments especially from 1970's and its studies on accounting standards and financial reporting mainly based on the activities of multinational companies. (Üstündağ, 2000: 49)

UN founded an Intergovernmental Working Group of Experts of International Standards of Accounting and Reporting (ISAR). ISAR was created in 1982 and is the only intergovernmental working group devoted to accounting and auditing at the corporate level. Its specific mandate is to promote the harmonization of national accounting standards for enterprises. ISAR accomplishes its mandate by discussing and promulgating best practices, including those recommended by IASB. In recent years, ISAR focused on important topics that the other organizations were not yet ready to address, such as environmental accounting. (Choi, Frost and Meek, 2002: 291)

### **1.6.6. Organization for Economic Development and Co-operation (OECD)**

As the OECD website ([www.oecd.org](http://www.oecd.org), December 18, 2009) explains, OECD brings together the governments of countries committed to democracy and the market economy from around the world to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development and contribute to growth in world trade.

The Organization provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies.

As related to international accounting standards, OECD does not see itself as a standard setter but as a platform that promotes internalization of accounting standards and financial reporting language. With parallel to this stand, similar to UN position, it acts as an observer in the process of internalization of accounting standards. (Üstündağ, 2000: 50)

### **1.7. Road blocks to Convergence: Obstacles to Harmonization of Accounting Standards and Problems (Controversies) in the Application of IAS (IFRS)**

There have existed some obstacles to the harmonization of accounting standards and establishing a global reporting language. Moreover, some problems have been experienced during the implementation of IASs and currently IFRSs.

### **1.7.1. Differences in the Functions, Regulations and Practices of Accounting Systems within Countries**

To begin with, differences in the socio-economic functions of accounting led to differences in the process of regulation. As stated in the preceding sections of this study in common or case law countries such as USA and Australia, details of accounting regulation are delegated to governmental agencies such as SEC which in turn might delegate their authority to a private accounting standard setting body such as FASB. In countries with a tradition of code law, for instance France and Germany, commercial law and tax law contain detailed accounting rules.<sup>8</sup> The legislative bodies in those countries have been reluctant to delegate authority to the private standard setting bodies that were set up only recently in France and Germany. Both, the French and the German Accounting Standards Committees do not have the ultimate power to issue accounting rules but have to ask for governmental approval. Thus, legislators and governments in those countries are determined to retain control of the process of accounting regulation. (Gebhardt, 2000: 1-2)

There exist large differences between the accounting practices of different countries too, emphasized before in this study. For instance, Countries of North American Free Trade Agreement (NAFTA) and member countries of EU have accepted different accounting standards. NAFTA countries have accepted United States Generally Accepted Accounting Principles (USGAAP). USGAAP is rule based and this is the most significant feature that differs it from IAS or IFRS. Therefore, it has prepared too detailed. On the other hand, as mentioned before, EU zone follows IASBs IFRS. (Yalkın, Demir D. and Demir V., 2008: 59)

### **1.7.2. Nationalism**

Another significant obstacle is nationalism. This may show itself in an unwillingness to accept compromises that involve changing accounting practices towards those of other countries. This unwillingness may exist on the part of

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<sup>8</sup> Çiftçi and Erserim (2008: 235) points out the difficulties of these countries in transforming their tax based accounting systems to information based accounting systems.

accountants and companies or on the part of states who may not wish to lose their sovereignty. (Nobes and Parker, 2004: 68) As Gebhardt (2000: 1-2) states, it is difficult to imagine that legislators or standard setters of other countries delegate authority to a body dominated by another country.

### **1.7.3 Technical Problems**

Ayanoğlu (2007: 106) points out the technical problems related to the standards. She claims that the increasing complexity of the standards creates difficulties especially for the emerging and developing economies. For instance, fair value concept that is referred in many standards, though a useful and modern approach to disclosure of financial statements, is not easy to be calculated in the economies lacking efficient markets. In such a case mathematical calculations in order to achieve fair value requires an advanced level of information and technical expertise that cannot be seen always in emerging economies compared to developed ones. Moreover, translation of the standards to national languages creates problems for countries that are not accustomed to an advanced level of accounting practices.

### **1.7.4 The Problem of Unfamiliarity**

As Nobes and Parker (2004: 68) and Chand and Patel (2008: 87-90) argue the lack of strong professional accountancy bodies in some countries blocks to convergence too. Lack of a well-defined and comprehensive set of accounting standards and an active independent regulator to facilitate the implementation and enforcement of accounting standards in some countries, has created the problem of unfamiliarity. This problem of unfamiliarity has been experienced greater in countries where the IAS approach is very different from the domestic tradition. These countries face a larger problem in terms of familiarization which has to be overcome through training courses and the availability of technical support. (Abd-El salam and Weetman, 2003: 80-81) The standards tend to provide limited guidance on applying the principles to specific transactions. Accountants are not given a specific road map to use when applying the principles to real world situations.

Instead they are encouraged to use professional judgment to apply the general rules to their particular circumstances. (Hines, 2007: 10) To use such a judgement, accounting professionals need a high level of education and competence in profession. However, because of the lack of experienced professional accountants, lack of education and professional training in line with the IFRSs or similar standards; this process of familiarization will most probably be expensive. (Chand and Patel, 2008: 87-90) In many developing countries or emerging markets, where the supervisory body of the capital market is not strong, the relative cost of non-compliance might be less than the cost of compliance.

### **1.7.5. Implementation and Enforcement**

In addition to these, as Chand and Patel (2008: 84) states some countries adopt IFRSs to gain instant respectability or to serve as a politically correct substitute for their own accounting standards without providing reporting incentives and employing mechanisms to enable compliance with these standards. Therefore one cannot be sure that harmonized accounting standards would lead to harmonized accounting practices and comparable financial reports.

Finally, I shall state that it should not be forgotten high quality standards implemented in a defective manner will not result in high quality financial reports. Without adequate enforcement, even the best accounting standards will be inconsequential. (Alexander, Britton and Jorissen, 2007: 42) Therefore, in order to facilitate convergence, an effective enforcement mechanism is necessary. Adequate enforcement, as stated precedingly, requires among other things, a reasonable supply of qualified and experienced accountants and, importantly, well-established accounting profession and regulatory systems. (Chand and Patel, 2008: 90)

One more (possibly the most critical one) controversial issue in the internalization of accounting standards is the convergence of United States GAAP and IASBs IFRS. Because of the importance of the subject, it is mentioned in a separate section below.



## 1.8. IASB IFRSs and US GAAPs Convergence

United States has a strong tradition of Generally Accepted Accounting Principles that these principles are followed by many developing countries and emerging markets but accounting scandals such as Enron, WorldCom, Adelphia and Tyco that have experienced in recent years showed that US GAAP has some deficiencies too. (İbiş and Özkan, 2006: 30)

As mentioned in different parts of this study, International GAAP prepared by IASB is principles based<sup>9</sup> in contrast to U.S. GAAP which provides a list of specific rules to apply in given accounting situations. The standards concentrate on general principles derived from a conceptual framework. A 2004 article in the CPA Journal illustrates this point: Principles-based accounting for leases is addressed in six IASB pronouncements and one Interpretation. In contrast, U.S. GAAP related to lease accounting is addressed in 20 Statements, nine FASB Interpretations, 10 Technical Bulletins, and 39 EITF Abstracts. (Hines, 2007: 10)

As Hines (2007: 6) states, in the foreign policy arena, the United States has always accustomed to use unilateral initiative and power and the trend is not different in accounting developments. For many years, The United States has been so cautious about joining a binding global accounting scheme that it does not have unilateral power to influence or set its own accounting rules. Under the current U.S. GAAP system, all accounting standards are promulgated by U.S. organizations, with the ultimate authority residing in a U.S. government agency. A private U.S. organization, FASB, issues standards but the Securities and Exchange Commission retains ultimate authority.

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<sup>9</sup> By following a principles based approach, IASs tend to include only a limited amount of guidance for applying general principles to typical transactions, encouraging professional judgement in applying the general principles to other transactions typical to an entity or industry. IASs also tend to include qualitative principles (a lease is a finance lease if its term is for the major part of the economic life of the asset) rather than quantitative guidelines (a lease is a finance lease if its term is %75 or more of the estimated economic life of the leased property) (Alfredson et al., 2005: 6)

However, by the increasing demand and pressure from capital markets for globally harmonized accounting standards and financial reporting language, by the negative effects of accounting scandals that US experienced and by the increasing acceptance of IASB and its IASs (IFRSs) especially by the EU; United States authorities on accounting standards that is FASB and SEC increased their interest on IASB work. Indeed, The IASB and FASB attempted to avoid conflicts and promote similarities where they can. They signed “The Norwalk Agreement” in October 2002. In September 2002, they launched the Short-Term Convergence Project as part of the Norwalk Agreement to cooperate on bringing standards closer together.

Before, there was an obligation of SEC that companies which prepare their financial statements according to IAS/IFRS must reconcile the number of their earnings and equity with US GAAP. (İbiş and Özkan, 2006: 32) This reconciliation was costly to prepare and led to companies publishing in effect two different operating results for the year, which was not always well accepted by the market. (Epstein and Mirza, 2005: 7) This obligation was abandoned in November 2007 which is an important step in the US GAAP and IFRS convergence.

On February 2006, a Memorandum of Understanding (MoU) between the FASB and the IASB was issued, entitled “A Roadmap for convergence between IFRSs and US GAAP 2006-2008”. The FASB and the IASB agreed on the following guidelines regarding their approach to convergence program: (Alexander, Britton and Jorissen, 2007: 60)

- Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB’s and IASB’s resources- instead; a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the Boards should seek convergence by replacing weaker standards with stronger standards.

In addition to these developments in August 2008, SEC declared the roadmap related to the final adoption of IFRS. (Çelik, 2009) Indeed, by 2008 a number of projects were completed. For example, the FASB issued new or amended standards to bring standards in line with IFRS, for example it adopted the IFRS approach to accounting for research and development assets acquired in a business combination (SFAS 141R), in others the IASB converged IFRS with US GAAP, for example the new standard on borrowing costs (IAS 23 revised) and segment reporting (IFRS 8), and proposed changes to IAS 12 Income taxes. For the period of 2009-2016 the intention is for the development of agreed standards to continue with a view to US companies being permitted on a phased basis to use IFRS for their financial reports by 2011 and for all companies to be able to do so by 2016. (Elliot B. and Elliot J., 2009: 153-154)

However, as Brouwer (2005:5) argues this rosy picture of cooperation is not the full one because the FASB works in a specific national legal framework, while the IASB does not. Equally, both have what they term “inherited” GAAP. The FASB also has a tradition of issuing very detailed standards that give bright line audit guidance, which are intended to make compliance control easier and remove uncertainties. Moreover, the litigation environment in the US also makes companies and auditors reluctant to step into areas where judgements have to be taken in uncertain conditions. (Epstein and Mirza, 2005: 11)

The definition and calculation of income is another important controversial issue between IASB and FASB. The FASB examines changes in the financial position of the company (assets and liabilities), while the IASB looks at earnings and expenses. This means that the book value of financial derivatives could improve company accounts under American standards, but not under IAS. American law makers underlined their continued belief in the asset/liability method in the Sarbanes/Oxley Act of 2002, despite the role of derivatives in company collapses. (Donnelly, 2007: 119-121)

For the intention of all US companies be able to use IFRS by 2016, Elliot B. and Elliot J. (2009: 154) emphasize on the uncertainty whether the target date can be achieved because attention might be diverted towards a review of fair value accounting<sup>10</sup> and there might be a political pressure on the SEC by members in Congress to delay mandating the use of IFRS for US companies.

To sum up this section, important steps have been taken in the road to the convergence of US GAAP and IASB IFRSs. SEC Commissioners expressed support for reasonable process to allow US companies to use IFRS in 2008. However, as mentioned above, there exist some conflicting issues too. Indeed, Hayn (2009) claims “smoke is rising” by quoting several speeches: “I will not be bound by the existing roadmap that’s out for public comment.” (Mary Schapiro, SEC Chairwoman; January 2009) “If you are going to have global standards, we need the U.S., but it can’t go indefinitely. We’ve been converging for seven years. We have a timetable to finish in 2011. It’s designed to fit these major economies-Korea, Japan, Canada, and India-who are converging that year. We have to finish this year.” (Sir David Tweedie, IASB Chairman, August 2009) As can be seen from these statements, the developments in 2011 will give us a clear understanding of the future of this long convergence story.

### **1.9. The Debate over the Adoption of International Financial Reporting Standards for Small and Medium Sized Enterprises**

Small and medium-sized entities are estimated to account for over 95 per cent of all companies around the world. For example, within the EU countries, in the United Kingdom, in the late 1990s SMEs accounted for 80 per cent of companies filling accounts and 50 per cent of non government employment. (Evans et al., 2005: 25, with reference to Dugdale et al., 1998) Germany has a traditionally even larger and more influential SME sector than the UK. In Italy and Spain, in 1990, SMEs made up 99.96 per cent of the total number of business entities, and accounted for

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<sup>10</sup> In November 2008, The US Congress gave SEC the Authority to suspend the use of fair value accounting. (Hayn, 2009)

82.84 per cent and 91.9 per cent, respectively, of employment. (Evans et al., 2005: 25, with reference to Paolini et al., 1999)

For a long time IASB has been criticized for not taking into account this importance of SMEs; it has been generally claimed that International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) have been developed mainly for the financial reporting requirements of large and listed enterprises.<sup>11</sup> (Di Pietra et al., 2008: 27) Whether these are suitable for the reporting needs of SMEs has been questioned. In fact, in many countries and regional bodies, there exist different accounting applications (differential reporting) for SMEs. For instance, within the EU, these entities are subject to reporting regimes which provide differing degrees of exemptions. (Di Pietra et al., 2008: 29)

Despite of the existence of the arguments in favor of differential reporting, there are also arguments against for differential reporting. The main arguments for differential reporting are undue burdens and disproportionate costs for SMEs, less complex transactions<sup>12</sup> and less need for sophisticated analysis of highly aggregated information for SMEs as well as perceived lack of relevance of statutory accounts<sup>13</sup> to the main user groups and finally easier transition of SMEs to full IFRSs. The arguments against differential reporting are the demand for universality<sup>14</sup>, the need for comparability and reliability, the fear of making smaller companies “second class citizens” and the risk of the creation of a two-tier accounting profession.

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<sup>11</sup> Indeed, IAS GAAP has sought applicability, in general to all enterprises, in all types of economy. (Alexander and Archer, 2004: 1.05)

<sup>12</sup> Financial statements of larger companies reflect more complex transactions and data and these are used by a larger set of users and for a wider set of decisions than SME accounts which creates a need for more extensive disclosures. However this does not apply to SMEs, whose stakeholders have other means of access to internal information. (John and Heleas, 2000 and Harwey and Walton (1996) quoted by Evans et al, 2005: 28)

<sup>13</sup> Although some argue that statutory financial statements are a useful source of information for management purposes for small companies, in general they were not considered as useful for decision making. John and Heleas (2000) states that: “Very few of the owner-managers have a proper understanding of the contents of statutory accounts... They often take the view that statutory accounts are of no practical use for decision making and prefer to use management accounts and a cash flow forecast.” (Evans et al., 2005: 29)

<sup>14</sup> Some academicians argue that different rules for different entities may lead to different true and fair views.

Despite of the existence of stated negative arguments, there is a widely accepted idea that a simplified, self-contained set of accounting principles that takes into account SMEs stakeholders needs is crucial. As Epstein and Jermakowicz (2007: 38) states this perceived need for a standalone set of simplified standards has become increasingly manifest in recent years. FASB for instance worked on a development of such a streamlined group of financial reporting requirements. In another example United Kingdom within this decade successfully implemented Financial Reporting Standards for Smaller Entities (FRSSE).

Not being indifferent to these developments and with the concern that if regulation of SMEs left under the control of other regulators, it might not be consistent with the IASB's Framework or with IFRS; IASB, in 2003, voted to develop specific standards for SMEs. These standards are intended to reduce the costs of preparing financial statements for SMEs and focus on user needs. In June 2004, the IASB Discussion Paper "Preliminary Views on Accounting Standards for Small and Medium-Sized Entities" was published. This included the Board's preliminary views and raised specific questions and issues relating to whether special standards for SMEs would be required. Comments on this Discussion Paper were invited to be submitted by 24 September. (Evans et al., 2005: 23) 117 organizations and individuals commented on this Discussion Paper. The IASB set up a subcommittee of the Board which made recommendations based on a review of the responses to the Discussion Paper. It concluded that there was a demand for SME standards and that the Board should therefore develop an Exposure Draft and On 15 February 2007 the IASB issued an Exposure Draft (ED) of a proposed IFRS for Small and Medium-Sized Entities. Together with this draft two other documents were published: Basis for Conclusions on the Exposure Draft IFRS for Small and Medium-Sized Entities and the Draft Implementation Guidance IFRS for Small and Medium-Sized Entities.

When responding to the Discussion Paper and then Exposure Draft, some interested parties have not supported the approach taken in the development of IFRS for SMEs. According to them, rather than simply streamlining existing standards, the

IASB should have taken a user-based, more conceptual approach in creating differential accounting for SMEs. They argued that the differences between large public companies and SMEs should have been incorporated into the conceptual framework. (Epstein and Jermakowicz, 2007: 38) The European respondents to the draft mainly emphasized on the fact that the standard does not really take into account stakeholders specific to SMEs and their needs. (Deaconu, Nistor and Popa, 2009: 39) Similarly Di Pietra et al., (2008: 30) state that:

*“To satisfy cost-benefit considerations, modification not only of disclosure, but also of the recognition or measurement principles in IFRS might be required. Therefore, the standards for SMEs should not be based on the concepts and principles in the IASB Framework and existing standards. Instead, suitable concepts for an international reporting framework for SMEs should be developed on the basis of further research.”*

In addition to these comments European Commission evaluated the Draft as insufficient for simplifying the life of European SMEs. The commissioner McCreevy (2007) in one of his speeches stated: (Di Pietra et al, 2008: 29)

*“We have repeatedly emphasized that accounting for SMEs must be simple and reflect the nature of businesses of small companies. The feedback we have receive from Member States, the European Parliament and stakeholders is that current IASB draft is not simple enough to be applicable for the bulk of SMEs in the EU. At this stage, therefore, I do not intend to propose that the IASB draft be endorsed for application in the EU.”*

In relation to the issue of simplification another important debate is the threshold criteria that is technical determination of which entities are targeted in these standards. The IASB in defining SMEs, prefers the employee number criteria and defines a typical SME would have 50 employees. However, the Board used this criterion as a guideline not as a quantified size test for defining SMEs. Such a focus helps the Board to decide the kinds of transactions and conditions that should be addressed in the IFRS for SMEs. However, studies have shown that in Europe the average employment number of the SMEs is 4 while in Turkey the average number of the employment among all the business entities is 3,68 employees per entity.

Therefore, some commentators in the process of responding to draft, emphasized that it would be wrong not to consider the micro-sized entities from the scope of these standards. (Özkaya, 2007: 98-99)

By evaluating these responds and criticisms to the Draft, IASB continued its studies on the standards for SMEs and published IFRS for SMEs at the end of June 2009. Although the criticism for a separate conceptual framework for SMEs has not been fully taken into consideration, IASB in line with the critics prepared a stand-alone standard<sup>15</sup> unlike the Exposure Draft that permitted the use of all accounting policy options in full IFRSs mainly by cross-reference to the relevant IFRS. Despite the existence of some exceptions<sup>16</sup> there is almost no cross references to full IFRSs in the IFRS for SMEs. To avoid cross-referencing, the IFRS for SMEs permits only the simpler accounting policy; for instance the cost model for property, plant and equipment. (Fisher, 2009: 30) As the IASB website explains ([www.iasb.org](http://www.iasb.org), January 02, 2010) where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option. For instance, no option to revalue property, equipment, or intangibles; a cost-depreciation model for investment property unless fair value is readily available without undue cost or effort; no ‘corridor approach’ for actuarial gains and losses.

Related to the threshold debate, IASB developed “public accountability”<sup>17</sup> criterion. According to this, the standard is used by SME entities that do not have public accountability and publish general purpose financial statements for external users. (Fisher, 2009: 30)

In responding the demands especially coming from EU Commission for more simplification, IASB took some measures; for instance the standard does not include

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<sup>15</sup> The IFRS for SMEs is a self contained standard of less than 230 pages. ([www.iasb.org](http://www.iasb.org), January 02, 2010)

<sup>16</sup> The section dealing with financial instruments permits an entity to apply IAS 39 Financial Instruments: Recognition and Measurement.

<sup>17</sup> An entity has public accountability if: 1- its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading In a public market; or 2- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. (Fisher, 2009: 32)



requirements relating to earnings per share, interim financial reporting and segment reporting because they are generally not expected to be relevant for SMEs. Borrowing and development costs are expensed by removing the cross references to full IFRSs. However, the continuation of the understanding of IASB that all gains and losses on financial instruments will be recognized in profit or loss, unavoidably calls for the usage of fair value concept in some cases. This will probably create difficulties especially for micro entities but the IASB considered this difficulty to some extent by establishing two different sections dealing with financial instruments: Section 11: Basic Financial Instruments addresses financial instruments measured at cost and Section 12: Other Financial Instruments Issues addresses more complex issues, including fair value measurement and hedging. As micro entities generally do not use advanced financial instruments, they will continue to measure their financial instruments at cost as they have been accustomed to. (Fisher, 2009: 30-31)

To sum up this section, I shall state that the standard is available for any jurisdiction to adopt, whether or not it has adopted full IFRSs. Each jurisdiction must determine which entities should use the standard. IASB's only restriction is that listed companies and financial institutions should not use it. ([www.iasb.org](http://www.iasb.org), January 02, 2010)

### **1.10. The Development of Financial Reporting Standards in Turkey**

As mentioned before, with the increasing globalization of capital markets and the liberalization of world trade; the need for producing more reliable, transparent and comparable accounting information systems increased and this need led to setting accounting standards in national level first and then harmonization of these standards in global level. For Turkey, as a developing country, in order not to being different to developments in international accounting and finance; to develop accounting standards that conform to IAS/IFRSs is crucial. In fact, while considering the efforts of being a member of European Union, being harmonious with IAS/IFRS and enforcement of these standards have become inevitable for Turkey. Therefore several important studies have been made in recent years in order to develop national

accounting standards which are in compliance with IAS/IFRS. These developments and the nature of Turkish Accounting System are analyzed in a historical perspective in the following paragraphs.

### **1.10.1. External Influence in the Turkish Accounting System**

To begin with, I shall state that the development of accounting standards in Turkey has been under the control and supervision of the government, and influenced by the laws and applications transferred from western countries where they have considerable economic and political effects on the country's legislations. (Üstündağ, 2000: 52) In accounting practices, initially French legislation and publications and then German legislation and publications have been effective. By increasing relations with United States (US) after 1950's; the effects of US system have been experienced. In the recent years, by the increasing efforts to integrate European Union (EU) as a full member, EU and IASB regulations have been followed. (Başpınar, 2004: 46)

### **1.10.2. Legal Regulations**

The accounting practices have been managed through legal regulations and provisions in Turkey. The main regulations are tax legislations, Turkish Commercial Code (TCC), Law of Capital Markets (legislations) and Banking Law (legislations). The first provisions in Turkey regarding accounting and financial statements were laid down in the TCC. Turkish Commercial Code, currently in force, was entered into force in 1956 and was substantially influenced by Continental European Codes, particularly Germany, Italy and Switzerland and therefore has been substantially influenced by tax laws. (Curuk and Cooke, 2005: 288, with reference to Tekinalp, 1992 and Mugan, 1995) Most of the provisions related to accounting practices in this code have become outdated. The Turkish Commercial Code was re-written and issued as draft. I will emphasize on it in the following paragraphs. In fact, the basic law covering the accounting applications in Turkey is the tax laws. The provisions in tax laws aim to determine tax obligations of the enterprises and therefore all

accounting practices have been carried out for the purpose of determination of tax. (Üstündağ and Alp, 2009: 689, with reference to Küçüksözen, 1995) The accountants consider that they are responsible to conform to tax laws because of the existence of comprehensive audits and effective sanctions in case of failure to comply with these provisions. (Karapınar, Ayıkoğlu and Bayırlı, 2007: 14)

### **1.10.3. Initial Studies for the Development of Accounting Standards and Uniform Chart of Accounts in Turkey**

The first organization that introduced accounting standards in Turkey was the Capital Markets Board. (CMB) The standards were published in the Official Gazette numbered 30064 and dated January 29, 1989 under the title of “Seri: XI, No: 1, “The Communiqué for the Rules and Principles Pertinent to Financial Statements and Reports in the Capital Markets”. Curuk and Cooke (2005: 288) argue that the European Union Fourth Council Directive has been influential in the preparation and content of this communiqué. This regulation could only be applied on the publicly held companies which were subject to the regulations of CMB. Therefore these standards could not be generalized but importantly they paved the way for the Uniform Accounting System. (Karapınar, Ayıkoğlu and Bayırlı, 2007: 7)

In 1992, the Ministry of Finance organized a committee to establish the accounting principles and a uniform chart of accounts that would be used by all companies. The Ministry published the committee’s report in a Communiqué on 26 December 1992 establishing the principles and the uniform chart of accounts to be in effect starting 1 January 1994. (Üstündağ and Alp, 2009: 687) The obligation of the application of Uniform Accounting System has been evaluated as a big step in the standardization of accounting practices due to the fact that it was prepared as compatible with the Fourth Directive similar to CMB Communiqué. 14 communiqués have been released and adapted until the writing of this study. The regulations have intended to provide fair accounting for operations and results of companies. (Yalkın, Demir D. and Demir V., 2008: 59)

#### **1.10.4. Turkish Accounting and Audit Standards Board (TAASC)**

Another important step in the adoption of international accounting standards in Turkey was the establishment of Turkish Accounting and Audit Standards Board (TAASC). It was founded according to a directive accepted by the board of directors of Professional Chambers and Union of Chambers of Certified Public Accountants of Turkey (TÜRMOB) on February 9, 1994. It conducted its studies concerning the purposes of developing and issuing accounting standards that will provide a basis to preparation and presentation of financial statements, of providing acceptance and application of these standards in the country and of providing harmonization of Turkish Accounting Standards with International Accounting Standards. The board had issued 19 standards during its operation period. However, these standards had not been applied by entities, because TAASC did not have any sanction power so as to force companies to follow these standards. TAASC has completed its activities by the establishment of Turkish Accounting Standards Board. (TASB) (Yalkın, Demir D. and Demir V., 2008: 63)

#### **1.10.5. The Other Studies of the Capital Markets Board and Banking Regulation and Supervision Agency**

Capital Markets Board after publishing “The Communiqué for the Rules and Principles Pertinent to Financial Statements and Reports in the Capital Markets” in 1989, have continued its studies on accounting standards and in order to make capital markets more reliable and transparent and increase interest of domestic and foreign investors to shares of listed companies and conform to the European Union regulation requiring for publicly traded EU companies to use the IFRS starting from 2005; CMB developed a study for the full harmonization of the accounting standards with the IFRSs. The opinions of the market actors have been taken and at the end of these efforts, “The Communiqué for the Accounting Standards in the Capital Markets” was published in the Reiterated Official Gazette numbered 25290 and dated November 15, 2003. The communiqué was entered in force and so valid on the first interim financial statements subsequent to January 01, 2005. (Karapınar,

Ayikođlu and Bayırlı, 2007: 7) The Communiqué included a complete set of 33 standards that are in harmony with IFRS. The companies which are subject to the Law of Capital Markets (except the companies in the banking sector which have to follow the rules of Banking Regulation and Supervision Agency) were obliged to prepare the financial statements and reports within the frame of provisions that are included in the Communiqué. At this point I shall point out that with these efforts of CMB; it is for the first time accounting practices for informing the public have been put on the agenda of Turkey. As Üstündađ and Alp (2009: 687) emphasizes outside the scope of regulations of the CMB, tax laws have been effective in accounting practices and as mentioned before accounting has been practiced for the purpose of correct determination of the tax base. The said Communiqué and other studies of CMB paved the way for an information based accounting understanding instead of tax based accounting in Turkey.

Similar to CMB studies, Banking Regulation and Supervision Agency (BRSA) issued Communiqués for Accounting Application Regulations. These Communiqués have included accounting standards in accordance with IAS/IFRS determining the principles of preparation and presentation of financial statements and reports for banking sector. International operations are huge in the banking sector therefore application of accounting standards that conform to IAS/IFRS is a noteworthy development in Turkey. By the application of these standards in banking sector, more reliable and transparent financial statements have been provided since 2005. (Yalkın, Demir D. and Demir V., 2008: 63)

#### **1.10.6. Turkish Accounting Standards Board (TASB)**

Undoubtedly, the most important development in the adoption of international accounting standards in Turkey was the establishment of Turkish Accounting Standards Board (TASB). It was established based on the Supplementary Article 1 of the Capital Market Law dated 15 December 1999 numbered 2499 as

amended by the law numbered 4487<sup>18</sup>. The Board<sup>19</sup> as a related institution of Prime Ministry has public entity, administrative and financial autonomy. Its establishment goal is to encourage the development of national accounting standards in favor of public interest to achieve reliable, comparable and understandable financial statements. (Üstündağ and Alp, 2009: 689) As can be seen from the above paragraphs, many different governmental institutions such as Ministry of Finance, CMB and BRSA issued regulations that are related to entities in their rule of authority and this has created a multi-layered structure in Turkish Accounting System. In fact, the most important establishment aim of TASB is to abolish this multi-layered structure by developing accounting standards applicable to all entities. In this aim, TASB has started to prepare a simplified set of accounting standards for small and medium-sized enterprises (SMEs), which are parallel to the IASBs IFRS standards for SMEs. Following the publication of Turkish Accounting standards for SMEs, it is expected that unity in accounting applications of SMEs in Turkey will be ensured. (Üstündağ and Alp, 2009: 697) In the process to conform to the rules of Basel II, SMEs must apply international accounting standards in order to provide loans from banks. Therefore, the study of the TASB is so important to prepare Turkish SMEs to the changing structure of financing in the world. By the application of these standards SMEs in Turkey will more easily integrate with the global markets because their financial statements will gain validity in the international markets.

Numerous countries national accounting standards bodies have been adopting IFRSs; however, approaches used for convergence differ significantly across countries. Various approaches to converge or harmonize include adoption of IFRSs in their entirety, full adoption of IFRSs with time lags, adoption of IFRSs with

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<sup>18</sup> TASB started its activities by holding its first meeting on 7 March 2002 and the related Board resolution was published on the Official Gazette Nr. 24726 dated 4 April 2002. "The Regulation on the Principles and Procedures on the Operations of the Turkish Accounting Standards Board" (Regulation) was published on the Official Gazette Nr. 25404 dated 16 March 2004. (Üstündağ and Alp, 2009: 689)

<sup>19</sup> The Board composed of nine members, one from each of the Ministry of Finance, the Ministry of Industry and Commerce, the Council of Higher Education, the Undersecretariat of Treasury, the Capital Market Board, the Banking Regulation and Supervision Board, the Commodity Exchanges and the Association of Chambers of Commerce, and two from the Union of Chambers of Self-Employed Accountants, Financial Consultants and Certified Financial Consultants of Turkey. (Üstündağ and Alp, 2009: 689)

amendments and additions to bring them in line with the local environment and continuation with the local accounting standards but in harmony with the IFRS. (Chand and Patel, 2008: 83) TASB has chosen the strategy of setting financial reporting standards fully compliant with IFRSs. In setting financial reporting standards fully compliant with International Financial Reporting Standards (IAS/IFRS), the TASB has followed the principle of the official translation procedure set out by the IASCF. An agreement called “Agreement for the Waiver of Copyright within Limited Territories (Waiver Agreement)” was signed with the Foundation providing the legal basis for this purpose. According to Waiver Agreement, TASB publishes IAS-IFRS, integral parts of these standards and SICs-IFRICs. (Üstündağ and Alp, 2009: 689-690) TAS and TFRS<sup>20</sup> issued by TASB are published in the Official Gazette and so they are legally regulated. (Karapınar, Ayıkoğlu and Bayırlı, 2007: 7)

#### **1.10.7. Recent Developments**

CMB, after the establishment of TASB as the unique organization which has the authority and power for the determination and applications of TAS/TFRS, followed a policy of helping the efforts of abolishing multi-layered accounting structure in Turkey and issued “Seri XI: No: 29: The Communiqué for the Principles of Financial Reporting Standards in the Capital Markets” that was published in the Official Gazette numbered 26842 and dated April 9, 2008. With this Communiqué it became a must for the publicly held companies to prepare financial statements in line with TAS/TFRS that are fully compliant with IAS/IFRS. Similarly, Banking Regulation and Supervision Agency (BRSA) accepted the regulation that the entities subject to the Banking Law, must prepare financial statements in line with TAS/TFRS that are fully compliant with IAS/IFRS from January 1, 2007. (Aysan, 2008: 48-49) In the same way, Republic of Turkey Prime Ministry Undersecretariat of Treasury issued “The Communiqué for Financial Reporting in Insurance and Reinsurance Companies and Retirement Companies” which was published in the Official Gazette numbered 26582 and dated July 14, 2007. By this Communiqué it is

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<sup>20</sup> A grouping of standards published by TASB can be seen in Appendix 1.

accepted for these companies in the insurance sector to use TAS/IFRS in their accounting practices. (Çiftçi and Erserim, 2008: 240) All these are very important steps in the development of accounting standards and an integrated accounting system in Turkey that are in harmony with the global accounting standards.

As mentioned above TCC of 1956 has still been in force. Many of its provisions related to accounting applications have become outdated. However, in recent years with the increasing demand coming from business environment, it was re-written and issued as draft form. In the draft we can see important provisions that ensure a legal status to TASB and TAS/IFRSs. According to the draft, entities must apply accounting practices in the framework and TAS/IFRSs in recording and preparing their financial statements. (Yalkın, Demir D. and Demir V., 2008: 65) Some academicians argue that when this new law comes into force integration will occur in the financial statements of entities in Turkey. However, some others stated their doubts for the effects of the new Turkish Commercial Code (draft) during the application process. They argue that accountants consider that they are responsible against tax legislations and the fact that no an amendment is made to the provisions of the tax legislations that promote the use of TAS/IFRS will be the most striving obstruction against applicability of the standards. Ministry of Finance has been expected to make necessary changes to the tax legislations and uniform chart of accounts in order to provide conformity with TASB's Financial Reporting Standards. Making amendments to the TCC without changing the tax legislations will not provide an ideal system of harmonized accounting practices for all the entities in Turkey and so will hinder the efforts of TASB in this process. (Karapınar, Ayıköğlü and Bayırlı, 2007: 14)

#### **1.10.8. Difficulties Faced During the Adoption of IAS/IFRS in Turkey**

In recent years by the efforts to adopt IAS/IFRS in Turkey, certain challenges have been experienced for both the enterprises and governmental bodies, for the public in general. These challenges occur both during the adaptation process and



during the implementation stage. In the following paragraphs, I will try to analyze the difficulties faced in this process.

#### **1.10.8.1. Tax Based Accounting System of Turkey**

International Financial Reporting Standards (IAS/IFRS) issued by IASB mainly intend to meet the sound information needs of investors, creditors and financial analysts. However, in Turkey, there is an accounting system for tax determination rather than a system for informing the public. (Gönen and Uğurel, 2007) In recent years, with the great efforts of CMB and TASB, accounting practices for informing the public have been put on the agenda of Turkey. Now it is left to Ministry of Finance to make efforts in order to conform tax legislations especially the Turkish Tax Procedural Law and Uniform Chart of Accounts to TAS/IFRS issued by TASB. This will promote a uniform accounting system in Turkey. In addition to these, the new TCC draft that makes TFRS usage for all entities an obligation should rapidly come into force. This is one of the delayed responsibilities of Turkish National Legislative Body.

#### **1.10.8.2. Complexity of the Standards and Technical Issues**

As Alp and Üstündağ (2009: 690-691) and Gönen and Uğurel (2007) emphasize the increasing complex structure of the IFRSs affect adversely their adoption and implementation. As mentioned before the use of the new concepts such as fair value, which is one of the main representatives of principle based accounting, has created difficulties in Turkey too as many other countries. Moreover, the translation of international standards; because of the use of lengthy English sentences and use of terminology that is very difficult to translate; has been a challenge in the adoption and implementation of the standards. TASB worked in depth in this issue and a glossary of terms had been prepared. To ensure the use of consistent terminology a working group composed of accounting academicians and professionals translated the glossary of terms.

### **1.10.8.3. Knowledge Shortfall of Turkish Accounting Profession**

As many developing countries, Turkey face with the problem of the lack of experienced professional accountants and professional training in line with the IFRSs. Indeed, introducing a system of continued professional education to prepare professional accountants for adequate interpretation and application of the IFRSs is an important requisite for the success of the harmonization process. (Chand and Patel, 2008: 87) Therefore, first of all, accounting programs in the universities should be reassessed and necessary course adaptations for a broader understanding of the standards for the students of the administrative and economic sciences should be made. (Ayboğa, 2002: 53) In fact, an integrated approach is necessary with the participation of universities, TÜRMOB, TASB and other related parties in order to overcome the knowledge shortfall on the standards. Comprehensive education and training programs is needed. In fact, with a correct strategy, TASB is working on training programs in cooperation with professional organizations of accountants and universities in Turkey. (Üstündağ and Alp, 2009: 691-692)

### **1.10.8.4. Enforcement**

Despite the many existing problems we can clearly say that Turkey realized an important achievement in the adaptation of TFRS fully compliant with IFRS but in order to achieve a uniform and well working accounting system, enforcement of these standards is crucial too. Indeed, effective enforcement is essential for the successful implementation of the standards. (Üstündağ and Alp, 2009: 692) Undoubtedly one of the required mechanisms for effective enforcement is auditing mechanism. In Turkey, independent auditing is compulsory for the companies of public ownership, capital market establishments as well as the banks and other financial organizations. For other entities there is no such an obligation. The new TCC draft imposes an independent auditing for other enterprises. This will help the establishment of uniformity in Turkish accounting and auditing system. One existing problem is the ongoing discussion about the authorization for the issuance of the audit standards between TÜRMOB and CMB. TÜRMOB has established Audit Standards Board and the Board has fully translated the International Audit Standards

into Turkish but the standards failed to be applicable. It is claimed by TÜRMOB that CMB has not been granted any authorization to make regulation in the fields of international audit standards. However, CMB issued the “Communiqué for the Independent Audit Standards in Capital Markets” in 2006. (Karapınar, Ayıkođlu and Bayırlı, 2007: 14)

In order to achieve an effective audit system in Turkey, this authorization problem should be rapidly settled and the new TCC draft that grants independent auditing for all entities in Turkey should come into force.

## **SECOND PART**

### **TURKISH ACCOUNTING STANDARDS 23: “BORROWING COSTS”**

In a rapidly globalizing world, business entities face with severe competition not only in national markets but also in international markets. This unavoidably requires new machines, plants, facilities; in short new investments to entities’ assets. These investments are financed by equities or by external financial resources. In recent years the number of the companies that resort to external financing has increased considerably because by this way companies can benefit from some tax opportunities and from the effect of financial leverage. Such a situation undoubtedly increased the importance of accounting of borrowing costs.

In Turkey, several important studies have been made in order to integrate with the global economy and to conform to International Accounting Standards. In order to achieve this aim Turkish Accounting Standards Board (TASB) has chosen the strategy of setting financial reporting standards fully compliant with IFRSs. In setting financial reporting standards fully compliant with International Financial Reporting Standards (IAS/IFRS), the TASB has followed the principle of the official translation procedure set out by the IASCF. One of these standards “TAS 23 Borrowing Costs” aim to prescribe the treatment of borrowing costs incurred in financing the acquisition, construction or production of certain assets.

#### **2.1. The Evolution of the Standard**

In the first half of 20<sup>th</sup> century, business entities in developed countries such as United States, considered the borrowing costs especially the interest expenses as part of income statement and therefore expensed these costs rather than capitalizing them. However, by the 1960’s with increasing competition, investments became important and so new assets are acquired or constructed. In this period companies preferred to declare more income in order to get more borrowings and provide new shares so as to meet increasing financing needs. As a result, capitalizing borrowing costs became a way of declaring more income for the entities. However, there was

any regulation that provides necessary principles and rules for the capitalization of borrowing costs during these years. In order to close this gap, firstly, in United States the “FAS 34 Capitalization of Interest Cost” was issued. In this Communiqué the conditions in order to capitalize borrowing costs have been systemized. After that, in 1983, International Accounting Standards Committee issued “IAS 23 Borrowing Costs” and revised it considerably in 1995. (Erdoğan and İltter, 2005: 205) Finally, the IASB amended IAS 23 in March 2007 to converge with US GAAP. The broad principles of IAS 23 Revised are the same as those in FAS 34 although the details differ.

In our country, Turkish Accounting and Audit Standards Board issued “TAS 14 Borrowing Costs” in parallel with IAS 23. The standard would come into force from 01.01.2000. After that, in order to fully integrate with global accounting developments “TAS 23 Borrowing Costs” which is fully compliant with IAS 23 was issued by the Board in November 2005. The Standard would come into force for the periods after 31.12.2005.

This Standard was updated by the following Communiqués in order to respond the challenges and developments occurred in International Financial Reporting Standards:

- The Communiqué Numbered 46 which was published in the Official Gazette numbered 26583 and dated July 15, 2007.
- The Communiqué Numbered 89 which was published in the Official Gazette numbered 26966 and dated August 13, 2008.
- The Communiqué Numbered 114 which was published in the Official Gazette numbered 27068 and dated November 28, 2008.

## **2.2. The Aim and the Core Principle of the Standard**

The aim of the standard is to establish rules for recognizing (accounting of) borrowing costs. In relation to this aim, the core principle of the standard is

capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset and recognizing of other borrowing costs as expense.

The standard sees the occurrence of financial expenses as the costs that is result of the financing function of the entities and therefore calls for recognizing all borrowing costs as expense in the period they are incurred except the ones that are directly attributable to the acquisition, construction or production of a qualifying asset. (Sevilengül, 2003: 607)

Before the issuance of Communiqué numbered 46, in 15.07.2007, the capitalization of borrowing costs into the cost of a qualifying asset is an “allowed alternative treatment” under the standard, and the “benchmark treatment” is to expense borrowing costs when incurred. After the issuance of this Communiqué, capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset became a must<sup>21</sup>. If an asset is not a qualifying asset and if the borrowing costs incurred in order to acquire or construct it then recognizing these costs as expense is a must too.

There are arguments in favor of capitalization of borrowing costs besides the arguments that are against capitalization. Arguments that are in favor of capitalization mainly emphasize the fact that borrowing costs form part of acquisition costs. The borrowing costs that are the result of the decision of the acquisition of an asset are not mainly different from other costs that are often capitalized. (Sönmez, 2003a) The costs included in assets are matched against revenue of future periods. This is an extension of the principle of periodicity. Moreover, capitalization results in better comparability between assets purchased and constructed. (Bekler, 2007) On the other hand, arguments against capitalization mainly emphasize on the fact that expensing borrowing costs causes better comparison of financial position of the business entities especially in time series analyzes. (Greuning, 2006: 178-179)

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<sup>21</sup> However, an entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value, for example a biological asset. (TAS 23. 4a)

Moreover, some academicians argue that capitalization of borrowing costs hinder reporting of financing preferences of the entities in the operating results. According to this thought, use of external financial resources is a preference of the entities. (Zaif, 1999: 107)

### **2.3. Definitions and Scope of the Standard**

The standard is to be applied in accounting for borrowing costs. The standard applies only to borrowing costs relating to external borrowings and not to equity. (Mirza, Orrell and Holt, 2008: 170) Therefore the standard does not deal with the imputed or actual cost of equity, including preferred capital not classified as equity. (TAS 23.3)

Two important terms that have been widely used in the standard was defined clearly.

1- Borrowing Costs: Borrowing costs include interest and other costs incurred by an entity in relation to borrowing of funds. Other costs can be exchange rate differences, commission and interest cost.

According to the standard borrowing costs may include;

- interest expense calculated using the effective interest method as described in TAS 39 Financial Instruments: Recognition and Measurement,<sup>22</sup>
- finance charges in respect of finance leases recognized in accordance with TAS 17 Leases
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.<sup>23</sup>

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<sup>22</sup> TAS 23 refers to the effective interest rate method as described in TAS 39. The calculation includes fees, transaction costs and amortization of discounts or premiums relating to borrowings. These components were already included in TAS 23. (PricewaterhouseCoopers, 2008: 3)

2- Qualifying Asset: A qualifying asset is an asset that necessarily takes a substantial period of time<sup>24</sup> to get ready for its intended use or sale. According to this definition financial assets and inventories that are manufactured, or otherwise produced, over a short period of time are not qualifying assets. If an asset is ready for its intended use or sale when acquired, it is not a qualifying asset too.

Depending on the circumstances, any of the following may be qualifying assets: (TAS 23.7)

- Inventories: The standard refers to inventories that require a long time to get ready to a saleable condition. For instance, if a company is distilling whisky that must be allowed 10 years to mature, it shall recognize it as a qualifying asset. (IFRS Workbooks for Accounting Professionals IAS 23, 2006: 4) Ships and aircraft being built are also qualifying assets in line with the Standard that emphasizes the period of time that the asset will be ready for its intended use or sale.

- Manufacturing plants: For instance, interest charges relating to the financing of petroleum fields and transport systems under development are capitalized as part of these investments. (Cairns, 1995: 661)

At this point, we must emphasize on the position of tangible fixed assets in the Standard. If a fixed tangible asset is ready to its intended use or sale when it is acquired by an entity, since the time variable of financing function do not exist, it will be wrong for the entity to capitalize the borrowing costs related to that asset. The

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<sup>23</sup> This is a newly revised issue in the Standard. According to this, the gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency, and borrowing costs actually incurred on foreign currency borrowings. Other differences that are not adjustments to interest costs may include, for instance, increases or decreases in the foreign currency rates as a result of the changes in other economic indicators such as employment or productivity, or a change in government. However, in my opinion it is a deficiency of the standard that it does not clarify which method should be used to estimate the amount of foreign exchange differences that may be included in borrowing costs. (PricewaterhouseCoopers, 2008: 12)

<sup>24</sup> There is any bright line for determining the substantial period of time. However, an asset that normally takes more than a year to be ready for use will usually be a qualifying asset. (PricewaterhouseCoopers, 2008: 3)



entity shall recognize the borrowing costs as expense in such a situation. However, if the tangible fixed asset becomes ready to its intended use or saleable condition in a substantial period of time, the acquisition or construction of the asset will create a cost position out of the entity's operating activities. In such a case the borrowing costs related to such a qualified fixed asset shall be capitalized. (Sevilengül, 2003: 605-606) Because of this reason the Standard intentionally give the example of manufacturing plant or power generation facility as qualified tangible fixed assets. However, according to Sevilengül (2003: 606) occurrence of the investment cost (carrying amount of the qualified asset) differently according to the usage of external financing sources and equity financing constitutes a deficiency of the capitalization principle of the Standard. This deficiency can be overcome by adding the opportunity costs of the equity financing used in the acquisition or construction of the qualified asset as part of the cost of that asset besides the borrowing costs of external financing.

- Power generation facilities

- Intangible assets: Intangibles such as capitalized development costs and other internally generated intangibles that meet the recognition criteria of TAS 38 (IAS 38) may also be qualifying assets. (Alexander and Archer, 2004: 4.04)

- Investment properties.

I shall note that the construction contracts that are hold in TAS 11 are also considered as qualifying assets. The determination of the amount of borrowing costs to be capitalized in financial statements of the constructor are based on the net position of the contract after taking into account any customer payments in respect of the contract.<sup>25</sup>

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<sup>25</sup> If the contract is in a net credit position during the whole construction period (advances in excess of costs incurred), no costs are capitalized. The constructor has not incurred any borrowing costs, as the financing was provided by the client. The net position in a contract may change over the construction period from net debit to net credit or vice versa. Capitalization is only required for those periods when the contract is in a net debt position. (PricewaterhouseCoopers, 2008: 14)

Some business entities feel difficult to understand the concept of qualifying asset in the spirit of the Standard. They think that assets that are expensive to purchase are qualifying assets and capitalization of borrowing costs related to these assets are required. Their justification is that the borrowing costs relating to the purchase of an expensive asset will be also quite significant. Therefore, it would be wrong on their thought to expense these costs. However, not the price of the asset but the period of time that an asset will be ready for its intended use or sale, determines whether an asset is a qualifying one or not and so the need for capitalization for borrowing costs. Such examples are generally observed in developing countries, where the costs of borrowing are quite high compare to other economies that prefer equity financing. (Mirza, Orrell and Holt, 2008: 170)

Example 1:<sup>26</sup>

Anatolian Inc. started to the construction of a manufacturing plant that is expected to be terminated in three years. Same company also started to repair its expensive power generation facility which is in use. This repair project is expected to take one and half year.

When analyzing these two situations from borrowing costs perspective, we can clearly see that the manufacturing plant project takes a long period of time (three years) to bring it for its intended use or sale so this plant is a qualified asset. Therefore, borrowing costs related to the construction of manufacturing plant shall be capitalized. On the other hand, the power generation facility though is an expensive asset, is not a qualified asset because the facility is already in use.

Some important terms are used in the Standard but defined in some other Standards. It would be helpful to clarify these terms in understanding the statements of this Standard. (Yükçü, İçerli and Uğurluel, 2008)

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<sup>26</sup> This example is developed from Aslanertik (2009: 5)

3- Recoverable Amount: The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use. (TAS 36)

4- Fair value less costs to sell: It is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. (TAS 36)

5- Value in use: It is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. (TAS 36)

Example 2:<sup>27</sup>

A business entity has a machine. If it sold, it would receive 25.000 TL for it. It has calculated that it is worth 30.000 TL to keep the machine in the business. This is the value it would give the business entity over its remaining economic life. Therefore, the recoverable amount of the machine is 30.000 TL.

## **2.4. Recognition**

For TAS 23, the most important point is to define whether an asset is a qualified one or not and the second crucial point is to determine which of the borrowing costs can be capitalized. (Aslanertik, 2009: 6) Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualified asset shall be capitalized as part of the cost of that asset. An entity shall recognize other borrowing costs as an expense in the period in which it incurs them. (TAS 23.8) When borrowing costs are recognized as an expense, these costs are expensed regardless of how they are applied. (Mirza, Orrell and Holt, 2008: 172) On the other hand, so as to capitalize borrowing costs related to a qualifying asset, borrowing costs can be measured reliably and it is probable that they will result in future economic benefits to the entity. Borrowing costs that do not meet these conditions

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<sup>27</sup> The example is developed from IFRS Workbooks for Accounting Professionals IAS 23 (2006: 7)

shall be recognized as an expense too. When an entity applies IAS 29 “Financial Reporting in Hyperinflationary Economies”, it recognizes as an expense the part of borrowing costs that directly relate to that qualifying asset can be readily identified.

Example 3:

Anatolian Inc. used a short term bank credit. At the end of the period the entity learned that 1.500 TL interest expense was accrued.

The borrowing costs (interest expense) related to bank credit are not directly attributable to the acquisition, construction or production of a qualified asset and therefore shall be expensed. According to this, the period end accounts shall be as follows:<sup>28</sup>

	/	
Financial Expenses		1.500
		Bank Credits 1.500

	/	
Short Term Borrowing Expenses		1.500
		Financial Expenses Applied 1.500

	/	
Financial Expenses Applied		1.500
		Financial Expenses 1.500

<sup>28</sup> The names of the accounts are written according to The Turkish Uniform Chart of Accounts.

	/	
Profit or Loss of the Current Period		1.500
Short Term Borrowing Expenses		1.500

I should emphasize on the point that as can be seen from this example, when borrowing costs are recognized as an expense, they shall be calculated on accrual basis not on cash basis.

Example 4: (Aslanertik, 2009: 11)

Anatolian Inc. constructs a new manufacturing plant that is planned to be completed in two years. The necessary financing has been provided by borrowing on foreign currency. (Interest rate is % 6)<sup>29</sup> If the entity borrows in its own currency the interest rate is % 12. In October 1, 2009 the entity took a credit of 500.000 \$. The exchange rate at the day of borrowing is 1 \$ = 1.5 TL. At the end of period (31.12.2009) the exchange rate is 1 \$ = 1.6 TL. Therefore the exchange loss according to this transaction is

$$500.000 \$ \times (1.6 - 1.5) = 50.000 \text{ TL}$$

On the other hand the interest cost during the year of 2009 is:

$$500.000 \times 0.06 \times 1.55^{30} = 46.500 \text{ TL}$$

Since the manufacturing plant is a qualified asset according to TAS 23.5, the exchange loss shall be capitalized. However, we must not forget that the borrowing costs shall include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

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<sup>29</sup> For simplification simple interest rate method is used.

<sup>30</sup> The average exchange rate for the year of 2009 is taken into account:  $(1.6 + 1.5) / 2 = 1.55$

Anticipated Interest Cost:  $500.000 \times 1.5 \times 0.12^{31} = 90.000$  TL

Interest Cost : 46.500

Exchange Loss: 50.000

Therefore, the total borrowing cost is 96.500 TL. According to TAS 23, Anatolian Inc. shall capitalize only 90.000 TL, the remaining costs ( $96.500 - 90.000 = 6.500$  TL) shall be recognized as expense.

_____ / _____	
Investments on Progress	90.000
Financial Expenses	6.500
	Banks 96.500
_____	

## **2.5. Capitalization of Borrowing Costs**

### **2.5.1. Borrowing Costs Eligible for Capitalization**

Borrowing costs that are directly attributable to obtaining a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. This is straightforward when funds are borrowed specifically for the purpose of obtaining a particular qualifying asset. In that case, the amount of borrowing costs eligible for capitalization as part of the cost of that asset for the period are the actual costs of that borrowing during the period, less any investment income from temporary investment of the funds borrowed.<sup>32</sup> (Alexander and Archer, 2004: 4.05) Investment income arises when the funds are drawn down

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<sup>31</sup> For simplification, simple interest rate is taken into consideration.

<sup>32</sup> At this point we must be careful that if an entity has investment income on general borrowings, it cannot deduct investment income from the borrowing costs available for capitalization because no specific guidance is given about general borrowings unlike specific borrowings. The funds invested temporarily cannot be considered to be those from the general borrowings rather than from other sources. (PricewaterhouseCoopers, 2008: 7)

and temporarily invested pending their expenditure on the qualifying asset. The amount capitalized is also restricted by the amount of expenditures on the assets which have been incurred. (Cairns, 1995: 662)

Example 5:

Anatolian Inc. decided to construct a new headquarter building that would meet the needs of rapidly growing company. The necessary financing needed for the construction would be approximately 3 Million TL. In order to realize the project Anatolian Inc. borrowed 3 Million TL from two main sources. Financing means was as follows;

- Bank term loans: 1 Million TL at % 5 a year<sup>33</sup>
- Institutional borrowings: 2 Million TL at % 6 a year

In the first phase of the construction of the headquarter, there were idle funds of 1 Million TL, which the company invested for a period of six months. Income from this investment is 50.000 TL.

When analyzing this situation in line with TAS 23 Borrowing Costs, we should first decide whether the new headquarter building is a qualified asset and then shall the borrowing costs related to this asset be capitalized or expensed. To begin with, the new headquarter building is an asset that necessarily takes a substantial period of time to get ready for its intended use. (TAS 23.5) Therefore it is a qualified asset. Then we can easily say that the borrowing costs related to the building are capitalized as part of the cost of the asset because they will result future economic benefits to the Anatolian Inc. and the costs can be measured reliably. (TAS 23.9)

Since the borrowings are particularly made for the financing of the headquarter building the amount that must be capitalized in the first year can easily be determined:

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<sup>33</sup> For simplification simple interest rate method is used.

$$\begin{aligned} &= (1 \text{ Million TL} * 0.05) + (2 \text{ Million TL} * 0.06) \\ &= 170.000 \text{ TL} \end{aligned}$$

At this point we do not forget the rule of the Standard that the amount of borrowing costs eligible for capitalization as part of the cost of that asset for the period are the actual costs of that borrowing during the period, less any investment income from temporary investment of the funds borrowed. (TAS 23.12 and 13) Therefore, the borrowing costs that can be capitalized by Anatolian Inc are:

$$\begin{aligned} &= 170.000 - 50.000 \\ &= 120.000 \text{ TL} \end{aligned}$$

### **2.5.2. Capitalization Rate**

As emphasized in TAS 23.11, in some cases it may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

When funds borrowed generally and used for the purpose of obtaining a qualified asset, the amount of borrowing costs eligible for capitalization shall be determined by applying a “capitalization rate” to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The



amount of borrowing costs that an entity capitalizes during a period shall not exceed the amount of borrowing costs it incurred during that period. (TAS 23.14)

**Figure 1. Calculation of Capitalization Rate**

$$\text{Capitalization Rate: } \frac{(\text{Borrowing 1} * \text{Interest Rate}) + (\text{Borrowing 2} * \text{Interest Rate}) + \dots + \dots + (\text{Borrowing n} * \text{Interest Rate})}{\text{Borrowing 1} + \text{Borrowing 2} + \dots + \text{Borrowing n}}$$

$$\text{Borrowing Cost that is Capitalized: Expenditures on the Asset} * \text{Capitalization Rate}$$

**Source:** Gençoğlu, 2007: 175

In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. (TAS 23.15)

Example 6: (Cairns, 1995: 665)

A business entity has three sources of borrowings during 2010: a three year loan of 5 Million TL with interest 8% a year, a ten year loan of 8 Million TL at an interest rate of 6% a year, and a variable rate bank overdraft. The two loans are outstanding throughout the year, the average amount of the bank overdraft is 2 Million TL and interest on the overdraft in 2010 is 300.000 TL.

If the three year loan is a borrowing made specifically for the purposes of acquiring a qualifying asset, it is excluded from the calculation of weighted average. In such a case, the weighted average (capitalization rate) shall be as follows:

	Outstanding Borrowing (TL)	Interest for 2010 (TL)
Ten year loan	8.000.000	480.000
Bank overdraft	2.000.000	300.000
Capitalization Rate	$(480.000 + 300.000) / (8.000.000 + 2.000.000) = 7.8 \%$	

Example 7: <sup>34</sup>

Anatolian Inc. started to construct a new warehouse that will be used in manufacturing activities. The construction is expected to take 2 years to be completed. The expenditures related to this warehouse during 2010 is as follows:

Date of Expenditures	Total Expenditures (TL)
January 1, 2010	20.000
January 31, 2010	15.000
March 31, 2010	30.000
November 30, 2010	30.000
December 31, 2010	5.000
Total	100.000

The borrowings of the Anatolian Inc. In 2010 is:<sup>35</sup>

- Specific borrowing (this credit is taken for only the purpose of using in the warehouse construction)

<sup>34</sup> This example is developed from TESMER-e-USE Education Notes ( 2009, 137-138) and Aslanertik (2009: 14)

<sup>35</sup> All of these credits are taken in 01.01.2010.

Borrowing	Amount	Time to Maturity	Interest Rate
Credit A	40.000	2 years	% 10

- Borrowings for general purposes

Borrowing	Amount	Time to Maturity	Interest Rate
Credit B	30.000	3 years	% 8
Credit C	50.000	5 years	% 6

According to this, the amount of borrowing costs that requires be capitalizing and expensing can be calculated as follows:

Date of Expenditures	Total Expenditures (TL)	Capitalization Rate	Average Accumulated Expenditures (TL)
January 1, 2010	20.000	12/12	20.000
January 31, 2010	15.000	11/12	13.750
March 31, 2010	30.000	9/12	22.500
November 30, 2010	30.000	1/12	2.500
December 31, 2010	5.000	0	0
Total	100.000		58.750

As can be seen from the above table, the expenditures made by the company for the construction is multiplied by capitalization rate and so the average accumulated expenditures are calculated.

Now we must calculate the borrowing cost of the specific borrowing of the entity:  $40.000 * 0.10 = 4.000$  TL

After that, we can calculate interest cost and weighted average interest rate related to borrowings for general purposes:

Borrowings	Amount (TL)	Interest Rate	Interest Cost (TL)
Credit B	30.000	% 8	2.400
Credit C	50.000	% 6	3.000

Weighted average interest rate:	$\frac{(30.000 * 0.08) + (50.000 * 0.06)}{(30.000 + 50.000)} = \% 6.75$
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According to this, the borrowing cost that shall be capitalized is 5.265 TL:

40.000 (specific borrowing) x 0.10 =	4.000 TL
18.750 (gen. purpose borrowing) x 0.0675=	1.265 TL
58.750	5.265 TL

The total interest cost of the period is: (4.000 + 2.400 + 3.000=) 9.400 TL

According to this, (9.400 – 5.265=) 4.135 TL interest cost shall be expensed as the financial expenses of the period.

Investments on Progress	5.265
Financial Expenses	4.135
	Banks 9.400

### **2.5.3. Excess of Carrying Amount of the Qualifying Asset over Recoverable Amount**

When capitalizing borrowing costs, there is a risk that the cost of an asset may be inflated above its recoverable amount. (IFRS Workbooks for Accounting Professionals IAS 23, 2006: 7) However, the Standard does not allow the carrying

amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value. If such a situation occurs, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards. (TAS 23.16)

Example 8: (Aslanertik, 2009: 18)

Anatolian Inc. has been constructing a power generation facility that will be terminated in two years. It is a qualifying asset since it takes a substantial period of time to get ready for its intended use or sale. The carrying amount of this qualifying asset that included capitalized borrowing costs is 40.000 TL. The recoverable amount of the asset has been calculated as 38.000 TL in the related accounting period. Therefore, according to TAS 23.16 impairment loss of 2.000 TL shall be recognized.

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Impairment Loss <sup>36</sup>	2.000
Provision for Impairment	2.000

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#### **2.5.4. Commencement of Capitalization**

The capitalization of borrowing costs shall commence on the “commencement date”. The commencement date for capitalization is the date when the entity meets all of the following conditions:

- expenditures for the asset are being incurred,
- related to these expenditures borrowing costs are being incurred
- activities that are necessary to prepare the asset for its intended use or sale are in progress.

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<sup>36</sup> Turkish Tax Procedural Law does not accept this expense in the issue of tax assessment. This will be deeply analyzed in the fourth part of our study.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include:

- Production or construction of the asset
- Technical or administrative work prior to the commencement of physical construction
- Storage which is a part of a maturing process of inventories (Cairns, 1995: 667)

However, it must be careful that such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalized during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalization. (TAS 23.19)

Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. They do not include amounts which have not yet been paid and which are not interest bearing liabilities. Moreover the total cost of the qualifying asset is reduced by any progress payments received, and any government grants. The net figure is the base cost on which borrowings can be capitalized. (IFRS Workbooks for Accounting Professionals IAS 23, 2006: 7)

#### **2.5.5. Suspension of Capitalization**

Capitalization shall be suspended during extended periods in which active development is interrupted unless that period is a necessary part of the process for the production of the asset.

An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalization. However, an entity does not normally suspend capitalizing borrowing costs during a period when it carries out substantial technical and administrative work. For example, capitalization would be suspended during an interruption to the construction of a bridge during very high water levels, which are common in the area where construction is taking place. However, capitalization of borrowing costs should not be suspended when there is only a temporary delay that is caused by certain expected or anticipated reasons, such as while an asset is getting ready for its intended use.

#### **2.5.6. Cessation of Capitalization**

Capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. (TAS 23.22) The term “substantially all” applies to assets that are complete apart from “minor modifications such as the decoration of a property to the purchaser’s or user’s specification” or which are physically complete even though routine administration work might still continue. This is also meant to prevent an enterprise from intentionally keeping the work on an asset slightly incomplete in order to continue the capitalization of borrowing costs until the asset is sold, leased, or put to use. (Alexander and Archer, 2004: 4.04) At this point we can make an interpretation that the rule of the standard that excess of the carrying amount of the qualifying asset over recoverable amount shall be written down or written off in accordance with the requirements of other Standards, can probably prevent the occurrence of such a situation.

Example 9: (IFRS Workbooks for Accounting Professionals IAS 23, 2006: 8)

An entity builds ships. When the ships are ready to be sold, capitalization ceases, even if no buyer has been found. Another entity is distilling whisky, which

matures over 10 years. It is ready for sale but a client asks for a minor change in packing that can be carried out in two months. In this case, the product is substantially complete before making the change in packing, so capitalization shall cease.

Example 10: (Gökçen, Akgül and Çakıcı, 2007: 215-217)

A business entity constructed a new manufacturing plant. In order to make this construction the entity got a long term bank credit that would be repaid at the date of maturity. At the end of the first year, 20.000 TL and at the end of the second year 30.000 TL interest expenses were accrued.

At the end of the second year the entity completed the construction of the new manufacturing plant. The construction costs were recognized as 500.000 TL. At the end of the third year the 25.000 TL interest expense was accrued.

According to this, since the manufacturing plant is an asset that necessarily takes a substantial period of time to get ready for its intended use, the entity capitalized the borrowing costs.

- In the first year 20.000 TL interest expense was accrued.

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Financial Expenses	20.000	
		Bank Credits 20.000

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Period-end records

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Investments on Progress	20.000	
		Financial Expenses Applied 20.000

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Financial Expenses Applied 20.000

Financial Expenses 20.000

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- In the second year 30.000 TL interest expense is accrued.

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Financial Expenses 30.000

Bank Credits 30.000

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Period-end records

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Investments on Progress 30.000

Financial Expenses Applied 30.000

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Financial Expenses Applied 30.000

Financial Expenses 30.000

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- At the end of the second year the construction has been completed.

According to this the amount that is accumulated in the “investments on progress” account is:  $500.000 + 20.000 + 30.000 = 550.000$  TL. At the end of the second year this amount shall be transferred to “Plant, Machinery and Equipment” account.

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Plant, Machinery and Equipment 550.000

Investments on Progress 550.000

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- In the third year 25.000 TL interest expense is accrued.

According to TAS 23.23 an asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. At the end of the second year the construction of the plant has been completed so cessation of capitalization is required on this date according to the Standard. After this date the borrowing costs that would occur shall be recognized as expense. Therefore the accounts at the end of the third year shall be as follows:

	/	
Financial Expenses		25.000
		Bank Credits 25.000

Period-end records

	/	
Long Term Borrowing Expenses		25.000
		Financial Expenses Applied 25.000

	/	
Financial Expenses Applied		25.000
		Financial Expenses 25.000

When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalizing borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale. (TAS 23.24)

A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill. (TAS 23.25)

## **2.6. Disclosure**

An entity shall disclose the amount of borrowing costs capitalized during the period, and the capitalization rate<sup>37</sup> used to determine the amount of borrowing costs eligible for capitalization.

## **2.7. Transitional Provisions**

When application of this Standard constitutes a change in accounting policy, an entity shall apply the Standard to borrowing costs relating to qualifying assets for which the commencement date for capitalization is on or after the effective date. (TAS 23.27)

However, an entity may designate any date before the effective date and apply the Standard to borrowing costs relating to all qualifying assets for which the commencement date for capitalization is on or after that date. (TAS 23.28)

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<sup>37</sup> Paragraph 26 refers to “rate” in the singular, but in practice, more than one rate may be used, because different qualifying assets may be funded by different borrowings. This may occur because subsidiaries are treated as financially autonomous and have different capitalization rates or because one qualifying asset is funded by specific borrowings while another is funded out of general borrowings. (Alexander and Archer, 2004: 4.07)

### **THIRD PART**

#### **TURKISH ACCOUNTING STANDARDS 2: “INVENTORIES”**

The valuation of inventory has always been one of the controversial issues of accounting because inventories, which are current assets<sup>38</sup>, represent generally important amounts for most companies' balance sheet; overvaluation or undervaluation resulting in distortions occurring in reported net income and net asset totals and so taxation may be underpaid or overpaid. In addition to these, as Black (2003: 100) states, an error in one year's stock figure has a “*knock-on effect*”, in that results of the succeeding year will also be distorted.

When we look to accounting history, we can observe many examples of manipulation of inventory values in order to create a more favorable impression. Sometimes these resulted in big reported accounting scandals. Some entities that are in need of external financing may resort to increasing the value of inventory at the year-end so as to create a positive influence on the creditors' evaluation of the entity's financial position. Some other entities may resort to decreasing the value of inventory at the year-end in order to increase cost of goods sold and so decrease net income and their tax obligations. Therefore, valuation of inventory is important and should be on a consistent and reliable basis so as to avoid manipulation of net income (profits) between accounting periods and comply with the generally accepted accounting principles.

In Turkey, with the aim of prescribing the accounting treatment of inventories and of providing proper valuation for them, the Turkish Accounting Standards (TAS)

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<sup>38</sup> The inventories are current assets because they satisfy the following criteria for classification as “current” set out in paragraph 66 of TAS 1 “Presentation of Financial Statements”:

According to this paragraph; an entity shall classify an asset as current when:

- (a) it expects to realize the asset, or intends to sell or consume it, in its normal operating cycle;
- (b) it holds the asset primarily for the purpose of trading;
- (c) it expects to realize the asset within twelve months after the reporting period; or
- (d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period. (TAS 1.66)

2 “Inventories” which is fully compliant with IAS 2 was issued by Turkish Accounting Standards Board.

### 3.1. The Evolution of the Standard

Before emphasizing on the evolution of the TAS 2 “Inventories”, it may be useful to say some words about the evolution of IAS 2 because as we stated before in the various parts of this study, TAS and TFRSs which have been issued by Turkish Accounting Standards Board, are fully compliant with the standards issued by IASB.

IAS 2 “Inventories” was issued by the International Accounting Standards Committee in December 1993. As the IASB website ([www.iasb.org](http://www.iasb.org), January 20, 2010) explains, it replaced IAS 2 “Valuation and Presentation of Inventories in the Context of the Historical Cost System” which was originally issued in October 1975. The Standing Interpretations Committee developed SIC-1 Consistency-Different Cost Formulas for Inventories, which was issued in December 1997. Limited amendments to IAS 2 were made in 1999 and 2000. In April 2001 the International Accounting Standards Board (IASB) resolved that all Standards and Interpretations issued under previous Constitutions continued to be applicable unless and until they were amended or withdrawn. In December 2003 the IASB issued a revised IAS 2, which also replaced SIC-1.<sup>39</sup> Today the only interpretation that refers to IAS 2 is SIC-32 Intangible Assets-Web Site Costs.

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<sup>39</sup> In the second and third paragraphs of the Introduction of IAS 2, the Board states the reasons for revising IAS 2:

*“The International Accounting Standards Board developed this revised IAS 2 as part of its project on Improvements to International Accounting Standards. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the project were to reduce or eliminate alternatives, redundancies and conflicts within the Standards, to deal with some convergence issues and to make other improvements.*

*For IAS 2 the Board’s main objective was a limited revision to reduce alternatives for the measurement of inventories. The Board did not reconsider the fundamental approach to accounting for inventories contained in IAS 2.”*

In Turkey, in order to attain global accounting developments TAS 2 “Inventories” which is fully compliant with IAS 2 was issued by the Turkish Accounting Standards Board in January 2005. The Standard would come into force for the periods after 31.12.2005.

This Standard was updated by the following Communiqués in order to respond the challenges and developments occurred in International Financial Reporting Standards:

- The Communiqué Numbered 38 which was published in the Official Gazette numbered 26136 and dated April 11, 2006.
- The Communiqué Numbered 78 which was published in the Official Gazette numbered 26966 and dated August 13, 2008.
- The Communiqué Numbered 123 which was published in the Official Gazette numbered 27068 and dated November 28, 2008.
- The Communiqué Numbered 131 which was published in the Official Gazette numbered 27104 and dated January 08, 2009.

### **3.2. The Aim and the Scope of the Standard**

The first paragraph of TAS 2 states the objective of the Standard as prescribing the accounting treatment for inventories. The principal issue with respect to accounting for inventory is the amount of cost to be recognized as an asset. Moreover, the Standard provides guidance on the determination of the cost and subsequent recognition of expense including write-down of inventory to its net realizable value. The Standard also emphasizes on the cost formulas that are used in assigning costs to inventories.

In the second and third paragraphs of the Standard, some types of inventories that are outside the scope of the Standard and other types of inventories that are exempted only from the measurement requirements in the Standard have been arranged.

According to this, the Standard applies to all inventories, except: (TAS 2.2)

- work in progress arising under construction contracts, including directly related service contracts;
- financial instruments; and
- biological assets related to agricultural activity and agricultural produce at the point of harvest.<sup>40</sup>

The inventories written in this second paragraph are excluded from all requirements of the Standard. On the other hand, the Standard does not apply to the measurement of inventories held by: (TAS 2.3)

- Producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realizable value in accordance with well-established practices in those industries. When such inventories are measured at net realizable value, changes in that value are recognized in profit or loss in the period of the change.
- Commodity broker-traders<sup>41</sup> who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less

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<sup>40</sup> Since agricultural activity is subject to special considerations, IASB developed a separate IAS, namely IAS 41 “Agriculture”. (TAS 41 is fully compliant with IAS 41.) This Standard defines agricultural activity as “the management by an entity of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets.” A biological asset is a living animal or plant. Biological assets and the produce derived from them cannot be measured using the cost-based concepts that form the basis of IAS 2. (TAS 2) The reason of this is that biological assets are not usually purchased; they are born and develop into their current state. Therefore, different accounting methods are necessary. For this reason IASB developed different concepts in IAS 41 rather than usual cost-based concepts of measurement that are used for assets. IAS 41 states that biological assets shall be measured at their fair value less estimated costs of sale. (Elliot B. and Elliot J., 2009: 515-516)

<sup>41</sup> Broker-traders are those who buy or sell commodities for others or on their own account. The inventories of these traders are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders’ margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this Standard. (TAS 23.5)

costs to sell, changes in fair value less costs to sell are recognized in profit or loss in the period of the change.

As can be seen above, the third paragraph of the Standard establishes a clear distinction between those inventories that are entirely outside the scope of the Standard which are described in the second paragraph and those inventories that are outside only the scope of the measurement requirements of the Standard. Therefore, the principles of measurement of inventories under TAS 2, that is the lower of cost or net realizable value, do not apply to inventories mentioned in the third paragraph. However, all other requirements of the Standard apply to these inventories.

### **3.3. Definitions**

Three important terms that have been widely used in the Standard was defined clearly again within the Standard. According to this;

*Inventories* are assets:

- held for sale in the ordinary course of business
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

According to the paragraph 8 of TAS 2, inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. In the case of a service provider, inventories include the costs of the service for which the entity has not yet recognized the related revenue.



At this point I should note that supplies or materials such as stationery would not be treated as inventories unless they are held for sale or are used in producing goods for sale. The paragraph 8 of TAS 16 states that spare parts and servicing equipment are usually carried as inventory unless those spare parts are expected to be used during more than one period, or can be used only in conjunction with an item of property, plant and equipment. Therefore, we can conclude that if spare parts are consumed regularly during the production process, they are carried as inventory. (Alfredson et al., 2005: 250)

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Net realizable value relies on the specific business of the firm that is the subject of the financial statements. On the other hand, fair value refers to the market, rather than to individual contracts. Therefore, the former is an entity-specific value, the latter is not. Net realizable value for inventories may not be equal to fair value less costs to sell. For instance, such a case may occur when a firm is supplying goods to clients at contract prices that no longer match market prices. (IFRS Workbooks for Accounting Professionals IAS 2, 2006: 3)

In writing this part of my study, I assume that the reader has a general understanding of cost accounting terms. Therefore, the explanation of these terms is outside the scope of this part. However, since it has always been a controversial issue for even accounting professionals, I believe that it must be useful to clarify the terms "cost", "expense", "cost of goods sold" and "loss" that I will refer many times in analyzing TAS 2 Inventories.

A *cost* is the value of assets given up, or to be given up, to acquire other assets. On the other hand, *expense* is the value of assets given up to generate revenue. In most cases, costs eventually become expenses. In fact, some become expenses virtually at the same time as the costs are incurred. In such cases the terms cost and expense can be used interchangeably. The distinction can be seen more clearly with an example. Let's consider a firm that buys sales supplies in bulk and uses them over time. The cost of supplies is the value of assets given up to acquire inventory of supplies. The expense for supplies will be the value of supplies that are given up (used) during a particular period of time. (Allen and Moriarity, 1991: 21)

When products are sold, accountants by convention refer to the cost of goods sold. The *cost of goods sold* is the accumulated cost of the products given up to generate revenues. In fact, since the transactions are related to revenue production, a more appropriate term might be expense for goods sold. (Allen and Moriarity, 1991: 21)

As I mentioned above, in most cases costs eventually become expenses. However, in some exceptional cases, assets are given up for nothing in return. In these cases, the value of the assets given up becomes a *loss*. Therefore, in the above example for instance, if some sales supplies are carelessly destroyed, the firm will have incurred a loss from destroyed supplies. (Allen and Moriarity, 1991: 22)

### **3.4. Measurement of Inventories**

According to TAS 2 Inventories shall be measured at the lower of cost and net realizable value.

#### **3.4.1. Cost of Inventories**

An important issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized.

The cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

#### **3.4.1.1. Costs of Purchase**

The paragraph 11 of TAS 2 states that the costs of purchase comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

Trade discounts are reductions in selling prices granted to customers. Such discounts may be granted as an incentive to buy, as a means to quit ageing inventory or as a reward for placing large orders for goods. Since the discount reduces the purchase cost, it is deducted when determining the cost of inventory; failure to do so would result in carrying inventory at amounts in excess of true historical costs. (Alfredson et al., 2005: 252) Although it is disputable in the theory, a discount for prompt payment which is not the same as a trade or volume discount would probably be an “other similar item” in the context of the sentence in paragraph 11. (Alexander and Archer, 2004: 22.09)

TAS 2 does not permit exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency to be included in the costs of purchase of inventories. IASB changed the previous version of IAS 2 that resulted from the elimination of the allowed alternative treatment of capitalizing certain exchange differences in IAS 21 the Effects of Changes in Foreign Exchange Rates. Since TAS 2 is fully compliant to IAS 2, this change is totally adopted by Turkish Accounting Standards Board.<sup>42</sup>

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<sup>42</sup> There are important differences with our Tax Procedural Law in the accounting of foreign exchange differences in the inventories. These differences will be analyzed in detail in the fourth part of our study.

Example 1:<sup>43</sup>

Anatolian Inc. purchased 100 units of personal computer from Germany. The unit purchase price is 1.000 Euro. The value of the purchase was financed by a bank credit on 01.10.2010. (1 Euro: 1.5 TL) The bank transferred (100 x 1.000 x 1.50=) 150.000 TL to the company's running account and transfer for the purchase value was made from this account.

The computers were taken from the Duty in 10.11.2010. For import duties and commission 3.000 TL, for transportation 1.500 TL and finally for insurance 1.000 TL was paid in cash.

According to TAS 2, the costs of purchase of the computers shall be recorded as follows:

---

01.10.2010	
Banks	150.000
Bank Credits	150.000

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01.10.2010	
Advance Payments for Orders	150.000
Banks	150.000

---

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10.11.2010	
Advance Payments for Orders	5.500
Cash	5.500

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<sup>43</sup> This example is developed from TESMER-e-USE Education Notes ( 2009, 32-33)

10.11.2010	
Commercial Goods (Inventory)	155.500
Advance Payments for Orders	155.500

Example 2:

Anatolian Inc. purchased 3.000 units of traded goods from Germany in credit terms, on 10.12.2010. The unit purchase price is 10 \$. At the date of purchase, the exchange rate is 1 \$: 1.40 TL. The company made the purchase recording but at the year end the exchange rate is 1 \$: 1.50 TL.

The rise ( $1.50 - 1.40 = 0.10$ ) in the exchange rate will be expensed according to TAS 2. This difference cannot be included in the cost of the inventories. According to this, financial expenses that amount ( $0.10 \times 3.000 =$ ) 300 TL shall be recorded at the year end. (31.12.2010)

/	
Financial Expenses	300
Bank Credits	300

**3.4.1.2. Costs of Conversion**

Contrary to the costs of purchase which scope is almost clear, the costs of conversion of inventory items are more problematic. The costs of conversion certainly include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed production overheads that is those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment; and of variable production overheads; that is those indirect costs of production that vary directly or nearly directly with the volume of production such as

indirect materials and indirect labor. Although it does not say in words, the Standard makes it quite clear that direct or marginal costing methods, which treat overheads as a period expense related to time, rather than as a production cost related to units of product, are not permitted. The fixed and variable overheads are required to be included as “systematically allocated” in cost of conversion. (Alexander and Archer, 2004: 22.09)

The allocation of variable production overheads is on the basis of the actual use of the production facilities, implying a machine-hour basis or some similar method. The allocation of fixed production overheads is explicitly required to be based on the normal capacity of the production facilities. According to the Standard normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Therefore the Standard makes it clear that normal capacity is to be a realistic expectation of practical outcomes, not an idealistic target or notional full capacity. (Alexander and Archer, 2004: 22.09) The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. (TAS 23.13)

Example 3:<sup>44</sup>

Anatolian Inc. produces two goods; X and Y. Fixed production overhead is 100.000 TL and normal capacity of production is 5.200 of X and 10.200 of Y but this reduced by 200 X and 200 Y for planned maintenance. The target of production was 6.000 X and 11.000 Y. It is estimated that Y will sell at twice the value of X.

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<sup>44</sup> This example is developed from Alexander, Britton and Jorissen (2007: 366)

According to this, fixed production overheads will be charged over 5.000 X and 10.000 Y as normal capacity that is after planned maintenance allowance. According to TAS 2, the target of production is irrelevant in the calculation unless this high production level is actually achieved in which case the fixed overheads to each unit will be decreased in order not to measure the item above cost.

Example 4:<sup>45</sup>

Anatolian Inc. is an entity that produces calculators. When the company works in full capacity, it can produce 24.000 units of calculator. In order to provide the machines work efficiently, they have been to brought to a stop three weeks in a year and two days in a month.

Direct materials per unit:	5 TL
Direct Labor Cost per Unit:	3 TL
Variable Overheads per Unit:	4 TL
Fixed Overheads:	80.000 TL

Yearly production according to theoretical capacity is 24.000 units

Monthly production is  $(24.000/12 =) 2.000$  units

Planned Production Cutoffs:  $21 + (12 \times 2) = 45$  days

Number of units that can be produced during planned cut off period:

$1.5 \text{ month } (45 \text{ days}) \times 2.000 = 3.000$  units

Normal Capacity: Theoretical Capacity – Number of units that can be produced during the planned cutoff period

Normal Capacity:  $24.000 - 3.000 = 21.000$  units

---

<sup>45</sup> This example is developed from TESMER-e-USE Education Notes (2009, 35-36)

a) According to these data, if it is assumed that the company makes production in its normal capacity, then the unit and total costs will be:

Total Direct Materials Expense	21.000 units x 5 TL/per unit=	105.000 TL
Total Direct Labor Cost	21.000 units x 3 TL/per unit=	63.000 TL
Total Variable Overheads	21.000 units x 4 TL/per unit=	84.000 TL
Total Fixed Overheads		80.000 TL
Total Production Cost		332.000 TL
Unit Production Cost	332.000/21.000=	15.80 TL

b) If it is assumed that the company makes production above its normal capacity, then the unit and total costs will be:

Total Direct Materials Expense	23.000 units x 5 TL/per unit=	115.000 TL
Total Direct Labor Cost	23.000 units x 3 TL/per unit=	69.000 TL
Total Variable Overheads	23.000 units x 4 TL/per unit=	92.000 TL
Total Fixed Overheads		80.000 TL
Total Production Cost		356.000 TL
Unit Production Cost	356.000/23.000=	15.47 TL

c) If it is assumed that the company makes production below its normal capacity, then the unit and total costs will be:

Total Direct Materials Expense	20.000 units x 5 TL/per unit=	100.000 TL
Total Direct Labor Cost	20.000 units x 3 TL/per unit=	60.000 TL
Total Variable Overheads	20.000 units x 4 TL/per unit=	80.000 TL
Total Fixed Overheads (*)		76.000 TL
Total Production Cost		316.000 TL
Unit Production Cost	316.000/21.000=	15.04 TL



(\*) Actual Capacity / Normal Capacity: 20.000 units /21.000 units= 0.95

Fixed Overheads that can be included in the cost of inventory:

80.000 TL x 0.95= 76.000 TL

Fixed Overheads that shall be recorded as period expense<sup>46</sup>:

80.000 TL – 76.000 TL= 4.000 TL

### **3.4.1.2.1. Joint and By-Product Costing**

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product.<sup>47</sup> When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. (TAS 23.14) The Standard does not refer to an obligatory allocation method but it provides guidance to users that the allocation can be on the basis of the relative sales value of each product either at the stage in the production process when the products become separately identifiable<sup>48</sup>, or at the completion of production.<sup>49</sup>

Most by-products, by their nature, are immaterial. TAS 2 suggests that by-products be valued at net realizable value which is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost. (TAS 23.14)

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<sup>46</sup> In Turkish Tax Procedural Law, absorption (full) costing method is preferred. Therefore, our tax system does not consider such an expense as legally acceptable in achieving taxable value. This subject will be analyzed in detail in the fourth part of our study.

<sup>47</sup> A by-product is one or more additional products that arise from a production process, but whose potential sales value is much smaller than that of the principal joint products that arise from the same process. (Bragg, 2005: 142)

<sup>48</sup> This stage is known as “*split-off point*”.

<sup>49</sup> Bragg (2005:143) interestingly argues that in allocating costs to joint products and by-products rather than advanced scientifically derived allocation methods, simple methods have been preferred. According to him, the reason for using simple methodologies is that the promulgators of IAS/IFRS and GAAP realize that there is no real management use for allocated joint costs; they cannot be used for determining break-even points, setting optimal prices or determining the exact profitability of individual products. They are rather used for other purposes which are more administrative in nature such as income reporting, transfer pricing, cost-plus contract calculations and of course inventory valuation.

In order to understand joint products and by-products, one must have a firm understanding of the split-off point. This is the last point in a production process where it is impossible to determine the nature of the final products. All costs that have been incurred by the production process up until that point must be allocated to the products that result from the split-off point. Any costs incurred after that point can be charged to specific products in a normal way. Therefore, a product that comes out such a process will be composed of allocated costs from before the split-off point and costs that can be directly traced to it, which occur after the split-off point. (Bragg, 2005: 142)

As mentioned above, the Standard does not state an obligatory cost allocation method for joint products and by-products but it emphasizes that costs of conversion be allocated between the products on a rational and consistent basis. Until recently, many cost allocation methodologies have been proposed in the accounting literature but only two methods have gained widespread acceptance. The first method is based on the sales value of all joint products at the split-off point. To calculate it, the inventory accountant compiles all costs accumulated in the production process up to the split-off point and then assigns these costs to the products based on their relative values.

Example 5:<sup>50</sup>

Bergama Inc. produces two joint products; A and B in the same production process. Both of the products are ready for sale at the split-off point. In December, 1.000 units of A and 1.500 units of B were produced. The joint costs at this month are 600.000 TL. Unit sales price of product A is 300 TL and unit sales price of product B is 600 TL.

According to these data, by using the sales revenue at the split-off point method, the allocation of joint costs shall be as follows:

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<sup>50</sup> This example is developed from TESMER-e-USE Education Notes (2009, 38)

Product	Production Quantity	Price (TL)	Total Revenue (TL)	Percent of Total Revenues
A	1.000	300	300.000	% 25
B	1.500	600	900.000	% 75
Total	2.500		1.200.000	% 100

Product	Percent of Total Revenues	Joint Costs (TL)	Cost Allocation (TL)
A	% 25	600.000	150.000
B	% 75	600.000	450.000
Total	% 100		600.000

Total cost of product A: 150.000 TL

Unit cost of product A:  $150.000/1.000= 150$  TL

Total cost of product B: 450.000 TL

Unit cost of product B:  $450.000/1.500= 300$  TL

The second allocation method is based on the estimated final gross margin of each joint product produced (net sales revenue method). The calculation of gross margin is based on the revenue that each product will earn at the end of the entire production process less the cost of all processing costs incurred from the split-off point to the point of sale. This method can be considered as more complicated compared to sales revenue at the split-off point method because it is an obligation for inventory accountant to accumulate additional costs through the end of the production process. This unavoidably requires a moderate technical knowledge of how the production works and where costs are incurred. In fact, the use of this method may be obligatory in cases where the final sales price of one or more joint products cannot be determined at the split-off point. (M. Bragg, 2005: 145)

Example 6:<sup>51</sup>

Bergama Inc. produces two joint products; A and B in the same production process. For both products additional costs are incurred after the split-off point. In December, 2.000 units of A and 2.500 units of B were produced. The joint costs at this month are 60.000 TL. Additional cost that was incurred after split-off point for product A is 10.000 TL and for product B is 15.000 TL. Unit sales price of product A is 25 TL and of product B is 30 TL.

According to these data, by using the net sales value method, the allocation of joint costs shall be as follows:

- Calculation of net total sales revenue and percent of net total sales revenue:

Prod.	Quantity of Production	Price (TL)	Total Revenue (TL)	Additional Costs After Split-off (TL)	Net Total Revenue (TL)	Percent of Net Total Revenues
A	2.000	25	50.000	10.000	40.000	% 40
B	2.500	30	75.000	15.000	60.000	% 60
Total	4.500		125.000		100.000	% 100

- Allocation of joint costs to the products:

Product	Percent of Net Total Revenues	Joint Costs (TL)	Cost Allocation (TL)
A	% 40	60.000	24.000
B	% 60	60.000	36.000
Total	% 100		60.000

---

<sup>51</sup> This example is developed from M. Bragg (2005: 145-146) and TESMER-e-USE Education Notes (2009, 38-39)

- Calculation of unit costs of the product A and B:

Prod.	Joint Cost Allocation (TL)	Additional Costs After Split-off (TL)	Total Costs (TL)	Quantity of Production	Unit Costs (TL)
A	24.000	10.000	34.000	2.000	17
B	36.000	15.000	51.000	2.500	20.40
Total	60.000	25.000	85.000	4.500	

Example 7: (Gürdal, 2007: 22)

Anatolian Inc. produces two products: A and B. A is the main product and B is the by-product. During the accounting period; the amount of joint costs incurred was 35.000 TL. During this period, 33.000 units of product A were produced. The expected sales price of by-product B is 2.500 TL. Completion costs that would be incurred so as to provide by-product ready for sale is 500 TL.

According to this,

Net Realizable Value of By-product:  $2.500 - 500 = 2.000$  TL

Total Production Cost: 35.000 TL

The Cost of Main Product:  $35.000 - 2.000 = 33.000$  TL (TAS 23.14)

Unit Cost of Main Product:  $33.000 / 33.000 = 1$  TL

### **3.4.1.3. Other Costs**

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. An example of such other costs is costs of designing products for specific customer needs.

According to the paragraph 16 of TAS 2, certain costs shall not be included in valuing inventory. They are recognized as expenses during the period they are incurred. Examples of such costs that are stated in the Standard:

- abnormal amounts of wasted materials, labor or other production costs;
- storage costs, unless those costs are necessary in the production process before a further production stage;
- administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- selling costs.

According to the paragraph 17 of TAS 2, TAS 23 Borrowing Costs identifies limited circumstances where borrowing costs are included in the cost of inventories. As we analyzed in detail in the second part of our study, according TAS 23, borrowing costs such as interest shall be included in the cost of inventories but only where such inventories are a qualifying asset; that is, one which takes a substantial period of time to get ready for its intended use or sale. In fact, inventory items would rarely meet this criterion.

When inventories are purchased on deferred settlement terms, these arrangements generally contain a financing element. According to TAS 2, that element for example a difference between the purchase price for normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.

Example 8: (Gürdal, 2007: 28)

Anatolian Inc. purchased 1.000 units of calculator. The purchase price is 10.000 TL. The purchasing transaction was made on deferred settlement terms that the purchase settlement is three months. Market interest rate is % 15.

According to TAS 2, we should first calculate the portion of financing element and then record this as interest expense. Different methods can be used in order to calculate this amount such as internal or external discount methods. Effective interest rate is one of such methods. According to this method:

Present Value:  $\text{Future Value (Value at the end of the maturity date)} / (1 + \text{interest rate})^{\text{Time to maturity / Maturity base}}$

Present Value:  $10.000 / (1 + 0.15)^{90/360} = 9.615 \text{ TL}$

Interest Expense:  $10.000 - 9.615 = 385 \text{ TL}$

	/	
Commercial Goods (Inventory)		9.615
Financial Expenses		385
Accounts Payable		10.000

#### **3.4.1.4. Cost of Inventories of a Service Provider**

According to the paragraph 19 of TAS 2, inventories of service providers are measured at costs of their production. These costs would consist primarily of labor and other personnel costs for those employees directly engaged in providing the service. The costs of supervisory personnel and directly attributable overheads may also be included, but paragraph 19 of TAS 2 prohibits the inclusion of labor and other costs relating to sales and general administrative personnel. Moreover, the cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers. It should be noted that such inventory assets would be recognized only for services in progress (work in process) (TAS 2.37) at reporting date for which the service provider has not yet recognized any revenue.

Example 9: <sup>52</sup>

Magnesia Inc. which operates in advertising sector prepared a product publicity project for a new product of Nysa Inc. The price of the project was 200.000 TL and would be paid at the end of the project. The project organization started on 10.11.2009 and terminated on 25.02.2010. Magnesia Inc. made 100.000 TL expenses in 2009 for this project. During 2010, up till to the end of the project an additional 50.000 TL expense was made. (Reporting period of the company is quarterly)

According to the paragraphs 19 and 37 of TAS 2, the journal entries shall be as follows:

---

.....2009

Service Rendering Cost	100.000
Expense Accruals	100.000

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31.12.2009

Work in Process	100.000
Service Rendering Cost Applied	100.000

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31.12.2009

Service Rendering Cost Applied	100.000
Service Rendering Cost	100.000

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---

.....2010

Service Rendering Cost	50.000
Expense Accruals	50.000

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<sup>52</sup> This example is developed from TESMER-e-USE Education Notes (2009, 41-42)



.....2010

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Work in Process      50.000

    Service Rendering Cost Applied   50.000

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25.02.2010

---

Completed Service Cost   150.000

    Work in Process   150.000

---

25.02.2010

---

Cost of Services Rendered   150.000

    Completed Service Cost   150.000

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25.02.2010

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Banks      200.000

    Domestic Sales      200.000

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31.03.2010

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Service Rendering Cost Applied      50.000

    Service Rendering Cost      50.000

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**Table 1.** A Summary of Allocation of Costs between Cost Pool and Expense Accounts in Accordance With TAS 2

	Cost Pool	Expense
Discounts on purchase price	***	
Travel expenses of buyers		***

Import duties	***	
Value Added Tax		***
Income Tax		***
Commission and brokerage costs	***	
Transport insurance	***	
Storage costs		***
Storage costs after receiving materials that are necessary in the production process	***	
Warranty cost		***
Audit and tax consultation fees		***
Depreciation and Cost Depletion	***	
Indirect labor and production supervisory wages	***	
Indirect materials and supplies	***	
Quality control and inspection	***	
Repair expenses	***	
Maintenance	***	
Selling expenses		***
Salaries of officers related to overall operations		***
Salaries of sales department		***
Officer's salaries related to production services	***	

**Source:** Bragg, 2005: 128

### **3.4.2. Techniques for the Measurement of Cost**

In the paragraphs 21 and 22, TAS 2 makes reference to two costing methods: the standard cost method and the retail method- both of which are acceptable for financial reporting purposes provided that their results approximate cost as defined in TAS 2. However, one must be aware of the fact that the purposes of the two methods are different. The standard cost method is a management tool which may need to be adapted to produce the information required by TAS 2. On the other hand, the retail

method is a practical means of measuring the cost of inventories for financial reporting purposes. (Cairns, 1995: 430-431)

Standard costs take into account normal levels of materials and supplies, labor, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions. The primary purpose of standard costs is to assist in the setting of budgets and evaluate the performance of management but they may be used to measure cost of inventories in accordance with the requirements of TAS 2 that mentioned above.

The retail method is used to measure inventories of large numbers of rapidly changing items with similar margins for which it is impractical to use other costing methods. Supermarket and department store chains often employ this method of approximating cost. (Alfredson et al., 2005: 254) Inventories are initially measured at selling price and then reduced to cost by applying the appropriate gross margin. However, problems occur with this method when a retailer deals in products of widely differing profit margins. (Alexander, Britton and Jorissen; 2007: 368) An average percentage may be taken into consideration but such an average for the all products may offset profits and losses. (Cairns, 1995: 431)

Example 10: (Gençoğlu, 2007: 186)

Anatolian Inc. is a retailer of digital cameras. The company generally operates with a gross margin of % 30. The beginning inventory of the accounting period was 300.000 TL. The company purchased 300 units of digital cameras during the period that cost 270.000 TL. The value of the sales at retail during the period was 400.000 TL.

According to this, the profit and the cost of goods sold and ending inventory at cost shall be calculated as follows:

$400.000 \times 0.30 = 120.000$  TL (profit)

$400.000 - 120.000 = 280.000$  TL (cost of goods sold)

$300.000 + 270.000 = 570.000$  TL (cost of total goods available for sale)

Cost of total goods available for sale - cost of goods sold: Ending inventory

$570.000 - 280.000 = 290.000$  TL (ending inventory at cost)

### **3.4.3. Cost Formulas**

The type of costing method used to value inventory is one of the central issues in inventory costing because the method used can have a significant impact on the level of reported income. There are several methods used in inventory costing such as specific identification; first-in, first-out (FIFO), last-in, last-out (LIFO) weighted average, replacement cost and base inventory. TAS 2 allows only the use of specific identification, first-in, first-out and weighted average methods.

#### **3.4.3.1. Costing Methods Accepted by TAS 2**

According to the paragraph 23 of TAS 2, the cost of items that are not ordinarily interchangeable<sup>53</sup> and goods or services produced and segregated for specific projects shall be assigned by using *specific identification* of their individual costs. Here it is assumed that the actual physical units that has moved in or out is known. However, the method is generally considered as impractical as the product will generally lose its separate identity as it passes through the production and sales process. Exceptions to this would arise in situations involving small inventory quantities with high unit value and low turnover rate. (Epstein and Mirza, 2005: 145) Therefore, such a method is most applicable in businesses such as home construction, where there are few units of inventory to track, and where each item is truly unique. (M. Bragg, 2005: 121)

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<sup>53</sup> The Standard makes it clear that a customized inventory, being by definition not interchangeable with other inventories shall be separately costed. However, it does not imply that identical items that are distinguishable, for example by registration numbers, shall be costed separately from each other. The criterion is interchangeability, not distinguishability. (Alexander and Archer, 2004: 22.11)

Since the applicability of specific identification method is limited, certain assumptions regarding the cost flows associated with inventory is required. However, it should be noted that these cost flows may or may not reflect the physical flow of inventory. In fact it has long been recognized that there is no such a need that the flow of costs mirror the actual flow of the goods with which those costs are associated. The important point is to select the appropriate method that most clearly reflects periodic income. (Epstein and Mirza, 2005: 146) TAS 2 allows the use of two cost flow assumptions. The first one is first-in, first-out method and the second is weighted average method.

The *FIFO method* assumes that the inventories that are purchased or produced first are used or sold first, which means that their associated old costs are used first and the ending or remaining items in the inventory being valued based on prices of most recent purchases. (Mirza, Orrell and Holt, 2008: 29) Because of this nature, the method reduces taxes payable in periods of declining costs. Although it is not a usual situation to see declining inventory costs, it sometimes occurs in industries where there is either severe price competition among suppliers or high rates of innovation that lead to cost reductions. In such cases, using the earliest costs first will result in the immediate recognition of the highest possible expense, which reduces the reported profit level and by this way reduces tax liabilities. With the same logic, the method shows higher profits in periods of rising costs. Moreover, since the old costs are used first, there is less risk for old and outdated costs to accumulate in inventory. (M. Bragg, 2005: 110) Another important characteristic of the FIFO method is that it provides the same results under either the periodic or perpetual system. This will not be the case for any other costing method. On the other hand, the most important flaw of the method is that it does not necessarily reflect the most accurate income figure when viewed from the perspective of underlying economic performance, as older historical costs are being matched against current revenues. (Epstein and Mirza, 2005: 146)

In the *weighted average cost method*, the cost of each item is determined from the weighted-average of the cost of similar items at the beginning of a period

and the cost of items purchased or produced during the period. The average may be calculated on a periodic basis or as each additional shipment is received (moving average method), depending upon the circumstances of the entity. If the entity selects calculating average after each additional shipment is received then when items are used or sold from stock, they are issued at the same weighted-average cost. If new units are added to stock, the cost of additional units are added to the weighted average of all existing items in stock, which will result in a new, slightly modified weighted average for all of the parts in inventory. (M. Bragg, 2005: 119) The method is popular within organizations holding a large volume of inventory at fluctuating costs. In recent years by the use of sophisticated computer software, the calculation of weighted average has become easier.

The question of which formula should be preferred has always been an important debate in the inventory accounting literature. As mentioned detail above, each method has some advantages as well as disadvantages. Therefore, the choice is a management judgement and depends upon first the nature of the inventory. For instance, it would be sound for a retailer company that sells perishable goods to select FIFO method. The choice also depends on the information needs of management and financial statement users, and the cost of applying the formulas. For example, the managers of a small-sized company that sells homogenous products may prefer to choose weighted-average method which is easy to apply. (Alfredson et al., 2005: 261)

According to the paragraphs 25 and 26 of TAS 2, inventories having a similar nature and use to the entity shall be valued using the same cost formula. However, in case of inventories with different nature or use, different cost formulas may be justified. For example, inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories or in the respective tax rules, by itself, is not sufficient to justify the use of different cost formulas. (TAS 2.25 and 26)

Example 11: <sup>54</sup>

Amyzon Inc. is a retailer of commercial good A. The purchase and sales transactions of the company in the first quarter of the year 2010 is stated in the below table. The entity is preparing its financial reports and tables quarterly. Let's calculate the cost of goods sold and ending inventory of the entity by using the FIFO and weighted average costing methods according to the following data.

Date-Transaction	Quantity	Price (TL)	Amount (TL)
January 1-Beginning Inventory	100	15	1.500
January 10-Purchases	300	20	6.000
January 15-Sales	250		
February 10-Purchases	100	25	2.500
March 15-Sales	200		

- If the company uses FIFO method, the cost of goods sold and cost of ending inventory shall be calculated as follows:

Date	Purchases			Sales			Balance		
	Quan.	Price	Amount	Quan.	Price	Amount	Quan.	Price	Amount
01.01	100	15	1.500				100	15	1.500
10.01	300	20	6.000				100	15	
							300	20	7.500
15.01				100	15				
				150	20	4.500	150	20	3.000
10.02	100	25	2.500				150	20	3.000
							100	25	2.500
15.03				150	20				
				50	25	4.250	50	25	1.250

<sup>54</sup> This example is developed from (Gürdal, 2007: 44-45)

Cost of Goods Sold: 8.750 TL

Ending Inventory: 1.250 TL

- If the company uses weighted average method (moving average), the cost of goods sold and cost of ending inventory shall be calculated as follows:

	Purchases			Sales			Balance		
Date	Quan.	Price	Amount	Quan	Price	Amount	Quan.	Price	Amount
01.01	100	15	1.500				100	15	1.500
10.01	300	20	6.000				400	18.75 <sup>55</sup>	7.500
15.01				250	18.75	4.687.50	150	18.75	2.812.50
10.02	100	25	2.500				250	21.25 <sup>56</sup>	5.312.50
15.03				200	21.25	4.250	50	21.25	1.062.50

Cost of Goods Sold: 8.937.50 TL

Ending Inventory: 1.062.50 TL

As can be seen from the results of this example, in FIFO costing method COGS is lower than weighted average method but on the other hand, the ending inventory in FIFO method is higher than weighted average method.

### 3.4.3.2. Costing Methods Rejected by TAS 2

Methods such as *base stock (inventory)* and *LIFO* often lead to inventories being stated in the balance sheet at amounts that bear little relationship to recent cost levels. When such a situation occurs, not only the presentation of current assets in the balance sheets of entities be misleading but also there is risk of distortion of subsequent results if inventory levels reduce and outdated costs are included the income statement. (Alexander, Britton and Jorissen; 2007: 363) On the other hand, the inventory is valued at the current cost of the individual item in the *replacement*

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<sup>55</sup>  $7.500 / 400 = 18.75$  TL

<sup>56</sup>  $5.312.50 / 250 = 21.25$  TL



*cost method*. This can be considered as an attractive approach because the value of the inventory could be seen as the cost at which a similar item could be currently acquired. However, the problem occurs again in achieving a reliable net income figure for the evaluation of the performance of the entities. Severe fluctuation of profit can occur because of dramatic challenges in world weather system, political developments or the manipulation of market forces. For example, when the Gulf Crisis of 1990 began, the cost of oil moved from around 13 \$ per barrel to a high amount of around 29 \$ per barrel in a short time. If oil companies had used replacement cost, this would have created huge fictitious profits. This might unavoidably have resulted in higher tax liabilities and most dramatically shareholders demanding dividends from a profit that existed only on paper. Therefore, the use of these costing methods is rejected by TAS 2 in conformity with IAS/IFRSs.

**Table 2.** Summary of Cost Formulas Accepted and Rejected by the TAS 2

Method	Acceptable
<u>Specific Identification of Cost:</u> The Cost of Purchasing or manufacturing identifiable units of stock.	Yes
<u>Average Cost:</u> Using an average price computed by dividing total cost of units by the total number of such units.	Yes
<u>FIFO (First In First Out):</u> Using the assumption that the stock on hand represents the latest purchases or production	Yes
<u>LIFO (Last In First Out):</u> Using the assumption that the stock on hand represents the earliest purchases or production	No
<u>Replacement Cost:</u> The cost at which an identical asset could be purchased or manufactured.	No
<u>Base Stock:</u> Ascribing a fixed unit value to a predetermined number of units in stock, any excess over this number being valued on the basis of some other method.	No

**Source:** Black, 2003: 106

#### 3.4.4. Net Realizable Value

As we stated before since the measurement rule required by TAS 2 for inventories is the lower of cost and net realizable value, an estimate of net realizable value must be made to determine if inventory must be written down. There may be many different reasons of the fact that net realizable value fall below cost such as a fall in selling price, product obsolescence, physical deterioration of inventories or an increase in the estimated costs of completion or the estimated costs of making the sale. The practice of writing inventories down below cost to net realizable value is consistent with the view that assets should not be carried in excess of amounts expected to be realized from their sale or use.

Example 12: (Greuning, 2006: 101)

Miletos Inc. purchased inventory on January 1, 2009 for 300.000 TL. On December 31, 2009, the inventory had a net realizable value of 275.000 TL. During 2010, the entity sold the inventory for 320.000 TL.

According to this, since TAS 2 requires the lower of cost or net realizable value reporting on inventory, the company must recognize a  $(275.000 - 300.000 =)$  25.000 TL provision for loss on inventories on the income statement of the year 2009 and when the inventory is sold in 2010, a profit of  $(320.000 - 275.000 =)$  45.000 TL shall be recognized on the income statement.

Inventories are usually written down to their net realizable value on an item-by-item basis, but in certain conditions, also by a group of similar or related items. It is however, not appropriate to mark down inventories by classification of inventories, such as finished goods or all inventories in a geographical segment or industry. (Mirza, Orrell and Holt, 2008: 29) Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item. (TAS 23.29)

Estimates of net realizable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realize. When making these estimates, managers of the companies can use different methods. For instance, if the inventories are traded on the stock or commodity exchanges, these listed official prices can be used. Moreover, market prices can be investigated and then used. In addition to these, the prices that are determined by the assessment committees or the expert opinions can be considered. (Gürdal, 2007: 50) These estimates of net realizable value take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period. (TAS 23.30) The purpose for which inventory is held should also be taken into account when reviewing net realizable values. For instance, the net realizable value of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realizable value of the excess is based on the general selling prices.

Example 13: (Gürdal, 2007: 52)

The entity detected that the packages of 150 units of traded good A deteriorated in the warehouse. The unit purchase price of product A is 250 TL and the unit sales price for healthy products is 350 TL. 100 units of A will be sold for 300 TL to the customers according to the requirements of an agreement accepted before. The company managers expect that the remaining 50 units can be sold for 200 TL in the market.

According to this, the net realizable value of 100 units is calculated for 300 TL. (TAS 23.31) The net realizable value of the remaining 50 units is calculated for 200 TL. Since the agreement price is above cost, there is no need for a write down for 100 units of product A. However, the net realizable value for the remaining units is below cost and therefore a provision for loss on inventories  $((250 - 200) \times 50 = 2.500 \text{ TL})$  is needed.

In the paragraph 32 of TAS 2, special provisions stated for the main cost measurement of the Standard that is the lower of cost and net realizable value while applying for materials and supplies. (Karakaya, 2007: 168) According to this, materials and other supplies held for use in the production of inventories are not written down below cost if the finished goods in which they will be incorporated are expected to be sold at or above cost. When the sale of finished goods is not expected to recover the costs, then materials are to be written down to net realizable value. According to the Standard, in such cases, the replacement cost of the materials may be the best available measure of their net realizable value.

Example 14: (Karakaya; 2007: 169)

At the end of the period (31.12.2010) the company's accounting staff detected 1.000 units of material X (unit purchase price is 10 TL) in the warehouse while controlling physical inventory. After a short investigation it is seen that the unit purchase price of (replacement cost) this material has fallen to 8 TL. Since this decrease in the prices is not temporary, a decrease in the price of the finished product A, whose material is the product X, has been realized. Before the fall in the prices of material X, the price of product A is 40 TL per unit, after the decrease in the prices, the price has fallen to 30 TL per unit.

While producing one unit of product A, two units of material X is used. Moreover, with the assumption that the production is made on normal capacity, transaction costs per unit (direct labor plus production overheads) is 18 TL. According to this;

The cost of material X: 10 x 1.000	= 10.000 TL
The net realizable value of material X: 8 x 1.000	= 8.000 TL
Write-down to net realizable value:	2.000 TL

The cost of finished product A:

Direct Materials and Supplies: 2 x 10 x 500	= 10.000 TL
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Transaction Cost: 18 x 500 = 9.000 TL  
 The cost of the product: 19.000 TL  
 The net realizable value of the product: 500 x 30 = 15.000 TL

As can be seen from the calculations above, the cost of the product A is higher than its net realizable value. Therefore, according to the paragraph 32 of TAS 2, the material X is to be written down to net realizable value. Undoubtedly, there is also a need for a write-down for finished product A.

	/	
Inventory write-down expense (Allowance Expenses) **		2.000
Inventory (Provisions for loss on Inventories) **		2.000
-Materials and other supplies		
	/	
Inventory write-down expense (Allowance Expenses) **		4.000
Inventory (Provisions for loss on Inventories) **		4.000
-Finished Products		

\*\* The account names within the parentheses are suggested by Turkish Uniform Chart of Accounts.

When inventories are written down to net realizable value, TAS 2 does not allow the lower, net realizable value to be treated as a new cost. If the same inventories continue to be held at the next balance sheet date, the enterprise must compare the original cost with a current estimate of net realizable value. This may result in the reversal of the previous period's write-down. (Cairns, 1995: 440) This occurs for example, when an item of inventory that is carried at net realizable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased. (TAS 2.33)

### **3.4.5. Recognition as an Expense**

According to the paragraph 34 and 35 of TAS 2, when inventory is sold the carrying amount of inventory shall be recognized as an expense when the related revenue is recognized. Moreover, the amount of any write-down of inventories to net realizable value and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs. The only exception to this rule relates to inventory items used by an enterprise as components in self-constructed property, plant or equipment. The cost of these items would be capitalized and recognized as expense via depreciation. (Alfredson et al., 2005: 270)

### **3.5. Disclosure**

According to the paragraph 36 of TAS 2, the financial statements shall disclose;

- the accounting policies adopted in measuring inventories, including the cost formula used;
- the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
- the carrying amount of inventories carried at fair value less costs to sell;
- the amount of inventories recognized as an expense during the period;
- the amount of any write-down of inventories recognized as an expense in the period
- the amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period
- the circumstances or events that led to the reversal of a write-down of inventories
- the carrying amount of inventories pledged as security for liabilities.

It should be noted that according to the paragraph 37 of TAS 2, the inventories of a service provider may be described as work in progress.

### **3.6. Special Issues: Ownership of Goods**

As I stated before, valuation of inventory should be reliable and consistent so as to comply with generally accepted accounting principles. In fact, in order to obtain an accurate measurement of inventory quantity and corresponding monetary representation of inventory and cost of goods sold in the financial statements, it is necessary to determine when ownership of inventories (title) has passed. Two important matters may create a question as to proper ownership: 1- Goods in transit 2- Consignment sales. (Epstein and Mirza, 2005: 141)

#### **3.6.1. Goods in Transit:**

At the end of accounting periods any goods in transit from seller to buyer can only be included only one of those parties' inventories, based on the conditions of sale. (Terms of trade) Under traditional legal and accounting interpretation, such goods are included in the inventory of the firm financially responsible for transportation costs. In order to clarify the subject we can emphasize on some shipping terms such as FOB, CIF and ex-ship.

The term FOB stands for free on board. If the goods are shipped *FOB destination*, transportation costs are paid by the seller and title does not pass until the carrier delivers the goods to the buyer. Therefore, these goods will be included in the seller's inventory while in transit. (Epstein and Mirza, 2005: 141) On the other hand, if the goods are shipped *FOB shipping point (basis)* the goods belong to the purchaser from the time they are shipped and shall be included in the buyer's inventory while in transit. (Alfredson et al., 2005: 261)

In a CIF (cost, insurance and freight) contract the buyer agrees to pay in a lump sum the cost of goods, insurance and freight charges. In such an arrangement,

the seller must deliver the goods to the carrier and pay the costs of loading, therefore title pass to the buyer upon delivery of the goods to the carrier. On the other hand, a seller who delivers goods ex-ship bears all expense and risk until the goods are unloaded. When the goods are unloaded both title and risk of loss pass to the buyer, therefore until unloading transaction, the goods shall be included in the seller's inventory accounts. (Epstein and Mirza, 2005: 142)

### **3.6.2. Consignment Sales:**

Under a consignment arrangement, an agent (the consignee) agrees to sell goods on behalf of the consignor on a commission basis. (Alfredson et al., 2005: 261) In some consignments, the consignee purchases the goods simultaneously with the sale of the goods to the customer. Legal ownership remains with the consignor until the agent sells the goods to a third party. This means that goods out on consignment are included in the inventory of the consignor until the date of purchase.

#### Example 15:<sup>57</sup>

Anatolian Inc. which started its business as an electronic products wholesaler in 01.01.2010 completed his first year of trading in 31.12.2010. Because of lack of experience the company managers are worried about end-of-year results.

The inventory ledger account balance at 31.12.2010, under the perpetual inventory system was 580.000 TL. However, the physical count revealed the cost of inventory on hand at 31.12.2010 to be only 540.000 TL. The managers expected an inventory shortfall as a normal process of company activities but such a shortfall was considered as excessive and so an investigation was made.

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<sup>57</sup> This example is developed from Alfredson et al. (2005: 262-263)



At the end of this investigation, managers discovered the following:

- Goods costing 4.000 TL were sold on credit to Aegean Inc. for 6.000 TL on 10.12.2010 on FOB destination terms. The goods were still in transit at 31.12.2010. Anatolian Inc. recorded the sale on 10.12.2010 but did not include these goods in the physical count.
- Included in the physical count were 3.000 TL of goods held on consignment.
- Goods costing 2.500 TL were purchased on credit from Yapan Ltd. on 15.12.2010 and received on 25.12.2010. The purchase was unrecorded at 31.12.2010 but the goods were included in the physical count.
- Goods costing 8.000 TL were purchased from Black Sea Supplies on 20.12.2010 on FOB shipping terms. The goods were delivered to the transport company on 25.12.2010. The purchase was recorded at 25.12.2010 but as the goods had not yet arrived, Anatolian Inc did not include these goods in the physical count.
- At 31.12.2010, Anatolian Inc. had unsold goods costing 15.000 TL out on consignment. These goods were not included in the physical count.
- Goods costing 10.000 TL were sold on credit to Mountain Ltd. For 12.500 TL on 24.12.2010 on FOB shipping terms. The goods were shipped on 28.12.2010. The sale was unrecorded at 31.12.2010 and Anatolian Inc. did not include these goods in the physical count.
- Goods costing 8.500 TL had been returned to Priene Inc. on 31.12.2010. A credit note was received from the Supplier on 10.12.2010. No payment had been made for the goods prior to their return.

According to this, managers of Anatolian Inc. made the following journal entries that are necessary on 31.12.2010 to correct errors and adjust inventory in line with the information about goods in transit mentioned above.

Workings	Recorded Balance (TL)	Physical Count (TL)
Balance Prior to adjustment	580.000	540.000
Add goods sold; FOB destination and in transit at 31.12.2010	4.000	4.000
Less goods held on consignment		(3.000)
Add unrecorded purchase	2.500	
Add goods purchased; FOB shipping and in transit at 31.12.2010		8.000
Add goods out on consignment		15.000
Less unrecorded sale	(10.000)	
Less unrecorded purchase returns	(8.500)	
Inventory shortfall	(4.000)	
End-of-period balance	564.000	564.000

\_\_\_\_\_ / \_\_\_\_\_

Exports (Foreign Sales) 6.000

Accounts Receivable 6.000

(Correction of sale recorded in error)

\_\_\_\_\_

\_\_\_\_\_ / \_\_\_\_\_

Commercial Goods (Inventory) 4.000

Cost of Goods Sold 4.000

(Correction of sale recorded in error)

\_\_\_\_\_

\_\_\_\_\_ / \_\_\_\_\_

Commercial Goods (Inventory) 2.500

Accounts Payable 2.500

(Correction of unrecorded purchase)

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Accounts Receivable 12.500  
Exports (Foreign Sales) 12.500  
(Correction of unrecorded sale)

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Cost of Goods Sold 10.000  
Commercial Goods (Inventory) 10.000  
(Correction of unrecorded sale)

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Accounts Payable 8.500  
Commercial Goods (Inventory) 8.500  
(Correction of unrecorded purchase return)

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Inventory Losses and Write-downs 4.000  
Commercial Goods (Inventory) 4.000  
(Unexplained variance written-off)

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**FOURTH PART**  
**COMPARISON OF TAS 23 BORROWING COSTS AND TAS 2**  
**INVENTORIES WITH THE TAX PROCEDURAL LAW**

The main purpose of the TAS/IFRS, which has been issued by the Turkish Accounting Standards Board, is to meet the stakeholders' need for transparent, understandable, comparable and reliable information. Therefore those standards are drawn up with full accounting concerns. However, our Tax Procedural Law No. 213 (TPL) regulates the matters related to the assessment and appraisal of the tax base, and naturally represents a tax-oriented approach. For this reason, in order to overcome the problems that might emerge in the measurement amongst the provisions of TPL and TAS/IFRSs, the 6<sup>th</sup> article of the "Communiqué Item No. 1 on the Conceptual Framework Regarding the Preparation and Presentation Principles for the Financial Statements" which was issued in the Official Gazette dated 16.01.2005 and No. 25702 was adjusted. This Article is titled as "Relation with the Tax Legislation" and it emphasizes that the financial statements to be regulated within the scope of the TAS/IFRS standards are related to the commercial balance sheet origination. The TPL provisions regarding the measurement of the economic assets are related to the calculation of the tax base. Thus, the taxpayers, moving from the trading profit to be formed in the financial statements they draw up according to TAS/IFRS provisions, shall calculate their external income or corporate tax bases by adding and reducing the positive and negative impacts of TPL's different measurement provisions, the non-allowable charges and the tax-exempt incomes to and from this profit. In addition according to this Communiqué, the Ministry of Finance reserves the right to make prudent and restrictive adjustments and request additional financial statements and reports from the taxpayers as long as those are in conformity with the Turkish Accounting Standards. (Çakmakçı, 2006) However, doubtlessly this development is not enough for the harmonization of our legislation with the International Accounting Standards, which are widely accepted around the world.

#### **4.1. The Aim of the Study**

In this part of our study, the provisions of the TAS 23 Borrowing Costs and TAS 2 Inventories Standards that we have reviewed in detail in the second and third parts and the provisions regarding the related matters in our Tax Procedural Law (TPL) will be compared, the differences will be laid out and so the necessary changes in order to harmonize with global accounting standards in our tax and accounting legislation, particularly Tax Procedural Law, Accounting System Implementation General Communiqués and Uniform Chart of Accounts will be demonstrated.

#### **4.2. The Methodology:**

A comparative analysis will be implemented. The provisions of TPL and other related legislation will be covered and these provisions will be compared with the provisions of the selected two Standards. The reader will be provided with comprehensive application examples so as to make easier the understanding of the analysis.

#### **4.3. The Comparison of TAS 23 Borrowing Costs with the TPL**

In the Article 258 of our Tax Procedural Law, valuation is defined as the assessment and appraisal of the values related to the calculation of the tax bases and the Articles 258 and 290 lay down the adjustments regarding the measurement of goods and fixed assets. Article 269 with the title “Properties” of the relevant Law, states that the commercial enterprises shall be measured by the cost values (prices) of their properties, and the same Article states that the integral parts and details of the properties, installations and facilities, ships and other vehicles, and also the intangible rights shall be measured by their cost prices just like the properties. Again TPL Article 270 with the title “Expenses within Cost Price in Properties” lays down the expenses to be added to the cost value other than the purchase price for the properties. According to this article; customs duties for machinery and installation,

transport and mounting expenses and the expenses deriving from the purchase and demolition of an existing building and leveling of its land shall be added to the cost value. In addition, the said Article states that the taxpayers are free to bring the notary, court, appraisal, commission and brokerage expenses and the Real Estate Purchase and Private Consumption Taxes into the cost value or to show them within general administrative expenses. In the same Law, Article 274 states that the commodity shall be measured by its cost price. Article 275 lists the elements to be included in the cost value of the finished goods, i.e. the manufactured commodity. According to Article 275 of the law, those elements are:

- The cost of the direct materials and supplied spent for creating the finished product,
- Labor falling to the finished product
- The share falling to the finished product from the overall manufacturing costs,
- The share falling to the finished product from the overall administrative costs (adding this share into the product cost is optional.)
- Packaging material's cost for the products that shall be placed on the market as packaged.

On the other hand, Article 262 of the same Law explains what we should understand from cost value as a measurement criterion. According to this, cost value means the sum of the payments made in connection with the acquisition or enhancement of a value and all expenses related to those. As seen, according to our Tax Procedural Law the criterion of "cost value" is used as the basis for the measurement of the tangible fixed assets and inventories. The way that borrowing costs in the tangible fixed assets, inventories and in finance leases are regulated in the relevant articles of the said Law and the Communiqués that have been issued as affiliated to this law, and the differences of those adjustments from the provisions of the Standard will be reviewed separately.

### 4.3.1. Borrowing Costs in Tangible Fixed Assets

When we review the above mentioned articles of our Tax Procedural Law, it is seen that: there is room for interest capitalization regarding the borrowing costs in the form of interest born by the taxpayer; at least this is not prevented; however it is not clarified how and with which method such capitalization shall be made and what will be the time limit for this. In order to fill this gap The Ministry of Finance issued the Tax Procedural Law Communiqué<sup>58</sup> No. 163 in 1985. This Communiqué separates the borrowing costs of the tangible fixed assets into two groups. The first group consists of the interests of the loans used in the financing of the tangible asset investments; and the second group consists of the exchange differences incurring from the values in case foreign exchange loan is used and fixed asset is imported from abroad. (Koçak, 2007: 74)

Tax Procedural Law Communiqué No. 163 addresses the interest expenses incurring from the loans used for financing tangible fixed assets separately for the establishment and operating periods. Establishment (investment) period indicates the duration until the end of the period when the enterprise capitalizes the value subject to depreciation, and the operating period indicates the duration after that date. It is obligatory to add the interest expenses belonging to the establishment period to the cost of the tangible fixed assets. In other words, definite interest expenses must be added to the cost of the fixed asset by being paid or accrued until the end of the fiscal period when the fixed assets are capitalized. (Sönmez and Açıan, 2004)

#### Example 1: (Koçak, 2007: 75)

Anatolian Inc. used a long-term bank credit in order to finance the purchase of a construction machine. The total amount of the credit is 300.000 TL and the maturity is five years. The interest expense incurred in the investment period is 50.000 TL.

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<sup>58</sup> This communiqué entered into force after being published in the Official Gazette dated 27 January 1985 and No. 18648.

According to the requirements of the Tax Procedural Law Communiqué No. 163 and Turkish Uniform of Chart of Accounts<sup>59</sup>, the following journal entries shall be recorded:

	/	
780 Financial Expenses		50.000
400 Bank Credits		50.000

	/	
258 Investments on Progress		50.000
781 Financial Expenses Applied		50.000

According to the relevant communiqué, the interest expenses of the operating period can be recorded as direct expenses in the current year or they can be added to the cost of the tangible fixed assets. Here it is seen that the taxpayers are given the right to choose.

Example 2:

Agean Inc. used a long-term credit in order to finance the purchase of a new machine. The interest expense that was incurred by the entity in the operating period was 30.000 TL. In refer to this right to choose vested by the Tax Procedural Law No. 163, the firm recognized this borrowing cost which incurred as interest expense as direct expense of the period.

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<sup>59</sup> Financial expenses are applied as follows in section 4 titled as “Adjustment and Presentation of Financial Statements” in Annex titled as “Accounting Procedures and Principles” of the Accounting System Implementation General Communiqués Item No. 1: The relevant borrowing cost is recorded as debt in 780 Financial Expenses Account in the period. At the end of the period the borrowing costs is recorded as debt into the relevant account of the 66 Financial Expenses in return for the receivables of 781 Financial Expenses Reflection Account. The borrowing costs that accumulate in the account no. 780 during the period are closed by being credited to the 781 Financial Expenses Reflection Account at the end of the period. (Evcı, 2008: 126 with reference to Marşap, 2001)



According to this, in line with the requirements of the Tax Procedural Law Communiqué No. 163 and Turkish Uniform of Chart of Accounts, the following journal entries shall be recorded:

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780 Financial Expenses	30.000	
		400 Bank Credits 30.000

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661 Long Term Borrowing Expenses	30.000	
		781 Financial Expenses Applied 30.000

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690 Profits or Loss of the Current Period	30.000	
		661 Long Term Borrowing Costs 30.000

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781 Financial Expenses Applied	30.000	
		780 Financial Expenses 30.000

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On the other hand, according to the Tax Procedural Law Communiqué No. 163, the borrowing costs related to the tangible fixed assets imported, through borrowings based on foreign exchange are separated into two groups, and the principles and the methods of recognition of the costs are defined in line with this.

- Exchange differences that emerge during the importation of the tangible fixed assets from abroad and until the capitalization date: the borrowing costs

included in this group shall be recognized so as to form a cost element of the imported tangible fixed asset and shall be subjected to depreciation.

- Exchange differences that emerge after the capitalization of the tangible fixed asset imported from abroad: based on the preference of the enterprises, those borrowing costs are either recognized as the expense of the relevant period and included in the income statement of that period or capitalized and recognized as an element of the acquisition cost of the relevant tangible fixed asset.

Within the framework of the provisions of the relevant Communiqué, if the taxpayer records the exchange differences that emerge the subsequent year or years as direct expense, then he/she pays less tax in the current year and forms a resource financing for him/herself since the total of the exchange differences in the current year reduces his/her tax base. If he/she adds the exchange differences to the cost of the asset, then he/she can calculate a depreciation cost, which is equal to the sum to be found by multiplying the amount of cost increase incurring from exchange difference with the depreciation rate and deducts this amount from his/her tax base. The amount left after deducting the amount recognized as expense (depreciation cost) from the amount capitalized due to the exchange difference, increases the value of the assets of the enterprise by the said amount. As a result of this situation the enterprise might gain a wealthier asset structure and thus its credibility might increase. (Sönmez, 2003b)

The concept of qualified asset, which is included in the TAS 23 Borrowing Costs Standard, is not covered in the said Tax Procedural Law Communiqué No. 163, and no such differentiation was made in terms of the assets and general provisions are laid down that are applicable for all assets. In accordance with this, an enterprise can capitalize its borrowing costs -for example that emerge as interest expenses- capitalized by necessity in the establishment period, in the operating period as well. This is optional for the enterprises. However, in another enterprise prefers the option of recognition as expense in the operating period, it will not be

possible to soundly compare the financial status of these two companies. In addition, the firm that capitalizes also in the operating period might have the disadvantage of including the asset in the balance sheet over its current market value during the whole depreciation period. However, according to TAS 23, interest capitalization can only be made for the qualified assets which take a long time to prepare for the intended use or sale; and for those assets, capitalization is ended when all procedures required to prepare the asset for the intended use or sale are completed in essence, and the borrowing costs that incur after that point are recognized as expense in the period they incur. (Erdoğan and İler, 2005: 205) On the other hand, according to TAS 23 exchange differences arising from foreign currency borrowings can only be added to the asset expenses to the extent that they are regarded as an adjustment to interest expenses and, in the case of the acquisition of a qualified asset, until the provisions regarding the ending of capitalization are realized. Apart from that they are taken into account as period expenses. Therefore, there are significant differences between our Tax Legislation and the provisions of the Standard in terms of the recognition of the borrowing costs incur from exchange differences.

#### **4.3.2. Borrowing Costs in Inventories**

In our Tax Legislation, the recognition of the borrowing costs incurred in relation with the inventories is also put under provision with a separate Tax Procedural Law Communiqué. Tax Procedural Law Communiqué No. 283<sup>60</sup>, which has been issued by the Ministry of Finance on this matter in 1995, lays down different adjustments in terms of the borrowing costs incurring from domestic borrowing costs and foreign exchange loans for the recognition principles and methods of the borrowing costs of the inventories. According to this;

- Borrowing Costs Incurring from Domestic Borrowing: According to the relevant Communiqué, it is not compulsory for the enterprises to give a share from the borrowing costs consisting of the interest expenses and similar

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<sup>60</sup> This Communiqué entered into force after being published in the Official Gazette dated 2 March 1995 and No. 22218.

expenses of the loans received for financing from the banks and similar institutions, to the inventories at the end of the period. If they wish the enterprises can capitalize the inventory-related part of the general borrowing costs by adding it to the inventory costs or can recognize all of it as period expense without paying attention to the relation of the general borrowing costs to the inventories.<sup>61</sup>

- Borrowing Costs Incurring from Foreign Exchange Loans: The borrowing costs incurring from the foreign exchange loans are separated into two in the Communiqué and the principles and procedures for the recognition of those costs are laid out: According to this, it is obligatory to recognize the exchange differences that occur in the period until the date of acquisition and recognition of the inventory items, as an element of the inventory cost. On the other hand the enterprises can capitalize the borrowing costs of the subsequent period after the recognition date of the inventory items by adding them to the cost of their inventories or recognize the exchange differences as the expense of the period they occur.<sup>62</sup> (Yalkın, 2000: 9-10)

As seen the Tax Procedural Law Communiqué No. 238 includes the financing costs only in the measurement of the end-of-period inventories and there is no clear provision on the costs incurred at the moment of acquisition. It can be deduced from the letter of the Articles 274 and 275 of the Tax Procedural Law that the borrowing costs will be taken into account as an element of the inventory cost. As a matter of fact, as we mentioned before, Article 262 of the Tax Procedural Law defines cost price as “the sum of the payments made in connection with the acquisition or enhancement of a value and all expenses related to those”. The concept of all related

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<sup>61</sup> At this point, the following issue springs to mind: Can the enterprises change their policies whenever they want within the framework of this right to choose vested in them? On this issue Ministry of Finance is off the opinion that this right cannot be changed any time, instead a preference must be made at the beginning and this preference must not be changed for at least two years. (The ruling by the Ministry of Finance dated 10.05.1990 and No. KVK 22113-1335) (Koçak, 2007: 80-81)

<sup>62</sup>As understood from the explanation so far, within the framework of the provisions of the communiqués no. 163 and no. 238, our legislation gives freedom to the enterprises to either recognize the borrowing costs of the periods following the capitalization date of a tangible fixed asset or inventory item as the expenses of the relevant period or to capitalize the relevant asset as a cost element. (Yalkın, 2000: 11)

expenses used in this expression inevitably covers the financing expenses related to the loans used for acquiring the said assets. However, inventories are current assets, and the term and interest payments of the debts related to those generally continue after the acquired goods or the finished product leaves the enterprise. Therefore, difficulties are encountered in correlating the inventory items with the incurred borrowing costs. Especially in the cases of general borrowing procedure, it is not proper to capitalize the borrowing cost that occurs after the inventory acquisition procedure is completed and capitalized. (Zaif, 1999: 97) Actually TAS 23 Borrowing Costs Standard states that the inventories that are produced or manufactured within a short period of time are not qualified assets; that the inventories that are ready for sale or the intended use at the moment of their purchase are not qualified assets; therefore the borrowing costs related to those cannot be capitalized; and that they should be recorded as expenses in the period they occur. However, as emphasized before, our legislation does not have a separation in terms of the inventories as qualified and non-qualified assets. Therefore, for the inventory item which it manufactures in a short time and thus not a qualified asset according to the Standard, any enterprise can make capitalization regarding the borrowing costs even after the asset is capitalized, according to the Tax Procedural Law Communiqué No. 238.

Another difference that we should highlight here is the recognition of the late interests (deferred) in case the inventory items are purchased on credit terms. As known both in our tax legislation and in our conventional accounting practices, the late interests included in the invoice during purchase are included in the cost of the inventory items. The entry records of the inventories are made over the deferred price written on the invoice. However, according to the basic principle in TAS 23 actual late interests are not to be added to the cost of the purchased goods as a borrowing cost. However, as we expressed in full, if the relevant value is a qualified asset, the late interest is added to the value cost as a borrowing cost. As we mentioned in the third part of our study, according to the eighteenth paragraph of TAS 2, when an entity purchases inventories on deferred settlement terms, the financing element, that is the difference between the purchase price for normal credit

terms and the amount paid, is recognized as interest expense over the financing period. (Karakaya, 2007: 167)

Example 3: (Karakaya, 2007: 168)

Pergamon Inc. purchased raw materials and supplies that will be used in the production processes on 01.12.2010. The purchase price on credit terms is 10.600 TL and the amount paid is 10.000 TL. Maturity is three months and payments will be equally at the end of each month.

According this, the journal entries that are compatible with TAS 2 shall be as follows:

_____ 01.12.2010 _____	
150 Raw Material and Supplies	10.000
182 Deferred Expenses <sup>63</sup>	600
320 Accounts Payable	10.600
_____	
_____ 31.12.2010 _____	
780 Financing Expenses	200
182 Deferred Expenses	200
_____	

#### **4.3.3. Borrowing Costs Due to Financial Lease Transactions**

A finance lease takes place in the leaseholder's records both as an asset and as a debt after its occurrence. With this procedure, the leaseholder has to pay a rent and its interest during the lease process. Borrowing costs emerge in relation this.

<sup>63</sup> This account name is not included in the Uniform Chart of Accounts at the moment. However, its use is recommended in the literature in order to ensure compatibility with the provisions of the Turkish Accounting Standards.

(Aslanertik, 2009: 7) In fact, as we mentioned in the second part of our study, according to TAS 23, borrowing costs may include finance charges in respect of finance leases recognized in accordance with TAS 17 Leases.

The legal infrastructure of the finance leases in our country was first built with the Finance Lease Law dated 10 June 1985 and No. 3226. The measurement provisions and accounting record methods related to taxation of those contracts are laid down in Doublet Article 290 of the Tax Procedural Law. The provision of this law was added to the Tax Procedural Law with the Law No. 4842 because the provisions of the Finance Lease Law No. 3226 were very different from the International Accounting Standards and therefore problems were encountered in implementation, and significant novelties have been thus introduced and much compatibility with the TAS 17 Lease Standard has been ensured. (Sayılgan, 2004: 70) The said article defines financial lease as “the type of lease that results in the leaseholder bearing all benefits and risks deriving from having the ownership of a value, without considering whether the property right is transferred to the leaseholder at the end of lease period.” This definition is in consistency with the one included in TAS 17. With the adjustment introduced by Doublet Article 290, the incomes and expenses qualified as lease income and lease expense by the parties of the financial lease contract in the past are turned into financing income and cost. With this adjustment the installment amount also includes the debt/claim capital installment amount. (Pekdemir, 2003: 49) Therefore, lease payments to be made by the leaseholder are separated as the capital and the interest. The separation procedure is made at the end of each period in a way ensuring the application of a fixed periodical interest rate to the remaining debt. Also according to the relevant Article’s provisions, leaseholder does the depreciation allocation for the value subject to financial lease. After the lease payments are separated as capital payment and interest payment as explained above, the interest expenses are deduced while calculating the income that is subject to taxation in the relevant period. I.e. in other words, the interest expenses are recognized in the form of period expenses as financial expenses. At this point, we again observe the issue that, the relevant Doublet Article 290 of the Tax Procedural Law does not include a definition for the qualified asset

which has a very important place in the application of TAS 23. Therefore, regardless the leased value is a qualified asset or a not, the interest expenses found by separating the capital from the lease amounts paid by the leaseholder and the other borrowing costs such as the exchange differences are transferred to the Income Statement as financing expense. However, according to TAS 23, if the leased value is a qualified asset, those financial expenses shall be capitalized by considering them as a cost element until the said value becomes ready for the intended use or sale thus forming the conditions to end of the capitalization, and the financial expenses after that date shall be considered as period expense.

On the other hand, Tax Procedural Law Communiqué No. 319 makes a clarification on the status of the financial expenses paid by the leaseholder. According to this, if the leaseholder companies use credit in Turkish Lira or a foreign exchange while purchasing an asset, the exchange differences and the interest expenses paid for the first year shall be added to the cost, if it is possible to add them to the asset's cost before contracting; otherwise and in other years they shall be recorded as expense. As seen, the financial expenses that can be capitalized by the leaseholder are limited with the part until the contract date for the first year. For example, if a machine that was purchased for lease on 01.06.2010 was leased on 01.10.2010, the borrowing costs pertaining to the four month period between the purchase date and the lease date shall be capitalized and the borrowing costs born after that date shall be recognized as period expense. (Şeker, 2005: 127)

#### **4.3.4. Accounting System Implementation General Communiqués and the Borrowing Costs**

Ministry of Finance, based on the authority vested upon it by Article No. 175 and Doublet Article No. 257 of the Tax Procedural Law No. 213, has issued Accounting System Implementation General Communiqués since 1992. The Accounting System Implementation General Communiqué Item No.1, which was published in the Official Gazette dated 26.12.1992 and no. 21447 express the aim of the adjustment as; proper and reliable recognition of the activities and outcomes of



the ventures and enterprises belonging to natural and legal persons keeping their accounts on balance sheet basis, ensuring that the information presented to the interested parties through financial statements reflect the actual status while keeping the coherence and comparability of that information and facilitating the audit in the enterprises. The said Communiqué states that the enterprises shall conduct their accounting system in accordance with the rules laid down in the Communiqué and its Annex; however the special provisions included in the tax laws shall be taken into consideration while assessing the profit subject to taxation. In the Section 4 titled as “Preparation and Presentation of the Financial Statements” in the Annex titled “Accounting Procedures and Principles” of the said Communiqué, it is seen that the financing expenses related to the borrowing costs are defined as “covering the interest, exchange difference and other items that incur from the sums borrowed by the enterprise and that are not added to the cost of the assets”. It can be concluded from this definition that any cost incurring from borrowing such as interest can be capitalized and added to the asset cost. However the relevant Communiqué does include the concept of qualified asset, which is a very important concept with respect to the capitalization of those costs that is stated in TAS 23; in addition no explanation is made on the cases where the borrowing costs can be capitalized and the cases where the borrowing costs can be recognized as financial expenses in the form of period expense. It is necessary to ensure the necessary compatibility with the provisions of the TAS 23 Borrowing Costs Standard both in the Accounting System Implementation General Communiqués and in the Uniform Chart of Accounts implemented by those Communiqués. For example, the scope of the deferred financial expenses incurring from deferred purchase should be laid down in the Accounting System Implementation General Communiqués and a new account code should be identified for this in the Uniform Chart of Accounts.

#### **4.4. The Comparison of TAS 2 Inventories with the TPL**

Although it is stated in the literature that TAS 2 provisions and Tax Procedural Law show parallelism with each other, because our Tax Regulations, especially our Tax Procedural Law, focus on determining assessment declared for

taxation, there might be some important differences between the Standard provisions and Tax Procedural Law and our accounting practices within the framework of Uniform Chart of Accounts as we have mentioned before.

The differences between TAS 2 and our established tax and accounting practices shall be examined in detail under several sections below. One of the differences between the Standard and TPL provisions from the view of recognizing the inventories and making them subject to taxation is the buying of the inventories on credit terms. (Late interest/deferred settlements) Since this matter was examined in detail in the previous sections, it shall not be dealt with here again.

#### **4.4.1. Absorption Costing Method vs Normal Costing Method**

When the methods constituting the costing accounting systems are examined it is seen that there are several classifications according to the scope of the expenses, realization of the expenses, main base in the distribution of the expenses and accounting form of the cost of inventories. Costing methods according to the scope of the expenses are generally divided into five in the literature: Absorption costing method, normal costing method, variable costing method, direct costing method and as the last one throughput costing method. In this classification, management recognizes some of the expenses as cost of inventory and some of the expenses as period expense and registers to its income statement accounts according to the method it used. (Boyar and Güngörmüş, 2006: 84; Karakaya, 2007: 324)

Absorption costing method, the first one of these methods, is a method which includes all the expenses related to production to the cost of inventory. In this method there is no distinction as fixed and variable productions overheads and all the production overheads (costs) and besides direct raw materials and supplies expenses and direct labor expenses are included in the cost of inventory. (Karakaya, 2007: 325)

Normal costing method is different from the absorption costing method and includes only some part of the fixed production costs to the inventory cost. Fixed production costs to be included in the cost of inventory are determined according to the capacity usage ratio of the entity in that period. Fixed production costs allocated to the capacity usage are included in the cost of inventory and part allocated to the unused capacity is directly transferred to the period-end accounts as the period expense. As a result, in this method the unit cost of inventory is comprised of the direct raw materials and supplies expenses, direct labor expenses, variable general production overheads and fixed production costs allocated to the capacity usage. (Karakaya, 2007: 325)

Variable costing method is a method which includes only the variable costs to the finished product's cost. In this method fixed costs are directly recognized as period expense and transferred to the period-end accounts. Because of this, it comprises of direct raw materials and supplies expenses, direct labor expenses and variable general production overheads.

In direct costing method, only direct production costs are added to the finished product's cost and indirect costs of production are transferred to the period-end accounts as the period expense. Because of this, in this method unit finished product's cost is comprised of only direct raw materials and supplies expenses and direct labor expenses. (Karakaya, 2007: 326)

Throughput costing method is a costing method which only includes the direct raw materials and supplies expenses to the product's cost and recognizes other costs as period expense in the income statement. (Boyar ve Güngörmüş, 2006: 84, with reference to Çakıcı, 2006)

When our Tax Procedural Law and Accounting System Implementation General Communiqués are examined, it is seen that our tax legislation adopts the absorption costing method in accounting the costs of inversion according to the scope of the costs. However in TAS 2 Inventories Standard, normal costing method

is used in charging the expenses according to their scope. As mentioned before, in normal costing method if the production is below the normal capacity usage there is negative capacity variance and if the production is above the normal capacity usage there is positive capacity variance. From the point of view of the Standard, positive differences are not transferred to the period-end accounts but the negative capacity differences are transferred to the period-end accounts as the period expense. (Karakaya, 2007: 683-684) According to our current accounting system practices and Uniform Chart of Accounts, there is no clarity about transferring these negative capacity variances to which period-end accounts. In the applications in our country, it is seen that the fixed expenses not charged to the costs are recognized in the account of “680 Idle Capacity Expenses and Losses” in the Extraordinary Expenses and Losses group within the frame of the Uniform Chart of Accounts (Akdoğan, 2004: 34). However, the explanation of the concerning account in the 5<sup>th</sup> Section titled “Uniform Frame of Accounts and Chart of Accounts and Chart of Accounts Explanations” of the annex titled “Accounting Procedures and Principles” of the Accounting System Implementation General Communiqué No.1 is that: “This account includes the expenses concerning the production belonging to period and parts which are not worked”. It is understood from the explanation of the account that it isn’t based on the normal costing method. Because, in the normal costing method the negative capacity variance in question, is related to the production which is below the normal capacity usage as explained before. However, this account is being used for transferring finished product’s costs to the period-end accounts in the situations which no production is made and for the units which stopped working. It doesn’t rely on an accounting based on the normal or expected capacity (Karakaya, 2007: 684). On the other hand it is stated in the 85<sup>th</sup> paragraph of the TAS 1 Presentation of the Financial Statements Standard that: “Entities shall show any of the profit or loss items as extraordinary items neither in income statement nor in footnotes.” and by this way, extraordinary reporting is cancelled. According to Boyar and Güngörmüş (2006: 88) the capacity variance arising here is concerned with the main activity of the management. From the view of the Uniform Chart of Accounts, because the “Operating Expenses” group numbered 63 is comprised of the expenses which is not charged on the productions costs, the capacity variance arising

here should be shown in the “Operating Expenses group numbered 63”. According to them if a new account under this group titled “634 General Production Overheads Capacity Variances” is opened, the applications of the Standard and our accounting system can be harmonized. In our opinion this approach is suitable. However, from the view of our Tax Legislation this harmonization may not be enough. If the item of inventory is sold, there shall not be any problem, but if the items concerned are not sold, as the cost in question shall not be able to decline and harmonization registration with our tax legislation is required. In this case, according to the TAS 12 Income Taxes Standard deferred tax debt or deferred tax asset may arise and in a permanent discrepancy situation some calculations for enabling the transition of the commercial profit to the fiscal profit might be required. (Dağdemir, 2008)

Example 4:<sup>64</sup>

Anatolian Inc. deals with the production and sale of the X product. Information concerning the production and sale in December, 2010 is as stated below:

Direct Raw Materials and Supplies Expenses	:	60.000 TL
Direct Labor Expenses	:	50.000 TL
General Production Overheads	:	40.000 TL
Fixed:		24.000 TL
Variable:		16.000 TL
Production Amount	:	10.000 units

The normal capacity of the management is 12.000 units and management has realized a production below its normal capacity.

Fixed General Production Overheads Charging Ratio:  
 $24.000 \text{ TL} / 12.000 \text{ units} = 2 \text{ TL per unit}$

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<sup>64</sup> This Example is developed from Örtten, Kaval and Karapınar (2007: 58-59)

Fixed General Production Overheads to be Added to the Production Cost:  
 2 TL x 10.000 units= 20.000 TL

Negative Capacity Variance (Fixed General Production Overhead to be  
 written as period expense) : 2 TL x 2.000 units= 4.000 TL

In the light of this information journal entries shall be as follows:

	/	
151 Work in Process		146.000
711 Direct Material Cost Applied		60.000
721 Direct Labor Cost Applied		50.000
731 Factory Overhead Cost Applied		36.000
	/	
711 Direct Material Cost Applied		60.000
721 Direct Labor Cost Applied		50.000
710 Direct Material Cost		60.000
720 Direct Labor Cost		50.000
	/	
731 Factory Overhead Cost Applied		36.000
634 Prod. Overheads Cap. Variances		4.000
730 Factory Overhead Cost		40.000
	/	
970 Non Allowable Charges		4.000
971 Non Allowable Charges A.P.		4.000

	/		
283 Deferred Tax Assets <sup>65</sup>		800 <sup>66</sup>	
693 Deferred Tax Income Effect			800

#### 4.4.2. Net Realizable Value:

As explained in the 3<sup>rd</sup> Section of our Study in detail, inventories cannot be followed with a value higher than the expected amount to be earned in case they are used or sold in the financial statements according to the TAS 2. In case the costs are higher than the value to be earned from the usage or sell than provision for loss on inventories is reserved. Reduction of the costs of inventory to the net realizable value is consistent with the principle of measuring the inventories with the lower of the cost or net realizable value. Although it is up to some specific conditions, during the year-end inventory procedures, inventories might be valued with their market prices (values) according to the Tax Procedural Law. Many academicians have the opinion that net realizable value meets the market price concept in the Law. (Demir, 2000: 144; Karakaya, 2007: 162). Law makes it possible to measure the inventories, of which selling value falls below their market prices, with the market prices instead of their cost value but valuation (measurement) with the lower of the cost or net realizable value is bonded with the application of the imputed cost measurement. In the Article 274 of the Tax Procedural Law is said that “Tax payer may apply the

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<sup>65</sup> This cost which is a non allowable cost in the 2010 accounting period because of the provisions of the Tax Procedural Law, as it shall be taken into consideration when the inventory item is sold “Deferred Tax Assets Registration” shall be made in accordance with the TAS 12 Income Taxes Standards because of the resulting timing difference. It means that management shall face a tax assessment which is 4.000 TL higher than the required one in the 2010 accounting period because of the provisions of the TPL. But when this inventory item is destocked in the next accounting period, this amount shall be taken into consideration in favor of the management in the tax assessment and the Standard and TPL provisions shall be consistent with each other. The accounting records above are made in order to provide this consistency.

283 Deferred Tax Assets and 693 Deferred Tax Income Effect accounts are not included in the Uniform Chart of Accounts yet but it is expressed in the literature that these accounts should be included into the Uniform Chart of Accounts in accordance with the related provisions of the TAS 12.(Akdoğan and Sevilengül, 2007; Örtün, Kaval and Karapınar, 2007: 58-59)

<sup>66</sup> 4.000 x 0.20 (Corporation Tax Rate)= 800

imputed cost measure instead of cost value in cases which selling prices of the commodity losses % 10 or more of their costs at the assessment date except for the procedure<sup>67</sup> stated in the second line of the 267<sup>th</sup> article”. This measure can be applied to the inventory items which are either a commercial commodity or a finished product. According to this, imputed cost application in inventories will be able to realize on the base of average price in the first line or on the base of assessment<sup>68</sup> in the third line. On the other hand in the 278<sup>th</sup> Article of the Law, it is stated that: “In the valuation of commodities losing their value because of natural disasters like fire, earthquake and flood or because of cases such as decaying, perishing, breaking down, cracking, rusting and commodities such as junks and wastes, rag, silk waste and discard which are not routinely evaluated, the imputed cost is used”. This provision also complies with the paragraph 28 of the Standard on a large scale which proposes to reduce the inventories to the net realizable value in case the inventories are partially or completely useless or they lose their selling prices and thus their costs cannot be earned back. Although the Turkish Tax Legislation is partially similar to the related provisions of the TAS 2 Inventories, in specific limitations and conditions, it also accepts the approach of measuring inventories the lower of the cost and the net realizable value. (Karakaya, 2007: 162-163) The main difference here is that: according to the 274<sup>th</sup> Article of the TPL, the application of the imputed cost is possible on the condition that the sale prices of the

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<sup>67</sup> According to the 267<sup>th</sup> Article of the Tax Procedural Law, imputed cost is the value of a commodity if it is sold at the assessment date when compared with its counterparts in case its real value cannot be found correctly or not known.

Imputed value is determined according to the principles below in order:

First row: (Average price principle) If the commodity of the same kind and quality was sold in the same month or in the previous month or two months before than the imputed price is calculated with the “Average sales price” by the tax payer according to the amount and sum of these sales. In order to apply this principle it is required that the amount of monthly sales of the commodity of which imputed cost to be calculated shouldn't be less than the %25 of the total amount of each commodity.

Second row: (Cost Price Principle) If the cost price of the commodity of which the imputed cost to be calculated is known or charged in this case tax payer states the imputed cost by itself by adding % 5 for wholesales and % 10 for retails.

Third row: (Assessment Principle) Imputed costs which cannot be found according to the principles written above are assessed by the assessment commission on the appeal of the persons concerned. Assessments are made by searching the cost price and market prices and for the used commodities by taking the wearing degrees into consideration. Tax payers' rights of litigation before the tax courts are reserved for the assessment prices. But opening of a case doesn't stop the assessment and collection of the tax. (TPL 267<sup>th</sup> article)

<sup>68</sup> In Turkish its meaning is: “takdir esası”



commodity is %10 or more than it lower than its cost price at the assessment date<sup>5</sup> while in the TAS 2 there is not any specified rate and it is judged that the lower of the cost or net realizable value of the commodity to be measured shall be taken into consideration as valuation measure. (Demir, 2000: 145) Besides, it is understood from the wording of the related Article of the TPL, that valuation with imputed cost is not an obligatory application but a right that might be chosen from the aspect of the tax payer. In fact, tax payer is given the choice of paying the income tax or corporation tax of the current accounting period in the next accounting period with the valuation procedure done. (Çakmakçı, 2006) However, according to TAS 2 if the net realizable value falls below the cost than the inventory item cannot be measured with the cost and it is required to reserve provision for loss on inventory item and to show the inventory with its net realizable value in the balance sheet. Another important point here is that, in order to make provision for loss on inventory item, which lost its value as a result of the cases stated in the 278<sup>th</sup> Article of the Tax Procedural Law, an allowable charge value<sup>69</sup>; assessment must be made by the assessment commission. Otherwise the provision reserved is considered as a non allowable charge and added to the tax assessment. In such a case, according to the TAS 12 Income Taxes Standard, Deferred Tax Assets or Deferred Tax Debt may arise.

The paragraph 34 of the Standard has been changed with the Communiqué dated 11.04.2006 and Numbered 38 concerning the changing of the TAS 2 Inventories. According to the paragraph in question, the amount of any write-down of inventories to net realizable value and all losses of inventories shall be recognized as expense in the period the write down or loss occurs. The amount of any reversal of any write down of inventories, arising from an increase in net realizable value, shall be recognized as expense in the period in which the reversal occurs. In our accounting applications within the frame of the Uniform Chart of Accounts reversal of provisions for the decline in the value of inventories because of the increase of the net realizable value is offset from the amount recognized as allowance (provision) expenses in that period. Reversed allowance expenses, on the condition that not

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<sup>69</sup> In Turkish its meaning is “Kanunen Kabul Edilen Gider”.

being more than the amount of the allowance expenses of the accounting period, is registered as revenue to the account of “644 Adjustments of Unused Allowances” (Gürdal, 2007: 71). According to many academicians from now on it is required to recognize allowance expenses under the title of a new account to be opened under the “Cost of Sales” account group instead of “654 Allowance Expenses” account; with the new regulation made in the Standard when loss on inventory arises. For example for this purpose Akdoğan and Sevilengül (2007) suggest opening “627 Allowance Expenses for the Loss on Inventories” account under the “62 Cost of Sales” group in the Uniform Chart of Accounts. Similar views are found in the literature. (Gençoğlu, 2007: 196; Gürdal, 2007: 71)

Example 5:

Pergamon Inc. has provided allowances for the decline in the value of inventories (loss on inventories) beforehand at the amount of 8.000 TL for the digital cameras having the registered value of 50.000 TL in its inventories. It is found that the net realizable value of these assets has risen to 45.000 TL in the current accounting period.

In this case allowance at the amount of 3.000 TL for the decline in the value of inventories should be reversed because of the rise of the net realizable value. According to the provisions of the Standard and also taking the changes suggested to be made in the Uniform Chart of Accounts into consideration, this reversed amount shall be taken into account in a way reducing the accrued cost of goods sold of the current accounting period.

	/	
158 Provision for Loss on Inventories	3.000	
627 Allowance Expenses	3.000	

#### 4.4.3. Cost of Inventories of a Service Provider

In the 8<sup>th</sup> paragraph of the TAS 2 Inventories Standard, it is stated that: “In the case of a service provider, inventories include the costs of the service for which the entity has not yet recognized the related revenue. In this way, inventory concept according to the Standard comprises not only items such as commercial goods, finished products or direct raw material and supplies but also service costs which currently cannot be met by any revenue. Certainly for making such an Article in the Standard, periodicity concept is effective. According to this fundamental accounting principle, matching of the revenues and expenses of the period is essential. According to this principle, costs have to be capitalized in cases which they aren’t reflected on the period-end accounts. As it is known, costs are transferred to expenses as their profits consume and they are transferred to the period-end accounts. Because in our current accounting system the stocking of the production costs aren’t foreseen for the service providers other than entities of construction and maintenance spread throughout years, there is no concerning account flow foreseen in the Uniform Chart of Accounts too. (Boyar and Güngörmüş, 2008a; Akdoğan and Sevilengül, 2007). In the present system, costs concerning the service rendering are collected in the 740 Service Rendering Cost account and transferred to the 622 Cost of Services Rendered account via 741 Service Rendering Cost Applied account in the end of the period without consideration to the periodicity concept.<sup>70</sup> However, according to the provisions of the Standard explained above, stocking of the costs which cannot be matched with the revenue is foreseen and with a new account to be opened under the “15 Inventories” account group of the Uniform Chart of Accounts harmonization with the Standard might be done. For example, Boyar and Güngörmüş (2008a) suggests opening the “154 Service Inventories” account. In this way, amounts collected in the 740 Service Rendering Costs account at the end of the period, by means of 741 Service Rendering Cost Applied account, costs concerning the part of the revenue which isn’t reflected on the financial statements can be transferred to the

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<sup>70</sup> In the current Uniform Chart of Accounts service costs can be stocked only for the entities of Construction and Maintenance Contracts Spread Through Out Years. For this “170 Construction and Maintenance Contract Costs Spread Through Out Years” account is used.

154 Service Inventories account and the rest can be transferred to the 622 Cost of Services Rendered account and so harmonization with the Standard is done. Similar suggestions can be found in the literature. For example Akdoğan and Sevilengül (2007) deem it suitable to open two new accounts concerning service inventories: “154 Incomplete Service Costs” account and “155 Completed Service Costs” account. According to the system they suggested, if the service rendered by the service provider company is not yet completed at the end of the period, than costs collected in the 740 Service Rendering Costs account, by means of 741 Service Rendering Cost Applied Account, is registered as debit to the 154 Incomplete Service Costs and later on, when the service is completed, cost in this account is registered as credit to this account and registered as debit to the 622 Cost of Services Rendered account. If the matching with the revenue shall be in the next accounting periods after the completion of the service, than cost is transferred to the 155 Completed Service Costs Account in return for the credit of the 154 Incomplete Service Costs Account. In our opinion, both suggestions provide harmonization to the Standard however as the approach in the suggestion of the Akdoğan and Sevilengül submits a more detailed presentation in the financial statements and reports, it shall be more suitable to the nature of the Accounting Standards built on the basic accounting principles such as understandability, transparency, adequacy and disclosure.

#### **4.4.4. Other Costs**

In the 5<sup>th</sup> Section titled “Uniform Frame of Accounts and Chart of Accounts and Chart of Accounts Explanations” of the annex titled “Accounting Procedures and Principles” of the Accounting System Implementation General Communiqué No.1 it is resolved that the general administrative expenses are consisted of the indirect material, indirect labor, personnel costs, outsourced benefits and services, other expenses, taxes and funds and depreciation expenses which are concerned with the general administration function of the management and has no direct relationship with the production or cost of the goods sold. According to the 275<sup>th</sup> Article of our

Tax Procedural Law entities aren't obliged to charge their general administrative expenses on the cost of the inventories but it is voluntary.

According to TAS 2 cost of the inventories is comprised of purchase costs, costs of conversion and other costs. General administrative expenses are in the scope of the other costs. According to the 15<sup>th</sup> paragraph of the Standard, other costs can be included in the cost of inventories only to the extent that they are incurred in bringing the inventories in their present location and condition. Thus the Standard, in a different way than the Tax Procedural Law which lets the entities charge the general administrative costs to the cost of inventory or not, regularizes that general administrative expenses which has no relation in bringing the inventories in their present location and condition, cannot be added to the product cost in any way and they have to be directly recognized as period expense.

Research and development expenses and design costs, which are normally accepted as period expenses, might be included in the production costs if any direct relation can be established with a special order according to the related provisions of the Standard. While in our current accounting applications these costs are recognized as operating expenses, Standard proposes that these costs can be included in the cost of inventories to the degree which they bring the inventories in their present location and condition. (Boyar and Güngörmüş, 2008b)

## CONCLUSION

The globalization of world capital and commodity markets increased considerably the volume of international trade and so the number of transnational companies that operate in many different countries outside their home. In this context, International Accounting Standards Board which is the successor of International Accounting Standards Committee, has formulated and published International Accounting Standards/International Financial Reporting Standards (IAS/IFRSs) to meet the increasing demand coming from different interested groups such as transnational companies, investors, creditors, big accounting firms and of course tax authorities for more reliable, understandable and comparable accounting information systems. In this process, the efforts of harmonizing or converging the different national accounting applications based on national accounting standards or other national legislations and the IAS/IFRSs, has increased considerably. In Turkey, Turkish Accounting Standards Board (TASB), which has public entity, administrative and financial autonomy, was established to develop national accounting standards that are in favor of public interest to achieve reliable, comparable and understandable financial statements. In this study, after covering a theoretical basis for the evolution of IAS/IFRSs and TAS/IFRSs in the first part; two of the Turkish Accounting Standards that were published by TASB; “Turkish Accounting Standards 23 Borrowing Costs” (TAS 23) and “Turkish Accounting Standards 2 Inventories” (TAS 2) were analyzed in the second and third parts subsequently.

In the fourth part of our study a comparative analysis was made to show the differences between these Standards’ provisions and our present tax and accounting practices based on Tax Procedural Law, Accounting System Implementation General Communiqués and Uniform Chart of Accounts. This analysis demonstrates that there exist important differences between our present tax and accounting practices and the Standards’ required practices. For instance, the concept of qualified asset, which is one of the critical components of TAS 23 Borrowing Costs Standard, is covered neither in our Tax Procedural Law nor in the General Communiqués of this Law.

According to TAS 23, interest capitalization can only be made for the qualified assets which take a long time to prepare for the intended use or sale; and for those assets, capitalization is ended when all procedures required to prepare the asset for the intended use or sale are completed in essence, and the borrowing costs that incur after that point are recognized as expense in the period they incur. However, our present tax legislation let enterprises capitalize their borrowing costs -for example that emerge as interest expenses- capitalized by necessity in the establishment period, in the operating period as well. This is a selection for the enterprises differently from the provisions of TAS 23.

Such important differences were observed between the provisions of TAS 2 and Tax Procedural Law (TPL) too. For instance, TPL adopts the absorption costing method in accounting the costs of inversion according to the scope of the costs. According to this method all of the production overheads go to the cost of inventory. However, in TAS 2 Inventories Standard, normal costing method is used in charging the expenses according to their scope. According to this method, differently from the method that was accepted in TPL, only some part of the fixed productions costs go to the inventory cost. Fixed production costs to be included in the cost of inventory are determined according to the capacity usage ratio of the entities. If the production is below the normal capacity usage, there is negative capacity variance and the negative capacity differences are transferred to the period-end accounts as the period expense. Naturally, such an application might influence tax assessment and some harmonization transactions may be required in terms of TAS 12. This is one of the important differences but there exist other differences, such as the use of net realizable value and accounting of cost of service providers, which may create difficulties for the entities, managers and accounting professionals as analyzed in detail in the fourth part of our study.

As stated several times in our study there are many different governmental institutions such as Ministry of Finance, Capital Markets Board and Banking Regulatory and Supervision Agency which issued regulations that are related to entities in their rule of authority and this has created a multi-layered structure in

Turkish Accounting System. This multi-layered structure creates a “regulations overload” and makes difficult to harmonize with TAS/TFRSs that are in full conformity with IAS/IFRSs. In fact, the most important establishment aim of Turkish Accounting Standards Board is to abolish this multi-layered structure by developing accounting standards applicable to all entities. In recent years, with the great efforts of Capital Markets Board and TASB important developments have been experienced related to the harmonization with International Accounting Standards. Now it is left to Ministry of Finance to make efforts in order to conform tax legislations especially the Turkish Tax Procedural Law and Uniform Chart of Accounts to TAS/TFRSs published by TASB. This will promote a uniform accounting system in Turkey and abolish present differences between TAS/TFRSs’ provisions and our tax and accounting legislation. In addition to these, the new TCC draft that makes TAS/TFRS usage for all entities an obligation should rapidly come into force. Undoubtedly, introducing a system of continued professional education to prepare professional accountants for adequate interpretation and application of the TAS/TFRSs is an important requisite for the success of this harmonization process.



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## APPENDIX 1

### A Grouping of Standards Published by TASB

<b>Standards Related to Presentation of Financial Statements</b>	<ul style="list-style-type: none"> <li>- TFRS 1: First-Time Adoption of TFRS</li> <li>- TAS 1: Presentation of Financial Statements</li> <li>- TAS 7: Cash Flow Statements</li> <li>- TAS 8: Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies</li> </ul>
<b>Standards Related to Financial Statements</b>	<ul style="list-style-type: none"> <li>- TFRS 3: Business Combinations</li> <li>- TAS 27: Consolidated and Separate Financial Statements</li> <li>- TAS 28: Investments in Associates</li> <li>- TAS 31: Financial Reporting of Interest in Joint Ventures</li> </ul>
<b>Standards Related to Balance Sheet and Income Statement</b>	<ul style="list-style-type: none"> <li>- TFRS 2: Share-Based Payment</li> <li>- TFRS 4: Insurance Contracts</li> <li>- TAS 2: Inventories</li> <li>- TAS 11: Construction Contracts</li> <li>- TAS 12: Income Taxes</li> <li>- TAS 16: Property, Plant and Equipment</li> <li>- TAS 17: Leases</li> <li>- TAS 18: Revenue</li> <li>- TAS 19: Employee Benefits</li> <li>- TAS 20: Accounting for Government Grants and Disclosure of Government Assistance</li> <li>- TAS 21: The effects of Changes in Foreign Exchange Rate</li> <li>- TAS 23: Borrowing Costs</li> <li>- TAS 32: Financial Instruments: Disclosure and Presentation</li> <li>- TAS 36: Impairment of Assets</li> <li>- TAS 37: Provisions, Contingent Liabilities and Contingent Assets</li> <li>- TAS 38: Intangible Assets</li> <li>- TAS 39: Financial Instruments: Recognition and Measurements</li> <li>- TAS 40: Investment Property</li> <li>- TAS 41: Agriculture</li> </ul>
<b>Standards Related to Disclosures of Financial Statements</b>	<ul style="list-style-type: none"> <li>- TFRS 5: Non-current Assets Held for Sale and Discontinued Operations</li> <li>- TFRS 6: Exploration for and Evaluation of Mineral Resources</li> <li>- TAS 10: Events After the Balance-Sheet Date</li> <li>- TAS 14: Segment Reporting</li> <li>- TAS 24: Related Party Disclosures</li> </ul>

	<ul style="list-style-type: none"><li>- TAS 26: Accounting and Reporting by Retirement Benefit Plans</li><li>- TAS 29: Financial Reporting in Hyperinflationary Economies</li><li>- TAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions</li><li>- TAS 33: Earnings Per Share</li><li>- TAS 34: Interim Financial Reporting</li></ul>
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