HOW NATIONAL TAXATION PROCEDURES DISTORT FINANCIAL REPORTING: ACCOUNTING FOR FINANCE LEASES IN TURKEY

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ABSTRACT

There has been a common or general accepted universality most likely called historical cost basis for basic financial statements, which are income statement and balance sheet. While balance sheet shows all assets of the firm and its sources as of the end of the period utilized, income statement covers the data about the firm's performance in terms of revenues, expenditures, incomes, expenses, etc. as of the period ended. There are common concepts and generally accepted principles as accrual basis for those statements. But from country to country there could be so many differences coming from their social, political, cultural, or economical situations. As a result of this, in Turkey, there are some differences from the universal ones that distort financial reporting. Most of them are the effects of taxation procedures.

Turkey, as a bridge between Europe and Asia, has had a high Inflation rate for the decades. Average rate for the last quarter of the century has been more than 80% annually. Consequently by utilizing historical cost basis, all financial reporting activities have been failure.

My objective in this paper is to explore to the international public about the accounting and reporting practices in Turkey in regarding

. The backround and evolution of the finance leases,

. The authorities of accounting standard setting for finance leases,

. Accounting approaches utilized for capital leases and their concequences,

. How taxation procedures distort financial reporting; income statement and balance sheet.

In order to achieve these objectives mentioned above, an illustrative example from the real accounting practice in the business enviroment of Turkey has been utilized in the paper. Consequently, the information users as interest groups of the enterprises could realize the differences between the approaches that have been explored in the paper. Interest groups can be national

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and/or international because of the globalization. Foreign capital investments as multinational companies have had at least two accounting sets: The first is to meet national taxation accounting rules, the second is to provide useful accounting information neded in regarding of the International Accounting Standards or the United States General Accepted Accounting Principles.

Currently, ali financial institutions, such as banks and finance teasing companies, whether national or international are supposed to prepare two different sets of financial reports. The first set is related to tax reporting. The second one, as required by the Department of Treasury is prepared to reflect the requirements of the International Accounting Standard No 17, Accounting for Leases, This second set of reporting has been in effect since December 31, 1997.

Introduction

In a workshop, in February 1998, Mrs.Olca Kaymakcı, one of the senior analysts of the Yapı Kredi Bank that has been a leading commerciai bank in Turkey, was complaining about financial reporting of the firms she had analysed over the past ten years. "I could certainly not understand or realize how our firms report their assets acquired by finance leases and liabiiities resulting from the lease agreements. They do not report assets and liabiiities resulting from the finance leases in their balance sheets. It is the same even for the firms controlled by the Turkish Capital Markets Board. In some cases the firms I had analysed did not have adequate disclosures in many areas. I do not know what to do and how to do it with respect to the firms that had acquired leased assets."

"Leasing" was imported to Turkish from the Western Languages as a part of the new financial jargon. "Lease" or "leasing" came into usage in Turkey around 1985, and was understood as "capital or finance[1]" leases in Turkey. But "lease or leasing" covered operational and finance leases in both the English Language Dictionaries[2] and the relevant accounting standards such as the International Accounting Standard (IAS), No 17 and the Statements of the Financial Accounting Standards Board (FASB), No 13 (FAS).

Turkey enacted the "Finance Leasing Law[3]" in 1985. Finance leasing has been one of the major financing sources for acquiring tangible assets in Turkey since then and certain rules and regulations were developed in the following implementation.

Turkey, as a bridge between Europe and Asia, has had a high inflation rate for decades. All indications[4] mentioned in the IAS No 29 for the hyper inflationary economies have existed in Turkey for a long period. Roughly the average rate of inflation for the last quarter of the century has been around 80% annually[5]. In this environment, it is absolutely useless to utilize historical cost basis for accounting and reporting, therefore ali financial reporting activities have been failure.

1) For this paper, "finance lease" is preferred, as mentioned in the IAS No 17, instead of "capital lease" in the FAS No 13.
2) Collins Cobuild, English Dictionary, 1997, p. 946.
3) Accepted by the Grand National Assembly of Turkey on June 6th, 1985, Law Number 3226, published on the Turkish Official Gazette, No.18795, June 28th, 1985.
4) See, IAS 29,p.3.
5) For further information, see: Mustafa A.Aysan, "Accountancy; A Business or A Profession? The Turkish Case," The 6th Jerusalem Conference on Accountancy, Nov.10-14, 1996, p.172.

There are certain accounting standard setting authorities in Turkey such as the Department of Finance, the Turkish Capital Markets Board, the Department of Treasury, the Turkish Accounting and Auditing Standards Committee (The TMUDESK) (in Turkish, Türkiye Muhasebe ve Denetim Standartları Komitesi), and the others. All of them have been operating independently each pursuing the objectives of its own.

Although the Turkish Capital Markets Board has long have been supposed to have a standard related to accounting and reporting for finance leasing since one of its principle missions is to provide full disclosures to the public, unfortunately no such standard has been issued so far.

Currently, ali financial institutions, such as banks and finance leasing companies, whether national or international are supposed to prepare two different sets of financial reports. The first set is related to tax reporting. The second one, as required by the Department of Treasury is prepared to reflect the requirements of the International Accounting Standard No 17, Accounting for Leases, This second set of reporting has been in effect since December 31, 1997.

The Purpose and Scope

In this paper, it is aimed to explain certain facts about Turkey; such as the accounting standard setting authorities, their approaches or rules on the accounting for finance leases. In order to achieve this objective, the topics that will be focused on are below:

Ø The background and evolution of the finance leases,

Ø The elements, principles, and the other features of finance lease,

Ø The authorities of accounting standard setting for finance leases,

Ø Accounting approaches utilized for finance leases and their consequences,

Ø How taxation procedures distort financial reporting; income statements and balance sheets.

An illustrative example will also be given to emphasize how the practices of accounting and reporting for finance leases in Turkey affect or distort financial statements.

These are not covered particularly in this paper since not accepted by the regulations as finance leases in this country:

Ø finance leasing by manufacturers or dealers (sales-type),

Ø sale and leaseback.

In Turkey, in a finance lease agreement, there must be at least three parties: the investor (lessee), the financial institution[6] (lessor) and the seller (manufacturer or dealer). In addition, tangible assets[7] to be leased such as used, old, remodelled, renovated, defect, out of standards, lower quality, and having similar features, have to be permitted by the Department of Treasury.

The Background and Evolution of the Accounting for Leases in the World and in Turkey

The first statement related to accounting for leases had been the FAS 13, which was issued in Nov., 76 and effected as of January 1, 77 for the northern American companies. This statement established standards of financial accounting and reporting for leases by lessees and lessors. FAS 13 superseded APB 5, APB 7, APB 18 (paragraph 18 and footnote 5), APB 27 and APB 31. And also many FASB Statements either superseded or amended FAS 13 standards.[8]

The International Accounting Standards Committee issued an exposure draft No 19 related to accounting for leases as proposed statement on Oct.31, 1980. It had been approved by the Committee as a standard (No 17) in March 1982 and it became operative for financial statements covering periods beginning on or after January 1, 1984. The standard was reformatted in 1994; no substantive changes were made. Also certain changes[9] have been effective as of the beginning of 1999. This standard does not deal with the following specialised types of leases:[10]

- *lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and*

- *licensing agreements for such items as motion picture films, video recording, plays, manuscripts, patents and copyrights.*

There have been same practices related to finance leases in Turkey since 1985, but there have not been national standards for accounting and reporting. Therefore, the firms as lessees do not present their finance lease agreements' proceedings in their balance sheets as assets or corresponding liabilities, nor

6) According to the Turkish Law, Financial institutions can be special companies established for finance leasing, investment banks and Islamic financial institutions permitted as a party in a finance lease agreement.
7) Article 12, "Guideline for Finahce Leasing Companies; Their Establishments and Operations," Published by the Ministry of State, Official Gazette, No.21212, April 28th, 1992.
8) For a list of affected FAS 13, kindly visit to www.mtgers.edu/Accounting/raw/fasb/st/status/statpg13.htm
9) For the prospective changes visit www.iasc.org.uk.
10) IAS No 17, International Accounting Standards, 1997, p. 284.

disclosure footnotes. The payments of lessees are accounted for as rent expenses in the income statement.

Lessors report the assets they have already leased in the balance sheets, and the rentals are accounted for as rent income in the income statement. This type of reporting can be accepted if the leases are operational ones, in both, IAS 17 and FAS 13 for the lessees and the lessors.

Since 1997, there has been a substantial change in reporting finance leases by the financial enterprises, both, as lessees and lessors. The Department of Treasury in Turkey has had an announcement that made the IAS 17 rules mandatory for the financial enterprises since it has the authority to bring in new regulations. This practice has affected about two hundred firms as lessees and lessors. Consequently, these companies currently have at least two reporting sets. The first one comes from traditional accounting principles that mainly consist of taxation procedures for the other interest groups such as the Department of Finance, the Turkish Capital Markets Board, etc. The second one must be prepared by the IAS 17, and submitted to the Department of Treasury.

Prior to this, the multinational companies operating in Turkey of course have had their own reporting practices; some of those have been utilizing the FAS 13, some others the IAS 17. They naturally have to choose one of these in order to report their activities to the main company in their homeland. Otherwise it will be difficult or impossible to make financial statements consolidated.

In some cases, there are important procedural differences[11], besides similarities, between IAS 17 and FAS 13. But, these are the outside of the scope of this paper.

The Department of Treasury has chosen IAS 17 in accounting for finance leases because Turkey has been an associate member of the European Union since 1961. Therefore IAS 17 has been more focused on the following parts of this paper.

Basic **Characteristics of** IAS 17

Examples of situations where a lease would normally be classified as finance lease in IAS 17 are below:[12]

Ø *The lease transfers* own*ership of the* asset *to the lessee by the* end *of the lease term,*

11) Kindly see, Robert W.Conklin, "Comparative Analysis of IAS 17, *Accounting for Leases*, and U.S.GAAP including FASB Statement No 13, *Accounting for Leases*," The IASC-U.S. Comparison Project: A Report on the Similarities and Differences betwepn IASC and U.S.GAAP, Edited by Carrie Bloomer, Financial Accounting Standards Board, 1996, p. 239-258.
12) IAS No 17, p. 288, and also FAS 13 has similarly this kind of criteria. Hanns Martin W.Schoenfeld, "Summary of FASB Statements," Unpublished Class Notes, University of Illinois at Urbana-Champaign, 1994, p.6.

Ø The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised,

Ø The lease term is for the major part of the useful life of the asset. Title may or may not eventually be transferred, and

Ø The present value at the inception of the lease of the minimum lease payments is greater than, or equal to substantially all of, the fair value of the leased asset, net of grants and tax credits to the lessor at that time. Title may or may not eventually be transferred.

A finance lease should be recognised as an asset and a liability in the balance sheet of a lessee at amounts equal at the inception of the lease to the fair value of the leased property, net of grants and tax credits receivable by the lessor or, if lower, at the present value of the minimum lease payments.[13] As a result of this, rental payments should be apportioned between the finance charge and the outstanding liability, and the asset should be depreciated like other similar assets.

The net outstanding investment in a finance lease should be recorded and reported as a receivable by the lessor. Therefore finance income should be recognised in a pattern reflecting a constant periodic rate of return on either the lessor's net investment outstanding or the net cash investment outstanding in the lease[14].

The **Turkish Case**

In Turkey, since 1985, the basic characteristics of the finance lease agreements have been as follows[15]:

§ There must be a finance lease agreement between lessor and lessee.

§ Only tangible assets such as lands, buildings, equipments, etc. can be leased, not intangible assets such as patent, trademarks, ete.

§ The parties determine the number of payments and the amounts of payments. The amounts can be fixed or variable. For certain assets, the number of payments must be at least 24, for the others, 48. The Department of Treasury is the only the authority to determine the payment periods by the kinds of assets.

13) Coopers & Lybrand, **Understanding IAS Analysis and Interpretation**, 1996, p.17-1.
14) Ibid, p.17-2.
15) Summarised from the Law, mentioned before.

§ The agreement must have a guaranteed and symbolic residual value such as a one-dollar price in order to transfer the asset to the lessee at the end of the lease agreement.

§ The currency of the agreement can be local or foreign (currency) but must be internationally convertible.

§ The total of payments must be at least USD 25,000. The Cabinet can increase the amount.

§ The parties should comply with the terms of the agreement. They can not stop their liabilities during the agreement period.

§ The lessee must have the right to purchase the asset at the end of the period, but not during the agreement period.

§ The agreement may not contain bargain purchase option during the lease agreement period.

§ The public notary must approve the agreement. And also in case of land, building or ship lease, the agreement must be marked at the register of title deeds.

§ If the lessor is not a local company or the foreign lessor does not have any official branch in Turkey, the agreement must be approved by the Ministry of State.

§ The lease agreement can not be transferred to the others.

A CASE STUDY[16]

X Bank Corp. (called lessee hereafter) has needed to purchase a new computer system. The iessee as investor examined its alternative courses of action and finally decided to have a finance lease agreement. As a result, the iessee and Y Leasing Co. (called lessor hereafter), which has been one of X Bank Corporation's subsidiaries, have had a finance lease agreement. The lessee has 99% of the shares of the lessor[17]. The terms are below:

• The lessor is going to purchase the computer system needed by the iessee, and pay a total of USD 150,000 to the manufacturing company on November 30, 1998. And it will collect USD 153,986 from this investment.

16) The case was taken from a real practice, but the figures have intentionally been changed to make them confident.
17) There is no limitation in the law to have a finance lease agreement among group companies.

- The computer system is going to be ieased by the lessee at the same day and the lessee is going to pay USD 93,968 as the first payment to the lessor.

- The number of payments will be ultimately 24, excluding the first one and the payments will be as shown in Table 1.

- The lessor has been utilising 2% monthly interest rate recentiy.

- At the end of the period, the lessee will have the right to purchase the computer system for USD 1.

- Ali risks and rewards of the computer system will belong to the lessee, including the installation, maintenance, and repair expenses.

RESULTS

In this case, the lessor as a Turkish financial enterprise would have to submit its financial statements to both the Department of Finance and the Department of Treasury, but these financial statements would not be identicai. The traditional accounting standards must be relevant for the financial reporting to the Department of Finance. The leased computer system and its accumulated depreciation would be reported for by the lessor in the balance sheet as of Dec. 31, 98.

Under the current accounting practise in Turkey, the lessor would account for $103,968 as rental income, and $30,000 as depreciation expense in the income statement for the Year ended Dec.31, 1998. As a result of this financial reporting, only from this agreement, the lessor reports $73,968 income before taxes. This situation is not certainly accepted by IAS 17. The Department of Treasury accepts the alternative reporting for the lessor by IAS 17. According to IAS 17, the lessor would account for $1,120 as finance or interest income, and no depreciation expense. There are substantial differences between two sets of reporting. That is why the Department of Treasury asks for two sets of the financial statements from the financial enterprises.

Under the current practise in Turkey, the lessee would have to submit one set of financial statements to both the Department of Finance, and a different set to the Department of Treasury. The traditional accounting standards must be relevant for the financial reporting to the Department of Finance. Nothing would be reported on the balance sheet as of Dec. 31, 1998, from the lease agreement. But, the lessee would account for $103,968 rental expense in the income statement. Of course, IAS 17 does not accept these practises. According to IAS, in addition to depreciation expense, the lessee would account for $1,120 finance charge in the income statement for the year of 1998.

SUMMARY AND CONCLUSION

The world has been becoming smalier day by day because of the worldwide globalisation. Consequently harmonised accounting standards throughout the world will become more important for especially international investors. This paper was aimed to explain how traditional or national standards distort financial reporting, particularly focusing on accounting for finance leases since finance leasing has been one of the major financing sources. As shown in this paper, the financial statements prepared by the traditional accounting basis are totally useless.

There are certain lessons to learn from the case study. The lessee is the owner of the lessor company. Two such companies always are able to manipulate their taxable incomes through lease transactions.

In summary, in order to make the financial reporting useful for external decision-makers in developing countries, the authorities or lawmakers should investigate the existing situation in the country, and then deregulate the negative differences from the international enviroment.

For instance, in Turkey, the Turkish Capital Markets Board should publish an announcement that all companies publicly reporting must follow the requirements of the International Accounting Standards, particularly by getting started with IAS 17. If the Board does have this announcement, the other authorities would follow. Otherwise it would be impossible to compare the firms via financial statements because some firms report the assets and liabilities resulting from lease agreements and some do not.

TABLE 1

The Elements of The Lease Agreement Between X Bank Corp. And Y Leasing Co.

Dates	Gross Investment	Unearned Income	Net Investment	Payments Collected	Income Earned	Proportions of Principle
Nov. 30, 98	153986	3986	150000			
Nov. 30, 98	60018	3986	56032	93968	0	93968
Dec. 31,99	50018	2866	47152	10000	1120	8880
Jan.31,99	40018	1923	38095	10000	943	9057
Feb.28,99	30018	1161	28857	10000	762	9238
Mar. 31,99	20018	584	19434	10000	577	9423
Apr. 30,99	10018	196	9822	10000	388	9612
May. 31,99	18	0	18	10000	196	9804
Others Totally	18	0	18	18	0	18
Residual Value				1	0	