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SOSYAL BİLİMLER ENSTİTÜSÜ
İŞLETME ANA BİLİM DALI
MUHASEBE FİNANSMAN (İNG.) BİLİM DALI

A TAX REVIEW OF FINANCIAL STATEMENT ITEMS AND A CORRELATING FIELD STUDY TO DETERMINE COMMON TAX EVASION ISSUES

Doktora Tezi

ŞEREF DEMİR

İstanbul, 2007

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Advisor: PROF. DR. NECDET ŞENSOY

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Sosyal Bilimler Enstitüsü Müdürlüğü

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1) Tez Danışmanı :	PROF. DR. NECDET ŞENSOY	
2) Jüri Üyesi :	DOÇ. DR. FİGEN ÖKER	
3) Jüri Üyesi :	PROF. DR. DURSUN ARIKBOĞA	
4) Jüri Üyesi :	PROF.DR.AHMET HAYRİ DURMUŞ	
5) Jüri Üyesi :	PROF.DR.NURAN CÖMERT DOYRANGÖL	

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GENERAL KNOWLEDGE

Name and Surname	**:** Şeref Demir
Field	**:** Business Administration
Programme	**:** Accounting-Finance
Advisor	**:** Professor Necdet Şensoy
Degree Awarded and Date	**:** PhD – March 7, 2007
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ABSTRACT

A TAX REVIEW OF FINANCIAL STATEMENT ITEMS AND A CORRELATING FIELD STUDY TO DETERMINE COMMON TAX EVASION ISSUES

The aim of tax auditing is to inquire, determine and obtain an accurate tax amount that must be paid. Within this framework, from the perspective of basic financial statement items, the issues an auditor examines in tax audits may be related to assets & liabilities in terms of their valuation measurements as regulated in Tax Procedural Law and revenues & expenses in terms of their taxability and deductibility (whether revenues and expenses have been correctly categorized and classified as tax deductible and non-tax deductible items).

The objective of this dissertation is to determine and reveal the probable deficiencies and discrepancies in financial statement items from the tax audit standpoint. This research was focused on the tax auditing for financial statements of individual and corporate income taxpayers from the standpoint of tax legislation. In addition to Turkish accounting and tax legislation, International Accounting Standards and US Generally Accepted Accounting Principles have been covered comparatively as needed.

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To determine and reveal potentially problematic areas which lead to tax evasion in basic financial statement items from the tax audit standpoint, a research of the literature was conducted; and a comprehensive list of probable tax deficiencies and discrepancies was drawn up. Furthermore a questionnaire was prepared and a field study was conducted to reveal the focal points of problematic tax deficiencies and discrepancies.

In order to determine the importance and prevalence of tax discrepancies and deficiencies, this questionnaire was presented to selected tax auditors to get their opinions on the frequency of each item on a scale of one (none) to five (most common). This research is not a statistical study, but it is a qualitative research based on evaluation of specific area.

According to the findings in the literature survey and the field study, the most common and important tax deficiencies and discrepancies could be faced in tax auditing were determined to be disguised profit distribution through transfer pricing and thin capitalization. In the concluding part of the dissertation, findings in the literature survey and the tax deficiencies & discrepancies which may be encountered by the tax auditors were discussed.

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GENEL BİLGİLER

İsim ve Soyadı : Şeref Demir
Anabilim Dalı : İşletme
Program : Muhasebe – Finansman (İng)
Tez Danışmanı : Prof. Dr. Necdet Şensoy
Tez Türü ve Tarihi : Doktora – 7 Mart 2007
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ÖZET

MALİ TABLO KALEMLERİNİN VERGİSEL ANALİZİ VE YAYGIN VERGİ KAÇAK KONULARINI SAPTAYAN BAĞLANTILI BİR ALAN ÇALIŞMASI

Vergi incelemesinden maksat, ödenmesi gereken vergilerin doğruluğunu araştırmak, tespit etmek ve sağlamaktır. Bu çerçevede, vergi incelemelerinde finansal tablo kalemleri yönünden bir inceleme elemanının inceleyeceği konular, Vergi Usul Kanunu'nda düzenlenen değerleme ölçüleri yönünden varlık ve borçların değerlemesi ile vergiye tabi olma veya indirilebilir olma yönünden gelirler ve giderler (gelir ve giderlerin doğru olarak kategorize edilip/edilmediği ve doğru bir şekilde kanunen kabul edilebilir veya kanunen kabul edilemez olarak sınıflandırılıp/sınıflandırılmadığı) hususlarına ilişkin olabilir.

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Literatür araştırması ve alan çalışması bulgularına göre vergi incelemelerinde karşılaşılması olası en önemli ve yaygın vergi kayıp/kaçak konuları transfer fiyatlandırması yoluyla örtülü kazanç dağıtımı ve örtülü sermaye olarak ortaya çıkmıştır. Tezin sonuç bölümünde, literatür araştırması bulguları ve inceleme elemanlarınca karşılaşılabilecek önemli ve yaygın vergi kayıp/kaçak konuları açıklanmıştır.

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ABBREVIATIONS

AICPA	: American Institute of Certified Public Accountants
CIF	: Cost, Insurance, Freight
CITL	: Corporate Income Tax Law
D&D	: Deficiencies and Discrepancies
EU	: European Union
FASB	: Financial Accounting Standards Board
FIFO	: First in First Out
GAAP	: Generally Accepted Accounting Principles
IAS	: International Accounting Standards
IFRS	: International Financial Reporting Standards
IRC	: Internal Revenue Code
IRS	: Internal Revenue Service
LCM	: Lower of Cost or Market
LIFO	: Last in First Out
IITL	: Individual Income Tax Law
MNC	: Multinational Corporations
SAT	: Standard Audit Techniques
SFAS	: Statements of Financial Accounting Standards
SSAP	: Statement of Standard Accounting Practice
VAT	: Value Added Tax

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1. INTRODUCTION

The aim of tax auditing is to inquire, determine and obtain an accurate tax amount that must be paid. A corporate tax audit is an examination of a corporation's books and documents to determine its records and reporting requirements in accordance with tax legislation. To make a proper determination, the books and records of a corporation and its financial statements must be examined from the perspective of tax legislation as prescribed by tax laws and supplementary regulations.

Auditing enables tax authorities to assess whether tax returns are, in essence, in accordance with tax legislation. Therefore, within the framework of basic financial statement items, the issues an auditor examines in tax audits may be related to assets & liabilities in terms of their valuation principles as defined in Tax Procedural Law; revenues & expenses in terms of their taxability and deductibility; whether revenues and expenses have been correctly categorized and classified as tax deductible and non-tax deductible items.

To fulfill the aim of determining and obtaining accurate taxes to be paid, every year, Ministry of Finance tax auditors conduct tax audits and prepare tax audit reports. However, in the current system, no evaluation is undertaken nor disclosed by the Ministry of Finance for the issues concerning tax discrepancies and deficiencies that have arisen in tax auditing conducted by tax auditors.

The objective of this dissertation is to determine and reveal the probable deficiencies and discrepancies which lead to tax evasions in basic financial statement items from the tax audit standpoint. In this study, research has been conducted on tax auditing issues covering all economic activities occurring in a fiscal year (taxation period) for corporations from the standpoint of tax laws, general tax communiqués and tax-related rulings. In addition to Turkish accounting and tax legislation, International Accounting Standards and US Generally Accepted Accounting Principles have been covered as needed.

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To determine and reveal potentially problematic areas which lead to tax evasion in basic financial statement items from the tax audit standpoint, an exploratory research of the literature was conducted. Problematic areas were determined and a list of probable deficiencies and discrepancies which may indicate tax evasion in tax auditing was drawn up. Furthermore, it was determined that a field study had to be conducted to gain a better understanding of the focal points of problematic tax deficiencies and discrepancies.

In accordance with the stated aim of this study, once the research of the literature of tax legislation was completed, a questionnaire was prepared for auditors to identify probable tax deficiencies and discrepancies in basic financial statement items during a tax audit. Within the field study, this questionnaire to test the frequency of particular tax evasion issues in basic financial statement items was utilized. The list of probable deficiencies and discrepancies was configured as an opinion survey presented to a selected group of tax auditors to test the frequency of each item on a scale of one (none) to five (most common). Finally, findings in literature survey and the focal points of the deficiencies & discrepancies possibly encountered by the tax auditors were discussed in the concluding section.

In the field study, respondents were selected as to two main criteria. First one was the tax audit reports they produced and the second one was the discrepancies in assessment they determined in their tax audit reports. 10 qualified and willing professionals who were recognized as among the most successful auditors participated.in the field study

This dissertation is divided into four parts:

1-Introduction: Taxes in Turkey, relation of financial statements and tax legislation, and presentation of financial statements.

2-Literature Survey: Review of financial statement items in terms of tax legislation, and subsequent identification of potentially problematic areas.

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3-Field Study: Opinion survey inclusive of these potential discrepancies and deficiencies; presented to tax auditing professionals to gain a better understanding of the focal points of problematic areas.

4-Conclusion: Analysis of research conducted in literature survey and field study.

1.1. Taxes in Turkey

To provide for public services and the national defense, and to meet other expenses, all societies need income, called "revenue," which they raise through taxes. Governments pay for all services through revenue obtained by taxing three economic bases, which are income, consumption and wealth.

In Turkey, Tax Laws levy several different types of taxes on individuals and businesses. The earnings of both individuals and corporations are subject to income taxes, which are called the individual income tax and corporate income tax, respectively.

The most important taxes on consumption are value added tax and private consumption tax. In instances of goods delivered and services rendered, taxpayers of value added tax are those who carry out these transactions, while in the process of importation, it is the one who imports the goods and services.

Taxes imposed on wealth comprise real estate taxes, consisting of building tax and land tax. Turkish citizens or foreigners (individuals or legal entities) who are owners of buildings and/or land are the taxpayers of real estate tax. Another tax imposed on wealth is the inheritance and gift tax. The taxpayer of the gift and inheritance tax is the person acquiring economic assets through inheritance or gratuities.

Some other taxes in Turkey are “special communication tax”, “motor vehicle tax”, ”stamp tax”, and “banking and insurance transaction tax”.

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1.1.1. Income Taxes

Income taxes consist of two main taxes which are the “individual income tax” and “corporate income tax”.

A taxpayer is an individual or legal entity to whom the obligation falls to submit taxes in accordance with tax laws.[1]

A tax responsible person is on record in the related tax office on behalf of the taxpayer concerning tax payments.[2]

1.1.1.1. Individual Income Tax

The income of individuals is subject to income tax. Income is the net amount of earnings and revenues which has been acquired by individuals in one calendar year.[3]

The earnings and revenues included in income are as follows:[4]

1-Commercial earnings

2- Agricultural earnings

3- Wages

4- Earnings of self employed professionals

5- Real estate revenues

6- Marketable securities revenues

7- Other earnings and revenues

In this tax law, unless there is legal regulation to the contrary, the above mentioned earnings and revenues are calculated with the values of real net amounts in determining taxable income.[5]

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[1] Tax Procedural Law, Article 8.
[2] Ibid, Article 8.
[3] Individual Income Tax Law, Article 1.
[4] Ibid, Article 2.

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The two main types of tax liabilities are full tax liability and limited tax liability. Full tax liability means taxpayers in this category are liable for all income they generate in Turkey or in other countries. Therefore their income regardless of whether it is inside or outside of Turkey is subject to tax. On the other hand, limited tax liable taxpayers are taxed only on income they generate in Turkey.

The income they generate outside of Turkey is not subject to tax in Turkey.

The individuals mentioned below are taxed on all of their earnings and revenues acquired in Turkey or in other countries:[6]

1- Those who have settled in Turkey

2- Turkish citizens, who are bound to official offices and organizations or units and enterprises that have their headquarters in Turkey and who have been living in foreign countries for their employment.

Those persons who have been taxed because of their earnings and revenues acquired in the countries where they live, will not be further taxed in Turkey for these earnings and revenues.[7]

The individuals listed below are assumed to be settled in Turkey;

1-Those whose place of residence is in Turkey (Places of residence are defined as places which are written in Civil Law Article 19 and the following articles)

2- Those living in Turkey continually for more than six months in one calendar year (temporary departures shall not put an end to the residence period)[8]

The foreigners listed below are not considered to be settled in Turkey, even if they have stayed for more than six months in Turkey:

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[5] Ibid, Article 2.
[6] Ibid, Article 3.
[7] Ibid, Article 3.
[8] Ibid, Article 4.

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1- Those persons coming to Turkey for specific and temporary tasks or business who are businessmen, scientists, experts, press and publication correspondents and other persons who are similar to the aforementioned, and the persons coming for education, treatment, or holiday.

2- Those that have been held or have stayed in Turkey for reasons beyond their control such as being under arrest, conviction, or illness.[9]

1.1.1.2. Corporate Income Tax

The incomes of the entities enumerated below are subject to Corporate Income Tax:[10]

1- Capital corporations

2- Cooperatives

3- Public economic entities

4- Economic enterprises belonging to associations and foundations

5- Joint ventures

Corporate income consists of all elements of income which are subject to income tax.[11]

Income of a corporation is treated as income derived from commercial activities. Taxable income from such an enterprise is defined as the difference between the net worth at the end of the reporting year and the net worth at the end of the preceding year, with certain adjustments, mainly to eliminate movements of capital items and to recognize special statutory allowances and disallowances.[12]

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[9] Ibid, Article 5.
[10] Corporate Income Tax Law, Article 1/1.
[11] Ibid, Article 1/2.
[12] Türkmen Derdiyok, **Turkish Tax Laws and Other Regulations Concerning Foreign Investors, Ministry of Finance**, The Board of Research, Planning, and Coordination, Publishing Number: 1999/353, Ankara 1999, p. 49.

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In determination of the net corporate profits, provisions concerning commercial profits of Individual Income Tax Law shall be applied.[13]

Exclusions:

The incomes mentioned below are excluded from corporate income tax.

1- Participation income from a full tax liable corporation.[14]

2- Participation income from a limited tax liable corporation, if the below mentioned conditions are met:[15]

-Participating to the capital of the foreign subsidiary shall be at 10 % at least.

-The holding period for the shares shall be one year at least.

-The minimum tax rate in home country shall be 15% at least. If types of businesses are supplying insurance services or providing finance including financial leasing or investment in marketable securities, the tax rate shall not be less than corporate income tax rate in Turkey.

-Income must be transferred to Turkey until the date of filing of the corporate income tax return in which the income is generated.

3- For a full tax liable joint stock company, capital gains generated from the sale of participation shares of a foreign subsidiary whose legal or business center is not in Turkey are excluded from corporate income tax, if the below mentioned conditions are met:[16]

-A minimum of 75% of total assets other than cash and cash equivalents must be composed of the shares of the foreign subsidiary for at least one continuous year.

[13] Derdiyok, p. 149.
[14] Corporate Income Tax Law, Article 5/ (1)/a/1-2.
[15] Ibid, Article 5/(1)/b/ 1,2,3,4.
[16] Ibid, Article 5/1-c.

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-The foreign subsidiary must have the status of limited liability or Joint Stock Company.

-The company in Turkey must have at least 10% of the shares of the foreign subsidiary; and,

-The shares must be held for at least two continuous years by the full tax liable joint stock company.

4- a) Earnings arising from portfolios of marketable securities investment funds and investment companies.[17]

b) Earnings arising from marketable securities investment funds and investment companies of those portfolios based on gold and precious mines.[18]

c) Earnings arising from venture capital investment funds or investment companies.[19]

d) Earnings arising from real estate investment funds or investment companies.[20]

e- Earnings arising from retirement investment fund.[21]

f- Earnings from housing financing funds and asset financing funds.[22]

5- Earnings provided from the selling of shares at a value which exceeds the nominal value from the establishment of, or raising of, capital.[23]

6- Earnings provided from construction, repair, assemblage and technical services done abroad and recorded in the general result accounts in Turkey.[24]

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[17] Ibid, Article 5/1-d-1.
[18] Ibid, Article 5/1-d-2.
[19] Ibid, Article 5/1-d-3.
[20] Ibid, Article 5/1-d-4.
[21] Ibid, Article 5/1-d-5.
[22] Ibid, Article 5/1-d-6.
[23] Ibid, Article 5/1-ç.
[24] Ibid, Article 5/1-h.

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7- 75 % of capital gains for sale of participation shares and real estates are excluded from corporate income tax, if the below mentioned conditions are met:[25]

-Sale profit shall be booked in a special reserve account for at least five years and must not be withdrawn from this account, or transferred to any account apart from the paid-up capital.

-Sale revenue must be collected within two years until the second year end subsequent to the year that the sale takes place.

If above mentioned conditions are not met, the taxes not accrued on time will be taken back with penalty.

7- Refunds calculated by cooperatives for their partners.[26]

Payments related to the exclusions other than finance expenses concerning participation exclusion are not accepted as deductible expenses in the determination of taxable income.[27]

Corporate Income Tax Return:

In general, the corporate income tax is assessed on the basis of declaration (tax return) by the person having the responsibility for his taxes.[28]

Corporations calculate corporate income for two purposes. One is for financial reporting purposes under accounting principles; another is done in accordance with the Tax Laws to determine the corporation's tax liability.

The tax laws are so complex, so great in number and of such differing nature that it is not practical to keep in mind all the provisions of the laws and all of the facts

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[25] Ibid, Article 5/1-c.
[26] Ibid, Article 5/1-i.
[27] Ibid, Article 5/3.
[28] **Taxation in Turkey**, Revenue Administration, Publication No. 21, September 2006, p.20.

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of the business which have direct bearing on tax liability. Certain records are needed to support tax returns and to meet the specific requirements of the law.[29]

Corporate income tax returns are submitted to the related tax office up to the evening of the twenty-fifth day of the fourth month following the month in which the accounting period closes.[30] Therefore taxpayers have to submit their tax returns to the tax office at the latest by the evening of the 25th of April.

In the US, "corporate tax return is due the 15th day of the third month after the close of the fiscal year."[31]

Under circumstances in which a limited liable taxpayer permanently leaves Turkey, the corporate income tax return shall be submitted to the tax office during the fifteen days prior to the taxpayer's departure.[32]

Special declarations shall be accepted for some earnings of limited liability tax payers. These declarations are submitted to the tax offices within fifteen days from the date of earnings.[33]

Corporate income tax is assessed on the date the return is submitted to the tax Office. If the return is posted, it shall be assessed three days following the date the return has arrived at the tax Office.[34]

Corporate tax is paid on or before the last day of the month in which the tax return is submitted.[35]

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[29] J. Brooks Heckert; James D. Wilson; **Controllership**, The Ronald Press Company, Second Edition, 1963, p. 750, 751.

[30] Corporate Income Tax Law, Article 14/3.

[31] George A. Plesko, *An Evaluation of Alternative Measure of Corporate Tax Rate*, **Journal of Accounting & Economics**, Volume 35, No.2, June 2003, p. 203-204.

[32] Corporate Income Tax Law, Article 25/5.

[33] Ibid, Article 26.

[34] Ibid, Article 16/5.

[35] Ibid, Article 21.

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1.2. Relation of Financial Statements and Tax Legislation

The purposes of financial statements are as follows:[36]

-To provide useful information in the decision-making process of investors, creditors and other related parties.

-To provide useful information in the evaluation of future cash flow.

-To provide information about assets, liabilities, changes in such items and operating results.

Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:[37]

(a) Assets;

(b) Liabilities;

(c) Equity; and

(d) Income and expenses, including gains and losses.

Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the framework.[38]

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[36] **General Communique** for Accounting System Applications, Serial Number 1, Item III/A.
[37] IAS 1, paragraph 7.
[38] IAS, paragraph 13.

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Accounting profit is profit or loss for a period before deducting tax expense. Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).[39]

"Firms have strong incentives to reduce taxes, if financial and tax accounting must conform, tax considerations may dominate other considerations. …. If financial accounting and tax accounting are separated, firms are able to simultaneously use financial reporting rules to meet the information needs of investors and tax accounting rules to minimize payments to the government." [40]

"Though income tax provisions for income and expense recognition can differ from financial reporting requirements, in many cases they are sufficiently similar so that items of income and expense are recognized in the same period for both tax and financial reporting purposes"[41]

In order to protect government revenues, the tax rules are designed to prevent taxpayers from understating revenues or overstating expenses.[42]

If a company does not keep its records in accordance with taxation principles, the tax authorities can reject the accounting records and assess taxable income themselves. Thus, companies tend to rigidly follow conservative tax requirements in their internal accounting systems.

1.2.1. Book Income and Taxable Income

Financial statements are to be prepared in accordance with those concepts and principles in Turkish Accounting Standards and Communiqués published by the Turkish Accounting Standards Committee related to the preparation and presentation of

[39] Ibid 12, paragraph 5.

[40] David A. Guenther, Danging Young, *The Association between Financial Accounting Measures and Real Economic Activity: a Multinational Study*, **Journal of Accounting & Economics**, Volume 29 No 1 February 2000, p. 55.

[41] Guenther, D.A., Maydew, E.L., Nutter, S.E., *Financial Reporting,Tax Costs, and Book-Tax Conformity*, **Journal of Accounting and Economics**, Volume 23, 1997, p. 225-248.

[42] Guenther, D.A., Maydew, E.L., Nutter, S.E., p.233.

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financial statements concerned with commercial (accounting) balance sheets. Provisions in Tax Procedural Law related to valuation are related to taxable profit (loss).

Accordingly, to reach taxable profit (loss) from accounting profit (loss) the following additions and deductions shall be made:

-Positive and negative valuation differences' effects in Tax Procedural Law shall be taken into consideration.

-Non-deductible expenses in determination of taxable income shall be added to accounting profit (loss).

-Exemptions and exclusions shall be deducted from accounting profit (loss).

Temporary differences between accounting profit and taxable profit are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:[43]

a- Taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (taxable loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

b- Deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of asset or liability is recovered or settled.

Some temporary differences arise when income or expense is included in accounting profit in one period but included in taxable profit in a different period. Such temporary differences are often described as timing differences.[44]

"Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." [45] For most corporations, taxable income is computed on the accrual basis rather than the cash

[43] IAS 12, paragraph 5.
[44] Ibid, paragraph 17.
[45] US Treas. Reg. 446(a).

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method. Despite book and taxable income being prepared on an accrual basis, differences between book and taxable incomes can be large.[46]

1.2.2. Book Income and Taxable Income worldwide

All over the world, many countries always want to have the possibility of reforming corporation tax by basing it more closely on accounting profit. Specifically, European and Japanese firms have more incentives to present only one set of accounting figures instead of one for financial reporting purposes and one for tax purposes.[47]

"Both the UK and the US are common- law countries. Accounting standards in these two countries are based on generally accepted accounting principles developed in the private sector by the accounting profession. Influence from the public sector on both standard setting and enforcement is relatively small."[48]

"Financial accounting and tax accounting are separated in the UK and the US. This means that to a large extent reported accounting income is not affected by tax considerations. Tax conformity refers to whether financial accounting rules must follow tax rules."[49]

Some believes "US GAAP is well defined, it is natural to ask why it should not be used directly as the basis of assessing taxation."[50]

However "IRS proposed adjustments are increasing in book-tax differences.[51] "Tax depreciation and amortization can differ significantly from financial depreciation and amortization."[52]

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[46] Michelle Hanlon, "*The Persistence and Pricing of Earnings, Accruals, and Cash Flows When Firms Have Book-Tax Differences*", **The Accounting Review**, Volume 80, No. 1, 2005, p. 140.

[47] Sanjai Bhagat, Ivo Welch, *Corporate Research & Development Investments International Comparisons*, **Journal of Accounting & Economics**, Volume 19 2&3 March-May 1995, p.449.

[48] David A. Guenther, Danging Young, p. 55.

[49] David A. Guenther, Danging Young, p. 55.

[50] Ron Peterson, "*A Taxing Problem*", **Accountancy**, November 2002, p. 94.

[51] L. F. Mills, *Book-Tax Differences and Internal Revenue Service Adjustments*, **Journal of Accounting Research** Volume 36, 1998, p. 343-356.

[52] Micheal J. Calegari, *The Effect of Tax Accounting Rules on Capital Structure and Discretionary Accruals*, **Journal of Accounting & Economics**, Volume 30 No 1 August 2000, p.8.

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"Financial accounting in Germany is completely subordinate to tax law. Available tax provisions can be used only if they are actually recorded for financial reporting purposes. Consequently, there is no distinction between financial statements prepared for tax purposes and those published in financial reports.[53]

"Financial accounting in France is heavily influenced by tax provisions. In fact, financial statements must meet the needs of tax authorities.[54]

"Like Germany, financial accounting must conform to tax accounting in Japan. However, unlike Germany, taxable income in Japan is based largely on financial accounting rules contained in the Commercial Code, except in cases where the Code does not prescribe an accounting treatment. Therefore, the effect of tax considerations on financial accounting in Japan is less than that in Germany."[55]

Thailand is the only country in the sample (among the East Asian countries Hong Kong, Malaysia, Singapore and Thailand) with explicit linkage between tax and financial reporting. Thai Tax Law requires conformity between financial and tax reporting if companies wish to claim expenses for tax purposes. This induces companies to adopt financial reporting methods that minimize taxes, for example for depreciation and goodwill, and to smooth reported income. We predict that reported earnings in Thailand conform more closely to firms' tax policies and are less oriented to the timely incorporation of gains and losses.[56]

1.3. Presentation of Financial Statements

Tax Procedural Law number 213, Article 275 and Repeated Article 257 has authorized the Ministry of Finance to regulate accounting system applications. In terms

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[53] F. Choi, C. Frost, G. Meek, 1999. **International Accounting**, Prentice-Hall, Upper Saddle River, NJ, p.58.

[54] A. Fortin, **Advances in International Accounting**, 1991, p. 65-105.

[55] David A. Guenther, Danging Young, p. 55.

[56] Ray Ball, Ashok Robin, Joanna Shuang Vu, *Incentive versus Standars: Properties of accounting income in four East Asian Countries*, **Journal of Accounting & Economics**, Volume 36, December 2003, p. 245.

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of this authority the Ministry of Finance has regulated the following issues with General Communiqués for the Accounting System:[57]

a) Basic Accounting Concepts,

b) Explanation of Accounting Policies,

c) Principles of Financial Statements,

d) Preparation and Presentation of Financial Statements,

e) The Framework Uniform Chart of Accounts, Account Plan and Its Function,

Principles of financial statement express the rules which have been regulated in the General Communiqués for Accounting Applications to be applied during the preparation and presentation of basic financial statements.

The entities which fall within the scope of this regulation shall conduct accounting systems under the rules which are regulated in General Communiqués for Accounting System Applications; however during the phase in which taxable income is determined, special regulations in tax legislation shall be taken into consideration.[58]

1.3.1. Types of Financial Statements

Financial statements include the following tables:[59]

1-Balance sheet

2-Income Statement

3-Cost of sales

4-Fund flow

5-Cash flow

[57] **General Communique** for Accounting System, Serial Number 1, Item 1.
[58] Ibid , Item V.
[59] Ibid, Item III.

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6-Profit distribution

7-Changes in equity

The balance sheet and income statement along with their disclosures and appendices constitute basic financial statements, while all other tables form supplementary financial statements.[60]

1.3.2. Balance Sheet

The balance sheet is the financial statement of an entity on a certain date presenting the assets and the sources of these assets.[61]

In the preparation of the balance sheet, the explanation given in financial statement principles shall be taken as basis. Assets placed on the balance sheet are arranged from most liquid to least liquid in terms of the speed of conversion to cash; liabilities placed on the balance sheet are arranged from the shortest maturity liabilities to the longest maturity liabilities.[62]

Assets consist of current and non-current assets. In the current asset group, assets that could be converted into cash or used in one year, or in the normal operating period. In non-current assets, assets that would not be sold or depreciated in one year under normal circumstances are placed.[63]

Liabilities consist of short and long term liabilities. Short term liabilities consist of liabilities which must be paid within a year; long term liabilities consist of liabilities which will be paid after one year. Equities constitute resources allocated to the entity by owners or shareholders.[64]

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[60] Ibid, Item III.
[61] Ibid, Item IV/A-1-a.
[62] Ibid, Item IV/A-1-b.
[63] Ibid, Item IV/A-1-c.
[64] Ibid, Item IV/A-c.

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Balance sheet principles:

The purpose of balance sheet principles is to define the financial position of an entity clearly and accurately at a specific date by determining and stating resources provided by owners and shareholders, retained borrowings, resources provided externally and assets acquired through the use of these resources.[65]

All assets, liabilities and equities are presented as gross values on the balance sheet. This principle is not an obstacle to the preparation of the balance sheet on a net value basis. The discount items shall be presented clearly under the corresponding accounts.[66]

Balance sheet principles relating to assets, liabilities and equities are explained as follows:[67]

Principles relating to assets:

1-Assets that can be converted to cash within one year or in a normal operating term are classified as current assets on the balance sheet.

2-Assets that cannot be converted to cash within a year or within the entity's normal operating period, and services from which the entity benefits for more than a period, are classified as non-current assets on the balance sheet. Non-current assets that have a life of less than a year at the end of the balance sheet date are reclassified as current assets.

3-Allowances for the diminution in value of assets are compulsory in order to present the assets at their fair values. In the valuation of marketable securities, receivables, inventories and other current assets, allowances are made where considered necessary. This principle is also valid for receivables, long term marketable securities, subsidiaries, associates, and other related items which are classified as non-current assets.

[65] Ibid, Item III/C-5.
[66] Ibid, Item III/C-5.
[67] Ibid, Item III/C-5.

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4- Prepaid expenses and accrued revenues shall be determined and recorded and presented separately on the balance sheet; prepaid expenses are expenses paid in cash before they are used or consumed; and accrued revenues are revenues earned but not yet received in cash.

5-Notes receivable classified as current and non-current assets shall be discounted at the balance sheet date in order to state them at their fair value.

6-Accumulated depreciations of tangible fixed assets and amortizations of intangible fixed assets shall be presented separately on the balance sheet.

7-Accumulated depletions of depletable assets shall be presented separately on the balance sheet.

8-All receivables (current or non-current), marketable securities, long term marketable securities, and other related accounts belonging to shareholders, personnel, subsidiaries and associates, shall be presented separately on the balance sheet as a basic principle.

9-Receivables that cannot be determined in certainty shall not be accrued; these types of receivables are presented in the notes and appendices of the balance sheet.

10-The specialty and scope of guaranties, mortgages given and other guarantees which do not fall within the scope of the balance sheet shall be specified in the notes or appendices of the balance sheet. Furthermore, total insurance amounts related to entities' assets are clearly presented in the disclosures and appendices of the balance sheet.

Principles relating to liabilities:

1-Liabilities due in one year or in within the normal operating term of the entity are presented under short-term liabilities on the balance sheet.

2-Liabilities that are not due in one year or within one year in the normal operating term of the entity are presented under long-term liabilities on the balance

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sheet. At the end of the term, those liabilities with a maturity of less than one year are transferred to the short-term liabilities group.

3-All liabilities of the entity that are known and estimated to their appropriate amounts, including ones that cannot be determined certainty or are controversial, shall be recorded and determined. Liabilities that are known but cannot be estimated to their appropriate amounts shall be clearly specified in the notes on the balance sheet.

4- Unearned revenues and accrued expenses shall be determined and recorded and presented separately on the balance sheet date; unearned revenues are revenues received in cash before they are earned and accrued expenses are expenses incurred but not yet paid at the statement date.

5-Notes payable on short and long term liabilities shall be subject to discounting to state them at their fair values.

6-Current and non-current payables, advances taken and other related account amounts belonging to shareholders, personnel, subsidiaries and associates shall be separately presented on the balance sheet as a basic principle.

Principles relating to equities:

1-The rights of owners or shareholders of the entity concerning the entity's assets constitute of equity group. The entity's paid capital at the balance sheet date, undistributed profit which may be presented under different names generated by as a result of operations, and net profit (loss) for the term shall be presented in the equity group on the balance sheet.

2-The paid capital of the entity is presented as a single account on the balance sheet. However, if the basic capital is separated into different share groups, basic capital accounts shall be presented on the balance sheet notes in a manner to reflecting each group's rights during profit distribution or liquidation or other important special circumstances.

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3-Capital which has been invested by shareholders is required to remain as capital. Any loss occurring in the entity and lessening of equity for any reason are followed up and recorded periodically and totally.

4-The current and previous term' losses are presented as deductible items under the equity group in order to state the net equity amounts on the balance sheet.

5-Equities consist of paid capital, capital reserves, retained earnings (profit reserves), previous terms' profits (losses), and current term profit (loss). Profit reserves consist of legal, statutory, extraordinary reserves, the undistributed portion of operational profit, allowances qualifying as reserves, and special funds. Capital reserves consist of stock share issuance premiums, shareholders' cancelled portions, and value increases in revaluation. Capital reserves shall not be transferred as income to the income statement.

Current/non-current distinction:

An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet.[68]

An asset shall be classified as current when it satisfies any of the following criteria:[69]

(a) It is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle;

(b) It is held primarily for the purpose of being traded;

(c)It is expected to be realized within twelve months after the balance sheet date; or

(d) It is cash or a cash equivalent, unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.

[68] IAS 1, paragraph 51.
[69] Ibid, paragraph 57.

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All other assets shall be classified as non-current.[70]

1.3.3. Income Statement

An income statement is a "form showing the elements used in arriving at a company's net income for the accounting period; also called profit and loss statement. It must be included in annual report."[71]

The traditional income statement has been known by many titles. IFRS refer to this statement as the income statement, but in the EU Fourth Directive and in many common-wealth countries it is referred to as the profit and loss account; and in the United States other names, such as the statement of income, statement of earnings, or statement of operations, are sometimes used.[72]

All items of income and expense recognized in a period shall be included in profit or loss unless a Standard or an interpretation requires otherwise.[73] As a minimum, the face of income statement shall include line items that present the following amounts for the period:[74]

(a) Revenue;

(b) Finance Costs;

(c) Share of the profit or loss of associates and joint ventures accounted for using the equity method;

(d) Tax expense;

(e) A single amount comprising the total of (i) the post-tax profit or loss of discontinued operations and (ii) the post-tax gain or loss recognised on the measurement

[70] Ibid, paragraph 57.
[71] Joel G. Siegel, Jae K. Shim, **Dictionary of Accounting Terms**, Third Edition, Barron's Educational Series, Inc., 2000, p. 221.
[72] Barry J. Epstein, Abbas Ali Mirza, **International Accounting and Financial Reporting Standards**, John Wiley & Sons, Inc., 2005, p. 47-48.
[73] IAS 1, paragraph 78.
[74] Ibid; paragraph 81.

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to fair value less costs to sell or on the disposal of the assets or disposals group(s) constituting the discontinued operation; and

(f) Profit or loss.[75]

As per the Turkish Uniform Chart of Accounts, income statement accounts consist of gross sales, sale discounts, cost of sales, operating expenses, income and profits from other operations, expense and losses from other operations, finance expenses, extraordinary income and profits and extraordinary expense and losses.

Income statement principles:

The principal purpose of the income statement is to provide a clear classification and presentation of sales, expenses, accounts related to profit and loss and operating results belonging to certain periods.[76]

All sales, revenues, profits, costs, expenses and losses are presented using gross amounts; such sales, revenue and profit items can not be removed from the scope of the income statement partially or totally through deduction of any cost, expense and loss items in the income statement.[77]

The corresponding income statement principles specified are as follows:[78]

a- Unrealised sales, revenues and profits shall not be presented as realised and those that are realised shall not be presented as more or less than their real value. In order to present operating results for a certain period or periods accurately, correct accounting entries shall be made at the beginning and end of the period or periods.

b- Sales and revenues for a certain period shall be compared with the cost and expenses incurred to generate them. In order to present costs and expenses accurately, correct accounting entries shall be made at the beginning and end of the period or periods for inventories, receivables and payables.

[75] Ibid, paragraph 81.
[76] **General Communique** for Accounting System, Serial Number 1, Item III/C/1.
[77] Ibid, Item III/C/1.
[78] Ibid, Item III/C/1.

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c- Depreciation, amortization and depletion expenses shall be provided for tangible, intangible and depletable assets.

d- Costs shall be allocated appropriately between tangible fixed assets, inventories, repair and maintenance and other expense groups. Direct costs shall be accrued directly, whereas costs relating to more than one operation shall be accrued directly and allocated taking into consideration time and usage factors.

e- Unusual and extraordinary profits and losses shall be accrued in the related period, but shall be presented separately from normal operating results.

f- All profits and losses shall be presented on the income statement of the current period except for those with a material effect on the financial statements of previous periods.

g- Allowances shall not be used to transfer the profit of a period to the subsequent period, or to decrease the current period arbitrarily.

h- In the event that changes occur in the valuation principles and cost method of the company, the effect of these changes shall be disclosed.

ı-Expenses and losses stemming from the consequences of possible future events or conditional cases, as well as those expenses and losses that can be approximated to their actual values are reflected on the income statement as accrual. Income and profit depending on possible future events are not accrued even if they have a high possibility of occurrence, but are explained in the notes to the financial statements.

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2. LITERATURE SURVEY

2.1. Cash on Hand

Cash, the most liquid asset, is the standard medium of exchange and the basis for measuring and accounting for all other items. It is generally classified as current assets. To be reported as cash, it must be readily available for the payment of current obligations, and it must be free from any contractual restriction that limits its use in satisfying debts.[79] The audit of cash balances is the last audit area studied because the evidence accumulated for the cash balances depends heavily on the results of the tests in all transaction cycles.[80]

The cash on hand account contains national currency and the Turkish Lira equivalent of foreign currencies physically held by the business. This account is credited when payments are made and when money is deposited to the company's bank accounts. The account always shows a debit balance.

The balance of the cash on hand account has to be equal to the money physically held. In addition to valuation, possible cash on hand movements and positions may indicate the assumptions that penal tax assessments in tax auditing will arise. The probable results of tax auditing of the cash on hand account are explained below.

2.1.1. Valuation

2.1.1.1. Valuation of Turkish Lira Cash on Hand

As per Turkish Tax Procedural Law, "the cash on hand based on Turkish Lira is valued at face value (nominal value).[81]

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[79] Keiso, Donald E.& Weygandt, Jerry J., **Intermediate Accounting**, Ninth Edition, John Wiley & Sons, Inc., 1998, p. 332.

[80] Arens, Alvin A. & Loebbecke, James K., **Auditing**, Seventh Edition, A Simon & Schuster Company, 1997, p.696.

[81] Tax Procedural Law, Article: 284.

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As per IAS, cash is a financial asset.[82] When a financial asset is recognized initially, an entity shall measure it at its fair value.[83] After initial recognition, an entity shall measure financial assets at their fair values.[84]

It can be said that fair value is equal to nominal value for cash. Therefore there is no difference for valuation between Turkish practice and IASs for national (functional) currency.

The cash on hand based on Turkish Lira does not affect profit/loss account because of valuation at nominal value (face value) for it.

2.1.1.2. Valuation of Foreign Currencies

According to IAS like Turkish Accounting Standards, "A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.[85]

Cash based on foreign currency is valued at the market value. If there is no market value for the foreign currency, the exchange rate applied for the valuation is determined by the Ministry of Finance.[86] In situations where the exchange rate has not been determined by the Ministry of Finance, the exchange rates declared by the Central Bank of the Turkish Republic are required to be used as the basis for the valuation. In this type of valuation, the foreign currency which has an effective buying exchange rate is valued with the effective buying exchange rate. If there is no effective buying exchange rate, then the currency buying exchange rate will be applied for the valuation.[87]

[82] IAS 32, paragraph 11.
[83] IAS 39, paragraph 43.
[84] Ibid, paragraph 46.
[85] IAS 21, paragraph 21.
[86] Tax Procedural Law, Article: 280.
[87] Tax Procedural Law, **General Communique,** Serial Number 283.

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In our country, since there is no foreign currency market, loans and receivables denominated foreign currencies shall be valued at exchange rates declared by Ministry of Finance.[88]

A difference between Turkish practice and IAS arises for the rates which are taken as the rates for valuation. As per IAS "For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example an average rate for a week or a month might be used for all transactions in each foreign currency occurring during the period. However if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate."[89] At each balance sheet date, foreign currency monetary items shall be translated using the closing rate.[90]

2.1.1.3. Recognition of Exchange Differences

Valuation of foreign currencies affects profit/loss account due to exchange rate differences.

On the valuation date, any positive exchange difference of foreign cash on hand are recorded in cash on hand account as debit and the foreign exchange gains account as credit; while any negative exchange differences are recorded in cash on hand account as credit and the foreign exchange losses account as debit.

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognized in profit or loss in the period in which they arise.[91]

Similarly to Turkish Tax System per IAS, "when monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all

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[88] M. Ali Özyer, **Vergi Usul Kanunu ve Uygulaması**, Tax Expert Association, Third Edition, December 2004, p. 464.
[89] IAS 21, paragraph 22.
[90] Ibid, paragraph 23.
[91] Ibid, paragraph 28.

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the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period."[92]

Some writers say "where the rate of exchange is fairly stable, slight fluctuations are not taken into consideration at all. A debit balance will signify a loss, and a credit balance will donate a profit.[93] However there is no that kind of flexibility neither IAS nor Turkish Tax Accounting System.

2.1.2. Examination of Large or Unusual Cash Disbursements

The true nature and source of the cash on hand must be recognized, and in and out cash activities must be based on verifiable business activities. The cash on hand must represent the business' own transactions and property. The cash flow must be controlled by authorized persons.

Cash activities between related parties are generally scrutinized whether there are cash transfers between related parties from the perspective of tax audit to evade tax. On the other hand "while the benefit of engaging in interaffliate cash transfers derives largely from government-created tax and financial asymmetries, consistently exploiting these opportunities potentially undermines a company's goodwill with home and/or host country governments and could enhance short run profits at the expense of long run profits."[94]

2.1.3. Cash on Hand with a Credit Balance

Cash on hand, as an asset account, is debited when cash is collected and is credited when payments are made for expenses, debts, or for other reasons and when the company deposits cash to its bank accounts. The account always shows a debit balance

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[92] Ibid, paragraph 29.

[93] Douglas Garbutt, **Carter's Advanced Accounts**, Sir Isaac Pitman & Sons Ltd., Fifth Edition 1962, p. 442, 443.

[94] Julie H.Collins, Douglas A. *Shackelford, Global Organizations and Taxes*, **Accounting & Economics**, Volume 24 No 2 December 1997, p. 151.

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or zero balance; it never shows a credit balance, since it can not be credited more than the debit balance. If this happens, it means that there is an error and it must be identified and corrected in accordance with accounting principles. Otherwise cash on hand account with a credit balance indicates the following tax evasion possibilities:

1- Concealment of income

2- Fictitious transactions

2.1.4. An Excessive Balance of Cash on Hand

Having a continuously large balance of cash on hand is one of the most common tax audit areas in balance sheet items. The cash on hand must correspond to the level of daily business and business volume. Except for days on which a company is scheduled to make large cash disbursements, the keeping of a large balance of cash on hand indicates two main possibilities:

1- Various expenses without documentation

2- Cash withdrawn by shareholders

The above mentioned possibilities require penal tax assessment. Therefore if there are large sums of cash on hand continuously, entities have to calculate interest and include it in the taxable income. The interest calculated is also subject to value added tax.

2.1.5. Cash Overages and Shortages

The reasons for the difference between the balance of the cash account and the cash on hand must be identified and corrected with proper accounting records. If the reason for the deficiencies of cash can not be identified and there is no person responsible for the cash on hand, the receivables from shareholders account are debited and the stock count and delivery deficiencies account is credited.

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In reality, this is the reduction of capital. The reduction of capital, with the exception of natural disasters, can not be recorded as a loss for taxable profit.[95]

To record damages as a loss due to natural disaster for taxable profit, the decision of the Tax Appraisal Commission is required. Even if there is a responsible person for the cash on hand, and clearly identified reasons for any deficiencies, the loss still cannot be recorded for taxable profit. It is, however, possible to record the loss for accounting profit. It is recorded in the other extraordinary expenses and losses account as debit. However this is a disallowed expenditure by tax law.

If the reasons for the surplus cash on hand are not known, the stock account and delivery surpluses account is credited temporarily. If the reason for the cash on hand surpluses can not be identified, this difference must be itemized as a positive increase between the beginning and ending shareholders equity. According to Income Tax Law, Article 38, this type of difference is part of the term profit. Therefore a surplus of cash on hand is recorded in the other extraordinary income and profit account as credit and included in taxable profit.

2.2. Checks Received

The checks received account is used for checks given by individuals and legal entities that have not yet been endorsed or given to a bank for collection are recorded. The checks received account is debited with the face values (nominal values) of checks and credited when they are collected or endorsed from the bank.

2.2.1. Valuation

Checks received denominated in foreign currency are valued like cash on hand in foreign currency. On the valuation date, any positive exchange differences of checks denominated in a foreign currency are recorded in the foreign exchange gains account as credit, while negative exchange differences are recorded in the foreign exchange losses account as debit.

[95] Income Tax Law, Article 88/3.

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Instead of giving money directly without interest, entities may realize transfer pricing through bartering checks on the same day mutually with those that have different maturity dates.[96]

2.2.2. Discounting of Checks

According to Turkish Commercial Law, a check must indicate an unconditional definite charge of payment for a certain amount, the person's first name and surname that will make the payment, the payment place, drawing day and place and drawing signature.[97] According to article 707 of the same law, the check shall be paid on sight. Any record contrary to this condition is not valid. A check based on a particular due date is paid on the day it is presented to be paid.[98] In other words, checks are direct payment instruments and legally mean payment in cash. Therefore, any due date on a check is void.

According to accounting principles and the Capital Market Law, the discounting of any undue checks to the real (present) value at the valuation date is compulsory. However, according to tax law, this is a non-deductible expense. It can not be recorded as expenses for taxable income.

According to a decree (June 10, 2002) of the Fourth Office of Council of State, checks based on a particular due date shall not be discounted.[99]

The Tax Lawsuit Office of the General Assembly of the Council of State, with its decision on 07.04.2000, number 2000/145 have rendered a decree which is that checks based on a particular due date are legally invalid. Therefore, they can not be discounted in accordance with Tax Procedural Law Article 281 and 285.

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[96] Onur ELELE, *Grup İçi Şirketlerde Karşılıklı Vadeli Çek Düzenlemesi Yoluyla Örtülü Kazanç Dağıtımı*, **Vergi Dünyası**, July 2002, p. 251.

[97] Turkish Commercial Law, Article 692.

[98] Ibid, Article 707.

[99] G. Kürşat Yerlikaya, *Vergi Usul Hukuku Bakımından Vadeli Çeklerin Reeskonta Tabi Tutulamayacağına Dair Bir Danıştay Kararı,* **Mali Pusula**, August 2005, p.8.

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2.3. Cash in Banks

A company may have a general purpose bank account in each of several locations, a payroll bank account, and several special purpose accounts with a separate general ledger account for each. However, on the balance sheet accounts will be combined in a single line item for cash.[100] Bank reconciliation on December 31, providing parallel records between a bank and the firms, is required to make sure that all receipts and payments are mutually included in records.

Most cash receipts and cash disbursements pass through the client's bank accounts, and most of the cash balance at year-end is in the client's bank accounts. Thus most of the direct tests of the cash balance make use of information obtained directly from banks. Common practice is for the auditor to confirm the year-end cash balance by direct correspondence with all banks with which the client has had accounts during the period.[101]

The cash in banks account contains money deposited and drawn on domestic and foreign banks and similar financial institutions. The cash in banks account is debited when cash is deposited in bank accounts, and credited when cash is withdrawn from banks by a company or by a third party.

Checks given and payment orders (-) represents payments from banks with checks or payment orders to third parties. This account is credited when checks are issued or when money orders are given, and debited when they are collected from banks.

2.3.1. Valuation

Time deposits and demand deposits in banks were valued at recorded value. However, with an amendment in Tax Procedural Law Article 281, "receivables based on time deposits and credit contracts are to be taken into consideration with their interest on the valuation date."

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[100] D. R. Carmicheal, John J. Willingham, **Auditing Concepts and Methods, A Guide To Current Auditing Theory and Practice**, Fifth Edition, p.205.

[101] D. R. Carmicheal, John J. Willingham, p.373, 374.

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This practice shall be taken into consideration demand deposits accounts for commercial entities not for real persons.[102]

Foreign currency time deposits and demand deposits in banks are valued at the market value. The effective buying exchange rate published by Ministry of Finance is applied as the market value. For foreign currencies which do not have effective buying exchange rates, the foreign exchange buying rate is applied in valuation.

Checks and payment orders given which adjust a company's bank account are valued at the face value (nominal value) like cash on hand at the valuation date. Checks given based on foreign currency are valued at the market value of the foreign currency written on the checks.

The interest on time deposits or demand deposits in banks during the fiscal year shall be taken into consideration in gross amounts.

In the case that the net amount is taken, withholding taxes paid can not be offset of yearly corporate income tax. In the case that the gross amount is taken, withholding taxes which are recorded as expenses will be incorrect as well.

2.3.2. Recognition of Foreign Currency Cash in Banks

On the valuation date, any positive exchange rate differences of foreign cash in bank accounts are recorded in the foreign exchange gains account as credit, while any negative exchange differences are recorded in the foreign exchange losses account as debit.

2.3.3. Valuation of Time Deposits

According to General Communiqué Number 67 of the Corporate Tax Code, at the valuation date, any accrued interest amounts from time deposits shall be calculated and included in the taxable income within the framework of the commercial income

[102] Ahmet KAVAK, *Vadeli Mevduatın Dönem Sonuna İsabet Eden Faizinin Beyanı ve Sorunları*, **Mali Pusula**, May 2005, p. 65.

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rulings pursuant to Income Tax Law Articles 38 and 39 and Corporate Tax Law Article 13.

However, the Tax Lawsuit Office General Assembly of the Council of State, with its 12.10.2001 decision, number 2001/311, rendered a decree canceling the General Communiqué Number 67 of the Corporate Tax Code related to the valuation of time deposits in bank accounts. Therefore, any interest obtained from time deposits must be included in taxable income on the date the interest is paid.

Finally, Tax Procedural Law Article 281 has been clarified with an amendment, to the original law, which states "…receivables are valued with recorded value"; the amendment also states "receivables based on time deposits and credit contracts will be taken into consideration with their interest on the valuation date." With this amendment, term interest is calculated and included in term taxable income regardless of whether it is collected.

As per IAS 12, interest revenue is included in accounting profit on a time proportion basis, but may, in some jurisdictions, be included in taxable profit when cash is collected. The tax base of any receivable recognized in the balance sheet with respect to such revenues is nil because the revenues do not affect taxable profit until cash is collected.[103]

2.3.4. Valuation of Repurchase Agreements

A repurchase agreement (repo, rp) is an agreement between a seller and a buyer, usually of U.S. government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time. It is widely used as a money market investment vehicle and as an instrument of the Federal Reserve Board's monetary policy.[104]

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[103] IAS 12, paragraph 17/a.

[104] Friedman, Jack P., **Dictionary of Business Terms**, Second Edition, Barron's Educational Series, Inc. 1994, p.517.

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According to General Communiqué Number 67 of the Corporate Tax Law, up until the valuation date, the accrual of interest amounts for repurchase agreements shall be included in the taxable profit within the context of commercial income rulings.

The Tax Lawsuit Office General Assembly of the Council of State, with its decision dated 12.10.2001, number 2001/311, has rendered a decree by which, up to the valuation date, the accrual of interest amounts for a repurchase agreement will be included in the taxable profit within the context of commercial income rulings.

Furthermore, the above mentioned amendment of Tax Procedural Law Article 281 states, "receivables based on time deposits and credit contracts are to be taken into consideration with their interest on the valuation date". This also includes current repurchase agreements, which means the term interest of repurchase agreements will be counted and included in term taxable income regardless of whether it is collected.

2.4. Other Liquid Assets

Other liquid assets consist of tax stamps, matured coupons, bank money orders and postal money orders (like foreign currency-cash-"in transit). When these liquid assets are acquired, the other liquid assets account is debited; when they have left the company's possession, the 108 Other Liquid assets account is credited.

In order to be classified in Other Liquid Assets, the instruments must be able to be converted to cash at any time without any loss in value. The Other Liquid Assets account can only start with a debit balance. Therefore, it can never have a credit balance.

2.4.1. Valuation

Other liquid assets based on Turkish lira are valued at the face value (nominal value) or recorded value. On the other hand, other liquid assets (i.e. cash in transit which are classified) based on foreign currency are valued at market value. If there is no

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market value for the foreign currency, the exchange rate applied for the valuation is determined by the Ministry of Finance.[105]

2.4.2. Checking Credit Card Sales and Invoices

With credit card sales, sellers collect the sale price after a certain time by paying a commission to the bank arranged by agreement. Commissions paid to banks are recorded in either the 780 Finance expenses account, or 653 Commission expenses account as an expense.

The problem arising from sales with credit cards in tax auditing is that invoices are not prepared on behalf of the customers who use credit cards for payment. Therefore, invoices must be prepared in the name of the cardholders or at least must contain all relevant and corresponding information in the company's records.

2. 5. Marketable Securities and Financial Long Term Assets

2.5.1. In general

Marketable securities are securities such as stock certificates, mutual fund participation certificates, government and corporate bonds, treasury bills, commercial papers, asset backed securities and other private and public sector securities (profit and loss participation certificates and income participation certificates).

As per IAS, a financial asset is any asset that is cash, an equity instrument of another entity, a contractual right, a contract that will or may be settled in the entity's own equity instruments.[106]

As per US GAAP, "Treasury bills, commercial papers, and money market funds are all examples of cash equivalents."[107] However, in Turkish accounting system, these financial instruments are classified under marketable securities.

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[105] Tax Procedural Law, Article 280.
[106] IAS 32, paragraph 11.
[107] Statements of Financial Accounting Standards 95.

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Marketable securities are acquired to be held as short term investments to provide interest income from debt securities or dividends or profits from price fluctuations in the stock certificates. Depending on maturities, marketable securities are classified as current or non current assets (financial long term assets).

On the other hand, financial non-current assets are long term marketable securities such as investments in associates, subsidiaries, or other long term investments in equity securities (bonds and stocks) that are held to achieve long term goals.

These are classified under "investments accounted for using the equity method" in IASs.[108]

Similarly to Turkish Accounting System, per IAS:

"An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture."[109]

"A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent)."[110]

Because stock cannot be depreciated for tax purposes, whereas tangible assets generally can, buyers usually prefer that any basis step-up apply to the underlying assets of the acquired subsidiary, rather than to the subsidiary stock. To achieve this in a taxable sale of a subsidiary stock, the buyer and seller can make a joint election to treat the sale as if it were actually a sale of the subsidiary's underlying assets, followed by a tax-free liquidation of the subsidiary into the parent.[111]

2.5.2. Valuation

According to Turkish Tax Procedural Law, there is no difference between marketable securities (short term securities) and financial long term assets for valuation.

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[108] IAS 1, paragraph 68.
[109] IAS 28, paragraph 2.
[110] Ibid, paragraph 2.
[111] Edward L Maydew, Katherine Schipper, Linda Vincent; *The Impact of Taxes on the Choice of Divestiture Method*, **Journal of Accounting & Economics**, Volume 28, No 2, December 1999, p. 121,122.

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Stock certificates are valued at the acquisition cost. Debt securities are valued at market value. Prior to the amendment of Tax Procedural Law Article 279, all securities including debt securities were valued at the acquisition cost.

On the other hand, it is not important that stock certificates were issued by an entity which is in Turkey or another country.[112]

If there is no market value or if it is understood that the market value has been formed in collusion, the tax basis for valuation is calculated by taking the acquisition cost plus any income (including any exchange rate differences) from the time of acquisition to the valuation date.

IASs and Turkish Tax valuation are different from each other in terms of valuation. As per IASs, valuation of financial assets is also different for initial and subsequent valuation.

According to IAS, when a financial asset is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset.[113]

For the purpose of measuring a financial asset after initial recognition, IAS 39 classifies financial assets into the following four categories:[114]

(a) Financial assets at fair value through profit or loss;

(b) Held-to-maturity investments;

(c) Loans and receivables; and

d) Available-for-sale financial assets.

[112] Gürol ÜREL, *Menkul Kıymetlerin Değerlemesi*, **Mükellefin Dergisi**, April 2002, p. 71.
[113] IAS 39, paragraph 43.
[114] IAS 39, paragraph 45.

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IAS states that after initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:[115]

a) Loans and receivables shall be measured at amortised cost using the effective interest method;

b) Held-to-maturity investment shall be measured at amortised cost using the effective interest method; and

c) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that is linked to and must be settled by delivery of such unquoted equity instruments, shall be measured at cost.

Per IAS, a gain or loss arising from a change in the fair value of financial asset that is not part of a hedging relationship shall be recognized, as follows:[116]

a) A gain or loss on a financial asset classified as at fair value through profit or loss shall be recognized in profit or loss.

b) A gain or loss an available-for-sale financial asset shall be recognized directly in equity, through the statement of changes in equity except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in equity shall be recognized in profit or loss. However, interest calculated using the effective interest method is recognized in profit or loss. Dividends on an available-for-sale equity instrument are recognized in profit or loss when the entity's right to receive payment is established.

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[115] Ibid, paragraph 46.
[116] Ibid, paragraph 55.

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2.5.3. Stock Certificates

2.5.3.1. Valuation of Stock Certificates

Stock certificates are valued at acquisition cost. As long as they remain as assets, any increase or decrease in value will not be included in taxable income. Whenever they are sold, profit and loss are calculated and included in taxable income. Any gains are recorded in the 645 Gains on sale of marketable securities account and losses are recorded in the 655 Losses on sale of marketable securities account.

According to the Council of State's decree (with which the Tax Administration concurs), exchange rate differences and interest expenses (finance expenses) shall not to be included in the acquisition cost of the securities on hand. They are directly recorded as expenses.

2.5.3.2. Stock Shares of Same Company Purchased at Different Dates

Entities can buy and sell the stock shares belonging to the same company on different dates and repeatedly. They can be bought and sold on the same day or on different days and at different prices. A potential problem can arise depending on which stock shares are sold and which remain on the balance sheet. This determination was important because it would affect the taxable term profit and loss.

The specific identification method or average cost method could be used in the valuation of stock shares. There was no clear regulation in the Turkish tax laws concerning the application of FIFO and LIFO. In an earlier version of Tax Procedural Law Article 274, LIFO was a permitted method for the valuation of merchandise inventories but it was not mentioned for the valuation of securities.

Prior to 01.01.2004, Tax Procedural Law Article 274 stated: "Inventories are valued at cost value. Taxpayers can use the LIFO method for the valuation of purchased or manufactured merchandise inventories. The taxpayers who have chosen LIFO do not have to give up this method for five years"; nonetheless, with an amendment to the Article, the LIFO method has been removed as an approved valuation method starting from the beginning of the year 2004.

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One of the valuation methods to use in determining which stocks have been sold is the specific identification method. Because ”the typesetting and document number on stock shares are mandatory”[117], and also “they are mandatory on bills and bonds in addition to the serial number”[118], whichever marketable equity securities are sold or left on hand can be specifically identified.

Other methods which can be applied in the valuation of stock shares are the average cost and moving average cost methods. Finally, Ministry of Finance stated that any valuation methods are allowed for valuation of stock shares.[119]

In the ruling letter given by the Ministry of Finance to the Bank Association, regarding stock share valuation, it was stated that the moving average cost valuation method shall be used for stock shares belonging to the same company which have been bought and sold on different dates, and/or at different prices.[120]

In cases when a part of the same type of marketable security or other type of capital market instrument purchased at different dates are subsequently alienated, the purchase price to be taken into consideration in the assessment of the withholding tax base, shall be determined through the application of the first-in-first-out method. However, daily weighted average price may be taken into account for the purchase-sale transactions which realized in the same day.[121]

When marketable security or other capital market instruments are given as a guarantee or be subject to loan transactions, mentioned securities are considered in client portfolio. Securities which are subject to loan transaction in cost calculation are assumed to out of portfolio.[122]

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[117] Serial 1 Number 5 **Communique of the Capital Market Board** published in the Official Gazette, date: 23.06.1989 and Number: 20204.

[118] Serial 11, Number 13 **Communique of the Capital Market Board** published in the Official Gazette, date: 14.06.1992 and Number: 21284.

[119] Income Tax Law **General Communique** Number 232, section 2.2.

[120] 22.04.1996 dated and 16964 numbered **Opinion of the General Revenues Directorate** of the Ministry of Finance to the Bank Association.

[121] Income Tax Law, **General Communiqué** Number 257, section 2-4-1-2.

[122] Ibid, Section 2-4-1-2.

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2.5.3.3. Stocks Acquired Due to Capital Increase through Bonus Issues

When capital and profit reserves are used to increase the capital, stock certificates without charge representing the increase of the capital are given to the shareholders. Adding capital reserves to the capital does not provide a real capital increase. Therefore giving stock certificates without charge to shareholders in this manner is not acceptable as a dividend payment. These kinds of capital reserve items in terms of tax laws are as follows:

1- Adding the revaluation fund to the capital (Tax Procedural Law Repeated Article 298, which has been abolished from the beginning of the year 2004)

2- Adding the cost increase fund to the capital (Income Tax Law Article 38, Last Paragraph, which has been abolished from the beginning of the year 2004)

3- Adding the profit from the sale of property or affiliates' shares (Corporate Tax Law, Article 5/ (1)-e).

Stock certificates acquired without charge will be disclosed in the notes of balance sheets in terms of the number of this kind of stock shares acquired.

At the time of the acquisition of any stock shares without charge, stock certificates acquired are recorded in the 242 Affiliates or 245 Subsidiaries accounts as debit at nominal value and in the 640 Affiliates' dividend income account as credit. According to Corporate Income Tax Article 5/ (1)/a, dividend income from affiliates falls within the scope of tax exclusions, and shall not be included in taxable profit. Affiliates' profit is also exempted from withholding income tax. (Income Tax Law Article 94/6-b-ii)

The US tax system subjects retained earnings to dividend taxes upon distribution to shareholders, while contributed equity is returned to shareholders as a non-taxable return of capital. From the shareholder's (proprietary) perspective,

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therefore, retained earnings to should be valued on an after-dividend-tax basis, while contributed equity should not.[123]

2.5.3.4. Valuation of Foreign Stock Shares

At the valuation date, foreign stock shares are valued at the acquisition cost like Turkish stock shares. There is no difference between Turkish and foreign stock certificates for the valuation. At this point a conflict often exists regarding the classification of the securities as stock certificates or bonds. The main problem is that some marketable securities are considered to be stock certificates in terms of the laws of the country in which the security is issued; however, they are considered bonds under Turkish laws and regulations. This is a crucial contrast for the valuation, since stock certificates are valued at the acquisition cost and bonds are valued at the market price.

Foreign stocks are the marketable securities representing shareholders' rights and are issued by foreign companies in accordance with their own countries' laws and regulations.[124] However, in order to value foreign stock shares at the acquisition cost, they must qualify as stock certificates according to Turkish laws and regulations.

If foreign marketable securities can not be characterized as stock shares and are instead accepted as bonds according to Turkish laws and regulations, they are valued at the market value and their income for the term shall be included in taxable income. In tax auditing, if any suspicious differences arise, it is the auditor’s responsibility to prove that these differences represent a willful intent to evade paying taxes rather than valuation differences.

On the other hand, the funds established in foreign countries nonetheless utilizing Turkish Capital (known in Turkish as mustachioed funds) may indicate discrepancies in accordance with the “Capital Market Law” and regulations governing foreign Exchange for the activities in Turkey.

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[123] Michelle Hanlon, James N. Myers, Terry Shevlin, *Dividend Taxes and Firm Valuation: A Re-examination*, **Journal of Accounting & Economics**, Volume 35, June 2003, p. 120.

[124] **Capital Market Board' Communique** published in Official Gazette, dated: 20.03.1996 and Number: 22586.

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Stock share sales between related parties in terms of Corporate Income Tax Law Article 5/1-c may be reported as an incidence of transfer pricing.

At the time of the acquisition of stock certificates without charge, the per stock acquisition cost is recalculated. Stock certificates' acquisition cost, including stock certificates without charge, is calculated with the following formula:

Total acquisition cost/ (stock certificates without charge + pre-existing stock certificates)

2.5.3.5. Issuance Premium of Stock Shares

The amounts arising from sales of stock shares which are issued and sold with premiums are followed up "issuance premium of stock shares account. The issuance premium is the difference between issuance price of shares and their nominal values. These differences shall be accepted as money kept in reserve and followed up issuance premium of stock shares items.

2.5.4. Investments in Associates

According to Turkish Tax Procedural Law, there is no difference between stock shares and investment in associates for initial recognition. Both are valued at acquisition cost. Carrying amount is not increased or decreased to recognise the investor's share of the profit or loss after the date of acquisition.

However per IAS, an investment in an associate shall be accounted for using the equity method.[125]

Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor' share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss.

[125] IAS 28, paragraph 13.

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Distributions received from an investee reduce the carrying amount of the investment.[126]

On the other hand, "the issuance of a stock by a firm has always been a nontaxable capital transaction to IRS."[127] According to the Turkish tax system it is also a nontaxable capital transaction.

In US taxation system, "for individual taxpayers, dividend income is taxed at a higher effective rate than capital gains income. This penalty is often referred to as a dividend tax penalty. An actively addressed question in the economics, accounting and finance literature is whether a dividend tax penalty is capitalized into the return on a firm's common stock."[128]

2.5.5. Private/Public Sector Bills, Notes and Bonds

2.5.5.1. Valuation

According to the written regulations of the Bills and Bonds Market of the Istanbul Stock Exchange, Article 2, the following marketable securities can be traded in the Istanbul Stock Exchange:

- Government bonds

- Treasury bills

- Income participation notes

- Private sector bonds

- Asset - backed securities

- Commercial papers

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[126] IAS 28, paragraph 11.

[127] John R.M. Hand, Terrance R.Skantz, *The Economic Determinants of Accounting Choices: The Unique Case of Equity Carve-Outs Under SAB 51*, **Journal of Accounting & Economics**, Volume 24 No 2 December 1997, p. 179.

[128] Dan Dhaliwal, Oliver Zhen Li, Robert Trezevant, *Is a Dividend Tax Penalty Incorporated into the Return on a Firm's Common Stocks*, **Journal of Accounting & Economics**, Volume 35, June 2003, p. 155-156.

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- Bonds issued by public administrations and associations

- Other acceptable marketable securities

However only public sector securities are traded in the Istanbul Stock Exchange.

Therefore, public sector securities are valued at the market price. The other debt securities are valued at the adjusted buying price[129] in which limited term income shall be included in term taxable profit.

Although Eurobonds are exchanged in the international money markets and their prices are formed in organized money markets, they are valued at adjusted buying price.[130]

Income participation notes shall be valued at adjusted buying price in accordance with Turkish Tax Procedural Law, Article 279. If they are based on foreign currency, exchange rate differences shall be included in the adjusted buying price.[131]

Bonds indexed to the inflation rate are also valued at the market price. If there is no market price, they are valued by the calculating the limited term income, and this income will be included in term taxable profit. Exchange rate differences, in addition to interest income, are also included in term taxable profit for bonds indexed to an exchange rate.

For fund participation certificates, even if less than 51% is invested in Turkish stock shares, taxpayers may claim that there is no market in which these certificates can be traded. Therefore they should be valued at acquisition cost. Tax auditors do not agree with this comment. They say that fund participation certificates' values are declared daily and they are convertible to cash depending on these values in any time. Therefore they shall be valued at market value.

[129] The adjusted buying price is the acquisition cost plus income (including exchange rate differences) from acquisition to the valuation date.
[130] The Decree of the Fourth Office of Council of State, dated 15.03.2003 and Basis: 2002/2452, Decision No: 2003/3203.
[131] M. Ali ÖZYER, *Menkul Kıymetlerin Değerlemesi*, **Vergi Dünyası**, Number: 214, June 1999, p.76.

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2.5.5.2. Selling Coupons of Government Bonds

Government bonds are generally issued with coupons. Coupons are given to buyers with the bonds at no extra charge. Bonds and coupons can be sold separately in the secondary market. Their prices are separately formed in the dynamics of the market.

At the issuance date, bonds and coupons acquired are recorded in total in the 112 Public sector bills, notes, and bonds account. Coupons without charge are noted in temporary accounts and when they are sold, the sales income from them is recorded in the 642 Interest income account and included in term taxable profit. The applicable temporary accounts are then balanced and closed.

For the buyers of coupons from the secondary market, they are assumed to be just like bonds and are recorded in the Public sector bills, notes, and bonds account. When they are sold, the sales profit is recorded in the 645 Gain on sale of marketable securities account and included in term taxable income.

2.5.6. Futures, Forwards and Options

Futures, forward contracts and options are areas carrying potential risks for tax deferment in Turkish tax accounting.

The primary issue in accounting for a futures contract is whether a change in the market value of a futures contract should be recognized as a gain or loss in the reporting period when the market price change takes place, or whether the gain or loss should be deferred to a later date.[132]

SFAS No. 80, "Accounting for Future Contracts" specifies two approaches for recording and reporting future contracts. The market-value approach and the hedge-deferral approach. There are two criteria that must be met if the hedge-deferral approach is used for future contracts:[133]

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[132] Thomas R. Dyckman, Ronald E. Dukes, Charles J. Davis; **Intermediate Accounting**, Fourth Edition, Volume I, Irwin McGraw-Hill, 1998, p. 684.

[133] Statements of Financial Accounting Standards No. 80, "**Accounting for Future Contracts**", August 1984.

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-The item to be hedged exposes the company to market price or interest rate risk.

-The futures contract reduces that risk and is designated a hedge.

The market-value approach must be used if the contract does not meet both these two criteria. The market-value approach requires that all gains and losses due to market price changes be recognized in the reporting period when the market value changes. The hedge deferral approach must be used if both criteria are met. The hedge deferral approach requires that all gains or losses due to market price changes be deferred and recognized at the termination of futures contract.[134]

Derivatives such as forwards and options are assets and liabilities and should be reported in the balance sheet at fair value.[135]

Fair value is the amount at which an asset or liability could be bought or sold between two billing parties. Quoted market prices in active markets are the best evidence of fair value and should be used if available. In the absence of market prices, the prices of similar assets or liabilities or accepted present value techniques can be used.[136]

2.6. Receivables

Receivables are categorized under two main groups of activities. One is operating activities and the other is non-operating activities. Receivables arising from operating activities are stated in the trade receivables group of accounts. This group consists of accounts receivable, notes receivable, deposits and guarantees given, and other trade receivables. Receivables representing commercial (operating) activities from the main company, affiliated companies and subsidiaries are obviously disclosed in notes.

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[134] Thomas R. Dyckman, Ronald E. Dukes, Charles J. Davis; p. 684.

[135] Statements of Financial Accounting Standards No.133, "**Accounting for Derivative Instruments and Hedging Activities**" 1998.

[136] Statements of Financial Accounting Standards No. 107, "**Disclosures About Fair Value of Financial Instruments**", 1991.

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Receivables arising from non-operating activities are classified under the "other receivables" group of accounts. This group of accounts consists of receivables from shareholders, subsidiaries, affiliates and personnel as well as other miscellaneous receivables. If receivables from shareholders, subsidiaries, affiliates and personnel arise from operating activities, they must be categorized under the trade receivables group of accounts and disclosed in notes.

All receivables arising from operating activities or non-operating activities are basically treated in the same way from the tax audit viewpoint. Therefore, all receivables should be considered under one main heading.

2.6.1. Valuation

Receivables are valued at the recorded value, which is the calculated value of an asset shown in accounting records. Unmatured notes receivables are allowed to be discounted to their value on the day of valuation. If any interest rate is stated on the notes, this rate is applied to the discount. If no interest rate is stated, the Central Bank Official discount rate is applied.[137]

As per IAS, a contractual right is a financial asset. A contractual right is to receive cash or another financial asset from another entity; or to exchange financial assets with another entity under conditions that are potentially favorable to the entity.[138]

When a financial asset is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset not at fair value through profit or loss, that are directly attributable to the acquisition or issue of the financial asset or financial liability.[139]

For the purpose of measuring a financial asset after initial recognition, IAS 39/45 classifies financial assets into four categories. One of them is loans and receivables.

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[137] Tax Procedural Law, Article: 281.
[138] IAS 32, paragraph 11.
[139] Ibid, paragraph 43.

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After initial recognition, receivables shall be measured at amortised cost using the effective interest method.[140]

Receivables based on foreign currency are valued at the market value of the foreign currency written on the notes. If there is no market value for the foreign currency, the exchange rate for the valuation is determined by the Ministry of Finance. The foreign currency, which has an effective buying rate, is valued at that rate. However, if there is no effective buying rate for the currency in question, the exchange buying rate is used for the valuation.

2.6.2. Recognition of Receivables Based on Foreign Currency

Receivables denominated in foreign currency shall be valued at the end of the year. On the valuation date, any positive exchange rate differences that have arisen from receivables based on foreign currency are recorded in 646 Foreign exchange gains as credit, and negative exchange differences are recorded in 656 Foreign exchange losses as debit.

2.6.3. Discounting of Receivables

The difference in the value of receivables between the nominal (face) value and present (current) value is called the discounting of receivables.

According to the Tax Procedural Law, notes receivable are allowed to be discounted to their present value on the date of valuation. The rate of interest indicated on the notes can be used for discounting. If there is no interest rate indicated on the notes, the Central Bank's official discount rate can be used as the discount rate.

The amount of reduction for the notes receivable to their net present value is calculated and recorded in the Discount of notes receivable (-) account as credit and the Interest expense account as debit.

In order to be able to discount receivables for tax purposes, the receivables must:

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[140] IAS 39, paragraph 46.

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- be recorded on a balance sheet

- be documented by a promissory note (a written promise to pay a stated amount of debt at a stated time)

- have a maturity date (stated time)

- have arisen from trade (operating) activities

Notes receivable arising from non-operating activities and notes of accommodation are not allowed to be discounted. If they are discounted, they will have to be added to the taxable profit as non-deductible expenses pursuant to tax laws.

Taxpayers discounting unmatured notes receivable to the present value of the valuation date must also discount unmatured notes payable in the same way.[141]

In the determination of the interest rate for discounting, if there is an interest rate written on the notes, this rate shall be applicable. If not, the Central Bank interest rate for short term advances shall be applicable as the interest rate.

According to accounting principles and Capital Market Law, the discounting of undue receivables without notes to the present value of the valuation date is compulsory. At the same time according to tax laws, these are non-deductible expenses. They shall not be recorded as expenses for taxable income.

The value-added tax of receivables is also not allowed to be discounted. If it is discounted, it shall also be added to taxable profit as non-deductible expenses in accordance with tax law.

However there are some opinions they say the value added tax is also possible to be discounted, since VAT is an element of entity's receivable.[142]

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[141] Tax Procedural Law, Article 281.
[142] Ruling letter of the Ministry of Finance, dated 10.08.2001, number 42547.

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2.6.4. Doubtful Receivables

SFAS No. 5 (FASB 1975) requires that firms disclose an unaccrued loss if there is a reasonable possibility that the firm has incurred such a loss. Firms must accrue a loss contingency if it is probable and reasonably estimable.[143]

The collectibility of receivables may become questionable in some cases. As per Turkish Tax Procedural Law, depending on the conditions involved in the acquisition and maintenance operating profit, receivables are to be considered doubtful under the following circumstances:[144]

1. Receivables involved in a lawsuit (that is, under consideration by a court of law), or involved in the execution (enforcement stage) of a court's decree.

2. Receivables demanded more than one time with a formal written request (notice of protest) which are not deemed to be worthy of bringing a lawsuit and/or execution against

Pursuant to the economic value at the valuation date, allowances for doubtful receivables must be provided to adjust the value of an asset account. Under the allowance method, an asset offset account (Allowance for doubtful receivable) is established as a deduction from the face value of account receivables and they are stated on balance sheets. Special situations for doubtful receivables are as follows:

1- Any guaranteed part of doubtful receivables shall not allowed to be reserved as an allowance.

2- An allowance for doubtful receivables from shareholders can be allocated only for the portion of the shareholder's notes receivable which exceeds that shareholder's equity in the company.

[143] Criste A. Gleason, Lilian F. Mills, *Materiality and Contingent Tax liability Reporting*, **The Accounting Review**, Volume 77, No. 2, April 2002, p. 318.
[144] Tax Procedural Law, Article 323.

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3- Doubtful receivables collected totally or partially in subsequent years are included in taxable income as income for the year when collected. This situation does not affect the previous year's taxable income.

Doubtful receivables which have been recorded as expenses must be tracked in all seriousness. Otherwise auditors may claim that they are not truly expenses.

Allowances for doubtful receivables are allocated in the year in which taxpayers file suit or take the debtor to court (Different judicial decrees exist on the subject).

2.6.5. Allowances for the VAT Part of Doubtful Receivables

Allowance for the VAT part of doubtful receivables is an issue which was under debate. The Fourth Office of the Council of State, with its 20.12.2000 decision, number 2000/5371, has rendered a decree in which the value added tax part of receivables is not allowed to be discounted in accordance with Tax Procedural Law Articles 281 and 285. The decree defines value added tax as receivable for the tax office but not receivable for sellers and therefore not allowed to be written off under doubtful receivables.

However Ministry of Finance has ended this debate through Tax Procedural Law General Communiqué Serial Number 334. As per the communiqué, in order to be able to allocate allowances for the VAT part of doubtful accounts:

- All conditions in Tax Procedural Law Article 323 shall be met,

- The receivables shall be recorded in related term's records,

-The receivables shall be included in related term's Value Added Tax Returns.[145]

[145] Tax Procedural Law, **General Communique,** Number 334.

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2.6.6. Uncollectible Receivables

Receivables which have no possibility of being collected as to a judicial decree or a document that gives a certain idea are defined as uncollectible (worthless) receivables. On the date receivables are characterized as worthless, they are recorded as loss at their recorded values.[146]

Uncollectible receivables allowed to be recorded as loss must have affected term profit/loss.[147]

If any allowance has been provided earlier for the uncollectible receivables, there is nothing to record loss again. However, if the receivable was not previously classified as doubtful, on the date when it is named an uncollectible receivable, it loses its economic value and is written off as an expense at the recorded value. It is allowed as a deduction for the fiscal year in which it becomes worthless.

The purpose of this deduction is to give relief to taxpayers who will otherwise have to pay tax for the recovery of bad receivables, since the receivable amounts were reported as income but never collected.

The fact that a debt is deemed worthless and deducted for tax purposes in one year, and later is collected in whole or in part, does not affect the previous taxable income. The amount, which has been written off as worthless and used as a deduction from taxable income, is then treated as income for the year when the debt is paid.

In the event of uncollectible receivables, instead of using the allowance method, the write off method is used. Under the write off method, uncollectible receivables (bad debts) are entered directly as a loss and no longer stated in the balance sheets. Receivables are restated at their collectible amounts without allowances, since uncollectible receivables will never be collected.

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[146] Tax Procedural Law, Article 322.

[147] N. Kemal Gündüz, Necati Perçin, **Amortismanlar ve Yeniden Değerleme**, Yaklaşım Publishing, Ankara 1997, p.187.

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France is the only country in which firms fail to make provisions for uncollectible amounts.[148]

On the other hand, as per Tax Procedural Law Article 324, relinquished receivables shall be held in the corresponding account for at most three years. This is income for the debtor. During the three years if it is not deducted from the debtor's term loss, it shall be added to the term profit of the third year.[149]

In the event of creditor and debtor companies mutually sign agreements (which have been approved by notary) about creditor's relinquish from their receivables, for creditors, the receivables will be relinquished receivables depending on the agreement document like a judicial decree or a document that gives a certain idea.[150]

2.6.7. IRS's Audit Techniques for Notes and Accounts Receivable

As per Internal Revenue Service, analyzing notes and accounts receivable are as follows:[151]

-Check entries in the general ledger control accounts. Look for unusual items, especially those which do not originate from the sales or cash receipts journals.

-Review detailed schedules of receivables for credit balances. This may indicate deposits, advance payments or over payments which could be additional income or unrecorded sales.

-Review detailed schedules for related party loans. Verify interest income is being accrued.

-Selected credit sales should be traced from the original invoices and postings through posting in the sales and accounts receivable journals.

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[148] Sanjai Bhagat, Ivo Welch, *Corporate Research & Development Investments International Comparisons*, **Journal of Accounting & Economics**, Volume 19, 1995, p. 450.
[149] Tax Procedural Law, Article 324.
[150] Şükrü KIZILOT, **Council of State Decrees and Ruling Letters**, 7th Book, Yaklaşım Publishing, Ankara, 2004, p. 1150.
[151] www.irs.gov/pub

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-Determine whether accrued income on interest bearing notes or accounts (i.e. finance charges) has been included in income.

2.6.8. Receivables from Related Parties

All receivables are required to be considered in terms of volume, maturity and interest rates. If relatively high amounts of receivables from related parties at the date of maturity are not collected or extended without overdue charges (or relatively low overdue charges), this may be a case of thin capitalization and/or transfer pricing.

Probably the most efficient means of clandestine transfer of company revenues (e.g. invisible profits) from the subsidiary to parent firm is through the transfer-pricing mechanism.[152]

The transfer price between divisions is not a real transfer of money; it is generally merely an accounting charge on the divisional books.[153]

Basically "in the incidence of transfer pricing, income that is required to stay in the corporate body is transferred to entities or individuals in various ways."[154]

Where an asset is purchased with company money in the name of one of the director shareholders this can give rise to a charge to tax as a distribution.[155]

2.7. Inventories

"Inventories are asset items held for sale in the ordinary course of business or goods that will be used or consumed in the production of goods to be sold. The description and measurement of inventory require careful attention because the investment in inventories is frequently the largest current asset of merchandising (retail) and manufacturing businesses."[156]

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[152] http://www.bilgiyonetimi.org/cm/pages/mkl_gos.php

[153] Richard A. Lambert, *Contracting Theory and Accounting*, **Journal of Accounting & Economics**, Volume 32 No 1-3 December 2001, p. 66.

[154] Mualla ÖNCEL, **Kurumlar Vergisi Açısından Sermaye Şirketlerinde Örtülü Kazanç ve Örtülü Sermaye**, Published by Research Institude of Bank and Commercial Law, number: 131, Ankara, 1978, p. 5.

[155] Peter Vaines, *Expensive Holidays*, **Accountancy**, October 2002, p. 108.

[156] Keiso, p.394.

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As per IAS 2, inventories are assets:[157]

(a) Held for sale in the ordinary course of business;

(b) In the process of production for such sale; or

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Types of inventories vary depending on the nature of the business. As a part of current assets, inventories consist of raw materials and supplies; work in process, finished goods and merchandise inventory.

A merchandising (commercial) operation has only one type of inventory, which are commercial goods. The costs of that inventory can be determined directly. They are mostly the amounts charged by the supplier of the goods. Manufacturing operations, on the other hand, carry three different types of inventories as follows.

1. Raw materials and supplies,

2. Work in process (semi-finished goods),

3. Finished goods.

Costs included in the various stages of inventory during the transformation of raw materials into finished goods are the raw material costs, labor and overhead costs.

2.7.1. Valuation

According to Tax Procedural Law, inventories are valued at cost.[158]

As per IAS, inventories shall be measured at the lower of cost and net realizable value.[159]

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[157] IAS 2, paragraph 6.
[158] Tax Procedural Law, Article 274.
[159] IAS 2, paragraph 9.

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Accordingly, inventories are valued at cost value and are stated at cost on balance sheets. However, cost value can not exceed current market value. This is referred to as the "lower-of-cost-or-market" rule which requires either a cost value (historical cost) or a current market value (replacement cost) to be assessed, whichever is lower. If the current market value is lower than the historical cost, current market value shall be used in valuation.

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.[160]

According to Turkish Tax Law, there is a limitation for the LCM (lower of cost or market). If the selling price of inventories is 10%, or more than 10% lower of their historical cost at the valuation date, taxpayers are allowed to apply Tax Procedural Law Article 267: Equivalent Value or Equivalent Charge (the second criteria is not applicable here) instead of cost value. This criterion can also be applied for manufactured goods.

2.7.2. Cost of Inventories

According to Tax Procedural Law, goods bought or manufactured are valued with cost value.[161]

Cost value is the total amount of payments and all other expenses related to acquire an asset and/or to increase its values.[162]

The cost of an inventory item includes all expenditures incurred to bring the item to its existing condition and location.[163]

In other words, c*ost value* is an amount which refers to the total payments made for the acquisition of an economic asset or else for the increase in its value, as well as all expenses associated with them.

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[160] Ibid, paragraph 6.
[161] Tax Procedural Law, Article 274.
[162] Ibid, Article 262.
[163] Accounting Research Bulletin No. 43, "**Restatement and Revision of Accounting Research Bulletins**".

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The cost of inventories shall comprise all costs of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition.[164]

2.7.2.1. Cost of Purchase

In the light of the cost value description given above, the cost value of goods purchased is as follows:

- Acquisition cost

- Insurance expenses paid until the goods have arrived at their place of employment

- Transportation, loading, unloading and porter expenses paid until the goods arrive at the place of employment

- Finance expenses related to the goods

- For imported goods: the value of CIF (cost, insurance, freight) and import duties, commissions and other expenses such as interest and commissions paid for import deposits.

According to the Tax Procedural Law, warehousing and depreciation expenses are not included in cost value, because these payments are not made for the acquisition of an economic asset, or for it to increase in value.

Expenditures, which are required to be included in the cost of goods, but have been recorded directly as expenses shall be checked.

As per IAS, the cost of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable

[164] IAS 2, paragraph 10.

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to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.[165]

As per IAS, an entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of financing.[166]

2.7.2.2. Costs of Production

The cost of production (finished goods and work in process) consists of the following elements:[167]

1- Direct raw materials and supplies expenses: These are the physical items that are transformed to become part of the finished goods.

2- Direct labor expenses: These are the labor costs to convert raw materials into finished goods.

3- Factory overhead (general production expenses): This includes all manufacturing costs other than the direct materials and direct labor costs.

4- General administration expenses (whether to include these in the production cost or write them off directly as an expense is the taxpayer's choice)

General administration expenses are the expenses beyond manufacturing. These expenses are allowed to be given as a share of the cost of manufacturing goods or to be written off as expenses directly. Taxpayers are free to choose one of them. However, partial allocation is not allowed. After choosing one of them, it must not be changed during the fiscal year.

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[165] Ibid, paragraph 11.
[166] Ibid, paragraph 18.
[167] Tax Procedural Law, Article 275.

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According to Value Added Tax Law, in cases in which the assessment of value added tax shall be determined in terms of equivalent value, the general administration expenses must be included in equivalent value.[168]

The cost of packaging for those products which are required to be sold in packages must be included in cost value. If those products not required to be sold in packages necessarily are sold in packages, the cost of the packages shall be recorded as expenses directly in 760 Marketing, sales and distribution expenses.

Manufacturing wastages and discarded goods are valued with equivalent value and recorded with these values. After that, these values are deducted from the manufacturing cost and then the remaining cost shall be the manufacturing cost.

As per IAS, the costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are 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 the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labor.[169]

Per IAS, administrative overheads that do not contribute to bringing inventories to their present location and condition are excluded from the cost of inventories.[170] Likewise in General Communiqué of Uniform Chart of Accounts, the portion of administrative overheads will not be shared to cost of production.[171]

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[168] Value Added Tax Law, Article 27
[169] IAS 2, paragraph 12.
[170] Ibid, paragraph 16.
[171] Nalan Akdoğan, **Maliyet Muhasebesi**, Gazi Publishing, Tenth Edition, Ankara 2000, p. 67.

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2.7.3. Taking Physical Inventory

According to Tax Procedural Law, entities need to take physical inventory to determine all assets, receivables and payables on the balance sheet date by means of counting, measuring, weighing and evaluating the certain type and the nature, in detail, of the inventory.[172]

However, in accordance with established practice, where an inventory based on actual count, measure, weight, and evaluation is not feasible or available, an accurate estimated inventory for the taxpayer is necessary for tax purposes.

Tax Procedural Law Article 190 states an exemption from taking inventory at least once a year for pharmacies and big manufacturing companies which have a license issued by the Ministry of Finance to be allowed to take physical inventory once every two or three years.

2.7.4. Inventory Overages and Shortages

Waste, breakage, theft, improper entry, failure to prepare or record requisitions, and any number of similar possibilities may cause the inventory records to differ from the actual inventory on hand. This requires verification of the inventory records by actual count, weight, or measurement. These counts are compared with the detailed inventory records. The records are then corrected to agree with the quantities actually on hand.[173]

The reasons for the difference between recorded inventory and inventory on hand must be identified and corrected with proper accounting recording entries. If the reason for the deficiencies of inventory can not be identified, this is a loss of assets causing reduction in the capital in reality. It can not be recorded as a loss for tax purposes, because reduction of the capital, except for natural disasters, is not deductible.[174]

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[172] Tax Procedural Law, Article 186
[173] Keiso, p.397
[174] Income Tax Law, Article 88/3.

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To record as a loss, due to natural disasters, damages for taxable profit, a judgment from the appraisal commission is required. Otherwise, no amount can be recorded as a loss in terms of taxable income. However, it is possible to recognize it as a loss for commercial profit even if there is no appraisal commission judgment. It is recorded in the 689 other extraordinary expenses and losses account as debit. However it is a non-deductible expenditure by tax law.

If the reason for the surplus inventory on hand is not known, the 397 Stock count and delivery surpluses account is credited temporarily. If the reasons for surpluses of the inventory on hand can not be identified, this difference creates a positive increase between beginning and ending shareholders' equity. According to Income Tax Law Article 38, this kind of gap is part of the term profit. Therefore any surplus of the inventory on hand is recorded in the 679 other extra ordinary income and profit account as credit and included in taxable income.

2.7.5. Inventory Misstatements

As an essential part of accounting, inventories at the beginning and ending of each fiscal year shall be taken into account to reflect a taxpayer's income properly. Correct inventory quantities shall be used in preparing true financial statements. In the determination of the cost of goods sold by inventory misstatements in which items are incorrectly included or excluded, the following possibilities should be taken into consideration at the end of the period.

First assumption: The beginning inventory and purchases are recorded correctly but not included in the ending inventory although they have not been sold. The results understate the ending inventory, overstate the cost of goods sold, and understate the net income. This situation requires penal tax assessment.

Second assumption: The beginning inventory and purchases are recorded correctly but are included in the ending inventory in higher than actual quantities. The results overstate the ending inventory, understate the cost of goods sold, overstate net income for the current year, and understate net income for the next year. Therefore both

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years' net income will be wrong. If the audited year in which net income is understated, this situation requires penal tax assessment regardless of the previous year.

Third assumption: The goods are not recorded as a purchase and are not counted in the ending inventory. Results for accounting purposes are an understated inventory and no effect on the cost of goods sold and net income, because the inventory error offsets itself. However it requires penal tax assessment for tax purposes, since these are unrecorded transactions.

Fourth assumption: The purchased goods have been recorded in higher than actual quantities and are counted in the ending inventory. Results for accounting purposes are an overstated inventory and no effect on cost of goods sold and net income, because the inventory error offsets itself for the current year in accordance with the following formula.

Beginning inventory + Purchases = Cost of goods sold + Ending inventory

However it requires penal tax assessment for the following year, since beginning inventory and cost of goods sold will be overstated and net income will be understated.

2.7.6. Inventory Cost Calculation Methods

The most common inventory cost calculation methods are: specific identification, average, moving average, FIFO (first in first out), and LIFO (last in first out). According to the General Communiqué concerning Tax Procedural Law 176, pursuant to the definition of cost value, actual cost must be applied in determining economic assets.

In accordance with Tax Procedural Law amended article 274 prior to year of 2004, taxpayers were also allowed to measure the cost value of inventories with the last in first out (LIFO) method as well as other methods of inventory valuation. However from 01.01.2004, LIFO is not an allowed inventory valuation method for tax purposes

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According to the IAS 2, the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.[175]

In order to apply specific identification of cost method, remaining amounts of every group of inventories must be identified in the year end.[176]

The cost of inventories other than those dealt with in paragraph 23 shall be assigned by using the first-in, first- out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories with a different nature or use, different cost formulas may be justified.[177]

Although the US has more detailed accounting regulations and disclosed items than the rest of the world together, the remaining discretion is enough to have allowed accounting researchers to produce an empirical comparative literature. There is considerably more heterogeneity across sample countries. The US is unusual in that LIFO is very common.[178]

2.7.7. Appropriateness Test of the Output Ratios and the Wastage Ratios

In tax auditing, the output (production) ratios of the sector the company works in shall be compared with the company's output ratios (derived from the company's records) to measure whether they corroborate each other or whether they have some deficiencies in comparison.

In the application of output ratios, wastage ratios for the sector and the company shall be used in determining the quantity of goods manufactured. Wastages are the disappearing or remaining parts of the supply and materials during the manufacturing process. If there is a normal wastage ratio arising from the nature of the work, an appraisal commission decision is not required.

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[175] IAS 2, paragraph 23.
[176] M. Emin Akyol, M. Küçük, **Ticari Emtianın Değerlemesi ve Muhasebe Kayıtları**, Turmob Publishing, 2000-16.
[177] IAS 2, paragraph 25.
[178] Sanjai Bhagat, Ivo Welch, p. 450.

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Abnormal amounts of wasted materials, labor or other production costs shall be excluded from the cost of inventories.

2.7.8. Allowances for Value Decrease of Inventories

According to Tax Procedural Law Article 278, damages due to the result of fire, earthquake, or flood, or in cases of spoilage, decay, breakage, cracking, or rust if there are important value decreases in inventories' economic value, their valuation shall be provided by the equivalent value method, pursuant to Article 267 of the Tax Procedural Law.

However, the above mentioned value decreases must fall within the scope of normal commercial necessities. Beyond these reasons for the value decreases of inventories (for example in the case of the goods which are stolen or lost), equivalent value is not allowed to be applied. Therefore, they are non-deductible expenses for tax purposes.

Taxpayers claiming their inventories have lost value in the ways mentioned in Tax Procedural Law Article 278 must prove this to the appraisal commission. To record a loss due to natural disasters for taxable purposes, a decision of the appraisal commission is required. The last date to apply to the appraisal commission is the last day of the fiscal year. However, if the value decrease has arisen from casualty losses, an application must be made as soon as possible without waiting for the last day of the fiscal year.

2.7.9. Recognition of the Value Decrease of Inventories

The allowance account is used to record allowances adjusting physical and economic losses incurred in the value of inventories because of natural disasters, damages, obsolescence, or other reasons.

According to the Turkish uniform chart of accounts, when the market value decrease of the inventories has been determined, the 654 Provision expenses account is debited and the 158 Allowance for decrease in value of inventories account is credited. When these inventories are either used in business or sold, then a comparison is made

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with the related inventory account and the provision is transferred to the 644 Provisions no longer required account.

2.7.10. Value Added Tax for Goods in Casualty Losses

According to Value Added Tax Law Article 30/c (with the amendment dated 05.02.2000), the value added tax of goods in casualty losses except earthquake and flood shall not be deducted from calculated value added tax. Prior to the amendment dated 5.2.2000, the exemption for earthquakes and floods was not within the scope of the article. Therefore the Value Added Tax of all goods in casualty losses shall not have been deducted from calculated value added tax. After 5.2.2000, the Value Added Tax belonging to those goods lost in earthquakes or floods shall be deducted from calculated value added tax.

In addition to the value added tax of the goods in casualty losses (except in earthquakes and floods), the value added tax of goods which have been stolen or lost are also not allowed to be deducted from the value added tax calculated on taxable transactions, because they are non-deductible expenses for tax purposes.

2.7.11. Inventories per Internal Revenue Service

As per Internal Revenue Service for specific techniques for analyzing inventories are as follows:[179]

-Obtain year-end physical inventory sheets and verify that all quantities and costs have been accurately extended.

-Reconcile total inventory per physical inventory sheets to amounts per books. Investigate any differences.

-Compare costs per physical inventory sheets to cost per purchase invoice, job cost reports, etc.

[179] www.irs.gov/pub

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-Review the general ledger for inventory write downs, reserves for obsolescence or other decreases to inventory and test for propriety.

-Check for gross profit variations and investigate any significant differences.

-Verify year and purchases were included in the ending inventory.

-Verify direct costs have been allocated to ending inventory (i.e., freight in, duty taxes, packaging materials, etc.).

-Determine whether all applicable indirect costs have been properly allocated to all items of ending inventory. (i.e., raw materials, work-in-process, and finished goods).

-Verify that ending inventory is the same as the prior year's ending inventory.

-Verify the ending inventory is the same as the subsequent year's beginning inventory.

2.8. Tangible Fixed Assets

Tangible fixed assets are assets acquired for use in the regular operation of a business. They are expected to provide benefits with an estimated useful life of longer than one year.

According to the Turkish Uniform Chart of Accounts, tangible fixed assets are classified as lands, land improvements, buildings, plant machinery and equipment, motor vehicles, furniture and fixtures, other tangible fixed assets, construction in progress and advances given. All these sub-accounts are listed in 25 Tangible fixed assets in Uniform Chart of Accounts.

All tangible fixed assets excluding land are subject to depreciation. Although land is not subject to depreciation, land improvements which face deterioration are subject to depreciation. Depreciation of tangible fixed asset accounts is stated under 257 Accumulated depreciation (-), which lasts throughout the life of the asset.

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In IASs, there are three types of tangible fixed assets:

1- Property, plant and equipment are tangible items that:[180]

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

2- Investment property is property (land or a building-or part of a building-or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:[181]

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply goods or services or for administrative purposes.[182]

3- An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.[183]

2.8.1. Valuation

2.8.1.1. Valuation in General

The initial measurement of a tangible fixed asset shall be at cost, including any expenditure which is necessary to bring the asset into a working condition. Subsequent related expenditures are also to be included in the cost if they increase the future

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[180] IAS 16, paragraph 6.
[181] IAS 40, paragraph 5.
[182] IAS 40, paragraph 5.
[183] IFRS 5, paragraph 6.

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economic benefit of the asset. Expenditures incurred after initial recognition must increase the future economic benefit of the asset to be included in the cost. Otherwise, they will be recorded as expenses directly.

In valuation after recognition, tangible fixed assets are valued at cost model. As per cost model, assets shall be carried at its cost less accumulated depreciation. Revaluation practice has been abolished from the beginning of the year 2004 in Tax Procedural Law. Prior to 2004, income and corporate taxpayers (except privileged companies) keeping books on a balance sheet basis might revalue their depreciable fixed assets and their accumulated depreciations at the end of each accounting period by multiplying their balance sheet values with the revaluation rate declared by the Ministry of Finance for that year.

Prior to abolition "If the revalued fixed asset is sold, the revaluation fund related to this asset should be treated as accumulated depreciation, according to the Turkish Tax Procedural Law. However this is impossible when the revaluation fund is added to the capital.[184]

This means when calculating the cost (or net book value) of a revalued fixed asset during sales, the revaluation fund amount related to this asset will be deducted from the book value (revalued acquisition cost) together with its accumulated depreciation, if the revaluation fund hasn't been added to the capital yet.[185]

UK generally accepted accounting principles (GAAP) permit fixed assets to be recognized in financial statements at revalued amounts. Under UK GAAP managers can increase or decrease the carrying value of assets when asset values fall. Upward revaluations are discretionary and not permitted under US GAAP, whereas, as under US GAAP, dawn ward revaluations are required when asset values fall."[186]

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[184] Necdet Şensoy; **Selected Topics on Turkish Tax Accounting**, Marmara University Publishing, Number: 550, İstanbul 1994, p.55.

[185] Necdet Şensoy, p.56.

[186] David Aboody, Mary E. Barth, Ron Kasznik; *Revaluation of Fixed Assets and Future Firm Performance: Evidence from the UK*, **Journal of Accounting & Economics**, Volume 26 No 1-3 January 1999, p. 150.

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Companies Act of 1985 sets forth UK GAAP for asset revaluations, specifically, Alternative Accounting Rules, Part C, Schedule 4. UK GAAP permits upward revaluations of long lived assets, including many types of intangible assets, but not goodwill. Dawn ward revaluations are required for all long lived assets, including goodwill, when the assets carrying amount exceeds its net realizable value.[187]

As per US GAAP, a tangible plant asset is initially recorded in the accounting records at its acquisition cost. The acquisition cost includes the purchase price (less any cash discount) plus all other reasonable and necessary expenditures to prepare the asset for use in operations. Therefore, the cost of a computer would include such costs as transportation, special wiring and site preparation, installation, and test runs. The cost of a building would include permit fees, excavation and grading costs, architectural and engineering fees, and construction costs. For assets constructed for a firm's own use, portions of the interest expense used to finance the construction are considered part of the asset cost and debited to the plant asset.[188]

Valuation as per IAS; 1- An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.[189]

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.[190]

According to "cost model" after recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.[191] As per "revaluation model" after recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the

[187] David Aboody, Mary E. Barth, Ron Kasznik; p. 152.
[188] FASB Statement No. 34, "**Capitalization of Interest Cost**" (as amended by FASB Statements No. 58 and 62).
[189] IAS 16, paragraph 15.
[190] Ibid, paragraph 29.
[191] Ibid, paragraph 30.

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revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.[192]

2- An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.[193]

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.[194]

After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value (except inability to determine fair value reliably).[195]

After initial recognition, an entity that chooses the cost model shall measure all of its investment property at cost model.[196]

3- An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

2.8.1.2. Valuation in Tax Procedural Law

All properties as a part of entities are valued at cost value. According to Tax Procedural Law, below mentioned assets are valued like properties:[197]

-Detailed and integral parts of real estate;

-Installation (electricity/plumbing/gas/central heating) and machines;

-Ships and other vehicles,

-Intangible assets (Non-material rights),

[192] Ibid, paragraph 31.
[193] Ibid, paragraph 20.
[194] Ibid, paragraph 30.
[195] Ibid, paragraph 33.
[196] Ibid, paragraph 56.
[197] Tax Procedural Law, Article 269.

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Equipments are valued at cost value. Cost value includes commissions and shipping charges besides purchase price.[198]

2.8.2. Determination of the Cost Value

In addition to the acquisition cost (base purchase price), cost value properties consists of the following expenditures:[199]

1. Those involved in the acquisition of machines and equipment: customs duties, outlays made for shipping and installation expenditures.

2. Those concerning the acquisition of land expenditures, incurred in preparing the land for use, such as excavating and grading of an existing building and the removal of unwanted existing structures. If any income is provided from an existing building's materials, it should be recognized as a cost deduction for parts.

3. Notary, court, value appraisal, broker and announcement expenditures, special consumption tax, and real estate purchase tax are all either added to the cost value or recorded as expenses for the current period. Taxpayers are free to choose one of these two options.

In cases where buildings and ships are constructed or machines and equipment are manufactured, the cost of construction or production of these tangible fixed assets replaces the purchase cost.[200]

In determining the cost of newly-constructed buildings, the cost of all materials expended in the construction and any other expenses incurred must be included in the cost.

The cost of properties which has been constructed consists of the following items:

-The cost value of the land on which the real estate will be constructed.

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[198] Ibid, Article 273.
[199] Ibid, Article: 270.
[200] Ibid, Article 271

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-If there is an existing building on the land on which real estate will be constructed, the cost of tearing it down and clearing the land (however, salvage value must then be deducted)

-Any undepreciated part of the existing building which has been torn down

-Materials of construction

-Labor expenses

-Notary, court, value appraisal and deed registry fees; if preferred, these may be added to cost value instead of being written off as direct expenses

In a tax audit, the cost of tangible fixed assets manufactured or constructed for use by a business entity has to be compared with their estimated cost in order to determine whether there are important differences between the realized and estimated costs.

Property sales between related parties, in terms of Corporate Income Tax Law Article 5-(1)/c, may be reported as an incidence of transfer pricing.

2.8.3. Interest Expenses and Exchange Rate Differences

Interest expenses paid or accrued for loans used in the acquisition of tangible fixed assets shall be included in the cost value of the asset by the end of the fiscal year in which the tangible fixed assets are capitalized. However, after the end of the fiscal year, interest expenses paid or accrued may be included in the cost of the tangible fixed asset or written off as an expense for the year in which the interest is accrued or paid.[201]

In the same way, exchange differences for loans used in the acquisition of tangible fixed assets shall be included in the cost value of the asset by the end of the fiscal period in which the tangible fixed assets are acquired. However, in subsequent years, they may be included in the cost of the tangible fixed asset and will be subject to

[201] **General Communique** of Tax Procedural Law, Serial Number 163.

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depreciation or written off as an expense for the year in which the interest is accrued or paid.[202]

Taxpayers are free to choose either to include interest expenses and exchange rate differences in the cost or to write them off as expenses directly after the year they are capitalised. Partial allocation is not allowed. After one is chosen, it shall not be changed. If including the expense/difference in the cost is preferred, after the year they are capitalized, they shall not be subject to revaluation and cost value increases.

Loan interest and/or exchange differences shall not be recorded directly as expenses for the capitalization term.

As per IAS, the cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the item in accordance with the allowed alternative treatment in IAS 23.[203]

Borrowing costs shall be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 11.[204] Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset.[205]

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.[206]

Under the allowed alternative treatment, borrowing costs that are directly attributable to the acquisition, construction or production of an asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the

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[202] Ibid, Serial Number 163 and 187.
[203] IAS 16, paragraph 23.
[204] IAS 23, paragraph 10.
[205] Ibid, paragraph 11.
[206] Ibid, paragraph 4.

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costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.[207]

2.8.4. Increase in Cost Value

Excluding expenditures for normal maintenance, repair and cleaning, any expenditure which increases the value of real estate, or expands the physical size of the real estate shall be added to the cost value.[208] Expenditure which increases the value of tangible fixed assets is capitalized and depreciated pursuant to Tax Procedural Code Article 313 and the related articles. But this capitalization and depreciation is dependent on the expenditures extending the useful life or expanding function and usefulness.

If the expenditures extend the usefulness and function of the real estate, they shall be added to the cost value of the real estate and capitalized for depreciation. If they increase the usefulness and function, depreciation allocations are dependent on the main assets' depreciation period. These allocations shall not exceed this period. However, if they extend the useful life of an asset, they are capitalized and depreciated over 5 years with 20% allocated for each year regardless of the assets' remaining depreciation. On the other hand, the normal maintenance, repair and cleaning expenditures of real estate are not capitalized. They are written off as expenses directly.

Similarly as per IAS, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognized in profit or loss as incurred.[209]

Parts of some items of property, plant and equipment may require replacement at regular intervals. An entity recognised in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met.[210]

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[207] Ibid, paragraph 12.
[208] Tax Procedural Law, Article 272.
[209] IAS 16, paragraph 12.
[210] Ibid, paragraph 13.

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2.8.5. Value Added Tax of Manufactured or Constructed Assets

Prior to the amendment of Value Added Law Articles 3/d, 10/f, 20/3 and 31, in the case of depreciable tangible fixed assets manufactured or constructed for use by business entities, they were assumed to have been delivered[211] and had to be computed with VAT. Value added tax calculated in this way would be deducted in three installments.[212] However this has not been effective from 1.1.1999.

2.8.6. Value Added Tax Paid for the Acquisition of Automobiles

As a general rule, Value Added Tax paid for acquisitions can be deducted from the Value Added Tax calculated on taxable transactions. However there is a special regulation exists for automobiles.

Except for those automobiles used by entities whose total or partial activities consist of renting cars out or the use of cars in various types of operations, the Value Added Tax paid as stated on invoices in the acquisition of automobiles is not allowed to be deducted from the Value Added Tax calculated on taxable transactions.[213]

The Value Added Tax paid on the acquisition of automobiles shall be included in the cost value (capitalized) or expensed directly at the discretion of the taxpayer, but it is not allowed to be deducted from calculated VAT.[214]

With the amendment of Individual Tax Law Article 68/7, self-employed taxpayers are also allowed to write off as expenses for automobiles, if they are included in inventory records.[215]

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[211] VATL,Repealed Article 3/d.
[212] Ibid, Repealed Article 31.
[213] Ibid, Article 30/b.
[214] Value Added Tax, **General Communique**, Number 23.
[215] Individual Income Tax Law, Article 68/7.

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2.8.7. Depreciations

2.8.7.1. Depreciations in General

Tangible fixed assets included in inventory records that are ready to be used by a business entity actively and are expected to be used for more than one year incurring physical wear, tear and obsolescence, are subject to depreciation. Furniture and fixtures costing less than 520 YTL for the year 2006 is allowed to be treated as expense items directly.[216] Depreciable fixed assets shall not be expensed directly, unless they are valued at lower than 520 YTL.

In order to be depreciated, using of capitalised tangible fixed assets is not a requirement.[217] According to Ozturk, it is not required to use and to have tangible fixed asset in the entity to be depreciated.[218]

As per IAS, depreciation of an asset begins when it is available for use.[219]

The depreciable amount of an asset shall be allocated on a systematic basis over its useful life determined by Ministry of Finance with General Communiqués.

As per IAS, the useful life of an asset is defined in term's of the asset's expected utility to the entity. The estimation of the useful life of the asset is a matter of judgment based on the experience of the entity with similar assets.[220]

Ministry of Finance is authorized to determine and change depreciation rates when needed.[221]

As per IAS, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.[222]

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[216] Tax Procedural Law Article 313.

[217] The Decree of the Fourth Office of the Council of State, dated 23.01.1978, Basis 1977/1418, Decision 1978/165.

[218] Bunyamin Özturk, **Dönem Sonu Envanter ve Değerleme**, 4th Edition, 2006, Maliye ve Hukuk Publishing, p.392.

[219] IAS 16, paragraph 55.

[220] Ibid, paragraph 57.

[221] Tax Procedural Law, Article 318.

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In the year in which tangible fixed assets are capitalized, depreciation may be calculated by applying either the straight line or diminishing balance method (declining balance method).

Tax depreciation and amortization can differ significantly from financial depreciation and amortization.[223]

No matter which day of the year the tangible fixed assets have been acquired (except automobiles), they shall be depreciated for the whole year. In the year in which a tangible fixed asset is sold, depreciation may not be calculated.

Depreciation expenses for past years in which depreciation has not been allocated, whether intentionally or unintentionally, may not be allocated at any ensuing years.

Land is not subject to depreciation[224] because it has an unlimited life. Other types of tangible fixed assets do not last forever, because of physical deterioration such as wear and tear and other factors such as obsolescence and inadequacy; they are therefore subject to depreciation. Buildings are subject to depreciation, but they are depreciated at their value before revaluation.

As per IAS, land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.[225]

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[222] IAS 16, paragraph 43.

[223] Micheal J. Calegari, *The Effect of Tax Accounting Rules on Capital Structure and Discretionary Accruals*, **Journal of Accounting & Economics**, Volume 30 No 1 August 2000, p.8.

[224] Tax Procedural Law, Article 314.

[225] IAS 16, paragraph 58.

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Whether the usefulness of a plant asset is terminated by physical deterioration or by obsolescence, it is the objective of depreciation accounting to spread the cost of the asset over the years of its usefulness in a systematic and sensible manner.[226]

Therefore depreciation is a process of cost allocation. It is not a process of valuation. Also, depreciation is not a process of generating funds to replace a particular asset. By matching depreciation expenses against revenues, we attempt to recover the original monetary investments in noncurrent assets made in the past.[227]

2.8.7.2. Methods of Calculating Depreciation

A number of alternative depreciation methods are used to calculate periodic depreciation charges. Each of them gives different results in determining income for book purposes as well as for tax purposes. The methods in the Tax Procedural Law that can possibly be used for calculating depreciation charges are described as follows:

(1) The straight line method: This determines a uniform portion of the asset's cost which must be allocated to each fiscal period equally. The formula is expressed as follows:

Cost of asset - Salvage value/ Number of years in estimated useful life of asset= Depreciation expense for each year

Mostly the salvage value is assumed to be zero.

Prior to 01.01.2004, Tax Procedural Law Article 315 stated that the maximum straight line depreciation rate was 20 %. However, the Ministry of Finance could determine and proclaim different depreciation rates which will be higher or lower than 20 %. In the General Communiqué of Tax Procedural Law Article 153, different depreciation rates have been proclaimed by the Ministry of Finance, in which buildings are subject to a 2% depreciation rate.

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[226] Johnson L. Glenn, Gentry A. James, Finney and Miller's, **Principles of Accounting Introductory**, 1982, p. 287.
[227] Spiller A. Earl, **Financial Accounting**, R. D. Irwin, 1971, p.273.

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From the beginning of 2004, taxpayers depreciate their tangible fixed assets with rates which will be determined and declared by Ministry of Finance. In the determination of rates which will be declared, useful life of assets shall be taken into consideration.[228]

Taxpayers using the straight line method for depreciation at the outset cannot later use the declining-balance method.

According to the ruling letter of the Ministry of Finance, in order to be depreciated, it is not necessarily required that tangible fixed assets be used during the periods over which a depreciable asset is expected to be used by the enterprise. Even if they are not used and not expected to undergo physical wear and tear, a decrease in value still occurs with the passing of time.[229]

(2) The declining-balance method: The use of the declining-balance method results in larger depreciation expenses during the early years of an asset's life and smaller depreciation expenses in later years. According to the Tax Procedural Law, in the declining balance method, the depreciation is calculated by using twice the straight line rate. In the following years, after deducting the accumulated depreciation from the acquisition value, the remaining cost will be subject to depreciation each year.

This method uses twice the straight line rate, but not more than 50 %.[230]

Taxpayers using the declining-balance method for depreciation at the beginning can use the straight line method. At this time, the remaining amount is depreciated in equal parts over the remaining years.

Tax considerations may lead firms to prefer accelerated depreciation and rapid asset write offs.[231]

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[228] Tax Procedural Law, Article 315.
[229] Ministry of Finance, Determination letter dated 20.03.1997 and number 11804.
[230] Tax Procedural Law, Repeated Article 315.
[231] David A. Guenther, Danging Young; *The Association between Financial Accounting Measures and Real Economic Activity: a Multinational Study*, **Journal of Accounting & Economics**, Volume 29 No 1 February 2000, p. 55.

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(3) Extraordinary depreciation method: The extraordinary depreciation method is allowed if tangible fixed assets which are subject to depreciation:[232]

1. Lose their value partially or completely due to disasters such as fire, earthquake, or flood;

2. Become partially or completely unusable because of new inventions reducing the technical productivity and value of the asset;

3. Are exposed to higher than normal wear and tear because of excessive productivity, time spent in use, etc.

If any one of the above mentioned cases is applicable, taxpayers can apply to the Ministry of Finance for the determination of an extraordinary depreciation rate with a written application. All evidence must be attached to the written application and submitted to the Ministry of Finance.

As per IAS, a variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight line method, the diminishing balance method and the units of production method.[233]

Extraordinary depreciation method is not an allowed in IAS. However, "to determine whether an item of property, plant and equipment is impaired, an entity applies IAS 36 Impairment of Assets."[234]

2.8.7.3. Depreciations for Automobiles

As a general rule, no matter which day of the year tangible fixed assets have been acquired, they shall be depreciated for the whole year. However there exists a special regulation for automobiles.

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[232] Tax Procedural Law, Article 317.
[233] IAS 16, Article 62.
[234] Ibid, paragraph 63.

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Except for automobiles used by entities whose total or partial activities consist of renting cars out or the use of cars in various types of operations, automobiles shall be depreciated in the short term. The formula to compute depreciation is as follows:

Depreciation for a year x the number of months left / 12

The month in which automobiles are capitalized is accepted as a complete month.

For those entities whose total or partial activities consist of renting cars out or the use of cars in various types of operations, no matter which day of the year a tangible fixed asset has been acquired, it is allowed to depreciate for the whole year.

With the amendment of Individual Tax Law Article 68/7, self-employed taxpayers are also allowed to write off as expenses of automobiles, if they are included in inventory records.[235]

In tax auditing, automobiles sold at a value lower than their insurance value may create a problematic situation. Automobiles especially sold to personnel at a value lower than their insurance value shall be deemed as wages and the difference between the market price and the sale price is considered wages.

2.8.8. Casualty Losses in Tangible Fixed Assets

Tangible fixed assets and their depreciation should be eliminated from the balance sheet when no future economic benefits can be expected from them. However, those taxpayers who claim their tangible fixed assets have lost their value because of natural disaster or fire must prove it to the appraisal commission.

In order to record a loss due to natural disasters for taxable purposes, the decision of the appraisal commission is required. The last date to apply to the appraisal commission is the last day of the fiscal year. However, if the value decrease has arisen from casualty losses, the application must be made as soon as possible without waiting for the last day of the fiscal year.

[235] Individual Income Tax Law, Article 68/7.

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2.8.9. Depreciable Assets per IRS

As per Internal Revenue Service for specific techniques for analyzing depreciable assets are as follows:[236]

-Determine if costs relating to the acquisition and installation of assets, leasehold improvements, etc. have been capitalized with the appropriate useful life.

-Ascertain if the taxpayer has transferred assets to a related party for less than fair market value.

Determining arm's length prices for transfers of intangibles is usually more difficult than for transfers of tangibles. As revealed by Shindler and Henderson's survey (1985), the majority of tax audits (80 %) on transfer pricing by the US Internal Revenue Service examines the transfer of tangibles.[237]

2.9. Leasing

Turkish Tax Laws and related regulations did not distinguish between finance (capital) leases and operating leases prior to 01.07.2003. With a provision added to Tax Procedural Law Repeated Article 290 which is effective on or after 01.07.2003, finance lease valuation has been regulated.

Prior to 01.07.2003, in practice, the assets in lease transactions were subject to be allocated as depreciation and revaluation by lessors. Lessees did not have the right to allocate depreciation and revaluation.

In accordance with Tax Procedural Law Article 283, lease payments are required to be recorded in the term the lease belongs to, not the term the lease payment is made.[238]

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[236] www.irs.gov/pub

[237] K. Hung Chan, Lynne Chow, *An Emperical Study of Tax Audits*, **Journal of Accounting & Economics**, Volume 23 No 1 May 1997, p. 96.

[238] M. Ali Özyer, **Vergi Usul Kanunu ve Uygulaması**, Third Edition, December 2004, Published by Association of the Board of Tax Experts, p. 535.

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In an operating lease, rent is recognized on a straight-line basis. If rental payments are uneven, the total scheduled payments ordinarily would be expensed equally over the lease term.[239]

There are judicial verdicts and opinions which state that "finance lease costs may be recorded in the term they are accrued as required by lease contracts.[240]

Lease amounts paid in respect to finance lease contracts can be recorded as expenses in the term in which they are paid or accrued as in a payment plan.[241]

2.9.1. Leasing per Tax Procedural Law and IAS

Pursuant to Tax Procedural Law Repeated Article 290, a finance lease is defined as all the substantial risks and rewards incident to ownership which rest with the lessee no matter whether or not possession of the leased object will be transferred to the lessee at the end of the lease.

The lessee has the right to allocate depreciation for the finance lease at market value or net present value of lease payments, whichever is lower. Interest expenses are recorded as expenses separately in the year they belong to.

The lessor still has the right to allocate depreciation for any residual value according to the following formula:

Net balance sheet asset value - Net present value of lease payments.

Of course if the net present value of the lease payments is bigger than the net balance sheet asset value, profit will arise and then there is no residual value to be depreciated. Interest income is recorded as income separately in the year it belongs to.

In lease transactions, if any of the following criteria is met, the lease termed to be called as finance lease. Otherwise it is called an operating lease:

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[239] Financial Accounting Standard Board Technical Bulletin 85-3, "*Accounting for Operating Leases With Scheduled Rent Increases*, 1985, par 1.

[240] The Decree of the Board of Tax Sue Offices of Council of State, date 24.01.1997 and Base: 1995/336 ve Decision: 1997/80.

[241] Advice Comission of the Board of Tax Experts; the Decision Number 286/1, Date 28.05.1999.

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-Transferring ownership to lessee at the end of the lease period,

-Having a right to buy the asset on the part of the lessee with a value lower than fair value,

-A Leasing period which is more than 80% of its useful life,

-The net present value of the lease payments is more than 90% of fair value.

Similarly, according to SFAS 13, a lessee should classify a lease transaction as a capital lease if it includes a noncancelable lease term and one or more of the four criteria listed below:

1-The agreement specifies that ownership of the asset transfers to the lessee.

2-The agreement contains a bargain purchase option.

3-The noncancelable lease term is equal to 75% or more of the expected economic life of the asset.

4-The present value of the minimum lease payments is equal to or greater than 90%of the fair value of the asset.[242]

Noncancelable in this context is cancelable by permission of the lessor or a new lease with the same lessor.[243]

According to Tax Procedural Law Repeated Article 290, concerning lessees, the liabilities arising from using the rights of assets which have been subject to financial leasing transactions and the liabilities arising from contracts made are valued with market value or net present value, whichever is lower.

Concerning lessors, receivables arising from contracts are valued at the total of all payments which will be made during the lease period. Assets which have been subject to leasing are valued at the amount which is the net balance sheet value – the net

[242] Statement of Financial Accounting Standards, No. 13, par.7, "**Accounting for Leases**" 1980.
[243] Statement of Financial Accounting Standards, No. 98, par.22, "**Accounting for Leases: Sale and Leaseback Transactions Involving Real Estate**, " 1988.

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present value of lease payments. If this value is zero or negative, the difference is processed as if the assets will be sold. The difference capitalized receivables amount – net present value of lease payment is valued at unearned revenues for future terms.

With a provision added to Tax Procedural Law Repeated Article 290 which is effective on or after 01.07.2003, leasing as per Turkish Tax System and IAS almost became same.

As per IAS, a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. An operating lease is a lease other than a finance lease.[244]

For valuation of IAS, at the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.[245]

Per IAS, a finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period.[246]

Similarly Turkish system in IAS, lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.[247]

Under UK GAAP, most standard property leases are treated as operating leases. While this may also be the case under IFRS, a review of each lease will be necessary to determine this. IFRS requires the land and building elements of a lease to be considered

[244] IAS 17, paragraph 4.
[245] IAS 17, paragraph 20.
[246] IAS 17, paragraph 27.
[247] IAS 17, paragraph 33.

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separately, unless title to the land expected to pass by the end of the lease, then the land element is an operating lease.[248]

Under IFRS finance lease treatment may be required for some building leases. This leads to a radically different presentation in the accounts. The lessor is required to account for the lease as a finance transaction de-recognising the leased assets (building) and recognizing the finance lease receivable. The rental payments it receives are then split between an operating lease element for the land and finance lease capital and interest elements on the building.[249]

"SFAS No.13 mandated that lessees capitalize many leases that were formerly operating. Mandated capitalization of leases of leases also has the potential to adversely affect lessees' reported income.[250] Ernst & Ernst illustrates[251] that reported income under the operating method is higher early in the lease life because the rental expense under the operating method is less than the sum of the initial interest and depreciation expense under capitalization. Later in the life of any individual lease, the interest expense on the capitalized leased diminishes so the income advantage of the operating method also diminishes.[252]

2.9.2. Lease Payments Exceeding Depreciation Charges

According to Financial Leasing Law Article 9, assets subject to leasing are transferred to the lessee, including ownership rights. According to Financial Leasing Law Article 6, rental costs and payments are freely decided by lessee and lessor. And, in Financial Leasing Law Article 7, contracts may not be revoked for at least 4 years.

Generally in the early years of leasing, taxpayers select high lease payments and write off the rental cost as an expense. This often creates big tax advantages when compared to the depreciation expenses.

[248] Andrew Marshall, *Structural changes*, **Accountancy**, March 2004, p. 93.
[249] Andrew Marshall, p. 93.
[250] Samir El-Gazzar, Steve Lilien, Victor Pastena, *Accounting for Leases by Lessees*, **Journal of Accounting & Economics**, Volume 8, No.3, October 1986, p. 218.
[251] Ernst&Ernst, 1977, *Accounting for leases*, **Financial reporting developments**, Retrieval no.38674, March 1977.
[252] Samir El-Gazzar, Steve Lilien, Victor Pastena, p. 218.

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Tax auditors sometimes report high lease payments as non-deductible expenses for taxable income. The deductible lease payments can not exceed the depreciation expenses. Auditors say that lease payments related to future terms, even if they have been paid or accrued in the first year pursuant to the contract, shall be recognized as prepaid expenses for future years.

However, The Tax Lawsuit Office of the General Assembly of the Council of State, with its 24.01.1997 decision (number 1997/80), have rendered a final verdict which states that financial leasing costs can be recognized as expenses for the term in which they are accrued, regardless of the amount, to determine taxable income.

In tax audit reports, this means auditors must prove that differences have arisen from intent to evade paying tax.

Another important tax audit issue is leasing transactions between related persons not in accordance with arm's length principle.

2.9.3. Leasehold Improvements

The expenditures made by lessees to extend the useful life or to expand the function and usefulness of leased depreciable fixed assets are called leasehold improvements costs.

According to Tax Procedural Code Article 327, leasehold improvement costs can be depreciated during the term of the lease in equal amounts. In the case of the lessee's leaving before the expiration date of the lease contract, the leasehold improvement costs that have not yet depreciated are recorded as expenses at one time.[253]

If the term of a lease is uncertain, the depreciation period shall be 5 years. However if the term of the lease is determined, it should still be depreciated over its estimated useful life or the remaining term of the lease, whichever is of shorter duration. The declining balance method can not be used for leasehold improvements, since Tax

[253] Tax Procedural Law, Article 327.

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Procedural Law Article 327 rules that equal amounts are used for depreciation. Revaluation was permitted to be made for leasehold improvements after the amendment (beginning 29.07.1998) of Repeated Article 298 of the Tax Procedural Law.

If a lessee makes expenditures for expanding the leased asset, or to increase its value, and regains these expenditures at the end of the lease contract, the special cost value method may not be employed. These items can be depreciated by the lessee separately.

2.10. Renewal Fund

According to Tax Procedural Law Article 328, the difference between the cost value and sale price of tangible fixed assets is realized as profit or loss. However, depending on certain specific conditions, a gain on the sale of fixed assets is noted under the renewal fund account on the liability side and not subject to taxation.

In the case of tangible fixed assets sold, the cost value of tangible fixed assets, accumulated depreciations, and revaluation funds are removed from the records and they are not stated on the balance sheets subsequent to the removal date.

The conditions that must be met to set aside a renewal fund are as follows:

-The asset sold must be replaced with the same type of asset from the standpoint of the nature of the business, or

-A decision and action to buy a replacing asset must have been made by the managers of the company,

-Profit arising from selling the tangible fixed assets must be noted in a special fund account under profit reserves on the liability side of the balance sheet,

-The fund must be used within three years for the depreciation of a new asset purchased,

-Books must be kept on a balance sheet basis

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According to the Uniform Chart of Accounts, the 549 Special funds (renewal funds) account can be used to track the selling profit. The renewal fund may not be added to the capital unlike the revaluation fund and escalation fund of cost. Moreover, if the fund is withdrawn from the entity or transferred to other accounts, it shall be subject to taxable income. After three years, if the renewal fund has not yet been used, it shall be added to the taxable income for the third year.

The selling of tangible fixed assets between holding companies and related parties must also be considered as a potential sign of transfer pricing.

In order to use renewal fund benefits, the corresponding conditions must be met. Renewal must be necessary for business requirement or business management must have been decided for renewal and set about buying tangible fixed asset.

2.11. Intangible Assets

Intangible assets are items lacking physical substance (e.g., goodwill) or representing a right granted by the government (e.g., patent, trademark) or by another company (e.g., franchise).[254]

Indeed, the valuation of many companies now heavily depends on their intellectual property assets.[255]

They consist of patents, copyrights, licenses, customer lists, brand names, franchises, trademarks, trade names, service brands, import quotas, computer software, marketing rights, specialized know-how, government granted franchises and goodwill.

Under international accounting standards and US GAAP, intangible assets are defined as both current and non current assets that lack physical substance. In the Turkish Uniform Chart of Accounts, intangible assets are classified under non current assets.

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[254] Joel G. Siegel, Jae K. Shim, **Dictionary of Accounting Terms**, Third Edition, Barron's Educational Series, Inc., p.230.

[255] Peter Rayney, *Another Brick in the Wall*, **Accountancy**, January 2003, p. 113.

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Intangible assets have two main characteristics. 1- They lack physical existence. Intangible assets derive their value from the rights and privileges granted to the company using them. 2- They are not financial instruments.[256]

Like the Turkish Accounting System, FRS 10 (Goodwill and Intangible Assets) defines "intangible assets" as non-financial fixed asset that:[257]

-have no physical substance;

-can be separately identified (i.e., they can be sold separately from the business); and

-can be controlled through legal rights (such as patent or custody or confidential data).

2.11.1. Valuation

Intangible assets are valued at cost including all costs of acquisition and expenditure, such as purchase price, legal fees, and other expenses necessary, to make intangibles ready for use or to create them.

According to Tax Procedural Law Article 313, intangible assets are subject to amortization and an amortizable amount should be allocated at cost value. Cost values are recorded in the related intangible assets account as debit. If their useful life is known, the amortization period will be this period; if it is not known, then equal amounts spread over five years will be the amortization period.

The cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited.[258]

Therefore the main rule is that the amortizable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. In order to do this the amortization method used should reflect the pattern in which the

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[256] Statement of Financial Accounting Standards No. 142, **Goodwill and Other Intangible Assets**.
[257] Peter Rayney, p.114.
[258] AICPA Opinions of the Accounting Principles Board, No. 17, "**Intangible Assets**" 1970.

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asset's economic benefits are expected to be consumed by the enterprise. If that pattern cannot be reliably determined, the straight-line method should be used. Furthermore, intangible assets are amortized on a straight-line basis, since tax practice requires a straight-line approach.

As well as the above mentioned legal regulations, there is a ruling letter given by the Ministry of Finance which explains that intangible assets such as patents, rights and computer programs are allowed to be amortized.[259]

According to IAS 38, an intangible asset shall be measured initially at cost.[260] Expenditure on an intangible item that was initially recognized as an expense shall not be recognized as part of the cost of an intangible asset at a later date.[261]

After recognition, an entity shall choose either the cost model or the revaluation model as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.[262]

The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised and an intangible asset with an indefinite useful life is not.[263]

In accordance with IAS 36 Impairment of Assets, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount.

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case,

[259] Ministry of Finance Ruling Letter, dated 15.12.1995, number 70020 and dated 03.02.2000, number 4638.

[260] IAS 38, paragraph 24.

[261] Ibid, paragraph 71.

[262] Ibid, paragraph 72.

[263] Ibid, paragraph 89.

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the asset is described as impaired and the Standard requires the entity to recognize an impairment loss.[264]

In performing the review for recoverability, the company would estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future net cash flows (undiscounted) is less than the carrying amount of the asset, an impairment loss would be measured and recognized. Otherwise, an impairment loss would not be recognized.[265]

FRS 10 requires goodwill and intangible assets to be amortized or written off against profits over their useful economic lives. There is a rebuttable presumption that the economic life of goodwill can not exceed 20 years.[266]

Intangible assets, most of which are not recognized as accounting assets is firms' financial statements, because intangible assets are of substantial economic importance for many firms and the effects of their non recognition is currently under debate in the accounting profession.[267]

2.11.2. Transfer Pricing of Intangible Assets

Today's world is increasingly knowledge-based, "where ideas, concepts and unique people skills are often essential to a company's commercial success. Indeed, the valuation of many companies now heavily depends on their intellectual property (IP) assets, which can command a large premium on sale."[268]

One of the factors linked to the effective operation of transnational businesses, and hence to the growth of related-party trade, is the increasing role of valuable intangibles in the economy.[269] A recent global transfer pricing survey has drawn

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[264] IAS 36, paragraph 1.

[265] Statement of Financial Accounting Standards No. 121, **Accounting for the impairment of long lived assets**, Norwalk, Conn.; FASB, 1994.

[266] Peter Rayney, p.114.

[267] Mary E.Barth, Ron Kasznik, *Share Repurchases and Intangible Assets*, **Journal of Accounting & Economics**, Volume 28 No 2 December 1999, p. 212.

[268] Peter Rayney, *Another Brick in the Wall*, **Accountancy**, January 2003, p.113.

[269] Robert Turner, Ernst and Young, **Study on Transfer Pricing**, **Working Paper**, December 1996, p.1.

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attention to a changing focus for tax authorities worldwide.[270] In future years, transfer pricing and issues associated with intangible… will be higher on the radar screen of tax authorities than ever before.[271]

Valuation, ownership, and transfer pricing methods applied to inter affliate intangible asset transactions, difficulties could arise when MNEs seek to provide revenue authorities with the required documentation regarding those transactions.[272] Transfer pricing is one of the most common tax audit issue for MNEs, since they are expected, "from the standpoint of the respective tax authorities, to warrant the highest tax base possible to each and every country where they operate"[273]

In the case that there have been any transactions with related parties (domestic taxpayers or foreign entities); the attributes of all transactions are considered in terms of arm's length principle from the perspective of tax auditing.

2.11.3. Leasing Transactions from Abroad

Leasing transactions of intangible assets (such as franchising and royalties) from abroad are subject to value added tax. According to VAT Law Article 9, the party based in Turkey is responsible for withholding and submitting Number 2 VAT Returns to the related tax office.

2.11.4. Computer Software Costs

Computer software packages and systems are normally valued at cost value. Similar to computers and machinery, under normal circumstances software packages and systems are capitalized and amortized over five years in equal amounts. However the Ministry of Finance is authorized to permit extraordinary amortization rates, if necessary.

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[270] Ernst and Young, "**Transfer Pricing 2003 Global Survey: Practices, Perceptions and Trends**, p.12.

[271] Ernst and Young, *International Tax Services, Transfer Pricing Brief*, "**Tax Authorities Closely Watching Intangibles in the Transfer Pricing Context**," June 8, 2004, p.1.

[272] Ernst and Young, p.8.

[273] International Chamber of Commerce, U.S., *Transfer Pricing Documentation,* Number: 180-46/1rev.9.final, p.1.

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According to the Statement of Financial Accounting Standards No.86, All computer software costs must be expensed until the company has completed planning, designing, coding, and testing activities necessary to establish that the product can be implemented to meet its design specifications. Subsequent costs incurred should be capitalized and amortized to current and future periods.[274]

Capitalized software costs should be valued at the lower of unamortized cost or net realizable value. If net realizable value is lower, then the capitalized software cost should be written down to this value.[275]

Financial analysts have reacted almost uniformly against any capitalization. They believe software costs should be expensed because of the rapid obsolescence of software and the potential for abuse that may result from capitalizing costs inappropriately.[276]

All software costs shall be capitalized and amortized in current and future periods.[277]

As per Turkish taxation application, computer programs shall be capitalized as intangible fixed assets.

As a rule of thumb, the asset should be classified as either an intangible asset or a tangible asset based on a relative or comparative dominance or significance of the tangible or the intangible component (or element) of the asset. For instance, computer software that is not an integral part of the related hardware equipment is treated as software (i.e., as an intangible asset). Conversely, certain computer software, such as the operating system, that is essential and an integral part of a computer, is treated as part of the hardware equipment (i.e., as property, plant and equipment as opposed to an intangible asset).[278]

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[274] Statement of Financial Accounting Standards No.86.
[275] Keiso, p.617.
[276] Keiso, p.618.
[277] SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, August 1985.
[278] Wiley IFRS 2005, p.237-238.

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On the hand, “an enterprise’s own web site that arises from development and is for internal or external access is an internally developed intangible asset that is subject to the requirements of IAS 38. All expenditure on developing such a web site shall be recognised as an expense when incurred.[279]

2.11.5. Leasehold Improvement

Any amounts paid by lessee to make physical improvements constituting an integral part of leased property are recorded as an intangible asset referred to as a leasehold improvement. Accountants consider this asset to be intangible because, although the improvement represents tangible property, the leased possesses only the legal right to use the improvement during the remaining life of the lease.[280]

Leasehold improvements are classified as intangible assets because the improvements revert to the lessor at the end of the lease. Leasehold improvements are amortized over the remaining term of the lease or life of the improvements, whichever is shorter.[281]

Like other assets, its cost is allocated as depreciation expense over its useful life of the asset or the lease term. Theoretically, such assets can be recorded in accounts descriptive of their nature, such as buildings or plant. In practice, the traditional account title used is leasehold improvements. Also, traditionally, depreciation sometimes is labeled amortization when in connection with leased assets and leasehold improvements. Both depreciation and amortization refer to the process of allocating an asset’s cost over its useful life.[282]

Excluding maintenance, repair and cleaning expenses, 264 Leasehold improvements consists of expenses which are made for improvements or increasing the

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[279] SIC-32: *Intangible Assets-Web Site Costs*, paragraph 7 and 8.

[280] Penne Ainsworth, Dan Deines, R. David Plumlee, Cathy Xanthaky Larson, **Introduction to Accounting: An Integrated Approach**, Volume II, Irwin McGraw, 1997, p. 667.

[281] Thomas R. Dyckman, Roland E. Dukes, Charles J. Davis, **Intermediate Accounting**, Volume I, Forth Edition, Irwin McGraw Hill, 1998, p. 599.

[282] J. David Spiceland, James F. Sepe, Lawrance A. Tomassini, **Intermediate Accounting**, Volume II, Second Edition, Irwin McGraw Hill, 2001, p. 679-680.

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economic value of leased immovable which will be left to the owner at the end of the lease term.

Expenses made are debited to the 264 Leasehold improvements account. If within the leasing period, these expenses are depreciated or the leasing period is longer than five years, they are depreciated over five years in equal amounts.

The expenditures made by lessees to extend the useful life or to expand the function and usefulness of leased depreciable fixed assets are called leasehold improvement costs. According to Tax Procedural Law Article 327, leasehold improvement costs can be depreciated over the term of the lease in equal amounts. In the case of the lessee's leaving before the expiration date of the lease contract, the leasehold improvement costs that have not yet been depreciated are recorded as expenses at one time.

If the lessee sells the leasehold improvements to the lessor before the expiration date of the lease contract, the lessee has to make out an invoice and calculate VAT. Any income/profit arising from this transaction is recorded in 679 other extraordinary income/profit accounts as credit, and any expense/loss is recorded in 689 other extraordinary expense/loss accounts as debit. To close corresponding accounts; 268 Accumulated depreciation is recorded as debit, 264 Leasehold improvement is recorded as credit. Even the leasehold improvements are transferred to the lessor for free, they are still subject to VAT at equivalent value.

If the leasing period is not determined and will be longer then 5 years, tax laws require the longest depreciation period to be five years. However there is no limitation for generally accepted accounting standards. Therefore even if five years are exceeded, leasehold improvements can be accepted as expenses in determining commercial income. However, these amounts will be accepted as non-deductible expenses in determining taxable income.

All VAT related to leasehold improvements is allowed to be deducted completely in the term (month) in which the expenses are incurred.

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If the term of the lease is uncertain, the depreciation period shall be 5 years. However if the term of the lease is determined, it should still be depreciated over its estimated useful life or the remaining term of the lease, whichever is of shorter duration. The declining balance method can not be used for leasehold improvements, since Tax Procedural Law Article 327 states rules that equal amounts are to be used for depreciation. Revaluation is permitted to be made for leasehold improvements after the amendment (beginning 29.07.1998) of repeated Article 298 of the Tax Procedural Law.

If a lessee makes expenditures for expanding the real estate, or to increase its value, and regains these expenditures at the end of the lease contract, the special cost value method may not be employed. These items can be depreciated by the lessee separately.

2.11.6. Establishment and Organization Expenses

According to Tax Procedural Law Article 282, first establishment and organization expenses which have been capitalized are valued at recorded value.[283] However whether these expenses are either to be capitalized or written off as expenses directly is optional for corporate income tax payers (Personal income taxpayers are required to write them off as expenses at one time).

Corporate Tax Law Article 8/ (1)-b states that first establishment and organization expenses are allowed to be deducted from revenues for the determination of corporate income.[284] (If these expenses are capitalized, amortizations which will be allocated in accordance with Tax Procedural Law are recorded as expenses). If corporations which have selected capitalization are dissolved within five years, the remaining part of these expenses is recorded as expenses in the corresponding year.

Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise

[283] Tax Procedural Law, Article 282.
[284] Corporate Income Tax Law, Article 8/(1)-b.

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and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred.[285]

2.11.7. Research and Development Expenditures

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.[286]

In Turkey's practice, like first establishment and organization expenses, research and development expenses which have been capitalized shall be valued at recorded value. Whether these expenses are either to be capitalized or to written off as expenses directly is optional for corporate income tax payers. Personal Income tax payers are required to write them off as expenses at one time.

Prior to Law Number 5228, which amended Corporate Income Tax Law Article 14/6, 20 % of yearly corporate income tax could be deferred over three years without interest, unless research and development expenditures did not exceed the companies' own expenditures. Deferred tax was to be paid over three years in equal amounts with corporate income tax installments.

With the amendment of Corporate Income Tax Law Article 14/6 (from 31/07/2004) and New Corporate Income Tax Law (from 01/01/2006) Article 10/ (1)-a;

Taxpayers are allowed to deduct 40% of these research and development expenditures that are solely related to new technology and information research in business enterprises.[287]

Deductions shall not be calculated from either those portions of expenditures which include expenditures not directly related to R&D or amortized deductions for

[285] Statement of Financial Accounting Standards, *Accounting and Reporting by Development Stage Enterprises*, No.7 Par.10.
[286] IAS 38, paragraph 8.
[287] Corporate Income Tax Law Article 10/(1)-a.

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depreciable fixed assets not used in R&D activities. The Ministry of Finance is authorized to determine the required documents, procedures of research and development expenditures and the scope of expenditures. (See General Communiqué number 86 published by the Ministry of Finance). Taxpayers can deduct research and development expenses from taxable income in yearly corporate or personal income tax returns.

As per IAS, expenditure on research shall be recognized as an expense when it is incurred.[288] An intangible asset arising from development shall be recognized, if, an entity can demonstrate the technical feasibility or completing the intangible asset so that it will be available for use or sale.[289]

IAS states that in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred.[290] Development costs may be capitalized and amortised over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred.[291]

Prior to 1975, U.S. firms were permitted to capitalize R&D costs.[292] The difficulties in accounting for the research and development expenditures are identifying the cost associated with particular activities, projects, or achievements and determining the magnitude of the future benefits and length of the time over which such benefits may be realized. Because of these latter uncertainties, the accounting profession has standardized and simplified accounting practice in this area by requiring that all research and development costs be charged to expense when incurred.[293]

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[288] IAS 38, paragraph 54.
[289] Ibid, paragraph 57.
[290] Ibid, paragraph 55.
[291] IAS 12, paragraph 17/c.
[292] Gerald I. White, Ashwinpaul C. Sondhi, Dov Fried, **The Analysis and Use of Financial Statements**, Second Edition, John Wiley & Sons, Inc. 1997, p. 332-333.
[293] Statement of Financial Accounting Standards No.2, *Accounting for Research and Development Costs*, par.2.

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A country that requires R&D expenditures to be capitalized and amortized, such as Finland, will have a higher accrual index than a country that requires R&D expenditures to be immediately expensed.[294]

The debate surrounding the accounting for R&D expenditures evolves around the trade-off between the expected benefits of the expenditures-which might qualify them as an asset, and the uncertainty surrounding these benefits- which precludes them from being recorded as assets.[295]

A firm's tax environment will also influence its investment decisions including R&D investments. Firms typically expense R&D in the year they are incurred, and tax credits are available to off set R&D expenditures.[296] However, the higher corporate tax rates in the future (correlated with current tax rates) may provide a disincentive to invest.[297]

2.11.8. Goodwill

Goodwill is often identified on the balance sheet as the excess of the cost over the fair value of the net assets acquired. According to Tax Procedural Law, goodwill is valued at recorded value.[298]

All amounts paid as goodwill are recorded in the 261 Goodwill account as debit. In the year it has occurred, goodwill shall be capitalized and started to be amortized over useful life in equal amounts. However VAT paid for goodwill can be deducted at one time in the corresponding month.

Goodwill amortization should be computed using the straight-line method unless another method is deemed more appropriate.

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[294] Mingyi Hung; *Accounting Standards and Value Relevance of Financial Statements: An International Analysis*, **Journal of Accounting & Economics**, Volume 30 No 3 December 2000, 405-406.

[295] Charles Shi, *On the Trade-off between the Future Benefits and Riskiness of R&D: A Bondholder's Perspective*, **Journal of Accounting & Economics**, Volume 35, No.2, June 2003, p. 250.

[296] Hall, B.H., 1992, *Investment and Research and Development at the Firm Level: Does the Source of Financing Matter?*, **Working paper.**

[297] Sangai Bhagat, Ivo Welch, p. 447.

[298] Tax Procedural Law, Article 282.

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Goodwill is recorded only when an entire business is purchased because goodwill is a "going concern" valuation and cannot be separated from the business as a whole.[299]

Positive goodwill is an asset which arises for numerous reasons, but cannot be realised separately from the business as a whole. The only way its value can reliably be ascertained is by selling the business.[300]

As per IAS, internally generated goodwill shall not be recognized as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.[301]

For purchased goodwill, SSAP 22 allowed two methods. The normally accepted treatment would be to write off goodwill immediately against retained reserves brought forward. Under this method, goodwill would never be shown as an asset in the balance sheet. The alternative treatment was to carry goodwill as an intangible fixed asset, to be amortised over its estimated useful life. It was not allowable to carry goodwill at cost indefinitely.[302]

Accounting for Goodwill, permitted both methods to be used, without expressing a preference, and even allowed either method to be used selectively for each different acquisition. In practice, nearly all British companies choose immediate write-off to reserves as their policy for all acquisitions.[303]

FRS 10 states that amortisation should be on a systematic basis, and there is a rebuttable presumption that useful lives will not exceed 20 years. No residual value may

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[299] FASB Discussion Memorandum 1976, *Conceptual Framework for Financial Accounting and Reporting Elements of Financial Statements and Their Measurements*, Keiso, p.602.
[300] www.accountingweb.co.uk/cgi-bin/item
[301] IAS 38, paragraph 48.
[302] www.accountingweb.co.uk/cgi-bin/item
[303] Ron Peterson, "*Straining Goodwill*" **Accountancy**, June 2002, p. 101.

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be attached to goodwill, and the straight line method of amortisation should normally be used.[304]

UK GAAP permits upward revaluations of long lived assets, including many types of intangible assets, but not goodwill. Downward revaluations are required for all long lived assets, including goodwill, when the assets carrying amount exceeds its net realizable value.[305]

In certain purchase business combinations, the purchase price is less than the fair value of the net assets acquired. The difference has traditionally been referred to as "negative goodwill". Some people suggest that since arm's length transactions usually favor neither party, the likelihood of the acquirer obtaining a bargain is considered remote, and apparent instances of negative goodwill are more often the result of measurement error (i.e. fair values assigned to assets and liabilities were incorrect to some extent) or of a failure to recognize a contingent or actual liability (such as for employee payment). However, negative goodwill can also derive from the risk of future losses.[306]

Negative goodwill should be shown separately on the face of the balance sheet, below the goodwill heading; a subtotal for the net amount of positive and negative goodwill should be shown. Negative goodwill should be written off to P&L in the periods expected to benefit from the associated assets.[307]

2.12. Depleteble Assets

Depleteble assets include expenses that: have a limited life due to the timing and intensity of production operations, or are closely related to certain assets, or are made for assets which are wholly subject to consumption. The accounts in this group

[304] www.accountingweb.co.uk/cgi-bin/item

[305] David Aboody, Mary E. Barth, Ron Kasznik; *Revaluation of Fixed Assets and Future Firm Performance: Evidence from the UK*, **Journal of Accounting & Economics**, Volume 26 No 1-3 January 1999, p. 152.

[306] Barry J. Epstein, Abbas Ali Mirza, **IFRS: Interpretation and Application of International Accounting and Financial Reporting Standards, 2005**, John Wiley & Sons, Inc. p. 356-357.

[307] www.accountingweb.co.uk/cgi-bin/item

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are research expenses and preparation and development expenses, both of which are related to natural resources.

Research costs are valued at cost and recorded in 271 Research expenses. That cost is capitalized and depleted in terms of natural resource quantity and reserves, if exploration efforts are successful. If they are unsuccessful, the cost is written off as a loss to 659 other extraordinary expenses/losses.

Preparation and development expenses are also valued at cost and recorded in 272 Preparation and development expenses. That cost is capitalized and depleted in terms of quantity and reserve of natural resources, if exploration efforts are successful. If they are unsuccessful, the cost is written off as a loss to 659 other extraordinary expenses/losses.

As per IAS, exploration and evaluation assets shall be measured at cost.[308] After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets.[309]

2.13. Prepaid Expenses and Accrued Revenues

Prepayment (payment in advance) is a payment made for goods or services before they are received. It is treated as deferred debits under the accruals concept, and it is shown as a debit balance under debtors in the circulating assets of the balance sheet.[310]

As it is necessary to match accounting principle with the calendar year for the account period of taxation (excluding special account periods), every periods' revenues and expenses are recorded in the corresponding year's accounts.

This group of accounts consists of expenses and revenues that arise in the current period, but relate to future periods. The accounts stated in this category are as follows.

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[308] IFRS 5, paragraph 8.
[309] Ibid, paragraph 12.
[310] R. Hussey; **A Dictionary of Accounting**, Oxford Paperback Reference, Market House Books Ltd., 1995 p. 261.

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2.13.1. Prepaid Expenses

Prepaid expenses are those expenses paid in cash and recorded as assets before they are used or consumed. As an asset account, prepaid expenses are debited when a cost is incurred to show the service or benefit that will be received in the future. Prepayments generally come into existence as rent expenses, insurance expenses and supplies.

Prepaid expenses are recorded as expenses either with the passage of time or through use and consumption. Therefore prepaid expenses are a kind of asset-expense account. Adjusting entries are required to determine taxable income. Prior to adjustment, assets are overstated and expenses are understated.

According to the Turkish Uniform Chart of Accounts, expenses relating to the upcoming months/years, which are paid in advance and which should not be recorded in expense accounts in the current period are followed up, in this account. Prepaid expenses that will be debited to expense and cost accounts in the upcoming period are debited to this account. In the following months/years, the account is credited when the amounts are transferred to related expense accounts.

According to Tax Procedural Law Article 283, prepaid expenses are capitalized at recorded value.

The minimum term for rent and insurance is usually one year. Insurance premiums and rent expenses normally are charged to the asset account for prepaid insurance and rent expenses when paid. At the financial statement date, it is necessary to debit Insurance/Rent Expenses and credit Prepaid Expenses for any cost that has expired during the period.

Prepaid expenses will be held in 180/280 Prepaid Expenses accounts until the term to which those expenses belong arrives. When the term comes, prepaid expenses are transferred to the appropriate expense account. For this purpose, 180/280 Prepaid Expenses are debited when a cost is incurred and when the term comes, the prepaid expense adjusting entry results in a debit to an expense account and a credit to the

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prepaid expense asset account. In other words, with the passage of time, the account is credited to transfer expenses to related expense accounts.

Although prepaid expenses expire either with the passage of time (for example; prepaid rent expenses and prepaid insurance expenses) or through use and consumption (e.g., supplies), Value Added Tax for these expenses can be totally deducted without waiting for the term they belong to.

From the withholding tax perspective, when prepaid expenses are incurred, withholding tax must be taken out in the same term, no matter which term the expenses are related to.

On the financial statement date, it is necessary to audit whether the proper expense account has been debited and Prepaid Expenses has been credited for the costs that have expired during the period.

On valuation days, it is necessary to check prepaid expenses whether the proper amount has been assigned to the term. If the prepaid expenses recorded in 280 Prepaid Expenses for The Following Years have less than one year remaining, they are transferred to the 180 Prepaid Expenses For The Following Period.

Fees covering multiple years such as subscription fees shall be expensed in accordance with the appropriate tax term.

The part of the fee belonging to the following tax term shall be capitalized in the 280 Expenses for Subsequent Years account, and shall be recorded in the corresponding term as expenses.

Deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.[311] A deferred tax asset shall be recognized for all deductible temporary differences.[312]

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[311] IAS 12, paragraph 5.
[312] Ibid, paragraph 24.

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2.13.2. Accrued Revenues

Accrued revenues are those revenues earned but not yet received in cash or recorded on the statement date. Some revenues, such as interest arising from time deposits and rent provided from real estate, may accrue with the passing of time. Because interest and rent have not been collected yet, they may be unrecorded. Some revenues, commissions and fees may also result from services that have been performed. Because only a portion of the total service has been provided, they may be unrecorded.

An adjusting entry is required to show the receivables that exist on the balance sheet date and to record the revenue that has been earned during the period. Prior to adjustment, both assets and revenues are understated. Accordingly, an adjusting entry for accrued revenues results in a debit to asset account 181/281 Accrued Revenues and a credit to revenue account 642 Interest Revenues.

Therefore when service is provided or rent revenue/interest revenue accrued, revenue and receivables are recorded. When cash is received; receivables are reduced. Revenues do not change at this time.

According to the Turkish Uniform Chart of Accounts, the Accrued Revenues account represents current period revenues that will be collected from third parties or revenues to be debited in the following period. At the end of the period, amounts to be calculated relating to the current period will be debited to this account. In the following period, when the receivables are collected this account is credited and related accounts are debited.

2.13.3. Sales Premiums, Revenue Premiums and Discounts

According to the explanation given in Value Added Tax Communiqué Serial Number 26:

While not shown on invoices and similar documents, at the end of the year or at the end of a definite term or when a specific sales target has been exceeded, payments made in the form of sales premiums, revenue premiums, and discounts shall be subject

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to Value Added Tax. This is due to the fact that these types of discounts are not directly related to the goods sold. Instead they arise from extra work and effort.

Therefore, the work done is a separate service provided by retail companies to wholesaler companies. In agreements between wholesalers and retailers, if the retail company is particularly successful, they often receive discounts on further purchases. Within the scope of VAT Article 4, this qualifies as a service and is therefore subject to VAT as per Article 1/1.

If these kinds of premiums and discounts have occurred in the previous year and have been based on documents, they shall be pertinent to taxable income.

Even if an invoice for the current term is to be issued in an upcoming year, the amount of this invoice is related to, and must be considered a part of, the current year, and recorded as expenses for the company paying the invoice amount and as revenues for the issuing company.

For companies taking advantage of them, premium and discounts are debited to 181 Accrued Revenues, and credited to 602 Other Revenues; for providers, they are debited to 611 Sales Discounts, and credited to 379 Provision for Other Liabilities and Expenses.

2.14. VAT Received

VAT Received is followed up in this account for calculated VAT on goods delivered and services rendered, and VAT related to the goods and services for those transactions which have not been realized or have been abandoned.

VAT received is recorded in this account as credit. Corrections are recorded in this account as debit. The balance of this account at the end of the taxation period is compared with the 191 VAT Credit account and/or the 190 VAT Carried Forward account. After this comparison, if the balance of this account is higher than the balances of the 191 VAT Credit account and/or the 190 VAT Carried Forward, the remainder in this account is transferred to the 360 Taxes and Funds Payable account for payments in maturities.

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2.14.1. Circumstances Requiring VAT Received

Circumstances requiring VAT Received are as follows:

a) Instances in which goods are delivered and services rendered, when the goods are delivered and the services rendered,

b) Instances in which invoices or similar documents have been given prior to the delivery of goods or rendering of services, when the invoices or similar documents are given with a limitation on the amounts on these documents,

c) Instances in which goods are delivered part by part or services are rendered in a similar manner, when every part of the goods delivered and services rendered,

d) In sales by intermediaries or consignees, when the goods are delivered to buyers,

e) Instances in which the goods are sent to buyers or persons who are authorized on the behalf of buyers, when goods have started in transit or the goods have been given to transporters or drivers,

f) For water, electricity, gas, heating, cooling and similar power distribution and usage, when these costs are accrued.

g) In export, as per the Customs Code when tax liability payments have been started, and for those transactions which are not subject to customs tax, when customs returns have been approved,

In addition to the above mentioned circumstances the following are subject to VAT;

-The goods delivered and services rendered without charges,

-Returns of goods purchased

In the circumstances mentioned below that VAT which has been previously deducted shall be recorded as cancelled:

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-Deducted VAT belonging to those transactions which have not realized or have been abandoned,

-Previously deducted VAT belonging to those goods in casualty losses:

According to Value Added Tax Law, aside from the value added tax of goods in casualty losses (except in earthquakes and floods), the value added tax of goods which have been stolen or lost are also not allowed to be deducted from the value added tax calculated on taxable transactions, because they are non-deductible expenses for tax purposes.[313]

2.14.2. VAT for Goods Delivered and Services Rendered without Charge

VAT for goods delivered and services rendered without charge due to a variety of reasons is a special issue in tax auditing. The main rule is to calculate VAT for goods delivered and services rendered without charge.

Income Tax Law Article 63 states that wages and salaries are payments in cash and/or benefits provided with goods which may be represented by cash.

According to Value Added Tax Law, instances in which the value of a transaction is not known, the tax base shall be determined using equivalent value.[314]

Equivalent value is used when an asset has no true value or whose value is unknown or indeterminable, and it should represent the calculated value of a similar asset if it were sold on the day of valuation. According to this rule the following transactions are valued at equivalent value.

-Goods withdrawn from enterprises by taxpayers or their husbands or wives, or their children;[315]

-Goods given to workers as wages;[316]

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[313] Value Added Tax Law, Article 30/c.
[314] Ibid, Article 27.
[315] Individual Income Tax Law, Article 41/1.
[316] Ibid, Article 63.

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-Donated goods;[317]

In manufacturing companies, goods given to workers without charge as wages shall be considered at gross value including withholding tax in the calculation of the cost of the goods. In these companies, goods given to management personnel are recorded as expenses directly or as general administration expenses. On the other hand, in service companies, the goods delivered and services rendered without charge are recorded as wages and salaries directly.

Since the aforementioned goods and services are accepted wages, their value, inclusive of VAT, is accepted as net wages, and stoppage income tax shall be withheld from this amounts. From net values to gross values, stamp tax rate shall be taken into consideration as well as stoppage income tax rate.

2.14.3. Value Added Tax for Deliveries Subjected to Donations and Grants

According to Value Added Tax Law Article 1, goods delivered and services rendered within the scope of commercial, industrial, agricultural, and independent personal activities in Turkey are subject to value added tax. Taking this into consideration, deliveries made even for donations and grants are subjected to value added tax. In accordance with Tax Procedural Law Article 267, equivalent value is applied to calculate value added tax.

On the other hand, those deliveries made in accordance with either Personal Income Tax Law Article 89/1, which legalizes insurance premiums, other deductions (including some donations and grants) or Corporate Income Tax Law Article 14/6 which again legalizes deductible expenses related to donations and grants, are exempted from value added tax.[318]

Value Added Taxes related to those donations and/or grants mentioned in Income Tax Code Article 89/1 and Corporate Income Tax Code Article 14/6 are added

[317] Individual Income Tax Law, Article 89 and Corporate Income Tax Law, Article 10

[318] Value Added Tax Law, Article 17/2-b.

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to the purchase prices and deemed non deductible expenses. Excess of the limits for deliveries in the case of donations and grants are also deemed non deductible expenses.

2.14.4. The Goods and Services not Subject to VAT

According to VAT Code General Communiqué Number 9, in the application of VAT, of the benefits provided to personnel, those mentioned below shall not be taxed.

a) Meals for personnel in office or an annex,

b) Company housing or company assigned housing,

c) Transportation services for personnel to commute together,

d) Items given to personnel as clothing.

Since these costs are one element of the cost involved in the management actions of companies, they shall not be taxed, and the applied taxes when these benefits have been acquired shall be considered deductions.

2.15. VAT Carried Forward

The value added tax carried forward account is the account in which value added tax is recorded which can not be deducted in one period and therefore will be deducted in the following period.

At the end of every month, after offsetting the value added tax credit account from the value added tax received account, the balance of the value added tax credit is recorded in the value added tax carried forward account as debit, and deductions from this account in the following period or periods are recorded as credit.

In the long term, profitable businesses produce a payable value added tax amount, unless goods delivered and services rendered are subject to a reduced rate or are exempted from value added tax completely. Under these circumstances, the lack of a VAT Payable amount probably points out some tax deficiencies and discrepancies.

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Value added tax payable has to be paid to the related tax offices. However if the value added tax credit is larger than value added tax received, at this time value added tax carried forward has arisen which may be deductible for the subsequent periods.

1- Taxpayers of value added tax shall arrange their obligatory bookkeeping records in a way which makes it possible to calculate and audit this tax.

In these records, at a minimum, the following points must be clearly presented.

a- The true nature of taxable transactions, non taxable amounts, calculated tax, and deductible tax amounts.

b- The true nature and differention of transactions exempted from tax, comprising deductible and non deductible transactions and calculated deductible tax amounts.

c- The true nature of non-deductible transactions not able to be deducted and tax amounts related to these transactions.

d- The changes in taxable and deductible amounts; paid and deleted taxes and tax refunds.

2- At the end of the term, taxpayers involved with the purchase and sale of goods have to show the amount of goods on hand in their inventory books and differentiate those goods subjected to value added tax and those not subjected to value added tax.

2.16. VAT Credit

Value added tax paid to sellers at the time of the purchase of goods and services is recorded in and followed up VAT Credit account.

Value added tax arising from the purchase of goods and services is recorded in the value added tax credit account as debit. Deductions due to legislation and

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adjustments made to this account and the debit balance moved to the value added tax carried forward account are recorded as credit in the value added tax credit account.

Transactions which are debited in value added tax credit account are the following:

- Value added tax paid for the purchase of goods and services which are requirements for business activities.

- Value added tax paid as responsible taxpayers in accordance with Value Added Tax Law Article 9.

- VAT carried forward for the following period from the balance sheets of companies which has been taken over.[319]

- Value added tax paid for goods and services which are sales returns, non-verified, or cancelled transactions.

- Value added tax refunded to travelers who are non residents.

- Value added tax belonging to depreciable fixed assets.

Non deductible value added tax is legalized in Value Added Tax Law Article 30. According to this article, those taxes mentioned below are not allowed to be deducted from taxable transactions.

a) Value added tax shown on purchase invoices related to delivered goods and rendered services transactions which are non taxable or exempted from value added tax or included in the cost of these goods and services.

b) Value added tax shown on invoices for the purchase of automobiles belonging to businesses, excluding entities whose activities are totally or partially related to renting cars or various types of car related operations.

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[319] Ruling Letter of Ministry of Finance dated 25.05.1999, number 20666.

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c) Value added tax belonging to goods which are lost, excluding those goods lost because of on earthquake, flood, disaster or fire which the Ministry of Finance has declared force majeure (circumstances beyond one's control)

d) Value added tax paid for those expenses which are deemed non deductible during the determination of taxable income according to Income Tax Law and Corporate Tax Law.

Concerning interconnected business, the main rule for the deduction of value added tax is that the goods and services for these activities must be related to the same commercial, industrial, and professional activities.

VAT on non deductible expenses is not permitted to be deducted from value added tax received.

Value added tax which can not be deducted is also assumed to be a non deductible expense.[320]

VAT on goods given in the place of wages shall not be deducted. The value of the goods including VAT is accepted as the net wages and is required to be taken as gross amount.

According to Value Added Tax Law Article 29/1-a and Article 34, in order to deduct value added tax, it is necessary to show it separately on invoices or similar documents.

The decision of the Board of the Council of State Tax Offices concurs; stating that value added tax for goods and services provided within the domestic market or for export must be shown on invoices or similar documents or customs receipts.[321]

Value Added Tax Law Article 29/3 states that right to deduct may be used in the taxable term during which related documents have been recorded in required books,

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[320] The Decree of the 11th Office of the Council of State, dated 04.03.1996, Basis 1995/2202, Decision 1996/1235.

[321] The Decree of the Board of the Council of State Tax Offices, dated 28.04.1995, Basis 1994/278, Decision 1995/147.

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unless the calendar year in which the tax related expenses were incurred has been exceeded.

Value added tax credit is valued at recorded value.

Exemptions in the Value Added Tax Code Law been legalized in Articles 11, 13, 14,15,16,17 and temporary articles. Since the described exemptions arranged in Articles 11, 13, 14 and 15 are complete exemptions, value added tax on invoices and similar documents related to these kinds of exemptions can be deducted. If these exemptions can not be deducted, then they are refunded.

Value added tax related to other exemptions can not be deducted. It is assumed to be a non deductible expense in determining taxable income for corporations. These exemptions are as follows:

- Customs exemptions,[322]

- Social, military and other exemptions,[323]

- Value added tax paid in the acquisition of participation shares and real estate, whose gains are added to capital by complete taxpaying corporations,[324]

- Construction contracts that have been entered into with house construction associations and construction contracts committed to social security associations and municipalities only for houses smaller than 150 square meters.[325]

2.17. Other VAT Issues in Tax Auditing

1- As per Tax Procedural Law General Communiqué Number 334, VAT is receivable directly arising from goods delivered or services rendered. In order to be able to allocate an allowance for doubtful receivables arising from the VAT on the

[322] Value Added Tax Law, Article 16.
[323] Ibid, Article 17.
[324] Ibid, Temporary Article 10.
[325] Ibid, Temporary Article 15.

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receivables, the circumstances stated in Article 323 of Tax Procedural law must be met, and receivables shall be recorded in term records and shall be included in VAT returns.

2- On foreign issued service invoices, VAT must be calculated if any exemption conditions have not been met.

3- Exchange rate differences arising from payments made abroad for services rendered are subject to VAT to be applied by the responsible person or entity.

Exchange rate differences arising from transactions which have been based on foreign currency shall be subject to VAT.

4- The interest paid for credit secured abroad from entities other than banks is subject to VAT and withholding tax to be applied by the responsible person or entity.

However in the event that loan is secured from a bank or other financial institutions, the interest paid is not subject to VAT and withholding tax.

5- Interest which has been calculated on shareholder's debt is subject to VAT (Different judicial verdicts exist on the subject).

6- The VAT base for payments made abroad is the gross amount. These services which have been bought are subject to withholding tax per Corporate Income Tax Law Article 24. These payments which have been made as net amounts will be taken as gross amounts and the gross amounts will be the tax base for VAT.

7- For domestic sales where the sales price is in foreign currency, any exchange rate differences shall be subject to VAT.

2.18. Prepaid Taxes and Funds

The prepaid taxes and fund account is the account in which, within a calendar year, prepaid and deductible income tax, corporate tax and other taxes and funds are recorded and followed up as required by legislation.

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Prepaid and deductible: income tax, corporate tax and other taxes and funds are debited to the prepaid taxes and funds account. At the end of the year, to provide to be deducted from income and corporate tax and funds that will be assessed, they are debited to 371 Prepaid Tax and Other Liabilities corresponding to the Current Year Profit account in the 37 Provision for Liabilities and Expenses group of accounts.

However the transferred amount can not be higher than the provisions for tax and other liabilities to the profit for the period. The untransferred amount remains as the balance of this account.

Per the Income Tax Law, Withholding taxes from income and yield which are included on yearly tax returns shall be deducted from the income tax calculated on tax returns.[326]

Withhelded taxes in accordance with the Corporate Tax Law from income which are shown on yearly tax returns are deducted from corporate tax calculated on tax returns.[327]

Withelded taxes shall be considered as taxes paid in advance on temporary tax returns or corporate income tax returns.

2.19. Work and Personal Advances

Advance: A payment on a contract before its completion; the payment of wages, salaries, or commissions before they have been earned.[328]

The work advances account is the account to record work advances given to staff and those not on staff who will purchase goods and services, and who will make expenses and payments on behalf of the business.

When work advances are given, the work advances account is debited. When the person who gets the advance presents a document of expense or payment, the work advances account is credited, and the corresponding account is debited.

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[326] Income Tax Law, Article 121.
[327] Corporate Tax Law, Article 44.
[328] Eric L. Kohler, **A Dictionary for Accountants**, Prentice-Hall, Inc., Third Edition, 1963, p. 28.

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Advances given to personnel for the purpose of paying expenses and services which will be made on behalf of a business are noted in the personnel advances account for personnel and workers' salaries, wages and travel allowances.

Payments made are recorded in the personnel advances account as debit. Cash refunds and withelded amounts from payments in progress and the amount on submitted documents are recorded in the personnel advances account as credit.

In the instance long term work advances on employees who have left from the company, these advances will be considered as benefits provided to them.

Advances given to employees for which repayment is postponed over a significant period, may be considered as wages.

Some judicial decrees state there is no need for the valuation of advances.

2.20. Liabilities in General

An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. [329]

Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognize future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.[330]

[329] IAS: Framework of Financial Statements, paragraph 60.
[330] Ibid, paragraph 63.

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Liabilities are "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."[331]

When a contingency comes into existence after the year-end, a liability can not be accrued because it didn't exist at the end of the year. However, if the failure to disclose the possible loss would cause the financial statements to be misleading, the situation should be described in a disclosure note, including the effect of the possible loss on key accounting numbers affected.[332]

Accounting standards require that the likelihood that the future events will confirm the incurrence of the liability be categorized as probable, reasonably possible, or remote.[333]

If one amount within a range of possible loss appears better than other amounts within the range, that amount is accrued. When no amount within the range appears more likely than others, the minimum amount should be recorded and the possible additional loss should be disclosed.[334]

A liability shall be classified as current when it satisfies any of the following criteria:[335]

(a) It is expected to be settled in the entity's normal operating cycle;

(b) It is held primarily for the purpose of being traded;

(c) It is due to be settled within twelve months after the balance sheet date; or

(d) The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

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[331] Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Concepts, No. 6*, **Elements of Financial Statements of Business Enterprises**, December, 1980.

[332] Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Standards No.5*, **Accounting for Contingencies**, March, 1975, par 11.

[333] Ibid, par 11.

[334] Financial Accounting Standards Board (FASB) Interpretation No. 14, *Reasonable Estimation of the Amount of the Loss*, 1976.

[335] IAS 1, paragraph 60.

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Current liabilities are obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.[336]

All other liabilities shall be classified as non-current.[337]

The Uniform Chart of Accounts states that short term liabilities consist of the liabilities of a company that are paid within one accounting period. Under short term liabilities: Financial liabilities, trades payable, other payables, advances taken, taxes payable and other liabilities, provisions for liabilities and expenses, deferred income and expense accruals and other short term liabilities are classified as subtitles.

2.21. Bank Loans

The most common way for a corporation to obtain temporary financing is to arrange a short term bank loan. When a company borrows cash from a bank and signs a promissory note, the firm's liability is reported as notes payable (sometimes bank loans or short-term borrowings). About two-thirds of bank loans are short term, but because many are routinely renewed, some tend to resemble long-term debt.[338]

Bank loans are classified under short term liabilities as well as long term liabilities. The 300 Bank Loans account comprises the amount of short term loans provided by banks and other financial institutions. Short term loans are recorded as credit when taken and as debit when paid 400 Bank Loans account comprises long term loans provided from banks and other financial institutions. Long term loans taken are recorded in this account as credit. When paid, they are recorded in this account as debit.

A liability that is due on demand or will be due on demand within a year should be classified as a current liability. Liabilities often become callable by the creditor when there is a violation of the debt agreement. If an agreement is violated, classification of the debt as current is required because it is a reasonable expectation that existing

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[336] American Institute of Certified Public Accountants, Committee on Accounting Procedures, **Accounting Research and Terminology Bulletins**, Final Edition, New York: 1961, p.21.

[337] IAS 1, paragraph 60.

[338] J. David Spiceland, James F. Sepe, Lawrence A. Tomassini, **Intermediate Accounting**, Second Edition, p.567.

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working capital will be used to satisfy the debt. Only if it can be shown that is probable that the violation will be cured within the grace period usually given in these agreements can the debt be classified as non current.[339]

Principal installments made for payables within a year and amounts whose maturities are less than a year are recorded in 303 Principal and Interest Payments of Long term Loans as credit and when paid are recorded in this account as debit. The 303 Principal and Interest Payments of Long term Loans account includes principal installments of long term loans which are payable within a year from the balance sheet date and any remaining part of loans for which the maturity date is less than a year and those interests which have been accrued but still not paid.

2.21.1. Bank Loan Valuation

According to Tax Procedural Code Article 285, liabilities are valued at recorded value. Those payables which are based on credit contracts are considered with interest which will be calculated up to valuation day. The unmatured payables which are attached may be discounted on valuation day. Discounting notes payable to the value on valuation day is a procedure to bring the notes' values to net present value on the balance sheet. The difference between recorded value and net present value is transferred to the profit/loss for the term account.

For companies which have used credit, in the form of bank loans, these loans are assumed to be account payables and due to they are not based on notes, discounting of their values on valuation day is not allowed under the Tax Procedural Code. The document utilized between a bank and credit user is a form of contract (and not notes payable) Therefore the valuation process for bank loans is different in comparison with notes payable. On valuation day, the interest from the date on which credit was issued to valuation day is recorded in the 780/797 Finance Expenses account as debit and in the 300/400 Bank Loans account as credit.

[339] Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Standards No.78*, **Classification of Obligations that Are Callable by the Creditor,** December 1983.

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According to Accounting System General Communiqués, account receivables/payables are allowed to be discounted. However when taxable income is calculated, these amounts shall be considered as non deductible expenses.

According to Law Number 5228 which has amended the Tax Procedural Law, liabilities are valued at recorded value. Those payables which are based on deposit or credit contracts are considered with interest which will be calculated up to valuation day. For receivables, a parallel law amendment has been enacted in Tax Procedural Law Article 281.

Prior to the amendment of Law Number 5228, bank loans' interest had to be recorded as expenses when it matured. The reason for this was that since banks are authorized to change interest rates before the maturity dates themselves, it was impossible to calculate interest for interim periods.

On valuation dates, according to amended articles 281 and 285 of the Tax Procedural Law, in the determination of taxable income, credit interest up to the valuation date shall be considered expenses, while deposit interest up to valuation date is considered to be income.

2.21.2 The Valuation of Bank Loans in Foreign Currencies

Tax Procedural Law states that foreign currencies are valued at market value. If there has been collusion in the establishment of market value, purchase value shall be used in valuation. If there is no market value, then the rate applied will be determined by the Ministry of Finance. This article is applicable for accounts and notes receivable in foreign currencies.

Positive exchange differences for payables and receivables in foreign currencies are transferred to the 646 Foreign Exchange Gains account. Negative exchange differences for option 7/A are followed up in 780 Finance Expenses, and for option 7/B, in 797 Finance Expenses. On the valuation date, these accounts are transferred to the 690 Profit (Loss) for the Period account.

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For positive exchange differences, companies shall use account number 646. However for negative exchange differences, 656 Foreign Exchange Losses shall not be used. According to the explanation presented in the Uniform Chart of Accounts, loans related to exchange rate differences can not be transferred to this account; instead, they must be recorded in the 780/797 Finance Expenses accounts.

2.21.3. Transfer Pricing and Thin Capitalization of Bank Loans

1-Back to back loans between related companies are transactions which may not be in accordance with the arm's length principle.

Although a variety of types of intercompany loans exist, the most important methods at present are direct loans, back-to-back financing, and parallel loans. Direct loans are straight extensions of credit from the parent to an affiliate or from one affiliate to another. The other types of intercompany loans typically involve an intermediary. A back-to-back loan may offer several potential advantages when compared with a direct intercompany loan. Two of the most important advantages are to avoid currency controls and reduce taxes. In the typical arrangement, the parent company deposits funds with a bank in country A that in turn lends the money to a subsidiary in country B.The bank simply acts as an intermediary.[340]

2-Interest rates and exchange differences concerning liabilities from related banks are the most likely to be audited from the perspective of transfer pricing and thin capitalization.

2.21.4. The Transfer of Bank Credits and Related Expenses

In group companies, especially within holding companies, one firm with a higher credit rating may secure a loan with better terms to be transferred inclusive of all interest and expenses to directly or indirectly related firms.

Credit transferred in this way provides commission revenues for the firms securing credit and lower cost loans for the other companies.

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[340] Alan C.Shapiro, **Foundations of Multinational Financial Management**, 1991, Ally and Bacon, p. 347.

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In the application of this process, the firm securing credit does not record these transactions in any way by simply transferring the credit with a bank slip. Under these circumstances, the company securing credit has to issue an invoice to the receiving company. All interest and commissions shall be subject to Value Added Tax from this type of loan transfer.

Of course, the receiving company is allowed to deduct the Value Added Tax which is shown on this invoice. The invoice shall be issued at the moment such a service has been rendered.

From the perspective of taxation methodology for Value Added Tax, if this kind of service is rendered continuously, instead of the issuance of a single invoice for the entire credit expenses, monthly invoices shall be preferred. Those expenses directly related to this credit shall also be included on the invoice in the same month the bank has accrued them. This is important in the submission of Value Added Tax returns in the month in which the expenses are incurred.

According to Value Added Tax Law Article 20, the taxable value of deliveries and services is total amount of credit expenses including the interest, and other values, services and benefits.

The transactions of those bank loans secured by one company and used by another company or companies for free are assumed to be a service rendered, and thus, under Value Added Tax Law Article 27/1, the related Value Added Tax shall be calculated with the application of equivalent value. Under these circumstances, taxable value consists of interest expenses, services, and other values and benefits.

2.21.5. Borrowing Costs in IASs

Borrowing costs shall be recognized as an expense in the period in which they are incurred, except to the to the extent that they are capitalized in accordance with paragraph 11.[341]

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[341] IAS 23, paragraph 10.

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In opposition to Turkish practice, as per IAS 23, paragraph 11, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset.[342]

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

2.22. Bonds and Notes Issued

2.22.1. In General

Firms frequently raise capital by issuing debt, and debt contracts.[343] In its simplest form, a debt contract specifies a sequence of interest and principal payments to be made by a firm (as a legal entity) to the debt holders, in return for funds they return.[344]

A long term bond produces two cash flows: (1) periodic interest payments during the life of the bond, and (2) the principal (face value) paid at maturity. At the date of issue, bond buyers determine the present value of these two cash flow using the market rate of interest. The periodic interest payments represent an annuity, and the principal represents a single-sum problem. The current market value of the bonds is the combined present values of the interest annuity and the principal amount.[345]

The Uniform Chart of Accounts states that the bonds issued by companies whose period of maturity is longer than one year shall be followed up in the 405 Bonds Issued account. In the instance that the bonds issued are convertible to stock certificates, or are convertible to cash in the early phase, the amounts and nature shall be specified in the footnotes.

The bonds issued are recorded in the 405 Bonds Issued account at their nominal value as credit. The principal payments and interest on the bonds, which are

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[342] Ibid, paragraph 11.
[343] Joy Begley, Gearld A.Feltham, *An Emperical Examination of the Relation between Debt Contracts and Management Incentives*, **Journal of Accounting & Economics**, Volume 27 No 2 April 1999, p. 229.
[344] Joy Begley, Gearld A.Feltham, p.232.
[345] Keiso, p.277-278.

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payable within one year from the balance sheet date, are recorded as debit to 405 Bonds Issued and as credit to the 304 Principal, Installment and Interest Payments of Bonds account.

Within one year of the balance sheet date, the principal and installments of bonds to be paid and interest which have accrued but not yet been paid are followed up in the 304 Principal, Installment and Interest Payments of Bonds account.

The above mentioned principal and installments of bonds and their interests are credited to the 304 Principal, Installment and Interest Payments of Bonds account and debited when they are paid.

On the other hand, the funds provided from short term money and capital market instruments such as finance bonds and bank bonds circulating in the market are followed up in the 305 Bonds and Notes Issued account. When the marketable securities which are described in this account are issued, the nominal value of such securities is credited to the 305 Bonds and Notes Issued account and other related accounts are debited. When such securities are paid, the 305 Bonds and Notes Issued account is debited.

2.22.2. Valuation of Bonds and Notes Issued

As per Tax Procedural Law Article 286, corporations shall value the bonds they have issued at the nominal (face) value.[346]

Nominal value has been described in Tax Procedural Law Article 266. The article states that "The nominal value is the value indicated on all types of notes, stock certificates and bonds."[347]

The meaning of the valuation of bonds at the nominal value is that the accrued interest to come into being prior to maturity is not to be taken into consideration, in other words this interest is not to be expensed.[348]

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[346] Tax Procedural Law, Article 286
"[347] Ibid, Article 266

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The aforementioned finance expenses for that entity to whom the bonds have been issued shall be taken into consideration for taxable income in the year they are paid.[349]

Interest rates and exchange differences concerning bonds and notes issued from related related parties are the areas to be audited from the perspective of transfer pricing and thin capitalization.

The valuation procedures of bonds issued are as follows:

2.22.2.1. The Valuation of Bonds Issued Below Nominal Value

A lump-sum payment note is a debt instrument that contains a promise to pay a specific amount of money at the end of a specific period of time. Lump-sum payment notes are often called non interest bearing notes because the note specifies only a face value and a due date. Thus the note does not have a face interest rate; it specifies only the amount the borrower promises to pay back at a future date.[350]

The difference between the nominal value and selling price of bonds, notes and other marketable securities which concern the upcoming period is followed up in the 308 Issuing Differences of Marketable Securities account.

The difference between the nominal value and selling price of bonds, notes and other marketable securities which concern future years is followed up in the 408 Issuing Differences of Marketable Securities account.

The difference between the nominal value of bonds and notes and their selling price are recorded in the 408 Issuing Differences of Marketable Securities account as debit. The portion which will be depleted in next term is transferred to the 308 Issuing Differences of Marketable Securities account by crediting the 408 Issuing Differences of Marketable Securities account.

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[348] Tax Expert Association, **Preparation Guide for Returns**, 2005, p. 935-936.

[349] M. Emin AKYOL, Muzaffer KÜÇÜK, **Uniform Chart of Accounts and Financial Statements**, Yaklaşım, p.1419.

[350] Ainsworth, P., Daines, D., David Plumblee, R., **Introduction to Accounting**, Second Edition, 2000, p. 617-618.

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The difference for the upcoming period, between the selling price and the nominal value of bonds, notes, or other marketable securities and the amounts transferred from 408 Issuing Differences of Marketable Securities account is recorded in the 308 Issuing Differences of Marketable Securities account as debit; the depleted amounts corresponding to the maturity of the securities are credited to the 308 Issuing Differences of Marketable Securities account.

2.22.2.2. Bonds Indexed to Foreign Currency, Gold or another Asset

As per Income Tax Law General Communiqué, in transactions relating to marketable securities or other capital market instruments indexed to foreign currency, gold or another asset, during the determination of the withholding base, the equivalents of the concerned assets in YTL prevailing on the date of transaction are taken as the purchase price and price of sale.

In the valuation of bonds issued which have been indexed to foreign currencies, inflation rates or other values, the differences between the indexed value and nominal value are finance expenses for the companies which have issued the bonds and finance income for the companies which have bought the bonds, in the determination of term profit for accounting purposes.

The above mentioned differences discussed under subheadings numbers 1 and 2 are allowed as deductible expenses for commercial income, and non deductible expenses for taxable income.

According to Turkish Tax Procedural Law provisions, since all bonds shall be valued at nominal value, the difference between indexed and nominal value is a non deductible expense. Therefore the difference to be added to term profit for accounting purposes shall be declared.[351]

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[351] Rüknettin KUMKALE, **Tekdüzen Hesap Planı**, Seçkin Publishing, Ankara 2004, p.966.

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2.22.2.3. The Valuation of Bonds Issued with Term Coupons

A periodic payment note is a debt instrument that contains a promise to make a series of equal payments consisting of both interest and principal at equal time intervals over a specified time period. Periodic payment notes are typically called installment notes. The difference between the total amount repaid and the face amount of the note is the interest expense.[352]

Bonds are sometimes issued with coupons. Coupons are paid once in three months, six months or yearly. As per Income Tax Law General Communiqué Number 257, the purchase price for bonds with Coupons is as follows:

During the purchase of a bond with coupon, if an accrued interest is available, the accrued interest total is accepted as the coupon purchase price; and the clean transaction price (Clean Price = Contract Price – Accrued Interest) is accepted as the purchase price of the bond. For a bond, accrued interest, implies the coupon interest that is required to be added on the clean transaction price and that proportional to the period of holding of the bond, and is calculated through the multiplication of ratio of the number of days, that have lapsed during the period lasting from the last coupon date to the value date to the number of days of coupon period, with the coupon interest to be paid.

Finance expenses (coupon interest payments) shall be taken into consideration in the calculation of corporate profit for the term in which the coupons have been paid. These expenses are accepted as deductible expenses for taxable income as well as profit for accounting purposes.

2.22.2.4. The Valuation of Bonds/Notes Denominated in Foreign Currency

On the valuation date, the exchange differences of bonds and notes issued denominated in a foreign currency are subject to valuation. The Tax Procedural Law states that foreign currencies are valued at market value. If there has been collusion in

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[352] Ainsworth, P., Daines, D., David Plumblee, R., **Introduction to Accounting**, Second Edition, 2000, p. 616.

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the establishment of market value, the purchase value shall be used in valuation. If there is no market value, then the rate applied will be determined by the Ministry of Finance.

Positive exchange differences for bonds and notes issued in foreign currencies are transferred to the 646 Foreign Exchange Gains account. Negative exchange differences for option 7/A are followed up in 780 Finance Expenses, and for option 7/B, in 797 Finance Expenses. On the valuation date, these accounts are transferred to 690 Profit (Loss) for the Period.

As per Income Tax Law General Communiqué, in cases when the marketable security or other type of capital market instrument is denominated in foreign currency, foreign exchange differences shall not be taken into consideration during the assessment of the withholding base. The rate of exchange prevailing on the date of the transaction will be taken as the basis; and in the absence of such a rate of exchange, the buying rate of exchange announced by the Turkish Central Bank shall be taken as the basis.

2.23. Trade Payables

2.23.1. In General

Payables are categorized under two main groups of activities. One is operating activities and the other is non-operating activities. Payables arising from operating activities are stated in the trade payables group of accounts. This group of items consists of accounts payable (suppliers), notes payable, deposits and guarantees taken, and other trade payables. Payables representing trading (operating) activities from the main company, affiliated companies and subsidiaries are obviously shown in detail in the notes.

Payables arising from non-operating activities are classified under the “other payables” group of accounts. This group of accounts consists of payables from shareholders, subsidiaries, affiliates and personnel as well as other miscellaneous payables. If payables from shareholders, subsidiaries, affiliates and personnel arise from operating activities, they must be categorized under the trade payables group of accounts and explained in the notes.

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2.23.2. Accounts Payable

The obligations to pay goods and services that have been acquired on open account from suppliers are called accounts payable.

Most trade credit is offered on open account. This means that the only formal credit instrument is the invoice. Because the time until payment usually is short (often30, 45, or 60 days), these liabilities typically are non interest bearing and are reported at their face amounts.[353]

It is sometimes difficult to distinguish between accounts payable and accrued liabilities, but it is useful to define a liability as an account payable if the total amount of the obligation is known and owed at the balance sheet date. The accounts payable account therefore includes obligations for the acquisition of raw materials, equipment, utilities, repairs, and many other types of goods and services that were received before the end of the year.[354]

Attention must be paid to transactions occurring near the end of one accounting period and at the beginning of the next. It is essential to ascertain that the record of goods received (the inventory) is an agreement with the liability (accounts payable) and that both are recorded in the proper period.[355]

As per Turkish Uniform Chart of Accounts, obligations without a promissory note arising from an entity's purchases of all goods and services in relation to trading activities are followed up in the 320/420 Accounts Payable (Suppliers) accounts. The accounts payable from partners, main companies, subsidiaries and affiliates shall be shown in the footnotes. When an obligation without a promissory note arises, the Accounts Payable account is credited; when it is paid this account is debited.

Accounts payable to foreign companies is also followed up in this account. Accounts payable based on foreign currency are valued at the exchange rate determined

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[353] J. David Spiceland, James F. Sepe, Lawrence A. Tomassini, **Intermediate Accounting**, Second Edition, 2001, p. 566.

[354] Alvin A. Arens, James K. Loebbecke, **Auditing An Integrated Approach**, Seventh Edition, 1997, p. 590.

[355] Keiso, p.618

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by the Ministry of Finance. The foreign currency, which has an effective buying rate, is valued at that rate. However, if there is no effective buying rate for the currency in question, the exchange buying rate is used for the valuation.

On the valuation date, any positive exchange rate differences that have arisen from accounts payable based on foreign currency are recorded in 646 Foreign Exchange Gains, and negative exchange differences are recorded in the 780/797 Finance Expenses account. Exchange rate differences followed up in the cost accounting account are transferred to 660 Short Term Borrowing Expenses account on the income statement.

Interest, additional charges and indemnities related to accounts payable are recorded in the 320/420 Account Payable account as credit and recorded in the related income statement account as debit. These expenses shall be taken into consideration in determining profit for accounting purposes.

2.23.3. Notes payable

Notes payable differ from accounts payable in that they are formally recognized by a written promissory note. Often these are of a somewhat longer term than open accounts and sometimes they bear interest.[356]

The principal and interest payments on the notes must be made in accordance with the terms of the loan agreement. For short term loans, a principal and interest payment is usually required only when the loan becomes due; but the loans over 90 days, the note usually calls for monthly or quarterly interest payments.[357]

As per The Turkish Uniform Chart of Accounts, obligations with promissory notes arising from an entity's purchases of all goods and services in relation to trading activities are followed up in 321/421 Notes Payable accounts. The accounts payable from partners, main companies, subsidiaries and affiliates shall be shown in the footnotes. When an obligation with a promissory note arises, the Accounts Payable account is credited; when it is paid this account is debited.

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[356] J. David Spiceland, James F. Sepe, Lawrence A. Tomassini, p. 567.
[357] Alvin A. Arens, James K. Loebbecke, p. 675.

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Notes payable to foreign companies are also followed up in this account. Notes payable based on foreign currency are valued at the exchange rate determined by the Ministry of Finance. The foreign currency, which has an effective buying rate, is valued at that rate. However, if there is no effective buying rate for the currency in question, the exchange buying rate is used for the valuation.

On the valuation date, any positive exchange rate differences that have arisen from notes payable based on foreign currency are recorded in 646 Foreign Exchange Gains, and negative exchange differences are recorded in the 780/797 Finance Expense account. Exchange rate differences followed up in the cost accounting account are transferred to 660 Short Term Borrowing Expenses account on the income statement.

Interest, additional charges and indemnities related to notes payable are recorded in the 321/421 Notes Payable account as credit and recorded in the related income statement account as debit. These expenses shall be taken into consideration in determining profit for accounting purposes.

2.23.4. Valuation

All payables are valued at the recorded value, which is the calculated value of a liability shown in accounting records. Immature notes payable are allowed to be discounted to their value on the day of valuation. If any interest rate is stated on the notes, this rate is applied to the discount. If no interest rate is stated, the Central Bank Official discount rate is applied.[358]

Payables based on foreign currency are valued at the market value of the foreign currency written on the notes. If there is no market value for the foreign currency, the exchange rate for the valuation is determined by the Ministry of Finance. The foreign currency, which has an effective buying rate, is valued at that rate. However, if there is no effective buying rate for the currency in question, the exchange buying rate is used for the valuation.

[358] Tax Procedural Law, Article: 281.

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On the valuation date, payables based on foreign currency, any positive exchange rate differences that have arisen from payables based on foreign currency are recorded in 646 Foreign Exchange Gains as credit, and negative exchange differences are recorded in 656 Foreign Exchange Losses as debit.

2.23.5. Discounting of Payables

Maturity value, the amount that will be paid at maturity, is the principal plus total interest for the life of the note. The amount of the discount on a note is the difference between its value on the date of discount and its value at maturity.[359]

According to the Tax Procedural Law, notes payable are allowed to be discounted to their present value on the date of valuation. The rate of interest indicated on the notes can be used for discounting. If there is no interest rate indicated on the notes, the Central Bank's official discount rate can be used as the discount rate. The amount of reduction for the notes payable to their net present value is calculated and recorded in the Discount of Notes Payable (-) account.

In order to be able to discount payables for tax purposes, the payables must:

-be recorded on a balance sheet,

-be documented by a promissory note (a written promise to pay a stated amount of debt at a stated time),

-have a maturity date (stated time),

-have arisen from trade (operating) activities.

Notes payable arising from non-operating activities and notes of accommodation are not allowed to be discounted. If they are discounted, they will have to be added to the taxable profit as non-deductible expenses pursuant to tax laws.

[359] Richard F. Kochanek, A. Douglas Hillman, **Financial Accounting**, 1990, p.448

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Taxpayers discounting unmatured notes receivable to the present value at the valuation date must also discount unmatured notes payable in the same way.[360]

In the determination of the interest rate for discounting, if there is an interest rate written on the notes, this rate shall be applicable. If not, the Central Bank interest rate for short term advances shall be applicable as the interest rate.

According to accounting principles and Capital Market Law, the discounting of undue payables without promissory notes to the present value at the valuation date is compulsory. At the same time according to tax laws, these are unacceptable amounts. They shall not be taken into consideration in the determination of taxable income.

The value-added tax of payables is also not allowed to be discounted. If it is discounted, it will also be added to taxable profit as non-deductible expenses in accordance with tax law.

2.23.6. Payables between Related Parties

All payables are required to be considered in terms of volume, maturity and interest rates. Between related parties, if high amounts of payables at the date of maturity are not paid or extended with relatively high/low overdue charges, this may be a case of thin capitalization and/or transfer pricing.

Interest and exchange rate differences concerning liabilities from related companies are the most likely to be audited from the perspective of thin capitalization and transfer pricing.

In the instance that an entity has given loans without calculating interest, transfer pricing review is made; in the instance an entity has given loans with calculated interest, a thin capitalization review is made for the debtor.[361]

In tax auditing, when auditors scrutinize loan interest which has been recorded as an expense, they will look into the loans positions that have caused this interest. If

[360] Tax Procedural Law, Article 281.

[361] Arif BAŞER, *Örtülü Kazanç Örtülü Sermaye Sarmalına İlişkin Çözüm Önerileri*, **Vergi Dünyası**, March 2001, p. 235.

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the loans subjected to interest qualifies as thin capitalization and corporation hasn't written off this interest as a non deductible expense, auditors set taxable income differences by rejecting the concerned expenses. At this time, the term "disguise" is used to express that an application of collusion has been made.[362]

Interest paid for loans taken from an entity's partners can be recorded as expenses on the condition that the loan which has been made doesn't have the appearance of thin capitalization.

2.23.7. Loans from Stockholders as per IRS

As per Internal Revenue Service for specific techniques for analyzing loans from stockholders are as follows:[363]

-Review loan agreements to determine if there is true debtor-creditor relationship. Large liabilities in relation to capital stock may indicate a "thin capitalization" situation.

-Determine the source of funds advanced by shareholders to ensure no outright diversion of corporate receipts.

-Review the rates of interest and the scheduled dates of repayment to ensure transactions are at arms-length. If "loans" are "equity capital" then:

-Disallow interest expense; treat as dividends.

-Disallow bad debt deductions claimed by the shareholder.

-Treat the entire repayment as a dividend.

In order to audit above mentioned situations, auditors:

-Analyze composition of account balance.

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[362] Abdurrahman Akdoğan, **Türk Vergi Sistemi ve Uygulaması**, Third Edition, Gazi Publishing, İstanbul 2001, p. 198

[363] www.irs.gov/pub

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-Determine if corporation is “thinly capitalized”

-Consider factors bearing on debt and equity.

-Review recording of interest expense and determine that interest accrued at year end is paid within statutory period.

2.23.8. Other Issues for Transfer Pricing and Thin Capitalization

Treasury Loss:

There is no regulation in Tax Codes concerning whether treasury loss is necessary or not to determine disguised capital or disguised profit.

In the case that treasury loss has been determined; there is no doubt that disguised profit distribution and thin capitalization have been applied. However if there is no treasury loss, the issue is being debated. Different ideas and judicial verdicts exist.

If there are conditions specified in the Law, the provision for disguised profit distribution shall be applied. There is no need to research whether there has been treasury loss.[364]

Exchange Rate Differences:

Some opinions states that exchange rate differences calculated on specific terms or on valuation day for money which has been given to an entity by partners as loans are the cost of usage for this money by the entity and this qualifies as interest.

When a loan has been given to a corporation, any differences that arise due to exchange rate fluctuations is not a value acquired for a service rendered, so the exchange rate differences shall not be taxed.[365]

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[364] The General Board of Appeal Comission of Taxes, dated 03.04.1957, Register: 101, Decision Number: 104.

[365] The Decree of General Board of Council of State Tax Court Offices, dated 14.04.1995 and Basis: 1994/201, Decision No: 1995/124.

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For exchange rate difference expenses arising from the Turkish Lira losing value against foreign currencies, there is no way for these expenses to be considered as interest which has been paid on thin capitalization.[366]

Exchange rate differences, even if related to thin capitalization, are not rejected as expenses, because it is impossible that any subject which has not been clearly specified in Law will be included in the scope of taxation through commentary.[367]

An exchange rate difference is not income or a benefit; moreover it is not a service or a value provided. Therefore it is impossible to be considered within the scope of interest.[368]

In the text of article (Corporate Income Tax Code Article 16), although the word "interest" is used, the important point here is to pay extra money as a result of thin capitalization and deduct it from corporate taxable income. This can be a portion of participation in profit or exchange rate differences as well as interest.[369]

In the instance where elements such as exchange rate differences arising as a result of valuation fall within the scope of thin capitalization, the valuation will not depend on anything of substance, therefore deduction of these elements from taxable income for the term is impossible.[370]

Value Added Tax:

Financial transactions occurring between taxpayers are called services rendered from the viewpoint of Value Added Tax. Service rendered is subject to value added tax as per VAT Code Article 4. Basically financial services are subject to Banking and Insurance Transaction Tax. However, as per The Law Number 6802 Article 30,

[366] The Decree of Fourth Office of Council of State, dated 23.12.1998 and Basis: 1994/3295, Decision No: 1998/5516.
[367] Mustafa Özyürek, **Finansal Forum Journal**, 15.11.2001.
[368] Mahmut Şekdur, Kur *Farkı ve Örtülü Sermaye Üzerine Farklı Bir Değerlendirme*, **Vergi Dünyası**, April 2001, p. 236.
[369] A. Naci Arıkan, *Şirket Ortaklarının Döviz Cinsinden Şirkete Verdikleri Örtülü Sermaye Cinsinden Borçlara İlişkin Kur Farklarının Vergisel Durumu*, **Vergi Dünyası**, November 2000, p. 231.
[370] Mesut Koyuncu, *Örtülü Sermaye Niteliğindeki Yabancı Para Cinsinden Borçlanmalarla İlgili Olarak Oluşan Kur Farklarının Gider Niteliği*, **Vergi Dünyası**, 1999, p. 216.

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taxpayers of Banking and Insurance Transaction Tax are banks, financiers and insurance companies. Therefore these transactions should be subject to VAT.

If disguised capital is determined to be within the context of Corporate Income Tax Code Article 16, the interest which has been paid or calculated is a non deductible expense in the determination of corporate income as per Corporate Income Tax Code Article 15/2. Therefore VAT which is shown on invoices belonging to these kind of expenses is not allowed to be deducted as per VAT Code Article 30/d.

If disguised profit distribution is determined to be within the in the context of Corporate Income Tax Code Article 17, the disguised profit which has been distributed is a non deductible expense in the determination of corporate income as per Corporate Income Tax Code Article 15/3. Therefore VAT which is shown on invoices belonging to these kind of expenses is not allowed to be deducted as per VAT Code Article 30/d.

Corporate Income Tax Code Article 17 is an article only concerned with Corporate Income Tax. Value Added Tax base difference will not be set up within the terms of this article. The transaction which can be performed is to re-evaluation the event to VAT Code Article 17. In auditing, this situation will cause differentiation between VAT and Corporate Income Tax bases.[371]

Money that capital companies have made their partners use is considered to be disguised profit distribution under Corporate Income Tax Article 17; interest must be calculated on the aforementioned money. The interest that will be calculated is also being the financial service cost for the partners from the capital companies, VAT must be calculated on this amount.[372]

In the transaction of lending money to partners through current accounts, the VAT base is the interest amount accrued in the name of the partners for this transaction. VAT shall be calculated on this interest amount.

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[371] Adnan ERSOY, *Örtülü Kazanç Müessesesi ve KDV Boyutu*, **Vergi Dünyası**, February 2004, p. 104

[372] Erdal Sönmez, Garip Ayvaz, *Ortaklar Cari Hesabı ve Örtülü Sermaye*, **Vergi Dünyası**, October 1997, p. 194.

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In the instance that the transaction of lending money to partners were made without interest or low interest rate relatively to equivalents, VAT base will be interest amounts found after interest calculation process.[373]

Determination of Equivalent Value:

The existence of transfer pricing shall be based on a calculation of differences to compare with equivalents. Selling and purchasing goods, financial transactions and wage payments are shown as differences from the perspective of the determination of equivalencies.

For transactions of purchasing and selling goods, if an entity's internal equivalents exist, these equivalent values shall be taken as the basis. In the case of goods withdrawn from entities; if they have been withdrawn for free, all equivalent value will considered as disguised profit distribution. If they are withdrawn at low values, the difference between the equivalent value and the purchasing/selling value will be assumed to be disguised distributed profit.

In financial transactions, if commercial credit has been withdrawn, the interest rate shall be used as an entity's internal equivalent interest rate. If no credit has been withdrawn, the average interest rate of financial institutions, taking maturity into consideration, or Central Bank advance transactions discount rates will be used.

In the case of giving debt to the company's partner for free, interest must be accrued at the rate of rediscount interest.[374]

In the transfer of bank credit between entities, the bank interest rate shall be used at the same rate.

In leasing transactions, if there is an equivalent value within an entity, this equivalent shall be taken into consideration. To do this, if there are leasing values for previous terms, net present value should be adjusted in terms of these values. If there is

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[373] Mehmet ALTINDAĞ, Abdullah TOLU; *Sermaye Şirketlerinin Ortaklarına Faizsiz veya Düşük Faizle Borç Para Vermelerinin BSMV ve KDV Karşısındaki Durumu*, **Vergi Dünyası**, July 1997, p. 191.

[374] The Decree of 3rd Office of the Council of State, Basis No: 1998/1700, Decision No: 1999/3185.

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no an equivalent value an entity, leasing values in same areas can be determined and taken as equivalents.

The most difficult determination of equivalent transactions is determining wages' equivalents.

One of the natural results of business life is that a company's partners and their relatives may work in a company's management. For the aforementioned people, if they work in positions which are appropriate to their skills and the wages for these positions are a normal level; disguised profit distribution is not a consideration.[375]

From this perspective, to show or to research equivalent corporations is not to go further than the forced application of this process.[376]

In the determination of disguised profit distribution, the equivalent value within an entity should be researched in the first place. Research for an equivalent outside the entity should be an applied method in the event the equivalent inside the entity cannot be determined.[377]

The term "equivalent" as per judicial verdicts is to be accepted as the value that those entities doing business in the same areas take as a basis for the same transactions or at least for very similar transactions.[378]

In the provision concerning disguised profit distribution in the Corporate Income Tax Code, bringing the criteria of a designated percent for sales etc., instead of equivalent entities' criteria, can eradicate the negative results of this application.[379]

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[375] Musa Örmeci, **Kurumlar Vergisi Kanunu Uygulama Esasları**, İstanbul, 1995, p.571-572

[376] Abdurrahman Akdoğan, **Vergilerin İncelenmesi ve Değerlendirilmesi**, Second Edition, Gazi University, Publishing No. 165/54, Ankara 1996, p.199

[377] H. Hüseyin Savaş, *Örtülü Kazanç Dağıtımında Emsal ve Danıştay'ın Konuya Yaklaşımı*, **Vergi Dünyası**, Number 234, February 2001, p.170-171.

[378] Murat Başaran, Tezcan Atay, *Kurum Fonlarının Ortaklara ve Aralarındaki Hukuksal ve/veya Ekonomik Bağ Bulunan Diğer Şirketlere Kullandırılması Eyleminin Örtülü Kazanç Dağıtım Merkezinde KDV Açısından Almaşık Bir Yaklaşımla Tartışılması II*, **Yaklaşım**, Year :9, Number: 102, June 2001, p.146.

[379] Yaşar Mehtibay, **Avrupa Topluluğunda Vergi Uyumlaştırması ve Türk Kurumlar Vergisi**, Turhan Publishing, Ankara 1996, p.479

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2.23.9. Transfer of Bank Loans to Related Parties

In credit transfer transactions, a company which has made credit contract with a financial entity transfers the credit to another company. In this way the transferring company has rendered a service to Transferee Company.

In a credit transfer transaction, the company which is one side of a credit contract which has been made with a financial entity has to consider this to be service rendering for a different service is to be presented to the company using the credit.

According to Value Added Tax Law Article 20, the taxable value of deliveries and services is the total amount of credit expenses including the interest, and other values, services and advantages. Therefore all interest and commissions shall be subject to Value Added Tax from this type of loan transfer. The invoice shall be issued at the moment such a service has been rendered.

The related Value Added Tax shall be calculated with the application of equivalent value as per Value Added Tax Code Article 27/1.

Concerning corporate income tax, this shall also be subject to taxation at equivalent value, since it is financial service rendering without charge. However, in order to be disguised capital or disguised profit distribution, interest rates from the bank to the credit taker and from the credit taker to credit holder are different.

“The European Court of Justice has issued what is being called a landmark judgment on the taxation of multinational companies in the case of C-324/00. What happened is that a German company borrowed money from a related company in the Netherlands. The German tax authorities argued that the company was thinly capitalized and that the interest paid on the loan should be re-characterised as a distribution. The tax authorities claimed that it was justified:

-to prevent the transfer of profits from one jurisdiction to another;

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-to provide consistency with the OECD Model Treaty imposing the arm's length principle between connected companies."[380]

2.24. Partners' Current Account

Entities may have commercial activities and/or financial relationships with their partners. In this context, work advance payments, deposited money, payables and receivables are followed up in the partners' current account. In commercial activities, as per the Turkish Uniform Chart of Accounts, 120/130 Buyers (Accounts Receivable), 320/420 Suppliers (Accounts Payable) are generally used as the partners' current account. For the financial relationship, the 131/231 Receivables from Shareholders account and the 331/431 Payables to Shareholders account are generally used the partners' current account.

One of the most common areas faced in tax auditing is partners' current account. Through using this account, money withdrawn from entity without interest or with relatively low interest may be used by partners in a disguised way. Therefore calculating proper interest rate for money withdrawn by partners from the partners' current account and recording it in the 642 Interest Income account is required. Otherwise, they may be considered as thin capitalization.

The capital advance account is not different from the partner's current account. In the instance money given to partners while there is no debt to them, this is finance service rendering. Payments which have been in the name of a capital advance are receivables from partners. Interest has to be accrued for these receivables. Otherwise the corporation would distribute corporate income without being taxed that is transfer pricing.[381]

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[380] Peter Vaines, *A Landmark Case*, *Thin Capitalisation*, **Accountancy**, February 2003, p. 118.

[381] Osman DERELİ, *Sermaye Avanslarının Örtülü Kazanç Dağıtımı Açısından İrdelenmesi*, **Vergi Dünyası**, November 2003, Number: 267, p. 79

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In the application of transfer pricing between two entities, whether tax evasion has occurred or not shall be taken into consideration for taxes that were paid or will be paid by the two entities.[382]

During the evaluation of transfer pricing, it is necessary to consider the manner of distribution and the person involved alongside the results which have arisen.[383]

The important thing here is that through these transactions, the entity is deprived of corporate income which has been transferred to a partner and/or partners.[384]

Even if profit has been distributed in hidden ways, unless it has been deducted from taxable income, it cannot be reviewed, since the case in which it is reviewed not profit distribution, but the deduction of profit distribution from taxable income.

From the view point of taxation, the issue which is unacceptable and is reviewed is the deduction of interest expenses which have been paid for that capital used in a disguised way.

There is no provision in the law that transfer pricing shall be recalculated from transfer pricing by means of adding the amount of transfer pricing to the partner's payables in the following year.[385]

For entities other than capital corporations, it is impossible to assess pursuant to 15/3 (Corporate Income Tax Article 15/3) because of the transactions lined up in the Article 17.[386]

For entities other than capital corporations, those elements of income which have been transferred outside of the corporation will be included in taxable income; the acceptance of any other result is unthinkable.[387]

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[382] The Decree of the Fourth Office of the Council of State, dated 19.10.1988, Basis No: 1987/4703, Decision No: 1988/3511

[383] The Decree of the Fourth Office of Council of State, dated: 13.10.1987, Basis No:1987/2585, Decision No: 1987/2881.

[384] Münir Bellek, *Ortaklar Cari Hesabının Borç Kalıntısı Her Zaman Örtülü Kazanç Dağıtımı Sayılır mı*?, **Mükellefin Dergisi**, March 2005, Number 15, p.12

[385] Tax Legislation Platform of CPAs of İstanbul, 15 July 2002, p. 27.

[386] Selahattin Paklar, **Kurumlar Vergisi Kanunu**, İstanbul 1984, p.431.

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2.25. Unearned Revenues and Accrued Expenses

2.25.1. Unearned Revenues

Revenues received in cash and recorded as liabilities before they are earned are called unearned revenues. Such items as rent, magazine subscriptions, and customer deposits for future service may result in unearned revenues. Unearned revenues are the opposite of prepaid expenses. When the payment is received for services to be provided in a future accounting period, an unearned revenue (a liability) account should be credited to recognize the obligation that exists. Unearned revenues are subsequently earned through rendering service to a customer. The recognition of earned revenue is delayed until the adjustment process. Then adjusting entry is made to record the revenue that has been earned and to show the liability that remains. A liability-revenue account relationship therefore exists with unearned revenues. In the typical case, liabilities are overstated and revenues are understated prior to adjustment. Thus the adjusting entry for unearned revenues results in a debit (decrease) to a liability account and a credit (increase) to a revenue account.[388]

Calculated VAT concerning incomes which are collected in advance must be declared in the term in which an invoice or similar document has been issued.[389]

As per Tax Procedural Code Article 287, incomes collected in advance which belong to future years are valued at recorded value. Incomes collected in advance will be held until the term to which they belong, at which time they are recorded in the income account for the related terms.

In the event, leasing value which have been paid in advance related to more than one year, each year's leasing value is recorded as income in that year. The leasing value belonging to the first year is recorded as income at the end of the term and the leasing values belonging to future years are recorded in the 480 Deferred Incomes for Future Years.

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[387] Yılmaz Özbalcı, **Kurumlar Vergisi Kanunu**, Ankara 1984, p.263-265
[388] Keiso, p.83.
[389] Value Added Tax Law, Article 10/b.

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"Firms can also defer taxable income by deferring the recognition of revenue. In order to protect government revenues, the tax rules are designed to prevent taxpayers from understating revenues or overstating expenses."[390]

If a receivable is due on terms exceeding one year, the proper valuation is the present value of future payments to be received, determined by using an interest rate commensurate with the risks involved at the date of the receivable's creation. In many situations the interest rate commensurate with the risks involved is the rate stated in the agreement the payee and debtor.[391]

Unearned revenues or advances result from customer prepayments for either performance of services or delivery of product. They may be required by the selling enterprise as a condition of the sale or may be made by the buyer as a means of guaranteeing that the seller will perform the desired service or deliver the product. Unearned revenues and advances should be classified as current liabilities at the balance sheet date if the services are to be performed or the products are to be delivered within one year or the operating cycle, whichever is longer.[392]

Some transactions do not result in a one-time delivery of a product or service, but rather in continual delivery. For example, revenue from contractual arrangements allowing others to use company assets (such as revenues from rent, interest, lease payments, and royalties) is recognized as time passes or as the asset is used. Revenue is earned with the passage of time and is recognized accordingly.[393]

Per same article, revenues which have been collected but belong to future periods are valued at recorded value. These types of revenues are recorded as revenues in the year to which they belong to.

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[390] David A. Guenther, Edward L. Maydew, Sarah E.Nutter; p. 233

[391] Wiley GAAP, 2005, p.221.

[392] Ibid, 2005, p.561.

[393] Thomas R. Dyckman, Roland E. Dukes, Charles J. Davis, **Intermediate Accounting**, The Fourth Edition, Volume I, Irwin McGraw Hill,1998, p. 268.

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2.25.2. Accrued Expenses

Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Interest, rent, taxes, and salaries can be accrued expenses. Accrued expenses result from the same causes as accrued revenues. Adjustments for accrued expenses are necessary to record the obligations that exist at the balance sheet date and to recognize the expenses that apply to the current accounting period. A liability-expense relationship exists with accrued expenses. Prior to adjustment both liabilities and expenses are understated. Therefore the adjusting entry for accrued expenses results in a debit (increase) to an expense account and a credit (increase) to a liability account.[394]

At the end of the accounting period, a company may have incurred or accumulated expenses that have not been paid in cash or recorded. These unpaid and unrecorded expenses are called accrued expenses. Examples of accrued expenses include salaries earned by employees but not yet paid and interest expense incurred but not yet paid.[395]

"The accrual method requires expense recognition in the accounting period in which the expense is incurred. In addition, under the matching principle some expenses (e.g., warranty claims) are estimated and recorded before they are paid. In contrast, an item may not be deducted for tax purposes until three conditions are satisfied: all of the events that determine the taxpayer's liability for the expense have occurred, the amount of the taxpayers' liability can be determined with reasonable accuracy, and economic performance has occurred. In the case of a liability that requires a payment for property or services, economic performance are deemed to occur as the property or services are provided to the taxpayer."[396]

"If all three conditions are met, the expense will be deductible for tax purposes in the current year and will also be properly accrued in the current year financial statements. Thus, deductibility of an accrued expense for tax purposes is a sufficient but

[394] Keiso, p.84-85.
[395] Richard F. Kochanek, A. Douglas Hillman, **Financial Accounting**, 1990, p.132.
[396] David A. Guenther, Edward L. Maydew, Sarah E.Nutter, p. 232.

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not a necessary condition for accrual of the expense for financial statement purposes."[397]

As per Tax Procedural Law Article 287, expenses which have not yet been paid and belong to the current year are valued at recorded value. These types of expenses are recorded as expenses in the year to which they belong to.

2.25.3. Taxable and Deductible Temporary Differences

Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:[398]

(a) Taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) Deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

A deferred tax liability shall be recognized for taxable temporary differences.[399] A deferred tax asset shall be recognized for all deductible temporary differences.[400]

2.26. Gross Sales

Gross sales comprise total values which have been received or accrued from goods sold or services rendered in the scope of the main activities of a business. Subsidies related to goods sold and services rendered, installment maturity differences on the date of sale, exchange rate differences arising exports in the relevant term, and tax refunds are shown in gross sales. VAT shall not be included in gross sales. Gross sales are divided into domestic sales, foreign sales and other income.

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[397] David A. Guenther, Edward L. Maydew, Sarah E.Nutter, p. 232-233.
[398] IAS 12, paragraph 5.
[399] Ibid, paragraph 15.
[400] Ibid 12, paragraph 24.

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Income from domestic and foreign subsidiaries which has been acquired by a holding company is followed up in this group of accounts, since the income constitutes part of the main operating income for the holding company.

When the business makes a sale then the proceeds of the sale are a positive part of the profit calculation which is referred to as revenue. On the other hand, this operating process involves the consumption of some business resources, as expense.[401]

To calculate net sales revenue on the income statement, merchandising businesses maintain three accounts to collect transaction data: Sales account, the sales returns and allowances account, and the sales discounts account. Using the balances in these accounts at the end of the period, net sales revenue is calculated. The revenue account "sales" records total or gross sales of merchandise for cash or on credit. Sales of merchandise are recorded by debiting cash or accounts receivable.[402]

2.26.1. Sale of Goods

Sales or service revenues are charges to customers for the goods and/or services provided during the period.[403]

Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:[404]

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

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[401] David Alexander, Christopher Nobes; **A European Introduction to Financial Accounting**, Prentice Hall, 1994, p.17

[402] Richard F. Kochanek, A. Douglas Hillman, "**Financial Accounting**", 1990 by Harcourt Brace Jovanovich, Inc., p. 242-243.

[403] Barry J. Epstein, Ervin L. Black, Ralph Nach, Patrick R. Delaney, **Interpretation and Application of GAAP**, 2005, John Wiley & Sons, Inc., p. 71.

[404] IAS 18, paragraph 14.

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(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain may retain a significant risk of ownership in a number ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:[405]

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

2.26.2. Rendering of Services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date. The outcome can be estimated reliably when all the following conditions are satisfied:[406]

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

[405] Ibid, paragraph 16.
[406] Ibid, Paragraph 20.

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(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered.[407]

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.[408]

2.26.3. Transfer Prices for Tax Purposes (IRC 282)

As per IRS sales auditing techniques "test check pricing and compare with sales to unrelated entities" is a step.[409] Internal Revenue Code Section 282 states that arm's length regulations link the calculation of a multinational's transfer price to a comparable transaction between uncontrolled (independent) parties.[410]

All other things equal, a multinational firm wants to set the transfer price to allocate all profit to the division in the lower tax jurisdiction Uncontrolled parties presumably have no such tax incentive when they negotiate a price with each other. As a result, an uncontrolled transaction price represents a fair division of profit across divisions, at least according to the logic underlying the arm's length philosophy. Under the regulations, the firm derives a fair transfer price for tax purposes by observing

[407] Ibid, paragraph 21.
[408] Ibid, paragraph 22.
[409] www.irs.gov/pub
[410] US Treas. Reg. Section 282.

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(inferring) the price of an actual (or hypothetical) uncontrolled sale of a good comparable to the good transferred between the multinational's divisions. Despite these regulations, a firm can still shift income in two ways.[411]

First, because it is difficult to identify comparable, uncontrolled transactions, the tax auditor often can identify only a range acceptable transfer prices. Hence, the auditor can not always detect a deviation from the true arm's length price. Second, because the firm's investment choices may affect the definition of comparability, the firm can manipulate the transfer price ex ante by distorting investment. The common perception is that the tax enforcement and/or ambiguity of existing regulations give firms too much ex post discretions over the tax transfer price[412] [413]

The transfer price must lie between the marginal cost of production and the domestic selling price.[414] Because the firm's input decisions can not affect the exogenously specified arm's length price, there is no ex ante shifting. Although the firm can choose an arbitrary transfer, the probability of regulatory intervention increases as the selected transfer price deviates from the arm's length price. The firm balances income shifting against penalty avoidance.[415]

2. 27. Domestic Sales

Total values which have been received or accrued in response to goods sold and services rendered to individuals and legal entities in domestic sales are followed up in the 600 Domestic Sales account. When sales are realized, the sales amount is credited to this account. Domestic sales are recorded in this account with gross values. On the date of sale, discounts shall not be included in the gross sale amount. The gross sale amount is the VAT base. Installment maturity differences, premiums and similar

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[411] Michael J. Smith, *Ex Ante and Ex Post Discretion over Arm's Length Transfer Prices*, **The Accounting Review**, Volume 77, No. 1, January 2002, p.161-162.

[412] Micheal J. Smith, p. 161-162, (Graham, G, *Clinton Sets Sights on Foreign Companies*, **The Financial Times**, June 24 1992).

[413] Micheal J. Smith, p. 161-162, (Judis, J. *A Great American Rip-Off: Phony Pricing Helps Foreign Firms Evade U.S.Ttaxes*, **San Diego Union Tribune**, August 18, 1993).

[414] Samuelson, L., *The Multinational Firm With Arm's Length Transfer Price Limits*, **Journal of International Economics**, 13 (4): 365-374, 1982.

[415] Kant, C., *Endogenous Transfer Pricing and the Effects of Uncertain Regulation*, **Journal of International Economics,** 24 (2): 147-157, 1988.

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incomes related to sales which are calculated subsequently and invoiced separately are not followed up in this account. They are followed up in the 602 Other Income account. Those goods sent to consignees or goods already on consignment elsewhere are not subject to being recorded as income unless they are sold.

In the current term, sales income which has been collected as prepayment but is related to subsequent terms and has been recorded in the 600 Domestic Sales account is recorded in the 600 Domestic Sales account as debit, and in the 380/480 Deferred Income for the Subsequent Months/Years to which it belongs as credit.

Those sales income amounts belonging to the current term, which had been collected as prepayment in the previous term and transferred to the 380/480 Deferred Income for the Subsequent Months/Years account, are recorded in the 380/480 Deferred Income for the Subsequent Months/Years account as debit, and in the 600 Domestic Sales account as credit.

2.28. Export Sales

Total values which have been received or accrued from goods sold and services rendered to individuals and legal entities abroad are followed up in the 601 Export sales account. When sales are realized, the sales are credited to this account.

Export sales are recorded in this account with gross values. The expenses corresponding to these sales are not deducted from sales income but are recorded in expense accounts. Sales to domestic entities based on foreign currency but not registered as exports are not included in foreign sales. Positive exchange rate differences related to sales abroad up to the end of the current year are accepted as revenues and recorded in the 601 Export Sales account. Sales denominated in foreign currency are valued at the exchange buying rate of the Turkish Republic Central Bank on the date of sale.

Transactions to tax havens shall be considered from the perspective of thin capitalization and/or transfer pricing. Therefore transactions for goods delivered and services rendered, or vice versa, to tax havens must be strictly documented.

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The audit guidelines issued by the SAT target the enterprises having transactions with affiliates in tax havens, such as the British Virgin Islands and Bermuda.[416]

Sales to companies in free zones may be audited especially concerning whether transfer pricing has been applied in accordance with the arm's length principle.

Group companies in tax haven territories and/or free zones which trade almost entirely with other group companies and which are designed solely to launder profits out of the tax system are always under observation.

Transfer pricing refers to the pricing of goods and services within a multi-divisional organization. Goods from the production division may be sold to the marketing division, or goods from a parent company may be sold to a foreign subsidiary. The choice of the transfer prices affects the division of the total profit among the parts of the company. It can be advantageous to choose them such that, in terms of bookkeeping, most of the profit is made in a country with low taxes.[417]

The issues are mentioned below are very crucial from the perspective of tax audit.

-All inter-group sales and purchases

-All money owed to and from inter group companies

A tax haven is a place where certain taxes levied at a low rate or not at all. Among tax havens, different jurisdictions tend to be havens for different types of taxes, and for different categories of people and/or companies. One way a person or company takes advantage of a tax haven is by moving to, and becoming resident for tax purposes in, the tax haven. Another way for an individual or a company to take advantage of a tax haven is to establish a separate legal entity (an offshore company, trust or foundation), subsidiary or holding company in the tax haven. Assets are transferred to the new

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[416] K. Hung Chan, Lynne Chow, p. 97.
[417] http://en.wikipedia.org/wiki/Transfer_pricing

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company or trust so that gains may be realised, or income earned, within this legal entity rather than earned by the beneficial owner.[418]

2.29. Other Income

Subsidies provided by the government such as tax refunds, installment maturity differences on the date of sale, and price stability support premiums for export are followed up in the 602 Other Income account. Subsidies, tax refunds, installment maturity difference payments, and price stability support premiums which have arisen due to activities in the term are credited to the 602 Other Income account.

Sales premium income is added to the term profit. Even in situations where it has not yet been calculated by sellers, they are calculated and recorded as income by buyers. Income accruals are recorded in the 181 account. When sellers send the premium statement, adjusting records are made. Since sales premiums are related to the income directly, they are recorded in 602 Other Income or the 649 Other Ordinary Income and Profit account as credit and transferred to the 690 Term Profit and Loss account at the end of the term.

2.30. Sales Deductions

Sales deductions comprise values which have to be deducted from gross sales to reach net sales. Sales deductions are divided into returns from sales, sale discounts and other deductions.

Since cash discounts, returns, and other allowances reduce the amount of cash inflow expected, they reduce the value of the asset. And it follows that these items also reduce the amount of revenue involved and should be accounted for as revenue reductions.[419]

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[418] http://en.wikipedia.org/wiki/Tax_haven

[419] R.F. Salmonson; **Basic Financial Accounting Theory**, Wadsworth Publishing Company, Inc., 1969, p. 100

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2.30.1. Return from Sales

Returns from sales comprise invoice amounts from goods sold and returned. The returned amount from sales is debited to the 610 Return from Sales account and credited to the corresponding account. Returns from sales are the same as the purchase of new goods. An invoice which has been issued by a buyer in the same amount is recorded in the 610 Returns from Sales account.

A customer may return merchandise because it is not exactly as ordered, or the customer may be entitled to an allowance, or a reduction of the amount owed, for defective or broken goods not returned. The effect of an entry to record a return or allowance is the opposite of a sale. However, when cash or the customer's account is credited, an account entitled "sales return and allowances", a contra account to sales, is debited.[420]

2.30.2. Sales Discounts

All kinds of cash and quantity discounts which are made subsequent to the issuance of an invoice and the realization of sales are placed in the sales discounts account.

A cash discount is a specific deduction for buyers in response to cash payments prior to the due date in credit sales.

A quantity discount is a deduction in the specified rate or quantity for buyers due to high volume purchases exceeding certain amounts.

Sales discounts are debited to the 611 Sales Discount account, and credited to the corresponding receivables account.

On the discounted invoices, the VAT base is the value after the discount. For this kind of discount, the seller sends a statement of account and wants the buyer to issue an invoice.

[420] Richard F. Kochanek, A. Douglas Hillman, p. 243.

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Customers who pay within a stated time period may be offered a reduction from the invoice price called a cash discount. Cash discounts are computed on the invoice amount, and payment terms to obtain the discount are stated on the invoice. Since a discount reduces the amount actually received from the sale, it is recorded as a debit to sales discounts.[421]

2.30.3. Other Deductions

Transportation expenses for goods sold which have been paid by the seller during the transportation of the goods; compulsory deductions for goods sold which are flawed, missing or damaged during transportation; and sales taxes (excluding VAT), funds etc. are shown in the 612 Other Deductions account.

Other deductions for goods sold or services rendered are debited to the 612 Other Deductions account without being deducted from sales revenue, and credited to the corresponding account.

2.31. Cost of Sales

The cost of sales comprises the cost of goods and services sold such as finished goods, semi-finished goods, raw materials, commercial goods, and inventory movements of an entity within the term.

In other words, cost of sales includes all expenses made for the production or purchase of goods and services which have been sold or transferred to the buyers in the term.

The realization of revenue from sales marks the time and measures the amount of (1) recapture of costs previously advanced in productive efforts, and (2) capture of additional assets (income) representing amount of compensation for capital service rendered, responsibility taken, risk assumed in the process of production.[422]

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[421] Richard F. Kochanek, A. Douglas Hillman, p. 245.

[422] William E. Thomas; **Reading in Cost Accounting Budgeting and Control**, South-Western Publishing Company, 1968, Third Edition, p. 186.

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Per IAS 2, the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.[423]

The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and 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.[424]

The costs of conversion of inventories include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.[425]

When inventories are sold, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable 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 realisable value, shall be recognised as reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.[426]

As per Turkish Uniform Chart of Accounts, the total cost of finished goods sold is credited to the 152 Finished Goods account and debited to the 620 Cost of Finished Goods Sold account. The cost of commercial goods sold comprises the cost of commercial goods and similar items purchased with the purpose of sale without being subject to any change.

The cost of commercial goods sold is credited to the 153 Commercial Goods account and debited to the 621 Cost of Commercial Goods Sold account. The cost of

[423] IAS 2, paragraph 10.
[424] Ibid, paragraph 11.
[425] Ibid, paragraph 12.
[426] Ibid, paragraph 34.

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services produced is recorded in the 622 Cost of Services account. The 622 Cost of Services Sold account is debited: in service businesses using the 7/A alternative, the 741 Service Production Cost Reflection account is credited; in small businesses using 7/B, the 799 Production Cost account is credited.

Expenses made for acquiring other sales revenues related to the main operating activities of a business are followed up in the 623 Cost of Other Sales account. Cost of Other Sales is debited to the 623 Cost of Other Sales account.

Purchased goods without documentation in the form of either bank transfer receipts or check payments, and lacking pertinent shipping documentation, may indicate discrepancies from the tax auditing perspective.

2.32. Cost of Imported Goods

1- All expenses related to imported goods shall be added to the cost. Per Tax Procedural Law Article 262, in the cost of goods purchased, the cost value comprises purchase value and expenses related to this purchase such as transportation, commission, customs taxes and other expenses.

2- Maturity differences paid for imported goods are accepted as financial services and subject to Withholding Tax per Corporate Income Tax Law Article 30 and are also subject to VAT to be applied by the responsible person or entity.

3- Discounts not suited to the arm's length principle on imported goods may be problematic from the perspective of the VAT tax base and customs tax base.

4- Additional invoices in the form of licenses, royalties etc. related to imported goods which have arrived previously may present a problem. As per Customs Law, it can be claimed that they are required to be included in the VAT tax base and customs tax base.

5- Interest and commission expenses and exchange differences:

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According to General Communiqué Number 238, exchange rate differences for imported goods until the goods are brought to the place of employment must be included in cost value. After the goods have become a part of inventory, the exchange rate differences shall either be included in the cost value or written off as expenses directly.

Interest and commission expenses shall also be included in cost value or written off as expenses directly.

Overdue charges stated on invoices when the goods have been bought are eliminated directly from the cost. However, overdue charges arising from payments that have not been paid on the due date are directly written off as expenses.

Similar to overdue charges, discounts stated on invoices when the goods have been bought are eliminated from the cost. However, discounts arising from early payments shall not be deducted from the cost value. They are recorded as income for tax purposes.

Purchase discounts stated on invoices when the goods have been bought are eliminated directly from the cost. However, purchase discounts at the end of the term are directly written off as income.

Sales premiums are recorded as income for tax purposes. According to Value Added Tax Law Article 26, sales premiums are not related to the cost of goods bought.

2.33. Research and Development Expenses

For research and development expenses made to decrease the cost of production, increase sales, and apply new production styles and technology, the following expenses are recorded in the 630 Research and Development Expenses account:

-Those which have not been capitalized,

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-And of capitalized expenses, those which have been amortized for a portion of the term.

At the end of the term, the expenses related to this function and followed up in the 7th group of accounts, in the 7/A alternative, the 751 Research and Development Reflection account is credited; in 7/B, the 798 Expense Varieties Reflection account is credited, and 630 Research and Development Expenses account is debited.

In the calculation of research and development deductions only 40 % of research and development expenses for new technology and information research are permissible which have been incurred by the entity.[427]

The deduction of research and development shall not be calculated from those expenses which are not directly related to research and development activities and from depreciation amounts for depreciable fixed assets which have not been used for research and development activities.[428]

Deferment of research and development expenses should be done from calculated corporate income tax which is prior to offsets.

2.34. Marketing, Sales and Distribution Expenses

The expenses made for marketing, sales and distribution activities related to goods and services consist of indirect raw material, indirect labor, personnel expenses, benefits and services provided externally, various expenses, taxes and duties, and portions of depreciation and amortization.

The expenses related to this function and followed up in the 7th group of accounts, at the end of the term, in alternative 7/A, the 761 Reflection account for Marketing, Sales, and Distribution is credited; in 7/B, the 798 Reflection account for Expense Varieties Reflection is credited, and 631 Marketing, Sales and Distribution expenses account is debited.

[427] Corporate Income Tax Law, Article 14/6.
[428] Ibid, Article 14/6.

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The below mentioned expenses incurred from warehouse to customers are accepted as marketing, sales, and distribution expenses.

-Labor expenses for marketing,

-Employee wages for marketing,

-Indirect raw material for marketing,

-Insurance expenses for marketing,

-Traveling expenses for marketing,

-Benefits and services provided from external sources for marketing,

-Distribution expenses,

-Advertisement, promotion, sample expenses,

-Export freight expenses,

-Sales commissions,

-Exhibition expenses,

-Vehicles and equipment expenses for sales and distribution,

-Leasing expenses,

-Depreciation for fixed assets concerning marketing and sales,

-Taxes and fees,

-Sales incentive expenses.

2.35. General and Administrative Expenses

The expenses made for the general administrative functions of a business consist of indirect raw materials, indirect labor, personnel expenses, benefits and

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services provided externally, various expenses, taxes and duties, and depreciation expenses which cannot directly be connected to the cost of goods sold or production.

The expenses related to these functions and followed up in the 7th group of accounts, at the end of the term, in alternative 7/A, the 771 Reflection account for General Administration Expense is credited; in 7/B, the 798 Reflection account for Expense Varieties is credited, and 632 General Administration Expenses account is debited.

The budgetary control of the foregoing items of expense and income, the general and administrative expenses can appropriately be separated from other charges and other credits.[429] General administrative activity includes some functions which relate to all other activities, but are not strictly administrative in nature.[430]

General administration expenses:

-Indirect raw material expenses,

-Indirect labor expenses,

-Employee wages and expenses,

-Benefits and services provided from external sources,

-Taxes and fees,

-Depreciation and depletion expenses,

-Other expenses.

General expenses:

-Wages

-Insurance expenses

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[429] Herman C. Heiser; **Budgeting Principles and Practice**, The Ronald Press Company, 1959, p. 279.

[430] J. Brooks Heckert, James D. Wilson, **Business Budgeting and Controls**, The Ronald Press Company, 1955, p. 371.

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-Expenses such as personnel education

-Finance expenses

-Leasing expenses

-Heating, lighting, and water expenses

-Communication expenses

-Advertising expenses

-Representation (special events marketing) and hospitality expenses

-Stationary expenses

-Fixture and equipment expenses

-Fees paid to professional associations

-Normal maintenance and repair expenses for real estate or tangible fixed assets which are valued like real estate

-Payments which are compulsory by law

-Other general expenses

2.35.1. Wages

1- Those wages paid abroad which originate from a company in Turkey must necessarily be subjected to withholding tax in Turkey.

2- All kinds of benefits provided to personnel are subject to tax as wages. All expenses, such as telephone, rent, transportation, fees, and traveling, paid on behalf of personnel shall be subject to tax as wages. The payments are accepted as net amounts. Therefore, the tax base shall be taken as a gross amount. Sales premiums, bonus premiums and similar payments are also accepted as wages.

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3- A house provided for an employee by his employer is exempted from tax up to 100 m2. As per Individual Income Tax Law, the exceeding part is accepted as wages and subject to tax with gross amounts.[431]

4- Private insurance expenses which do not exceed the social insurance portion for personnel are allowed to be deducted from taxable income. As per Individual Income Tax Law, the exceeding part is accepted as wages and subject to tax with gross amounts.[432] From the perspective of the stamp tax, including the exempted part as a total premium gross amount shall be subject to tax.

5- As per Individual Income Tax Law, allowances for clothing other than that makes up a uniform are subject to tax as wages.[433] VAT included in the value shall be considered as wages.

6- The true nature of petrol expenses given to managers for their private cars is accepted as wages. Per Individual Income Tax Law, exemption is only allowed for service vehicles which carry all personnel in their commute to and from work.[434]

7- Turkish personnel receiving wages from foreign employers may be required to submit tax return. Per Individual Income Tax Law, wages paid in foreign exchange to service personnel by employers whose business headquarters are not in Turkey and who are limited liable taxpayers are excluded as wages.[435]

In order for a corporate taxpayer to be able to deduct salaries, the salaries must be reasonable and, in addition, must be paid for personnel services actually rendered.[436]

2.35.2. Insurance Expenses

In tax auditing, limitations on insurance costs to be paid abroad shall be taken into consideration.

[431] Individual Income Tax Law, Article 23/9.
[432] Ibid, Article 63/9.
[433] Ibid, Article 61.
[434] Ibid, Article 23/10.
"[435] Ibid, Article 23/14.
[436] US Treas. Reg. Section 162.181.

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Per Individual Income Tax Law, insurance contracts must be made with a company whose headquarter are in Turkey.[437]

The interest payments for insurance premiums abroad which have not been paid in maturity are accepted to be the same as interest arising from receivables. Therefore interest payments for insurance premiums abroad are subject to withholding tax per Corporate Income Tax Law Article 30.

2.35.3. Finance Expenses

Finance expenses comprise interest, exchange rate differences, credit commissions and other similar expenses incurred from loans and not being added to the cost of assets are followed up in the 66 Finance Expenses.

Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.[438]

Borrowing costs may include:[439]

(a) interest on bank overdrafts and short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of finance leases recognised in accordance with IAS 17 Leases; and

(e) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Short term borrowing expenses is the account in which interest and other similar expenses which are not being added to the cost of assets and are related to loans

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[437] Individual Income Tax Law, Article 89.
[438] IAS 23, paragraph 4.
[439] Ibid, paragraph 5.

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with a maturity of at most one year are followed up in the 660 Short term borrowing expenses account.

At year's end, finance expenses followed up in the 7th group of accounts, for the 7/A alternative, the 781 Finance Expense Reflection account is credited; for 7/B, the 798 Expense Varieties Reflection account is credited, and the 660 Finance Expenses account is debited.

The interest and similar expenses related to loans with a maturity of more than one year are followed up in the 660 Long term borrowing expenses account.

In the determination of commercial income, in order to be considered a deduction, financial expenses shall be related to the business like all other expenses.[440]

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtness.[441]

Interest means compensation for the use or forbearance of money. Interest is the amount which one has contracted to pay for the use of borrowed money. Interest for income tax purposes is only interest upon indebtedness, and not all obligations are indebtedness.[442]

With respect to stated interest accruing on an indebtness over a term of years but payable only at maturity, a taxpayer on an accrual basis may not deduct full amount in year of payment but must claim annual deductions of interest as it accrues.[443]

2.35.3.1. Financial Expenses Concerning Loans Utilized by Other Entities

Those businesses withdrawing unnecessary credit to be used by another entity may not consider any related expenses for this credit as deductible expenses in the determination of commercial income.[444]

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[440] The Decree of the13th Office of the Council of State, dated 22.01.1975 and Basis Number: 1973/187, Decision Number 1975/216.
[441] US Treas. Reg. Section 163.
[442] Ibid, Section 163.4.
[443] Ibid, Section 163.19.

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From the standpoint of tax legislation, the origin of this credit and the circumstances under which it was obtained are not important. The importance lies in the determination of whether this credit has been utilized in the acquisition and maintenance of income.

Businesses that have withdrawn credit may extend it to others within this framework. In this situation, the related expenses shall be recorded in the records of whichever business has used this credit.[445]

2.35.3.2. Finance Expenses Concerning Goods Purchased or Produced

Allocation of any portion of interest and commission expenses paid by businesses to banks or similar credit institutions for loans which have been withdrawn to provide financing is not compulsory for ending inventory. Accordingly, taxpayers shall record such payments as expenses directly; or, if they wish, they may add the portion to the cost of the goods.[446]

Exchange rate differences from the date of purchase of goods up to their inclusion in a business inventory must be included in the cost. If exchange rate differences arise later concerning the goods remaining in the inventory, they are recorded as expenses in the related years or are included in the cost.[447]

2.35.3.3. Interest Expenses Related to Loans for Investment Financing and Exchange Rate Differences Arising due to Import of Assets

Those interests for loans related to the foundation period of a company which have been used for investment financing are to be added to the investment cost to be depreciated with tangible fixed assets; those interests for loans related to the time of

[444] The Decree of the Third Office of Council of State, dated: 02.02.1989 and Basis Number: 1988/1751, Decision Number: 1989/269.
[445] The Decree of the Fourth Office of Council of State, Date: 28.09.2000 and Basis Number 19998/3838, Decision Number 2000/3856.
[446] General Communique of Tax Procedural Law, Serial Number 238, Part B.
[447] Ibid, Serial Number 238, Part B.

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active business for a company are to be directly recorded as expenses or to be added to the cost to be depreciated.[448]

Those exchange differences arising due to the use of foreign currency loans for export of tangible fixed assets, or arising due to the valuation of loan installments concerning these fixed assets, have to be added to the cost of the fixed assets up to the end of the term in which the fixed assets have been acquired; those exchange differences arising subsequent to the end of the term in which the fixed assets have been acquired are to be directly recorded as expenses or to be added to the cost to be depreciated.[449]

The preference for whether those loan interests belonging to the term in which the loan is secured are directly recorded as expenses or depreciated has to be decided at the outset. In the event that recording directly as an expense is preferred, this is not allowed to be switched in the subsequent years to the addition of expenses to the cost to be depreciated; if, at the outset, depreciation is preferred, a subsequent switch to recording directly as an expense is not possible.[450]

Up to the end of the term in which tangible fixed assets have been acquired through the use of foreign currency loans, unfavorable exchange differences for businesses have to be added to the cost; favorable exchange differences have to be deducted from the cost. For those negative or positive exchange differences arising subsequent to the end of the term in which tangible fixed assets have been acquired, taxpayers have the right either to record them directly as expense/income or to add them to the cost.

Interest and exchange differences arising prior to investment, for the investment credit which has been kept in banks to be spent on investments, have to be directly recorded to the final accounts instead of adding them to the cost of investment.[451]

[448] Tax Procedural Law, General Communique Serial Number 163.
[449] Ibid, Serial Number 163.
[450] Ruling Letter of Ministry of Finance, dated 17.10.1991 and number 74460.
[451] Ruling Letter of Ministry of Finance dated 20.03.2002, number 12363.

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Loan interests which have been used in the acquisition of tangible fixed assets and have arisen up to the date on which the assets have been capitalized have to be included as an element of the acquisition cost.

2.35.3.4. Finance Expenses Concerning the Purchase of Stock Shares

Finance expenses and exchange differences arising subsequent to the purchase of stock shares, which have been purchased through the use of credit, have to be directly recorded as expenses.[452]

Since stock shares are valued at purchase value, those elements such as finance expenses and exchange rate differences which arise subsequent to the purchase date are not allowed to be added to the purchase cost. This is the difference between valuation of purchase value and cost value.

2.35.4. Distribution of Collective Expenses in Holding Companies

In practice, holding companies and their subsidiaries and affiliates or group companies have some collective expenses (pooled cost). In some situations, these collective expenses are itemized on only one expense document and each entity does its records based on this document copy. This situation is not acceptable in terms of Tax Procedural Law documentation procedure and the application of Value Added Tax in tax auditing. In tax auditing, auditors claim that the firms whose names are on invoices are responsible for the management of electric, water, postal and other services. Therefore these companies are considered to be intermediary service provider by auditors and so these companies shall calculate for every company' proportion which are benefited from these services and have to issue invoices for every single company separately including value added tax.

Corporate Income Tax Code General Communiqué Number 33 states that financing is a kind of service, the cost of which shall be distributed among related companies which are using these services. In order to be recorded as expenses, between

[452] Ruling Letter of Ministry of Finance dated 21.05.1999, number 20289.

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related companies, all services must be definitely rendered and the types of service must be specified with details on invoices, and if there is more than one service on an invoice, every service amount must be shown separately.

In practice, it is not common to see the transfer of bank loans as thin capitalization. However, if the prices and amounts for goods and services between related parties are obviously higher or lower than other transactions of a similar nature, or free of charge, this is a strong indication of transfer pricing. This situation may be transfer pricing and require penal tax assessments in tax auditing.

In order to prevent penal tax assessment, companies should institute sales policies for goods that are consistent and adhere to the same guidelines, regardless of whether the purchaser is a shareholder, affiliate, subsidiary, personnel, or any other party. Therefore, above mentioned services shall be rendered with a fair profit margin.

In the invoicing of services by holding companies, the nature and the cost of the service shall be specified in detail on the invoice. If a distribution key is used, the underlying principles of this key shouldn't change from year to year. The cost must be commensurate with the service rendered.

The rules to Turkish holding companies for distribution of collective expenses are also applicable to foreign capital companies in Turkey whose invoices arriving from their headquarters which are in abroad. However, the tax administration in particular does not tend to accept the expense distribution approach for these companies.

2.35.5. Vehicle Expenses

As per Income Tax Law, expenses for vehicles, which are part of an entity or leased and are used in the business, are allowed in the calculation of net profit.[453]

Accordingly all expenses for all vehicles which are included and used in business are allowed to be recorded as expenses. Prior to 1999, half of the expenses of

[453] Income Tax Law, Article 40/5.

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automobiles and other vehicles which were being used for personnel necessities were allowed to be recorded.

Outside of normal repair, maintenance and cleaning expenses for vehicles, those expenses made to increase the value of a vehicle shall be added to the cost value of the vehicle and shall be depreciated as per Tax Procedural Law Article 269 and 272.

Those expenses increasing the value of an asset which are required to be added to cost value are expenses extending the economic life of the asset or increasing the functions of the vehicle in normal economic life. These types of expenses are not allowed to be directly recorded as vehicle expenses.

Expenses which are made for the renewal of engine elements and those expenses which are made for the frame of vehicles are required to be added to the cost to be depreciated.

On the other hand, those exchange rate differences arising subsequent to the end of the term in which the fixed assets have been acquired, are to be directly recorded as expenses or to be added to the cost to be depreciated. However the preference for whether those loan interests belonging to the term in which the loan is secured are directly recorded as expenses or depreciated has to be decided at the outset. In the event that recording directly as an expense is preferred, this is not allowed to be switched to the addition of expenses to the cost to be depreciated, or vice versa, in subsequent years.

Expenses and depreciations of vehicles such as yachts, cutters, boats, speed boats, planes and helicopters which are not directly related to the main activities of the entity, are not considered to be expenses or depreciable in the determination of income.

IRS auditing techniques for automobile expenses are as follows[454]:

-Obtain list of persons for whom automobiles are purchased or leased and determine business purchase.

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[454] www.irs.gov

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-Where employees receive reimbursement for use of personal automobiles assure that proper accountability is made to employer.

-Assure that reimbursements and allowances to employees are included in employees' income required.

2.36. Dividend Income from Subsidiaries and Affiliates

Dividend income provided from subsidiaries in which the company holds a capital share is followed up in the 640 Dividend Income from Subsidiaries account. Income or loss arising from sales of marketable securities such as stock shares and bonds are not recorded in this account.

Dividend income from affiliated companies is followed up in the 641 Dividend Income from Affiliates account.

Dividend income provided from full liable corporations due to participation from their capital is excluded from corporate income tax. This is to prevent double taxation. Since the subsidiaries which have acquired these gains have already been taxed, if the company providing dividends from subsidiaries is taxed for these gains, it will be the second time they are taxed.

2.37. Interest Income

The interest income account is the account in which interest income provided from all kinds of short and long term financial investments is followed up.

Turkish-lira time deposits and demand deposits in banks are valued at recorded value. What is more, with an amendment in Tax Procedural Law Article 281, "receivables based on time deposits and credit contracts are to be taken into consideration with their interest on the valuation date."

This also includes current repurchase agreements, which means the term interest for repurchase agreements will be counted and included in the term taxable income regardless of whether it is collected up to the end of the term.

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Interest income provided from time deposits or demand deposits in banks during the fiscal year must be included in taxable income as a gross value. Withholding taxes held by banks are recorded in the 193 Prepaid Taxes and Funds account and net income is recorded in the 102 Banks account as debit.

2.38. Gains on the Sale of Marketable Securities

The gains on the sale of marketable securities account is the account in which gains on the sale of marketable securities are followed up. When marketable securities are sold, the positive difference between the cost value and the sales value is recorded as credit in the 645 Gains on Marketable Securities account.

Stock certificates are valued at the acquisition cost. As long as they remain as assets, any increase or decrease in value will not be included in taxable income. Whenever they are sold, profit and loss are calculated and included in taxable income. Any gain is recorded in the 645 Gains on Sale of Marketable Securities account.

The 111 Private Sector Securities or 112 Public Sector Securities accounts are debited for the total amount of interest income and exchange rate differences for bills, notes and bonds; and 642 Interest Income or 646 Foreign Exchange Gains are credited. In this way on the balance sheet, bills, notes and bonds are replaced with new values that include interest income and foreign exchange gains, and on the income statement, the interest income and foreign exchange gains are placed in the term taxable profit.

2.39. Foreign Exchange Difference Gains/Losses

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different Exchange rates.[455]

The foreign exchange gains account is the account in which foreign exchange gains are followed up. (Exchange rate differences arising from exports in the term are transferred to the 601 Export Sales account, not the 646 Foreign Exchange Gains

[455] IAS 21, paragraph 8.

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account). Gains arising from exchange transactions are credited to the 646 Foreign Exchange Gains account.

On the valuation date, any positive exchange rate differences of foreign cash in bank accounts are recorded in the Foreign Exchange Gains account as credit.

Foreign exchange gains come into being in two ways. One of them is when foreign currency which the company has held as cash on hand, cash in banks or checks received accounts, leaves the company's possession. The other one comes into being as a result of valuation on valuation days. Pursuant to Tax Procedural Law, assets, receivables and payables denominated in foreign currencies shall be valued at the foreign currency exchange rate which has been issued by the Ministry of Finance. As a result of this valuation, the difference between recorded values and values reached with valuation will comprise foreign exchange gains/losses.

When monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period.[456]

2.40. Discount Interest Income

The discount interest income account is the account in which discount interest income is followed up. Discount interest income occurring on notes payable at the end of the term, and interest income occurring from the cancellation of a discount on notes receivable at the beginning of the next year are followed up in the 647 Discount interest income account.

According to Tax Procedural Law, notes payable are allowed to be discounted to their present value on the date of valuation. The rate of interest indicated on the notes

[456] IAS 21, paragraph 29.

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can be used for discounting. If there is no interest rate indicated on the notes, the Central Bank's official discount rate can be used as the discount rate. The amount of reduction for the notes payable to their net present value is calculated and recorded in the Discount of notes payable (-) account.

Per the Uniform Chart of Accounts, calculated discount amounts are recorded in the 322, 422, 327, 427 discount of notes payable accounts as debit and are recorded in the 647 Discount Interest Income account as credit.

2.41. Allowance Expenses

2.41.1. Allowance for Marketable Securities

Allowances for losses arising from significant and continuous decreases in market values of marketable securities are followed up in the 119 Allowance for Decrease in Value of Marketable Securities (-) account in order to offset the effect of the losses.

2.41.2. Allowance for Doubtful Receivables

As per Turkish Tax Procedural Law, depending on the conditions involved in the acquisition and maintenance operating profit, receivables are to be considered doubtful under the following circumstances:[457]

1. Receivables involved in a lawsuit (that is, under consideration by a court of law), or involved in the execution (enforcement stage) of a court's verdict

2. Receivables demanded more than one time with a formal written request (notice of protest) which are not deemed to be worthy of bringing a lawsuit and/or execution against

As per U.S. Treasury Regulation Section 161.12, a liability may not be taken as deduction for income tax purpose if it is contingent or if the obligation is in dispute; the

[457] Tax Procedural Law, Article 323.

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liability accrues only in year in which the obligation becomes fixed, and if disputed, in year in which dispute is finally resolved.[458]

Pursuant to the economic value at the valuation date, allowances for doubtful receivables must be provided to adjust the value of an asset account. Under the allowance method, an asset offset account (Allowance for doubtful for receivables) is established as a deduction from the face value of account receivables and they are stated on balance sheets. Special situations for doubtful receivables are as follows:

1- Any guaranteed part of the receivables must not be included in the allowance.

2- An allowance for doubtful receivables from shareholders can be allocated only for the portion of the shareholder's notes receivable which exceeds that shareholder's equity in the company.

3- Doubtful receivables collected totally or partially in subsequent years are included in taxable income as income for the year when collected. This situation does not affect the previous years' taxable income.

2.41.3. Allowances for Value Decrease of Inventories

According to Tax Procedural Law Article 278, damages due to the result of fire, earthquake, or flood, or in cases of spoilage, decay, breakage, cracking, or rust if there are important value decreases in inventories' economic value, their valuation shall be provided by the equivalent value method, pursuant to Article 267 of the Tax Procedural Law.

However, the above mentioned value decreases must fall within the scope of normal commercial necessities. Beyond these reasons for the value decreases of inventories (for example in the case of those goods which are stolen or lost), equivalent value is not allowed to be applied. Therefore, they are non-deductible expenses for tax purposes.

[458] US Treas. Reg. Section 161.12.

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Taxpayers claiming their inventories have lost value in the ways mentioned in Tax Procedural Code Article 278, must prove this to the appraisal commission. To record a loss due to natural disasters for taxable purposes, a decision of the appraisal commission is required. The last date to apply to the appraisal commission is the last day of the fiscal year. However, if the value decrease has arisen from casualty losses, an application must be made as soon as possible without waiting for the last day of the fiscal year.

The allowance account is used to record allowances adjusting physical and economic losses incurred in the value of inventories because of natural disasters, damages, obsolescence, or other reasons.

According to the Turkish uniform chart of accounts, when the market value decrease of the inventories has been determined, the 654 Provision Expenses account is debited and the 158 Allowance for decrease in value of inventories account is credited. When these inventories are either used in business or sold, then a comparison is made with the related inventory account and the provision is transferred to the 644 Provisions no longer required account.

2.42. Losses on Marketable Securities Sales

The 655 Losses on the Sale of Marketable Securities account is the account in which losses on the sale of marketable securities are followed up. When marketable securities are sold, the negative difference between the sale value and the cost value is recorded as debit in the 655 Losses on Marketable Securities account.

Stock certificates are valued at the acquisition cost. As long as they remain as assets, any increase or decrease in value will not be included in taxable income. Whenever they are sold, profit and loss are calculated and included in taxable income. Any loss is recorded in the 655 Losses on sale of marketable securities account.

Unless they are sold, only for accounting profit, important value decreases in inventories' economic value, their valuation shall be provided by the equivalent value method, pursuant to Article 267 of the Tax Procedural Law.

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However, the above mentioned value decreases must fall within the scope of normal commercial necessities. Beyond these reasons for the value decreases of inventories (for example in the case of those goods which are stolen or lost), equivalent value is not allowed to be applied. Therefore, they are non-deductible expenses for tax purposes.

Taxpayers claiming their inventories have lost value in the ways mentioned in Tax Procedural Code Article 278, must prove this to the appraisal commission. To record a loss due to natural disasters for taxable purposes, a decision of the appraisal commission is required. The last date to apply to the appraisal commission is the last day of the fiscal year. However, if the value decrease has arisen from casualty losses, an application must be made as soon as possible without waiting for the last day of the fiscal year.

The allowance account is used to record allowances adjusting physical and economic losses incurred in the value of inventories because of natural disasters, damages, obsolescence, or other reasons.

According to the Turkish uniform chart of accounts, when the market value decrease of the inventories has been determined, the 654 Provision Expenses account is debited and the 158 Allowance for decrease in value of inventories account is credited. When these inventories are either used in business or sold, then a comparison is made with the related inventory account and the provision is transferred to the 644 Provisions no longer required account.

2.43. Foreign Exchange Losses

Foreign exchange losses account is the account in which foreign exchange losses are followed up (Exchange rate differences arising from loans are not recorded in this account; they are recorded as finance expenses).

On the valuation date, any negative exchange rate difference of foreign cash in bank accounts is recorded in the Foreign exchange loss account as debit.

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Foreign exchange losses come into being in two ways. One of them is when foreign currency which the company has held as cash on hand, cash in banks or checks received accounts, leaves the company's possession. The other one comes into being as a result of valuation on valuation days. Pursuant to Tax Procedural Law, assets, receivables and payables denominated in foreign currencies shall be valued at the foreign currency exchange rate which has been issued by the Ministry of Finance. As a result of this valuation, the difference between recorded values and values reached with valuation will comprise foreign exchange gains/losses.

2.44. Discount Interest Expenses

The discount interest expense account is the account in which discount interest expenses are followed up. Discount interest expenses occurring on notes payable at the end of the term, and interest expenses occurring from cancellation of a discount on notes receivable in the beginning of the subsequent year are followed up in the 657 Discount interest expense account.

According to Tax Procedural Law, notes receivable are allowed to be discounted to their present value on the date of valuation. The rate of interest indicated on the notes can be used for discounting. If there is no interest rate indicated on the notes, the Central Bank's official discount rate can be used as the discount rate. The amount of reduction for the notes receivable to their net present value is calculated and recorded in the Discount of notes receivable (-) account.

Per the Uniform Chart of Accounts, calculated discount amounts are recorded in the 122, 222, 137, 237 discount of notes payable accounts as credit and are recorded in the 657 Discount Interest Income account as debit.

Taxpayers discounting unmatured notes receivable to the present value of the valuation date must also discount unmatured notes payable in the same way.[459]

[459] Tax Procedural Law, Article 281.

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2.45. Deductible and Non Deductible Expenses

2.45.1. Requisite Conditions for Deduction of General Expenses

a) Incurred expenses shall be directly related to acquiring and maintaining commercial income.

b) Expenses for tangible fixed assets shall not be accepted.

If expenses are incurred for the purchase of tangible fixed assets, there will be no general expenses to be deducted as the tangible fixed assets will be depreciated.

c) All expenses shall qualify as deductible expenses under the law.

As per IRC Section 161.41. To be deductible as an ordinary and necessary business expense, an expenditure must be paid or incurred during the taxable year, must be made to carry on a trade or business. To be deductible as a business expense in computing income tax, an item must be paid or incurred by taxpayer within the taxable year, incurred in carrying on a trade or business, and must be both ordinary and necessary. For an item to qualify as an "ordinary and necessary expense" deductible under this section, five requirements must be met:[460]

1- Item must be paid or incurred during taxable year

2- must be for carrying on any trade or business

3- must be an expense

4-must be necessary

5-must be ordinary

[460] US Treas. Reg. Section 161.41.

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Determination whether expenditure is ordinary expense deductible in computing net income must be made on basis of what is ordinary for particular business in which it is incurred.[461]

Ordinary expense is one that is normally to be expected, in view of circumstances facing business, and a necessary expense is one that is appropriate and helpful to the business.[462]

To be deductible as an "ordinary and necessary" expense paid or incurred during the taxable year in carrying on any trade or business" the item must be not only a business expense but also such an expense that it is both ordinary and necessary, "ordinary" meaning normal, usual or customary, and the fact that and obligation to pay has arisen is not sufficient to authorize the deduction.[463]

Deductions for income tax purposes are statutory. Deduction is a matter of legislative grace and may be taken only when permitted by statute.[464]

Before an expense becomes deductible for income tax purposes, all events which fix amount and liability of tax payer must have occurred. General rule as to deductibility is that there can be no loss for tax purposes on amounts which never been reported as income.[465]

In asserting a claim for deduction, taxpayer must show that he has satisfied every requirement of appropriate statute and its accompanying regulations. Taxpayers desiring to take deduction for income tax purposes must comply with statutory and regulatory requirements related thereto.[466]

2.45.2. Deductible Expenses in Individual Income Tax Law

The deduction of the following expenses is allowed for the determination of net profit.

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[461] Ibid, 162.57.
[462] Ibid, 162.59.
[463] Ibid, 162.60.
[464] Ibid, 161.7.
[465] Ibid, 161.8.
[466] Ibid, 161.9.

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1. General expenses made for the acquisition and maintenance of commercial income (Taxpayers who are active in exportation, construction, repair, assembling and transportation abroad are also allowed to deduct a lump expense, for amounts equal to at least 0.5 % of their earnings incurred as foreign currency from these activities for the equivalent of business expenses abroad).[467]

2. Food and lodging expenses for employees and workers at the place of business or in its annexes, treatment and drug expenses, clothing expenses under Article 27, insurance premiums and retirement payments (The conditions of insurance premiums and retirement payments to be deducted are: They must be paid to insurance companies or retirement and relief funds in Turkey, and insurance companies or retirement and relief funds must have the status of a legal entity).[468]

3. Under the condition they are relevant to the business; losses, damages and indemnities paid based on contract, or judicial decree, or by order of the law.[469]

4. Travel and lodging expenses relevant to the business and commensurate with the importance and length of the work.[470]

5. Expenses for vehicles which are acquired through leasing or are assets of an entity and used in business.[471]

6. Taxes, dues, and charges such as building, land, consumption, stamp and municipal taxes on the condition of relevance to the entity.[472]

7. Depreciations in compliance with Tax Procedural Law Provisions.[473]

8. Fees paid by companies to unions. (On condition however that monthly fees paid cannot exceed daily total net payment of wages).[474]

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[467] IITL, Article 40/1.
[468] Ibid, Article 40/2.
[469] Ibid, Article 40/3.
[470] Ibid, Article 40/4.
[471] Ibid, Article 40/5.
[472] Ibid, Article 40/6.
[473] Ibid, Article 40/7.
[474] Ibid, Article 40/8.

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9. Contribution margins paid by companies to individuals' retirement systems. (Total payment of contribution margins which have been paid by employers or employees and have been considered in determination of the tax base shall neither exceed 10 % of monthly wages nor national total minimum wage for a year. Outside the individual retirement system, premiums paid for personal certificates of insurance shall not exceed 5% of monthly wages acquired in payment month.[475]

10. In procedures and principles specified by the Ministry of Finance: food, cleaning, clothing and heating cost values donated to associations and foundations which act as food banks with the aim of helping poor people.[476]

2.45.3. Non-deductible Expenses in Individual Income Tax Law

The deduction of the following expenses is not allowed for the determination of net profit:

1. Money withdrawn or other assets in kind taken from the entity by owners of the entity, or by a spouse or children. (The value of other assets taken from an entity are valued at equivalent value and added to that withdrawn by the owners of the entity).[477]

2. Salaries, wages, bonuses, commissions, and compensations paid to the owners of the entity, or to their spouses, or to their minor children.[478]

3. Interest on capital invested in the entity by the owners of the entity.[479]

4. Interest on current accounts or other types of receivables owed to the owners of the entity or to their spouses, or to their minor children.[480]

5. All fines and tax penalties and compensations arising from misdemeanors by the owners of the entity. (Compensations which are written as fines on contracts shall not be considered to qualify as punitive compensation).[481]

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[475] Ibid, Article 40/9.
[476] Ibid, Article 40/10.
[477] Ibid, Article 41/1.
[478] Ibid, Article 41/2.
[479] Ibid, Article 41/3.
[480] Ibid, Article 41/4.

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6. Fifty percent of the announcement and advertisement expenses of all alcohol and alcoholic drinks, and tobacco products. (The Council of Ministers is authorized to increase this rate to 100% or to decrease it to 0%).[482]

7. Expenses and depreciations of maritime vehicles with engines such as yachts, cutters, boats, speed boats and of air vehicles such as planes and helicopters acquired by leasing or recorded as assets of the entity, which are not directly related to the main activities of the entity.[483]

8. Deduction of a certain portion of financial expenses for taxpayers who value inventories with LIFO method or revalue their fixed assets. (Interest expenses, commissions, overdue charges, exchange rate differences, and any other expenses or cost elements, except expenses added to the cost of investment) arising from the loans used for a tax entity are subject to financial expense restrictions which are 25% of total expenses and costs after applying the reduction rate. (This provision was repealed from the beginning of 2004)[484]

9. Compensation expenses paid due to material and immaterial losses which have arisen through press or radio and television broadcasting activities.[485]

2.45.4. Deductible Expenses in Corporate Income Tax Law

In the determination of corporate income calculated as commercial profit, the following expenses are allowed to be deducted from the proceeds:

1. Expenses from the issuance of stock certificates and bonds. (These expenses comprise paper and printing expenses, court, notary and other certification and registration expenses, stamp dues, and other fees and dues paid for issuance,

[481] Ibid, Article 41/5
[482] Ibid, Article 41/6.
[483] Ibid, Article 41/7.
[484] Ibid, Abolished Article 41/8.
[485] Ibid, Article 41/9.

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commissions given to banks for issuance, expenses for the registration of stocks and bonds in the stock market and all other kinds of similar expenses).[486]

2. Organization and establishment expenses at founding. (In the case wherein these expenses have been capitalized, the depreciation to be allocated from these values as per Tax Procedural Law is recorded as an expense).[487]

3. Expenses made for Board of Trustee meetings, and merger, dissolution, and liquidation expenses.[488]

4. In insurance and reinsurance companies, contingencies relevant to insurance contracts which are valid on balance sheet date. (In life insurance companies using mathematical prediction models, the expenses invested in marketable securities whose dividends and interests are exempted from tax shall not be shown as expenses).[489]

Insurance technical reserves consist of the following:

a. Undetermined damage contingencies[490]

b. Unacquired premium contingencies[491]

c. Life mathematic contingencies[492]

5. Research and development deductions calculated at 40 % of research and development expenses which are only for new technology and information research which have been incurred by the entity. The deduction of research and development shall not be calculated from those expenses which are not directly related to research and development activities and from depreciation amounts for depreciable fixed assets which have not been used for research and development activities.[493]

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[486] CITL, Article 8/(1)/a.
[487] Ibid, Article 8/(1)/b.
[488] Ibid, Article 8/(1)/c.
[489] Ibid, Article 8/(1)/e.
[490] Ibid, Article 8/(1)/e-1.
[491] Ibid, Article 8/(1)/e-2.
[492] Ibid, Article 8/(1)/e-3.
[493] Ibid, Article 10/(1)/a.

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2.45.5. Non-deductible Expenses in Corporate Income Tax Law

In the determination of corporate income, the following expenses are not allowed to be deducted.

1. Interest paid or calculated on equity.[494]

2. Interest paid or calculated on thin capitalization.[495]

3. Interest paid or calculated on transfer pricing.[496]

4. Reserves of any kind or under any name (including all types of reserves allocated pursuant to Turkish Commercial Law, special laws for entities or main contract and regulatory decisions as well as allowances which have been allocated by banks in terms of Bank Law).[497]

5. Corporate income tax, all fines and tax penalties, late payment fees and interests as per the Law Concerning Public Receivables Collection Procedure.[498]

6. Losses arising from sales of marketable securities at lower than nominal values, commissions paid, and all kinds of similar expenses.[499]

7. Fifty percent of the announcement and advertisement expenses of all alcohol and alcoholic drinks, and tobacco products. (The Council of Ministers is authorized to increase this rate to 100% or to decrease it to 0%).[500]

8. Expenses and depreciations of maritime vehicles with engines such as yachts, cutters, boats, speed boats and of air vehicles such as planes and helicopters acquired by leasing or recorded as assets of the entity, which are not directly related to the main activities of the entity.[501]

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[494] Ibid, Article 11/(1)/a.
[495] Ibid, Article 11/(1)/b.
[496] Ibid, Article 11/(1)/c.
[497] Ibid, Article 11/(1)/ç.
[498] Ibid, Article 11/(1)/d.
[499] Ibid, Article 11/(1)/e.
[500] Ibid, Article 11/(1)/ı.
[501] Ibid, Article 11/(1)/f.

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9. Compensation expenses paid due to material and immaterial losses which have arisen through press or radio and television broadcasting activities.[502]

[502] Ibid, Article 11/(1)/h.

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3. FIELD STUDY

3.1. Introduction

Tax evasion is a term used to describe illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obliges to pay.[503]

This field study is part of the dissertation entitled "Tax Review of Basic Financial Statement Items and A Correlating Field Study to Determine Common Tax Evasion Issues". The purpose of this survey is to determine the importance and prevalence of particular evasion points in basic financial statement items from the tax audit standpoint.

Probable deficiencies and discrepancies which may indicate tax evasion in tax auditing have been listed at the end of the field study. In the determination of the level of importance and prevalence of probable tax deficiencies and discrepancies, the following evaluation scale was applied:

(5) Very common and highly important

(4) Quite common and important

(3) Somewhat common and important

(2) Slightly common and not very important

(1) Neither common nor important

According to the evaluation scale above, for each item of the basic financial statements, a number was assigned to evaluate potential tax deficiencies and discrepancies in terms of prevalence and importance. Only one number for each situation was chosen.

[503] Susan M. Lyons, **International Tax Glossary**, Revised 3rd Edition, IBDF Publications, p.115.

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Respondents' comments on the deficiencies and discrepancies as well as any further deficiencies and discrepancies that they thought they should have been added, were appreciated in the "Comments/Additions" section at the end of every group of items. Subsequent to completing the list, two questions about usefulness and practicability of tax discrepancies and deficiencies list were answered by tax auditors.

3.1.1. Respondents

Respondents to be communicated with have to be knowledgeable about the pertinent issues. Therefore, in this research, nonrandom sampling technique has been used. "In this type of sampling, some members of the population may not have any chance of being selected in the sample."[504]

People who are knowledgeable about tax deficiencies and discrepancies are tax auditors and they are not willing to share their experiences with others, because of their official duties. Therefore they were assured that their identities would be held in total confidence.

In the field study, respondents were selected as to two main criteria. First one was the tax audit reports they produced and the second one was the discrepancies in assessment they determined in their tax audit reports. 10 qualified and willing professionals who were recognized as among the most successful auditors participated. In the field study, these 10 auditors were determined to fall well within an acceptable range of respondents due to the nature of the research, which is exploratory and qualitative rather than statistical and quantitative research.

For the data collection process, the questionnaire was given to tax auditors by hand and any questions or need for clarification that arose during the answering process were addressed. Accordingly, the survey respondents were interviewed and their verbal answers and comments were written down by the author of this dissertation.

[504] Mann, P., **Statistics for Business and Economics**, John Wiley & Sons, Inc., Canada, 1995, p.361.

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3.1.2. Three Criteria for Good Measurement

True measurement of concepts requires a process of assigning precise scores or numbers to the attributes of people or objects.[505]

The purpose of exploratory research is to indicate the concept to be investigated. For example, in the research for this thesis the determination of the focal points of tax deficiencies & discrepancies was the concept to be investigated. There are three major criteria for evaluating field study measurements: reliability, validity, and sensitivity.

3.1.2.1. Reliability

Reliability applies to a measure when similar results are obtained over time and across situations. Broadly defined, reliability is the degree to which measures are free from error and therefore yield consistent results.[506]

As the questions in the opinion survey correspond with almost every heading in the Turkish Uniform Chart of Accounts, they were designed to cover the vast majority of possible tax deficiencies & discrepancies. At the same time, the tax professionals' varied levels of experience and backgrounds also provided a great variety of potential situations encountered. Given these two facts, the similarity of results obtained from such different perspectives and across so many questions demonstrates a high level of reliability in the research conducted.

3.1.2.2. Validity

The purpose of measurement is to measure what we intend to measure-but this obvious goal is not as simple as it sounds at first. Validity addresses the problem of whether a measure measures what it is supposed to measure. If it does not measure what we designate it to measure, there will be problems.[507]

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[505] Jum C. Nummally, **Psychometric Theory** , New York: McGraw-Hill, 1967, p. 2.

[506] J. Paul Peter, "*Reliability: A Review of Psychometric Basis and Recent Marketing Practice*" **Journal of Marketing Research,** February 1979: 6-17.

[507] Zikmund, William G., **Business Research Methods**, Third Edition, October 1990, p. 262.

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What it is intended to measure in this research was to determine and reveal the probable deficiencies and discrepancies which lead to tax evasions in basic financial statement items from the tax audit standpoint. The items presented in the opinion survey have been formulated to follow the structure of the Turkish Uniform Chart of Accounts, thus covering a full spectrum of tax auditing deficiencies and discrepancies. Moreover, to increase validity, an appeal for the comments of the varied participating professionals is stated after every group of subpoints enumerated in the survey, in the instance that any further deficiencies and discrepancies may exist outside those covered in the survey.

3.1.2.3. Sensitivity

Sensitivity refers to an instrument's ability to accurately measure variability in stimuli or responses. A more sensitive measure, with numerous items on the scale, may be needed.[508]

As the opinion survey presented to tax auditing professionals is the research instrument for this thesis, the number of items and detail of each item are intended to create a high level of sensitivity in the research conducted. Moreover, the five point scale applied by respondents to each question accurately measured the variability of responses.

3.2. Evaluation of the Field Study

The rates of prevalence and importance of tax discrepancies and deficiencies have been ranked by taking into consideration the results from the aforementioned "Field Study" conducted with tax auditors. (See Appendices 5.1, 5.2, 5.3)

Ranking and evaluation as well as other particular points emphasized by tax auditors will be discussed and assessed in following sections.

[508] Zikmund, William G., p. 264.

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3.2.1. Cash on Hand

During the exploratory research, the tax discrepancy and deficiency risks concerning cash on hand were determined to comprise 5 subpoints. The first 2 subpoints, “large or unusual cash disbursement” and “excessive balance of cash on hand” were graded by all tax auditors with the full five points which means they are “very common and highly important” issues in tax auditing.

On the other hand “cash on hand with credit balance” got only 1 point (neither common and nor important at all) from all participants except one person who gave 2 point (slightly common and not very important). “Cash overages and shortages” got 1 point from all participants. “Valuation of foreign currencies” got 19 in total and 1.9 on average meaning the issue was determined to be “slightly common and not very important”

The tax discrepancy and deficiency points concerning the prevalence and importance cash on hand and the total and average grades given by tax auditors are as follows:

D&D sub points for the cash on hand	Total grade	Average
Large or unusual cash disbursement	50	5.0
Excessive balance of cash on hand	50	5.0
Valuation of foreign currency	19	1.9
Cash on hand with credit balance	11	1.1
Cash overages and shortages	10	1.0

Tax auditors’ comments and additions for cash on hand are as follows:

-Cash on hand overages and shortages can be only encountered for insignificant amounts.

-Transaction volume of cash and cash equivalents in a year is significant. One of the most important issues in tax auditing is the ratio between yearly transaction volume of cash and cash equivalents and the capital and/or the sales volume of an entity.

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In the case when sales/purchase volume is low, but cash movements from cash on hand and/or cash movements in bank accounts are relatively high, the entities shall be targeted in the initial investigation of a tax audit.

3.2.2. Checks Received

During the exploratory research, the tax discrepancy and deficiency risks concerning checks received were determined to comprise 4 points. None of these were given 4 points "quite common and important" or 5 points "very common and important". Subpoints 1, 2 and 3 "transfer pricing using bartering checks", "thin capitalization using bartering checks" "discounting of checks", were graded at 3 points on average "somewhat common and important". "Valuation of checks denominated in foreign currency" was given 21 in total, and 2.1 on average, meaning "slightly common and important".

The tax discrepancy and deficiency points concerning for prevalence and importance checks received and the total and average grades given by tax auditors are as follows:

D&D sub points for checks received	Total grade	Average
Transfer pricing using bartering checks	33	3.3
Thin capitalization using bartering checks	31	3.1
Discounting of checks	29	2.9
Valuation of checks denominated in foreign currency	19	1.9

As per tax auditors' comments and additions, between related parties, when one side gives checks which are payable within a specified length of time in response to checks they were paid, these funds are thereby being used without interest by related parties.

3.2.3. Cash in Banks

During the exploratory research, the tax discrepancy and deficiency risks concerning cash in banks were determined to comprise 5 subpoints. No subpoint in this

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group received a grade of 4 or higher. “Interest income of time deposits”, with a total of 31, and 3.1 on average received the most points in this group, and was determined to be “somewhat common and important”. The other 3 subpoints received approximately 2 points on average; slightly common and not very important”.

The tax discrepancy and deficiency points concerning for prevalence and importance cash in banks and the total and average grades given by tax auditors are as follows:

D&D sub points for the cash in banks	Total grade	Average
Interest income of time deposits	31	3.1
Exchange rate valuation of foreign currencies	22	2.2
Recognition of interest income	20	2.0
Interest income of repurchase agreements	19	1.9

Tax auditors’ comments and additions for cash in bank are as follows:

-Shareholders, subsidiaries and/or associates’ investment and deposits accounts shall be investigated from the perspective of relationship to the entity. These accounts may be arisen from the funds which were transferred to the entity. In the determination of the income and fund transfers, related parties’ bank account details must be provided.

-The funds transferred to offshore are important from the perspective of 1) Interest income, and 2) Foreign exchange differences.

3.2.4. Other Liquid Assets

The tax discrepancy and deficiency risks concerning other liquid assets were determined to comprise 2 subpoints. However, auditors did not find either subpoint to be of importance, and rated both subpoints accordingly. “Valuation of foreign currency” received 1 point from every participant, indicating that it is viewed as “neither common nor important”. “Checking credit card sales and their invoices” only received 2 points from 3 participants, while the rest gave it 1 point.

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The tax discrepancy and deficiency points concerning the prevalence or importance of the "other liquid assets" group and the total and average grades given by tax auditors are as follows:

D&D sub points for the other liquid assets	Total grade	Average
Checking credit card sales and their invoices	13	1.3
Valuation of foreign currency in transit	10	1.0

3.2.5. Stock Certificates

The tax discrepancy and deficiency risks concerning stock certificates were determined to comprise 5 subpoints. Of these, "stock sales to related parties as transfer pricing" and "valuation of foreign stock shares" were graded by the participants to indicate "very common and highly important" tax evasion categories, receiving 45 and 46 total points respectively, or 4.5 and 4.6 points each on average. For the remaining three subpoints, "valuation of stock certicates" received a total of 39 (an average of 3.9), indicating that this is a "quite common and important" issue in tax auditing, while "determination of sale profit (loss) for stock shares of same company purchased" received a total of 29 (2.9 on average) making this a "somewhat common and important" issue. Finally, Allowances for value decreases of stock certificates; whether adjustments done for tax purposes received a total of 16 points (1.6 on average), making it a "slightly common and not very important" issue.

The tax discrepancy and deficiency points concerning the prevalence or importance of the "stock shares" group and the total and average grades given by tax auditors are as follows:

D&D points for the stock certificates	Total grade	Average
Valuation of foreign stock shares	46	4.6
Stock sales to related parties as transfer pricing	45	4.5
Valuation of stock certificates	39	3.9
Sale profit for shares due to capital increase	29	2.9

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Allowances for value decreases of stock certificates; whether adjustments done for tax purposes	16	1.6

As per tax auditors' comments and additions, derivatives in companies' portfolios are sometimes reported as stock shares and so valuation differences may be important.

3.2.6. Marketable Securities Other Than Stock Shares

The tax discrepancy and deficiency risks concerning "Marketable securities other than stock shares" were determined to comprise 4 subpoints. According to the survey participants, all these subpoints are potential indicators of tax evasion. Of these, "futures, forward contracts and options used for tax deferral" and "the activities in Turkey funds considered to be foreign but in fact Turkish" were found to be "very common and highly important", receiving a total of 47 and 46 points, respectively, or an average of 4.7 and 4.6. "Valuation of fund participation certificates" had a total of 42 points, or 4.2 on average, and "valuation of bills and bonds" received 39 total points, an average of 3.9 making it a "quite common and important" issue.

The tax discrepancy and deficiency points concerning the prevalence or importance of the "marketable securities" group and the total and average grades given by tax auditors are as follows:

D&D sub points for marketable securities other than stock shares	**Total grade**	**Average**
Futures, forward and options used for tax deferral	47	4.7
The funds considered to be foreign but in fact Turkish	46	4.6
Valuation of fund participation certificates	42	4.2
Valuation of bills and bonds	39	3.9

Comments offered by the participants concerning tax deficiencies and discrepancies other than those arising from the exploratory research phase indicated the

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importance of the funds that appear to be foreign but are in fact Turkish. During the auditing, the funds may be considered to be transfer of credit from abroad for a specified commercial or financial operation.

3.2.7. Receivables

The tax discrepancy and deficiency risks concerning "receivables" were determined to comprise 6 subpoints. Of these, "transfer pricing through receivables" and "thin capitalization through receivables" in particular were found to be "very common and highly important", receiving a total of 46 and 45 points, respectively, or an average of 4.6 and 4.5. Other than these two subpoints, "doubtful receivables, if properly adjusted" had a total of 31 points, or 3.1 on average; "uncollectible receivables if properly adjusted" received 30 total points, an average of 3.0; and "discounting of receivables, if properly adjusted" had a total of 29 points, or 2.9 on average – all three of these subpoints were, according to their averages, considered to be "quite common and important" issues. "Valuation of receivables based on foreign currency", with 19 total points (1.9 on average) was evaluated as a "slightly common and not very important" issue.

The tax discrepancy and deficiency points concerning the prevalence or importance of the "receivables" group and the total and average grades given by tax auditors are as follows:

D&D sub points for receivables	**Total grade**	**Average**
Transfer pricing through receivables	46	4.6
Thin capitalization through receivables	45	4.5
Doubtful receivables, if properly adjusted	31	3.1
Uncollectible receivables if properly adjusted	30	3.0
Discounting of receivables, if properly adjusted	29	2.9
Valuation of receivables based on foreign currency	19	1.9

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In addition to the subpoints arising from the exploratory research phase, comments offered by the survey participants concerning tax deficiencies and discrepancies for the receivables are as follows:

-In the compliance determination of doubtful receivables, an analysis is necessary for whether the sales volume and doubtful receivables are commensurate or not.

-Thin capitalization through receivables may be come into being by means of receivables which are not collected from related parties to fund them.

-In transfer pricing through receivables, whether a contract and/or a decision by the board of directors specifying sales and/or purchases conditions are researched by tax inspectors.

3.2.8. Inventories

The tax discrepancy and deficiency risks concerning the “Inventories” group of accounts were determined to comprise 8 subpoints. Of these, “appropriateness test of output ratios and wastage ratios” at a total of 43 points, 4.3 on average; “cost of goods sold; whether calculated properly” at a total of 42, on average 4.2; and “inventory errors” at a total of 39, on average 3.9 were all found to be “quite common and important” issues in tax auditing. “Equivalent value in valuation, if properly applied” at a total of 29 points, on average 2.9, was found to be a “somewhat common and important” issue. Both “lower of cost or market rule, if properly applied” and “allowances for value decrease of inventories” had a total of 19, on average 1.9, making them “slightly common and not very important” issues, while “inventory overages and shortages” at a total of 11, on average 1.1, making it “neither common nor important at all” issues.

The tax discrepancy and deficiency points concerning the prevalence or importance of the “inventories” group and the total and average grades given by tax auditors are as follows:

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D&D sub points for inventories	Total grade	Average
Appropriateness test of output ratios and wastage ratios	43	4.3
Cost of goods sold; whether calculated properly	42	4.2
Inventory errors	39	3.9
Equivalent value in valuation, if properly applied	29	2.9
Lower of cost or market rule, if properly applied	19	1.9
Allowances for value decrease of inventories	19	1.9
Inventory overages and shortages	11	1.1

In addition to the subpoints arising from the exploratory research phase, comments offered by the questionnaire participants concerning tax deficiencies and discrepancies for the "inventories" group of accounts are as follows:

-Inventory mistakes may concern interim tax periods.

-Especially in manufacturing entities, determination of part of secondary materials, scraps, supplies, raw materials which belong to the period and their resell shall be considered as an issue in tax auditing.

3.2.9. Tangible fixed assets

The tax discrepancy and deficiency risks concerning "tangible fixed assets" were determined to comprise 10 subpoints. Of these, both "transfer pricing through real estate sales" with a total of 46, on average 4.6, and "depreciations, whether allocated appropriately" with a total of 45, on average 4.5 were deemed "very common and highly important" issues, while "loan interest and/or exchange differences recorded directly as expenses for the capitalization term" with a total of 41, on average 4.1 was found to be a "quite common and important" issue. "Determination of the cost value of tangible fixed assets purchased, manufactured, or constructed" with a total of 33, on average 3.3; "improvements that increase the cost of real estate, whether included in the cost or written off as expenses directly" with a total of 32, on average 3.2; "Assets in casualty losses to be based on appraisal commission decision" with a total of 30, on average 3.0; and "renewal fund, whether allocated properly" with a total of 28, on

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average 2.8 were rated as "somewhat common and important" issues in tax auditing. "Value Added Tax paid at acquisition for automobiles" with a total of 18, and an average of 1.8 was found to be a "slightly common and not very important" issue, while "tangible fixed assets with completed useful life, but still in records; unrecorded sales of tangible fixed assets as scrap" with a total of 12, on average 1.2 were deemed to be "neither common nor important" issues.

The tax discrepancy and deficiency points concerning the prevalence or importance of the "tangible fixed assets" group and the total and average grades given by tax auditors are as follows:

D&D sub points for tangible fixed assets	Total grade	Average
Transfer pricing through real estate sales	46	4.6
Depreciations, whether allocated appropriately	45	4.5
Loan interest and/or exchange differences recorded directly as expenses for the capitalization term	41	4.1
Determination of the cost value of tangible fixed assets purchased, manufactured, or constructed	33	3.3
Improvements that increase the cost of real estate; whether included in cost or written off as expenses	32	3.2
Assets in casualty losses not to be based on appraisal commission decision	30	3.0
Renewal fund; whether allocated properly	28	2.8
Value Added Tax paid on acquisition for automobiles	18	1.8
Assets completed useful life, but still in records; unrecorded sales of tangible fixed assets as scrap	12	1.2

3.2.10. Leasing

The tax discrepancy and deficiency risks concerning "leasing" were determined to comprise 5 subpoints. Of these, "transfer pricing through leasing transactions" with a total of 47, on average 4.7, was deemed a "very common and

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highly important" issue, while both "for operational leasing, whether lease payments are recorded as expenses in equal amounts" with a total of 42, on average 4.2, and "for lessee, depreciations whether allocated appropriately (the rule of lower of market or net present value of lease payments)" with a total of 39, on average 3.9 were rated as "quite common and important" issues. "Leasehold improvements; whether depreciated over the term of the lease in equal amounts" with a total of 27, on average 2.7 was found to be a "somewhat common and important" issue, and "interest expenses for lease payments" with a total of 13, on average 1.3 was considered a "neither common nor important" issue.

The tax discrepancy and deficiency points concerning the prevalence or importance of the "leasing" group and the total and average grades given by tax auditors are as follows:

D&D sub points for leasing	**Total grade**	**Average**
Transfer pricing through leasing transactions	47	4.7
For operational leasing, whether lease payments are recorded as expenses in equal amounts	42	4.2
For lessee, depreciations whether allocated appropriately	39	3.9
Leasehold improvements; whether depreciated over the term of the lease in equal amounts	27	2.7
Interest expenses for lease payments	13	1.3

3.2.11. Intangibles

The tax discrepancy and deficiency risks concerning "Intangibles" were determined to comprise 6 subpoints. Five of these subpoints were given a rating of 4 points or higher. "Transfer pricing of intangible assets" received the full 5 points from all respondents, 50 points in total, while "Leasing of intangible assets abroad; whether VAT and withholding tax withheld from gross payments" received 4 points from only two respondents, while the remaining eight gave it the full 5 points for an total of 48 points; both of the above supoints were thus deemed "very common and highly important" issues. Other than these top two issues, "amortization of intangible assets"

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with a total of 42, on average 4.2; "computer software costs, whether capitalized or expensed" with a total of 41, on average 4.1; and "valuation of intangible assets" with a total of 40, on average 4.0 were felt to be "quite common and important" issues in tax auditing. Of the intangible fixed assets group, only the "capitalized establishment and organization expenses written off expenses directly" sub point, with a total of 21 points, on average 2.1, was rated as a "slightly common and not very important" issue.

D&D points for intangible assets	**Total grade**	**Average**
Transfer pricing of intangible assets	50	5.0
Leasing of intangible assets abroad	48	4.8
Amortization of intangible assets	42	4.2
Computer software costs, whether capitalized or expensed	41	4.1
Valuation of intangible assets	40	4.0
Capitalized establishment and organization expenses written off expenses directly	21	2.1

In addition to the subpoints arising from the exploratory research phase, comments offered by the survey participants concerning tax deficiencies and discrepancies for the "intangible fixed assets" are as follows:

-Capitalization of intangibles is under debate. From some perspectives, intangibles such as know how, compilation, and movies should be recorded directly as expenses. However, from the auditors' perspective, these shall be capitalized.

-Internet sites should be taken as workplaces and capitalized.

3.2.12. Depleteble Assets

The tax discrepancy and deficiency risks concerning "depleteble assets" were determined to comprise only 1 subpoint. Of the auditors, 7 gave this issue only 1 point, deeming it "neither common nor important", while the remaining three gave it 2 points, raising its importance only to "slightly common and not very important". With a total of 13 points, on average 1.3, "valuation of depleteble assets" was considered "neither common nor important" either.

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D&D sub points for depleteble assets	Total grade	Average
Valuation of depleteble assets	13	1.3

As per tax auditors' additions, "depleteble assets" group of accounts may be important tax audit issue in terms of types of operations of entities.

3.2.13. Prepaid Expenses and Income Accruals

The tax discrepancy and deficiency risks concerning "prepaid expenses and income accruals" were determined to comprise 2 sub points. Of these, "accrued revenues; whether correct amounts are recorded in related income accounts" with a total of 41 points, on average 4.1, and "prepaid expenses, whether correct amounts are recorded in related expense account" with a total of 39, on average 3.9 were both found to be "quite common and important" issues in tax auditing.

D&D sub points for prepaid expenses and income accruals	Total Grade	Average
Accrued revenues; whether correct amounts recorded in related income accounts	41	4.1
Prepaid expenses; whether correct amounts recorded in related expense account	39	3.9

3.2.14. VAT Credit

The tax discrepancy and deficiency risks concerning VAT Credit were determined to comprise 4 subpoints. None of these received an average importance rating of 3 points or greater from the respondents. "Value added tax on invoices for the purchase of automobiles to businesses" with a total of 23, on average 2.3, and "value added tax on the goods which are lost" with a total of 22, on average 2.2, were determined to be "slightly common and not very important" issues. "Value added tax paid for expenses deemed non-deductible per IITL and CITL" with a total of 14, on average 1.4, and "value added tax on purchase invoices related to transactions which are

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non-taxable or exempted from value added tax" with a total of 13, on average 1.3, were considered to be "neither common nor important" issues.

D&D sub points for VAT Credit	Total grade	Average
Value added tax on invoices for the purchase of automobiles	23	2.3
VAT of the goods which are lost or stolen	22	2.2
Value added tax paid for expenses deemed non deductible per IITL and CITL	14	1.4
VAT on purchase invoices related to transactions which are non-taxable or exempted from value added tax	13	1.3

According to the tax auditors, tax deficiencies and discrepancies for value added tax credit will not be examined directly from movements in this account but rather from movements in related accounts.

3.2.15. VAT Received

The tax discrepancy and deficiency risks concerning VAT Received were determined to comprise 5 subpoints. None of these received an average score of 4 points or more. "Goods delivered and services rendered without charge" with a total of 37, on average 3.7, received the highest risk rating in this group – close in value, according to the valuation chart outlined above, to a "quite common and important" issue in tax auditing. "VAT of the goods in casualty losses" with a total of 26, on average 2.6, was deemed to be a "somewhat common and important" issue, while the remaining categories received a rating of "neither common nor important": "returns of goods purchased" had a total of 12 points, on average 1.2; "VAT for transactions not realized or abandoned" had a total of 11, on average 1.1; and "VAT received, if calculated properly" had a total of 10, on average 1.0.

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D&D sub points for value added tax received	Total grade	Average
Goods delivered and services rendered without charges	37	3.7
VAT of the goods in casualty losses	26	2.6
Returns of goods purchased	12	1.2
VAT for transactions not realized or abandoned	11	1.1
VAT received; if calculated properly	10	1.0

As per tax auditors' comments and additions, the accuracy of VAT received can be determined through an examination of sales. Term sale trends can be examined in terms of piling sales up.

3.2.16. Work Advances

The tax discrepancy and deficiency risks concerning "work advances" were determined to comprise 2 subpoints. Both subpoints in this group received a grade of 4 or higher. "Valuation of advances" with a total of 42, 4.2 on average; and "transfer pricing through work advances" with a total 41, and 4.1 on average were determined to be "quite common and quite important.

The tax discrepancy and deficiency points concerning the prevalence and importance work advances and the total and average grades given by tax auditors are as follows:

D&D sub points for work advances	Total grade	Average
Valuation of advances	42	4.2
Transfer pricing through work advances	41	4.1

3.2.17. Bank loans

The tax discrepancy and deficiency risks concerning "bank loans" were determined to comprise 4 subpoints. The first 2 sub points, "transfer pricing through bank loans" "thin capitalization through bank loans" were graded by all tax auditors

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with the full five points which means they are “very common and highly important” issues in tax auditing.

On the other hand “bank loan valuation” got 29 in total, and 2.9 on average; “valuation of bank loans in foreign currencies” 28 in total, and 2.8 on average meaning these issues were determined to be “slightly common and not very important”.

The tax discrepancy and deficiency points concerning the prevalence and importance of the bank loans group and the total and average grades given by tax auditors are as follows:

D&D sub points for the bank loans	**Total grade**	**Average**
Transfer pricing through bank loans	50	5.0
Thin capitalization through bank loans	50	5.0
Bank loan valuation	29	2.9
Valuation of bank loans in foreign currencies	28	2.8

3.2.18. Bonds and Notes Issued

During the exploratory research, the tax discrepancy and deficiency risks concerning “bonds and notes issued” were determined to comprise 3 sub points. All 3 sub points, “valuation of bonds and notes issued”, “transfer pricing through bonds and notes issued”, and “thin capitalization through bonds and notes issued” were graded by all tax auditors with the full five points which means they are “very common and highly important” issues in tax auditing.

The tax discrepancy and deficiency points concerning for prevalence and importance bonds and notes issued and the total and average grades are as follows:

D&D sub points for bonds and notes issued	**Total grade**	**Average**
Valuation of bonds and notes issued	50	5.0
Transfer pricing through bonds and notes issued	50	5.0
Thin capitalization through bonds and notes issued	50	5.0

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3.2.19. Trade Payables

During the exploratory research, the tax discrepancy and deficiency risks concerning "trade payables" were determined to comprise 4 sub points. "Thin capitalization through partners' current account" was graded by all tax auditors with the full five points which means they are "very common and highly important" issues in tax auditing. "Transfer pricing through trade payables", and "thin capitalization through trade payables" were graded mostly 4 and 5 by the tax auditors indicating these are "very common and highly important" issues in tax auditing. On the other hand "discounting of payables" got 22 on total, and 2.2 in average; meaning the issue was determined to be "slightly common and not very important".

The tax discrepancy and deficiency points concerning the prevalence and importance of the "trade payables" group and the total and average grades given by tax auditors are as follows:

D&D sub points for trade payables	Total grade	Average
Thin capitalization through partners' current account	50	5.0
Transfer pricing through trade payables	46	4.6
Thin capitalization through trade payables	45	4.5
Discounting of payables	22	2.2

3.2.20. Unearned Revenues and Accrued Expenses

The tax discrepancy and deficiency risks concerning "unearned revenues" and "accrued expenses" were determined to comprise 2 subpoints. "Unearned revenues; whether recorded as revenues in the related term" got 32 in total, 3.2 on average; "accrued expenses; whether recorded as expenses in the related term" 29 in total, 2.9 on average; meaning the issues were determined to be "somewhat common and important".

The tax discrepancy and deficiency points concerning the prevalence and importance of the "unearned revenues" and "accrued expenses" group and the total and average grades given by tax auditors are as follows:

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D&D sub points for unearned revenues and accrued expenses	Total grade	Average
Unearned revenues, whether recorded as revenues in the related term	32	3.2
Accrued expenses, whether recorded as expenses in the related term	29	2.9

3.2.21. Sales and Purchases

The tax discrepancy and deficiency risks concerning "sales and purchases" were determined to comprise 11 subpoints. "Sales without invoices", "transfer pricing of sales", "purchases with fake invoices", and "transfer pricing of purchases" were graded by all tax auditors with the full five points which means they are "very common and highly important" issues in tax auditing.

On the other hand "determination of cost of sales" got 43 in total, 4.3 on average; "purchased goods without documentation" 42 in total, 4.2 on average; "sales to companies in free zones/tax havens" 41 in total, 4.1 on average; "sales premium income not added to the term profit" 39 in total, 3.9 on average; "unrecorded purchase discounts 36 in total, 3.6 on average; meaning these issues were determined to be "quite common and important".

"Financing elements on deferred settlements not included in gross sales" received 31 in total, 3.1 on average; "net sale amount taken as VAT base instead of gross amount" 30 in total, 3.0 on average; meaning these issues were determined to be " somewhat common and somewhat important". None of the sales and purchases issues were given less than 30 in total.

The tax discrepancy and deficiency points concerning the prevalence and importance of the "sales and purchases" group and the total and average grades given by tax auditors are as follows:

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D&D sub points for the sales and purchases	Total grade	Average
Sales without invoices	50	5.0
Transfer pricing of sales	50	5.0
Purchases with fake invoices	50	5.0
Transfer pricing of purchases	50	5.0
Determination of cost of sales	43	4.3
Purchased goods without documentation	42	4.2
Sales to companies in free zones/tax havens	41	4.1
Sales premium income not added to the term profit	39	3.9
Unrecorded purchase discounts	36	3.6
Financing elements on deferred settlement not included in gross sales	31	3.1
Net sale amount taken as VAT base instead of gross amount	30	3.0

3.2.22. Imported Goods

The tax discrepancy and deficiency risks concerning "Imported goods" were determined to comprise 5 sub points. "Transfer pricing of imported goods", "discounts of imported goods not suited arm's length principle" were graded by all tax inspectors with the full five points which means they are "very common and highly important" issues in tax auditing.

On the other hand "valuation of imported goods at cost value" got 47 in total, 4.7 on average; "financing elements on deferred settlement for imported goods" got 46 in total, 4.6 on average; meaning these issues were also determined to be "very common and highly important" issues in tax auditing.

The tax discrepancy and deficiency points concerning the prevalence and importance of "imported goods" and the total and average grades given by tax auditors are as follows:

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D&D sub points for imported goods	Total grade	Average
Transfer pricing of imported goods	50	5.0
Discounts of imported goods not suited to arm's length	50	5.0
Valuation of imported goods	47	4.7
Financing elements on deferred settlement for import	46	4.6

3.2.23. Research and Development Expenses

The tax discrepancy and deficiency risks concerning "research and development expenses" were determined to comprise 2 subpoints. "Research and development expenses written off as expenses directly" got 33 in total, 3.3 on average; "More than 40% of research and development expenses written of as expenses" 32 in total, 3.2 on average; meaning the issues were determined to be "somewhat common and important" issues in tax auditing. The tax discrepancy and deficiency points concerning the prevalence and importance of "research and development expenses" and the total and average grades given by tax auditors are as follows:

D&D sub points for research and development expenses	Total grade	Average
Research and development expenses written off as expenses directly	33	3.3
More than 40% of research and development expenses written of as expenses	32	3.2

3.2.24. Establishment and Organization Expenses

During the exploratory research, the tax discrepancy and deficiency risks concerning "establishment and organization expenses" were determined to comprise only one subpoint. "Capitalized establishment and organization expenses written off as expenses directly" got 21 in total, 2.1 on average meaning the issue was determined to be "slightly common and not very important" in tax auditing.

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3.2.25. Marketing, Sales and Distribution Expenses

The tax discrepancy and deficiency risks concerning "marketing, sales and distribution expenses" were determined to comprise 2 subpoints. "Marketing, sales and distribution expenses belonged to the goods in inventories" got 43 in total, 4.3 on average meaning the issue was determined to be "quite common and important" in tax auditing. "Inappropriate expenses recorded as marketing, sales and distribution expenses" got 33 in total, 3.3 on average meaning the issue was determined to be "somewhat common and somewhat important" in tax auditing.

The tax discrepancy and deficiency points concerning the prevalence and importance of "marketing, sales and distribution expenses" and the total and average grades given by tax auditors are as follows:

D&D sub points for marketing, sales and distribution expenses	**Total grade**	**Average**
Marketing, sales and distribution expenses belonged to the goods in inventories	43	4.3
Inappropriate expenses recorded as marketing, sales and distribution expenses	33	3.3

3.2.26. General Administration Expenses

The tax discrepancy and deficiency risks concerning general administration expenses were determined to comprise 3 subpoints. "High business expenses" got 33 in total, 3.3 on average; "transfer of private expenses to business" 32 in total, 3.2 on average; and "inappropriate expenses recorded as general administration expenses" got 30 in total, 3.0 on average; meaning all issues were determined to be "somewhat common and important" in tax auditing.

The tax discrepancy and deficiency points concerning prevalence and importance of "general administration expenses" and the total and average grades given by tax auditors are as follows:

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D&D sub points for general administration expenses	Total grade	Average
High business expenses	33	3.3
Transfer of private expenses to business	32	3.2
Inappropriate expenses recorded as general administration expenses	30	30

3.2.27. Vehicle Expenses

The tax discrepancy and deficiency risks concerning vehicle expenses were determined to comprise 3 subpoints. “Expenses for vehicles which are not part of an entity, leased, or used in the business” got 44 in total, 4.4 on average; “expenses made to increase the value of a vehicle” 41 in total, 4.1 on average meaning both issues were determined to be “quite common and important” in tax auditing.

The tax discrepancy and deficiency points concerning prevalence and importance of “vehicle expenses” and the total and average grades given by tax auditors are as follows:

D&D sub points for vehicle expenses	Total grade	Average
Expenses for vehicles which are not part of an entity, leased, or used in the business	44	4.4
Expenses made to increase the value of a vehicle	41	4.1

3.2.28. Wages

The tax discrepancy and deficiency risks concerning “wages” were determined to comprise 3 subpoints. “Wages paid abroad from Turkey by a Turkish company” got 43 in total, 4.3 on average; “all kinds of benefits in gross amounts provided for employees” 42 in total, 4.2 on average meaning both issues were determined to be “quite common and important” in tax auditing. On the other hand, Private insurance expenses more than social insurance got 26 in total, 2.6 on average meaning the issue was determined to be “somewhat common and important” in tax auditing.

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The tax discrepancy and deficiency points concerning the prevalence and importance of “wages” and the total and average grades given by tax auditors are as follows:

D&D sub points for wages	Total grade	Average
Wages paid abroad from Turkey by Turkish company	43	4.3
All kinds of benefits in gross amounts provided for employees	42	4.2
Private insurance expenses more than social insurance	26	2.6

3.2.29. Dividend Income from Subsidiaries and Associates

“Income/loss arising from sales of stock shares recorded in the dividend income” got 13 in total, 1.3 on average meaning the issue was determined to be “neither common nor important” issue in tax auditing.

3.2.30. Interest Income

As it has already been included in the cash in banks group in the balance sheet items, interest income herein is not evaluated again as income statement items.

3.2.31. Gains/Losses on the Sale of Marketable Securities

As it has already been included in the marketable securities group in the balance sheet items, gains/losses on the sale of marketable securities herein are not evaluated again as income statement items.

3.2.32. Foreign Exchange Gains/Losses

As it has already been included in the balance sheet items wherever necessary, foreign exchange gains/losses are herein not evaluated again as income statement items.

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3.2.33. Discount Interest Income/Expenses

As it has already been included in the receivables and payables group in the balance sheet items, discount interest income/expenses herein are not evaluated again as income statement items.

3.2.34. Allowance Expenses

As it has already been included in the marketable securities, receivables and inventories groups in the balance sheet items, allowance expenses herein are not evaluated again as income statement items.

3.2.35. Finance Expenses

The tax discrepancy and deficiency risks concerning finance expenses were determined to comprise 10 sub points. “Finance expenses involved in capitalization” and “finance expenses involved in transfer pricing” were graded by all tax auditors with the full five points which means they are “very common and highly important” issues in tax auditing.

On the other hand “finance expenses not properly calculated” 43 in total, 4.3 on average; “improper allocation of finance expenses concerning goods purchased or produced” 42 in total, 4.2 on average; “finance expenses concerning loans utilized by other entities” 41 in total, 4.1 on average; “finance expenses related to loans used for investment financing and exchange differences arising due to import of tangible fixed assets for foreign credit” 41 in total, 4.1 on average; “finance expenses concerning the purchase of stock shares” 39 in total, 3.9 on average, “finance expenses not related to the business” 39 in total, 3.9 on average; meaning all issues were determined to be “quite common and important” in tax auditing.

The tax discrepancy and deficiency points concerning prevalence and importance finance expenses and the total and average grades given by tax auditors are as follows:

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D&D sub points for finance expenses	Total grade	Average
Finance expenses involved in thin capitalization	50	5.0
Finance Expenses involved in transfer pricing	50	5.0
Distribution of finance expenses in holding companies	44	4.4
Finance expenses not properly calculated	43	4.3
Improper allocation of finance expenses concerning goods purchased or produced	42	4.2
Finance expenses concerning loans utilized by others	41	4.1
Finance expenses related to loans used for investment financing and exchange differences arising due to import	41	4.1
Finance expenses concerning the purchase of shares	39	3.9
Finance expenses not related to the business	39	3.9

3.3. Determination of Focal Points

Probable deficiencies and discrepancies which may indicate tax evasion in tax auditing listed above per item groups on the balance sheet and income statement, the following evaluation scale was applied: (5) Very common and highly important, (4) Quite common and important, (3) Somewhat common and important, (2) Slightly common and not very important, (1) Neither common nor important..

In this section, the focal points of the deficiencies & discrepancies encountered by tax auditors, as explained in the field study, are classified and discussed for the whole list.

In the determination of the level of importance and prevalence of probable tax deficiencies and discrepancies, the following evaluation scale in total was applied:

Total Grade

45-50 Very common and highly important

35-44 Quite common and important

25-34 Somewhat common and important

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15-24	Slightly common and not very important
10-14	Neither common nor important at all

Particular deficiencies and discrepancies from the tax audit standpoint that have been determined to be applicable for this survey have been put in order according to the scores below, ranked from the highest scoring items to the lowest.

3.3.1. Very common and highly important D&D sub points for all groups

	Total grade	Average
1-Large or unusual cash disbursement	50	5.0
2-Transfer pricing of intangible assets	50	5.0
3- Thin capitalization through partners' current account	50	5.0
4- Transfer pricing through bank loans	50	5.0
5- Thin capitalization through bank loans	50	5.0
6- Finance expenses involved thin capitalization	50	5.0
7- Finance Expenses involved transfer pricing	50	5.0
8-Excessive balance of cash on hand	50	5.0
9- Valuation of bonds and notes issued	50	5.0
10- Transfer pricing through bonds and notes issued	50	5.0
11- Thin capitalization through bonds and notes issued	50	5.0
12- Sales without invoices	50	5.0
13- Transfer pricing of sales	50	5.0
14- Purchases with fake invoices	50	5.0
15- Transfer pricing of purchases	50	5.0
16- Transfer pricing of imported goods	50	5.0
17- Discounts of imported goods not suited arm's length principle	50	5.0
18- Leasing of intangible assets abroad	48	4.8
19- Valuation of imported goods	47	4.7
20- Futures, forward contracts and options used for tax deferral	47	4.7
21- Transfer pricing through leasing transactions	47	4.7

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22- Transfer pricing through trade payables	46	4.6
23- The funds considered to be foreign but in fact Turkish	46	4.6
24- Transfer pricing through receivables	46	4.6
25- Financing elements on deferred settlement for imported goods	46	4.6
26- Valuation of foreign stock shares	46	4.6
27- Transfer pricing through real estate sales	46	4.6
28- Thin capitalization through receivables	45	4.5
29- Stock share sales to related parties	45	4.5
30- Depreciations, whether allocated appropriately	45	4.5
31- Thin capitalization through trade payables	45	4.5

3.3.2. Quite common and important D&D sub points for all groups

	Total grade	Average
1- Distribution of finance expenses in holding companies	44	4.4
2- Expenses for vehicles which are not part of an entity, leased, or used in the business	44	4.4
3- Wages paid abroad from Turkey by a Turkish company	43	4.3
4- Appropriateness test of output ratios and wastage ratios	43	4.3
5- Finance expenses not properly calculated	43	4.3
6- Determination of cost of sales	43	4.3
7- Marketing, sales and distribution expenses belonged to the goods in inventories	43	4.3
8- Purchased goods without documentation	42	4.2
9- For operational leasing, whether lease payments recorded as expenses in equal amounts	42	4.2
10- All kinds of benefits in gross amounts provided for employees	42	4.2
11- Valuation of fund participation certificates	42	4.2
12- Cost of goods sold; whether calculated properly	42	4.2

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13-Amortization of intangible assets	42	4.2
14- Improper allocation of finance expenses concerning goods purchased or produced	42	4.2
15- Valuation of work advances	42	4.2
16- Transfer pricing through work advances	41	4.1
17- Finance expenses concerning loans utilized by other entities	41	4.1
18- Finance expenses related to loans used for investment financing and Exchange differences arising due to import of tangible fixed assets for foreign credit	41	4.1
19- Computer software costs whether capitalized or expensed	41	4.1
20- Expenses made to increase the value of a vehicle	41	4.1
21- Loan interest and/or exchange differences recorded directly as expenses for the capitalization term (for tangible fixed assets)	41	4.1
22-Accrued revenues; whether correct amounts recorded in related income account	41	4.1
23- Sales to companies in free zones/tax havens	41	4.1
24- Valuation of intangible assets	40	4.0
25– Prepaid expenses; whether correct amounts are recorded in related expense account	39	3.9
26- Valuation of bills and bonds	39	3.9
27- Valuation of stock certificates	39	3.9
28- Inventory errors	39	3.9
29- For lessee, depreciations for financial leasing whether allocated appropriately (the rule of lower of market or net present value of lease payments)	39	3.9
31- Sales premium income not been added to the term profit	39	3.9
32- Finance expenses concerning the purchase of stock shares	39	3.9
33- Finance expenses are not related to the business	39	3.9
34- The goods delivered and services rendered without charges	37	3.7

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35- Unrecorded purchase discounts	36	3.6

3.3.3. Somewhat common and important D&D sub points for all groups

1- Transfer pricing using bartering checks received	33	3.3
2- Determination of the cost value of tangible fixed asset purchased, manufactured, or constructed	33	3.3
3- Inappropriate expenses recorded as marketing, sales and distribution expenses	33	3.3
4- High business expenses as general administration expenses	33	3.3
5- Research and development expenses written off as expenses directly	33	3.3
6- More than 40% of research and development expenses written of as expenses	32	3.2
7- Improvements that increase the cost of real estates (tangible fixed assets); whether included in cost or written off as expenses directly	32	3.2
8- Discount interest income/expenses	32	3.2
9- Transfer of private expenses to business	32	3.2
10- Unearned revenues; whether recorded as revenues in the related term	32	3.2
11- Financing element on deferred settlement not included in gross sales	31	3.1
12- Thin capitalization using bartering checks received	31	3.1
13- Interest income of time deposits for cash in banks	31	3.1
14- Doubtful receivables, if properly adjusted	31	3.1
15- Uncollectible receivables if properly adjusted	30	3.0
16- Tangible fixed assets in casualty losses to be based on appraisal commission decision	30	3.0
17- Net sales amount taken VAT base instead of gross amount	30	3.0
18- Inappropriate expenses recorded as general administration expenses	30	3.0

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19- Discounting of checks received	29	2.9
20- Determination of sale profit (loss) for stock shares acquired due to capital increase	29	2.9
21- Accrued expenses; whether recorded as expenses in the related term	29	2.9
22- Bank loan valuation	29	2.9
23- Equivalent value in valuation, if properly applied	29	2.9
24- Discounting of receivables, if properly adjusted	29	2.9
25- Valuation of bank loans in foreign currencies	28	2.8
26- Renewal fund (for tangible fixed assets); whether allocated properly	28	2.8
27- Leasehold improvements; whether depreciated over the term of the lease in equal amounts	27	2.7
28- VAT of the goods in casualty losses, whether they are added to calculated VAT	26	2.6
29- Private insurance expenses more than social insurance	26	2.6

3.3.4. Slightly common and not very important D&D sub points for all groups

1-Value added tax on invoices for the purchase of automobiles to businesses	23	2.3
2- Exchange rate valuation of foreign currency cash in banks	22	2.2
3- Allowances for value decreases of stock certificates	16	1.6
4- Value added tax of the goods which are lost	22	2.2
5- Discounting of trade payables	22	2.2
6- Capitalized establishment and organization expenses written off expenses directly	21	2.1
7- Interest income not included in taxable income as a gross value	20	2.0
8- Recognition of interest income for cash in banks	20	2.0
9- Valuation of checks received denominated in foreign		

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currency	19	1.9
10- Interest income of repurchase agreements for cash in banks	19	1.9
11- Valuation of receivables based on foreign currency	19	1.9
12- Lower of cost or market rule, if properly applied (for inventories)	19	1.9
13- Allowances for value decrease of inventories	19	1.9
14- Valuation of foreign cash on hand	19	1.9
15- Value Added Tax paid at the acquisition of automobiles (tangible fixed assets);	18	1.8

3.3.5. Neither common nor important D&D sub points for all groups

1- Value added tax paid for expenses which are deemed non deductible per IITL and CITL	14	1.4
2- Value added tax on purchase invoices related to transactions which are non-taxable or exempted from value added tax	13	1.3
3- Interest expenses for lease payments	13	1.3
4- Valuation of depleteble assets	13	1.3
5- Checking credit card sales and their invoices for other liquid assets	13	1.3
6-Tangible fixed assets completed depreciation life, but still in records; unrecorded sales of tangible fixed assets' as scrap	12	1.2
7- Returns of goods purchased	12	1.2
8- Cash on hand with credit balance	11	1.1
9- Transactions not realized or abandoned (VAT Received)	11	1.1
10- Inventory overages and shortages	11	1.1
11- VAT Received; if calculated properly	10	1.0
12- Overages and shortages cash on hand	10	1.0
13- Valuation of foreign currency in transit	10	1.0

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4. CONCLUSION

4.1. Focal Points of Tax Deficiencies and Discrepancies

As stated in the introduction to this dissertation, a corporate tax audit is defined as an examination of a corporation's books and documents to determine that its records and reporting requirements are in accordance with tax legislation as prescribed by tax laws and supplementary legislation. The first section of this study is correspondingly preoccupied with exploratory research conducted on basic financial statement items. This research has determined a number of problematic areas in the tax literature which has led to potential tax deficiencies and discrepancies.

However, it was determined that empirical qualitative research had to be conducted to gain a better understanding of the focal points of problematic deficiencies and discrepancies. Accordingly, the list of probable deficiencies and discrepancies was configured as an opinion survey to be presented to a selected group of professionals, in order to determine how they would evaluate the findings of the exploratory research phase of this study concerning probable tax deficiencies and discrepancies uncovered in basic financial statement items during tax auditing. The survey was organized to test the frequency of each item on the list on a scale of one (none) to five (most common).

These results narrowed the focus of the literature research conducted because they ordered the deficiencies and discrepancies from the most to least likely to occur, as well as taking into consideration any further problematic areas identified by those tax auditors who took part in the field study.

Through a comparison of the data collected from the selected professionals, the correlating focal points of those deficiencies and discrepancies most frequently encountered in basic financial statement items during tax auditing have been identified in the "Determination of Focal Points" part.

Accordingly the most common and important tax deficiencies and discrepancies faced in tax auditing are transfer pricing and thin capitalization. Besides

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transfer pricing and thin capitalization, “large or unusual cash disbursement”, “excessive balance of cash on hand”, “valuation of bonds and notes issued”, “sales without invoices”, “purchases with fake invoices”, “leasing of intangible assets from abroad, valuation of exported goods, futures, forward contracts and options used for tax deferment”, “Turkish funds considered to be foreign”, “valuation of foreign stock shares”, and “depreciations” are the other most common and important issues in tax auditing.

There is no comprehensive transfer pricing legislation in the Turkish Tax System. But thin capitalization and transfer pricing are covered in Corporate Tax Code Article 16 and 17 indicating some major characteristics of transfer pricing.[509] However, regulations concerning thin capitalization and transfer pricing have been rearranged in new Corporation Tax Law Article 12 and 13.

One of the most important results determined in this research is that transfer pricing and thin capitalization issues relate to several accounts on the balance sheet and income statement. Balance sheet and income statement items concerning thin capitalization and transfer pricing are shown below with their total grades and averages received in the field study for all groups.

	Total grade	Average
1-Transfer pricing of intangible assets	50	5.0
2- Thin capitalization through Partners’ current account	50	5.0
3- Transfer pricing through bank loans	50	5.0
4- Thin capitalization through bank loans	50	5.0
5- Finance expenses involved in thin capitalization	50	5.0
6- Finance expenses involved in transfer pricing	50	5.0
7- Transfer pricing through bonds and notes issued	50	5.0

[509] Mehmet AKTAŞ, **Uluslar arası Transfer Fiyatlandırması ve Türk Vergi Sistemindeki Konumu**, Yaklaşım Publishing, November 2003, Number: 131, p.84.

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8- Thin capitalization through bonds and notes issued	50	5.0
9- Transfer pricing through sales	50	5.0
10- Transfer pricing through purchases	50	5.0
11- Transfer pricing through imported goods	50	5.0
12- Discounts of imported goods not suited to arm's length principle	50	5.0
13- Transfer pricing through leasing transactions	47	4.7
14- Transfer pricing through trade payables	46	4.6
15- Transfer pricing through receivables	46	4.6
16- Transfer pricing through tangible fixed assets' sales	46	4.6
17- Thin capitalization through receivables	45	4.5
18- Stock shares sales to related parties as transfer pricing	45	4.5
19- Thin capitalization through trade payables	45	4.5
20- Transfer pricing through work advances	41	4.1
21- Sales to companies in free trade zones/tax havens	41	4.1
22- Transfer pricing using bartering checks	33	3.3
23- Thin capitalization using bartering checks	31	3.1

The tax discrepancy and deficiency risks concerning thin capitalization and transfer pricing were determined to comprise 23 sub points. The first 12 sub points were graded by all tax auditors with the full five points which means they are "very common and highly important" issues in tax auditing.

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The tax discrepancy and deficiency risks concerning thin capitalization and transfer pricing issues between 13-21 sub points were determined to be “quite common and important” in tax auditing.

The last two tax discrepancy and deficiency risks concerning “thin capitalization and transfer pricing issues” sub points number 22 and 23 were determined to be “somewhat common and important in tax auditing.

Very common and highly important issues other than transfer pricing and thin capitalization

The tax discrepancy and deficiency risks concerning cash on hand were determined to comprise 5 sub points. The first 2 sub points, “large or unusual cash disbursement” and “excessive balance of cash on hand” were graded by all tax auditors with the full five points which means they are “very common and highly important” issues in tax auditing.

The transaction volume of cash and cash equivalents in a year is significant. One of the most important issues in tax auditing is the ratio between yearly transaction volume of cash and cash equivalents and the capital and/or sales volume of an entity. In the case that sales/purchases volume is low, but cash movements from cash on hand and/or cash movements in bank accounts are relatively high, the entities shall be targeted in the initial investigation of a tax audit.

The tax discrepancy and deficiency risks concerning cash in banks were determined to comprise 5 sub points. No sub point in this group received a grade of 4 or higher. However according to tax auditors, shareholders, subsidiaries and/or associates’ investment and deposits accounts shall be investigated from the perspective of their relationship to the entity. These accounts may arise from the funds which have been transferred to the entity. In the determination of the income and fund transfers, related parties’ bank account details must be provided.

Other subpoints graded as very common and highly important issues in tax auditing are “valuation bonds and notes issued”, “sales without invoices”, “purchases

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with fake invoices", "leasing of intangible assets from abroad", "valuation of imported goods", "futures, forward contracts and options used for tax deferral", "Turkish funds considered to be foreign but in fact Turkish", "Financing elements on deferred settlement for imported goods", "valuation of foreign stock shares", "depreciations; whether allocated appropriately".

The issues other than thin capitalization and transfer pricing shown above were not given high ratings as much as these two central issues. Accordingly, the following sections explore these two issues (thin capitalization and transfer pricing) in greater depth.

4.2. Thin Capitalization

Sub points graded as very common and highly important issues in tax auditing for thin capitalization are "thin capitalization through Partners' current account", "thin capitalization through bank loans", "finance expenses involved in thin capitalization", "thin capitalization through bonds and notes issued", "thin capitalization through receivables", "thin capitalization through trade payables.

One the most common and important tax deficiencies and discrepancies faced in tax auditing is thin capitalization. It was stated in Corporate Tax Law Article 16. However, regulations concerning thin capitalization have been rearranged in new Corporation Tax Law Article 12. International practices, especially OECD practice, have been taken into consideration in the amendments.

As per the article, in the instance wherein the ratio of borrowings from partners or from persons related to partners exceeds triple the borrowing shareholder's equity at any time within the year, the portion in excess of three times the shareholder's equity shall be taken into account as thin capitalization for the related year.

In the application of this article, "persons related to partners" is defined as:

- A corporation in which the partner directly or indirectly owns at least 10% of shares, or voting rights or right to receive dividends.

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- a corporation or an individual that directly or indirectly owns at least 10 % of the capital, or voting rights or right to receive dividends from a partner or corporation related to the partner.

The above mentioned ratios shall be jointly taken into account for lending shareholders and the persons related to shareholders.

According to the amendments in the article:

- The “continuous use of the loan” requirement has been abolished,

- For related party loans, only the portion exceeding three times the shareholder’s equity shall be considered as thin capital,

-The related persons for partners are defined,

-Those situations which shall not be considered as thin capitalization are separately specified.

According to these new regulations, due to the extremely high ratio of allowed borrowings (1 to 3 in regular situations, and if banks and similar institutions are involved 1 to 6) from partners or from persons related to partners is allowed, the issue of thin capitalization will henceforth not be a very common nor highly important issue in tax auditing.

4.3. Transfer Pricing

Transfer pricing is a tax security provision to keep corporate income and in this way to preserve shareholders’ benefits. As one of the most important issues for corporations, transfer pricing is stated in Corporate Tax Law Article 17. However, regulations concerning transfer pricing have been rearranged in new Corporation Tax Law Article 12. International practices, especially OECD practice, have been taken into consideration in the amendments.

As per the new regulation, related parties are defined and methods are prescribed to determine transfer prices.

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"Transfer pricing" is an increasingly important and contentious area of the tax law in the U.S. and around the world.[510]

The transfer pricing literature has examined a number of different incentive problems: one is the "allocation of effort between products that are sold externally versus products that are transferred internally, and tax effects of transfer pricing versus incentive effects."[511]

The objectives of international transfer pricing focus on minimizing taxes, duties, and foreign exchange risks along with enhancing a company's competitive position and improving its relations with foreign governments. [512]

On the other hand, charging a high transfer price may help an MNC draw profits out of a country that has stringent controls on foreign remittances, it may allow an MNC to shift income from a country that has high income tax rates to a country that has low rates.[513]

As tax administrators become more aggressive in seeking revenues, transfer pricing examinations and litigation have increased in number and scope, and taxpayers have become increasingly vulnerable to double (or even triple) taxation.[514]

In the result of the field study, those sub points graded very common and highly important issues in tax auditing for transfer pricing are "transfer pricing through intangible assets", "transfer pricing through bank loans" "finance expenses involved in transfer pricing", "transfer pricing through bonds and notes issued", "transfer pricing through sales", "transfer pricing through purchases", "transfer pricing through imported goods", "discounts of imported goods not suited to arm's length principle", "transfer pricing through leasing transactions", "transfer pricing through trade payables", "transfer pricing through receivables", transfer pricing through tangible fixed assets'

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[510] http://www.jonesday.com/transfer_pricing/
[511] Richard A. Lambert, p. 66.
[512] Ray H. Garrison, Eric W. Noreen, **Managerial Accounting**, Ninth Edition, 2000, p.587.
[513] Ray H. Garrison, Eric W. Noreen, p.587.
[514] http://www.jonesday.com/transfer_pricing/

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sales", "stock shares sales to related parties as transfer pricing", "transfer pricing through work advances", "sales to companies in free trade zones/tax havens".

Accordingly, there is no doubt that, the most common and important tax deficiencies and discrepancies faced in tax auditing are found in the issue of transfer pricing.

If corporations enter into transactions regarding the purchase or sale of goods or services with related parties, where the prices are not set in accordance with the arm's length principle, then profits are considered to be distributed in a disguised manner through transfer pricing. Disguised profit distributions through transfer pricing are not accepted as tax deductible in the determination of corporate income.

Purchasing, selling, manufacturing and construction transactions, leasing transactions, borrowing and lending, transactions which require premiums, salaries and similar payments are considered as the purchase or sale of goods or services in every situation and under all conditions.

Accordingly, the phrase purchase or sale of goods or services comprises all economic, financial, commercial activities and employment relations between related parties.

In the text of the new regulation, all transactions with entities resident in countries or regions which have been proclaimed to cause harmful tax competition by the Council of Ministers, are considered to have been carried out with related parties.

Arm's length principle is defined as the application of the same prices for the purchase or sale of goods or services between related parties as the prices that would be determined had the same transactions been carried out between unrelated persons.

4.4. Unique Responses

One of the most important facets of qualitative research is the inclusion of professional respondents' own experience in the field. To accommodate and encourage the tax inspectors polled to share their valuable experiences and thereby contribute

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directly to the findings of the research, the questions listed below were asked. The professionals' responses are also listed and analyzed in-depth throughout this section.

In the current approach to tax auditing, a great deal of time is lost due to the non-standardization inherent in today's tax auditing techniques in Turkey. Therefore, respondents were accordingly asked the following two questions: whether the tax deficiencies and discrepancies identified in the survey would be helpful during the tax auditing processes, and whether a standardized auditing process would be implementable.

Two questions at the end of the tax discrepancies and deficiencies list would be answered were as follows:

1- Do you think the deficiencies and discrepancies listed in the survey would be helpful during the tax auditing?

Yes ____ No ____

Comments...

2- Do you think a standardized audit would be implementable, and if not, why?

Yes ____ No ____

Comments...

1. In response to the first question, every professional agreed that the list in this survey would, indeed, be helpful during the auditing process. Three respondents stated unconditionally that it would be helpful, while the remaining seven people found the list would be helpful under certain conditions. The first condition is that the tax professionals utilizing this list must have relatively the same amount of experience and knowledge. According to these seven respondents, an independent analysis of the items in the list is necessary; however, this alone is not sufficient for some items. For transfer pricing and thin capitalization in particular, in-depth analysis must be conducted. Moreover, connections and effects between accounts must be defined and analyzed,

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because most of the time, tax deficiencies and discrepancies are not related to a single account but rather to a number of accounts, requiring the scrutiny of the relationships between accounts as well. Therefore, the determination of tax deficiencies and discrepancies for one account is a proper and useful initial process during an audit; nevertheless, the majority of the time, in order to reach all potential deficiencies and discrepancies, an examination based on principles rather than on specific rules is necessary. The helpfulness of the prepared, standardized list will accordingly depend on the knowledge, experience, and performance of the tax inspectors involved in any particular audit.

2. In their answers to the second question, the same three tax professionals who stated unconditionally that the list in the survey would be helpful (in question one), also unconditionally agreed that standardized auditing would be implementable. The remaining seven respondents – those who answered the list would be helpful under certain conditions in the first question – responded that standardized auditing would also be implementable under certain conditions. According to this second group, standardized implementation would be difficult, since each entity's size and type of operation is unique, requiring a correspondingly unique focus on specific accounts and transactions in the tax auditing process. Therefore, a standardized audit cannot be applied due to these widely varying differences in operations. However, a standardized tax audit could be applied through an approach which takes into account certain basic principles for different types of entities.

4.5. Conclusion

At the current time, according to the data collected in the field study, the most important issues in tax auditing are thin capitalization and transfer pricing. However in the near future, the frequency and importance of thin capitalization will decrease due to the extremely high ratio of permitted borrowing between related parties because of new regulation in corporate income tax law. Simultaneously, with the expansion of multinational corporations, transfer pricing is in the process of becoming even more important and prevalent than it already is.

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One of the most important defaults to form a standard tax audit index is that the issues of transfer pricing and thin capitalization may be related to several items on the balance sheet and income statement. Therefore, in the determination of transfer pricing and thin capitalization, many items must be considered and evaluated together. The issues relating to transfer pricing and thin capitalization show application differences from entity to entity and/or from sector to sector.

On the other hand, the best approach to tax auditing is the utilization of a standardized list of tax deficiency and discrepancy on the part of experienced, knowledgeable, and high performing tax auditing professionals. While this research indicates that such a standardized list would quite probably time saving and effective, it is necessarily limited tool in and of itself as tax deficiencies and discrepancies are most likely to be uncovered in the relationship between multiple accounts rather than the examination of any single account.

Another conclusion to be drawn from the research herein is that each tax examination is unique. The standardized list of items presented in the field study as a result of the exploratory research phase, is a suggested list, neither all inclusive nor required in every tax examination. The accounts and transactions to be focused on must be decided by the tax professionals involved in any particular audit.

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APPENDICES

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APPENDIX 1: Questionnaire in English

A Tax Review of Basic Financial Statement Items and a Corrrelating Field Study to Determine Common Tax Evasion Issues

This survey is part of ongoing research for a dissertation entitled “Tax Review of Basic Financial Statement Items and A Correlating Field Study to Determine Common Tax Evasion Issues”. The purpose of this survey is to determine the importance and prevalence of particular evasion points in basic financial statement items from the tax audit standpoint.

Probable deficiencies and discrepancies which may indicate tax evasion in tax auditing are listed below. This research is solely directed towards corporations. In the determination of the level of importance and prevalence of probable tax deficiencies and discrepancies, the following evaluation scale will be applied:

(5) Very common and highly important
(4) Quite common and important
(3) Somewhat common and important
(2) Slightly common and not very important
(1) Not common nor important at all

For each item of the basic financial statement, assign a number according to the evaluation scale above, evaluating potential tax deficiencies and discrepancies in terms of prevalence and importance. Choose only one number for each situation. Your comments on the deficiencies and discrepancies included in the list, as well as any further deficiencies and discrepancies that you think should be added, would be appreciated in the “Comments/Additions” section at the end of every group of items.

There are two questions at the end of the tax discrepancies and deficiencies list. Subsequent to completing this list, these questions will be answered. Your significant contributions are greatly appreciated.

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Balance Sheet Items

1. Cash on hand

1.1. Large or unusual cash disbursement ( )

1.2. Valuation of foreign currency ( )

1.3. Cash on hand with credit balance ( )

1.4. Excessive balance of cash on hand ( )

1.5. Cash overages and shortages ( )

1.6. Comments/Additions…

2. Checks received

2.1. Discounting of checks ( )

2.2. Valuation of checks denominated in foreign currency ( )

2.3. Transfer pricing using bartering checks ( )

2.4. Thin capitalization using bartering checks ( )

2.5. Comments/Additions…

3. Cash in banks

3.1. Exchange rate valuation of foreign currencies ( )

3.2. Interest income of time deposits ( )

3.3. Interest income of repurchase agreements ( )

3.4. Recognition of interest income ( )

3.5. Comments/Additions…

4. Other liquid assets

4.1. Valuation of foreign currency in transit ( )

4.2. Checking credit card sales and their invoices ( )

4.3. Comments/Additions...

5. Stock certificates

5.1. Valuation of stock certificates ( )

5.2. Allowances for value decreases of stock certificates; whether

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adjustments done for tax purposes ( )

5.3. Stock share sales to related parties as transfer pricing ( )

5.4. Determination of sale profit (loss) for stock shares acquired due to capital increase ( )

5.5. Valuation of foreign stock shares ( )

5.6. Comments/Additions...

6. Marketable securities other than stock shares

6.1. Valuation of bills and bonds ( )

6.2. The funds considered to be foreign but in fact Turkish ( )

6.3. Valuation of fund participation certificates ( )

6.4. Futures, forward contracts and options used for tax deferral ( )

6.5. Comments/Additions...

7. Receivables

7.1. Valuation of receivables based on foreign currency ( )

7.2. Discounting of receivables, if properly adjusted ( )

7.3. Doubtful receivables, if properly adjusted ( )

7.4. Uncollectible receivables, if properly adjusted ( )

7.5. Thin capitalization through receivables ( )

7.6. Transfer pricing through receivables ( )

7.7. Comments/Additions...

8. Inventories

8.1. Inventory overages and shortages ( )

8.2. Inventory errors ( )

8.3. Cost of goods sold; whether calculated properly ( )

8.4. Lower of cost or market rule, if properly applied ( )

8.5. Equivalent value in valuation, if properly applied ( )

8.6. Appropriateness test of output ratios and wastage ratios ( )

8.7. Allowances for value decrease of inventories ( )

8.8. Comments/Additions...

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9. Tangible fixed assets

9.1. Determination of the cost value of tangible fixed asset purchased, manufactured, or constructed ( )

9.2. Improvements that increase the cost of real estates; whether included in cost or written off as expenses directly ( )

9.3. Transfer pricing through real estate sales ( )

9.4. Loan interest and/or exchange differences recorded directly as expenses for the capitalization term ( )

9.5. Depreciations, whether allocated appropriately ( )

9.6. Tangible fixed assets completed depreciation life, but still in records; unrecorded sales of tangible fixed assets' as scrap ( )

9.7. Renewal fund; whether allocated properly ( )

9.8. Assets in casualty losses not to be based on appraisal commission decision ( )

9.9. Value Added Tax paid at the acquisition of automobiles ( )

9.10. Comments/Additions...

10. Leasing transactions

10.1. Transfer pricing through leasing transactions ( )

10.2. For lessee, depreciations whether allocated appropriately (the rule of lower of market or net present value of lease payments) ( )

10.3. For lessee, interest expenses for lease payments ( )

10.4. For operational leasing, whether lease payments recorded as expenses in equal amounts ( )

10.5. Leasehold improvements; whether depreciated over the term of the lease in equal amounts ( )

10.6. Comments/Additions...

11. Intangible assets

11.1. Valuation of intangible assets ( )

11.2. Amortization of intangible assets ( )

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11.3. Transfer pricing of intangible assets ( )

11.4. Leasing of intangible assets abroad; whether value added tax and Withholding tax has been withheld from gross payments ( )

11.5. Computer software costs, whether capitalized or not ( )

11.6. Capitalized establishment and organization expenses written off expenses directly ( )

11.7. Comments/Additions...

12. Depleteble assets

12.1. Valuation of depleteble assets ( )

12.2. Comments/Additions...

13. Prepaid expenses and income accruals

13.1. Prepaid expenses; whether correct amounts recorded in related expense account ( )

13.2. Accrued revenues; whether correct amounts recorded in related income accounts ( )

13.3. Comments/Additions...

14. VAT Credit

14.1. Value added tax on purchase invoices related to transactions which are non-taxable or exempted from value added tax ( )

14.2. Value added tax on invoices for the purchase of automobiles ( )

14.3. Value added tax of the goods which are lost or stolen ( )

14.4. Value added tax paid for expenses deemed non deductible per IITL and CITL ( )

14.5. Comments/Additions...

15. VAT Received

15.1. VAT received; if calculated properly ( )

15.2. Goods delivered and services rendered without charges ( )

15.3. Returns of goods purchased ( )

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15.4. Transactions not realized or abandoned ( )

15.5. Value added tax of the goods in casualty losses ( )

15.6. Comments/Additions...

16. Work advances

16.1. Valuation of advances ( )

16.2. Transfer pricing through work advances ( )

16.3. Comments/Additions...

17. Bank loans

17.1. Bank loan valuation ( )

17.2. Valuation of bank loans in foreign currencies ( )

17.3. Transfer pricing through bank loans ( )

17.4. Thin capitalization through bank loans ( )

17.4. Comments/Additions...

18. Bonds and notes issued

18.1. Valuation of bonds and notes issued ( )

18.2. Transfer pricing through bonds and notes issued ( )

18.3. Thin capitalization through bonds and notes issued ( )

18.4. Comments/Additions...

19. Trade payables

19.1. Discounting of payables ( )

19.2. Thin capitalization through trade payables ( )

19.3. Transfer pricing through trade payables ( )

19.4. Thin capitalization through Partner current account ( )

19.5. Comments/Additions...

20. Unearned revenues and accrued expenses

20.1. Accrued expenses; whether recorded as expenses in the related term ( )

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20.2. Unearned revenues; whether recorded as revenues in the related term ( )

20.3. Comments/Additions...

Income Statement Items

1. Sales and purchases

1.1. Financing element on deferred settlement not included in gross sales ( )

1.2. Net sale amount taken as VAT base instead of gross amount ( )

1.3. Sales premium income not added to the term profit ( )

1.4. Determination of cost of sales ( )

1.5. Purchased goods without documentation ( )

1.6. Sales without invoices ( )

1.7. Transfer pricing of sales ( )

1.8. Sales to companies in free zones/tax havens ( )

1.9. Purchases with fake invoices ( )

1.10. Transfer pricing of purchases ( )

1.11. Unrecorded purchase discounts ( )

1.12. Comments/Additions...

2. Imported goods

2.1. Valuation of imported goods ( )

2.2. Financing elements on deferred settlement for imported goods ( )

2.3. Transfer pricing of imported goods ( )

2.4. Discounts not suited arm's length principle ( )

2.5. Comments/Additions...

3. Research and development expenses

3.1. Research and development expenses written off as expenses directly ( )

3.2. More than 40% of research and development expenses written of as expenses ( )

3.3. Comments/Additions...

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4. Establishment and organization expenses

4.1. Capitalized establishment and organization expenses written off expenses directly ( )

4.2. Comments/Additions...

5. Marketing, sales and distribution expenses

5.1. Inappropriate expenses have been recorded as marketing, sales and distribution expenses ( )

5.2. Marketing, sales and distribution expenses belonged to the goods in inventories ( )

5.3. Comments/Additions...

6. General administration expenses

6.1. Inappropriate expenses recorded as general administration expenses ( )

6.2. High business expenses ( )

6.3. Transfer of private expenses to business ( )

6.4. Expenses for vehicles which are not part of an entity or leased, or used in the business ( )

6.5. Expenses made to increase the value of a vehicle ( )

6.6. Comments/Additions...

7. Wages

7.1. Wages paid abroad from Turkey by a Turkish company ( )

7.2. Private insurance expenses more than social insurance ( )

7.3. All kinds of benefits in gross amounts provided for employees ( )

7.4. Comments/Additions...

8. Dividend income from subsidiaries and associates ( )

8.1. Income arising from sales of stock shares recorded in the dividend income ( )

8.2. Comments/Additions...

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9. Interest income

9.1. Time deposits not taken into consideration with their interest on the valuation date ( )

9.2. Repurchase agreements not taken into consideration with their interest on the valuation date ( )

9.3. Interest income not included in taxable income as a gross value ( )

9.4. Comments/Additions...

10 Gains/losses on the sale of marketable securities ( )

10.1. Comments/Additions...

11. Foreign exchange gains/losses

11.1. Foreign exchange gains/losses have not been properly valued and included in taxable income ( )

11.2. Comments/Additions...

12. Discount interest income/expenses

12.1. Interest income/expenses not properly calculated and included in taxable income ( )

12.2. Comments/Additions...

13. Allowance expenses

13.1. Allowance for diminution in the value of marketable securities ( )

13.2. Allowance for doubtful receivables ( )

13.3. Valuation for allowance for value decrease of inventories ( )

13.4. Comments/Additions...

14. Finance expenses

14.1. Finance expenses not properly calculated ( )

14.2. Distribution of finance expenses in holding companies ( )

14.3. Finance expenses concerning loans utilized by other entities ( )

14.4. Finance expenses related to loans used for investment financing

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and exchange differences arising due to importation of tangible

fixed assets for foreign credit ( )

14.5. Finance expenses concerning the purchase of stock shares ( )

14.6. Finance expenses involved thin capitalization ( )

14.7. Finance Expenses involved transfer pricing ( )

14.8. Finance expenses not related to the business ( )

14.9. Improper allocation of finance expenses concerning goods

purchased or produced ( )

14.10. Comments/Additions...

QUESTIONS

1- Do you think the deficiencies and discrepancies listed in the questionnaire would be helpful during the tax auditing?

Yes ____ No ____

Comments...

2- Do you think a standardized auditing would be implementable, and if not, why?

Yes ____ No ____

Comments...

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APPENDIX 2: Questionnaire in Turkish

Finansal Tablo Kalemlerinin Vergisel Analizi ve Yaygın Vergi Kaçak Konularını Saptayan Bağlantılı Bir Alan Çalışması

Bu araştırma "Temel Mali Tablo Kalemlerinin Vergisel Analizi ve Yaygın Vergi Kaçak Konularını Saptayan Bağlantılı Bir Alan Çalışması" konulu doktora tezi için yapılan çalışmanın bir parçasıdır. Araştırmanın amacı vergi incelemesinde temel mali tablo kalemleri yönünden vergi kaçaklarının önem ve yaygınlık derecelerini tespit etmektir.

Temel mali tablo kalemlerinin vergisel analizi sonucunda vergi kaçaklarına yol açabilecek olası hata ve noksanlıklar aşağıda sıralanmıştır. Araştırma kurumlar vergisi mükelleflerine yöneliktir. Hata ve noksanlıkların hangi oranda önemli ve yaygın olduğunun belirlenmesinde aşağıda yer alan derecelendirme tablosu uygulanacaktır.

(5) Çok yaygın ve çok önemli
(4) Oldukça yaygın ve önemli
(3) Kısmen yaygın ve önemli
(2) Az yaygın ve önemli değil
(1) Hiç yaygın ve hiç önemli değil

Derecelendirme tablosunda yer alan beş kategoriyi kullanarak temel mali tablo kalemlerinin her biri için vergi kayıp ve kaçaklarının sizce ne kadar yaygın ve önemli olduğunu puanlayınız. Her bir durum için sadece bir sayı veriniz. Yorumlarınızı ve size göre vergi kaçağı konusu olabilecek olan ancak listede yer almayan hususları her hesap grubunun sonundaki yorumlar/ilaveler satırına ekleyiniz.

Vergi vergi kayıp kaçakları listesinin sonunda iki adet soru bulunmaktadır. Puanlama işlemleri tamamlandıktan sonra bu sorular cevaplandırılacaktır.

Yaptığınız önemli katkı nedeniyle içten teşekkürler.

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Bilanço Kalemleri

1. Kasa

1.1.Büyük ya da aşırı tutarlarda nakit ödemeler

1.2. Yabancı paraların değerlemesi

1.3. Kasanın alacak bakiyesi vermesi

1.4. Aşırı tutarlarda kasa bakiyesi

1.5. Kasa sayım fazlalık ve noksanlıkları

1.6. Yorumlar/İlaveler...

2. Alınan çekler

2.1. Çeklerin reeskonta tabi tutulması

2.2. Yabancı paraya dayalı çeklerde değerleme

2.3. Çek takası yoluyla transfer fiyatlandırması

2.4. Çek takası yoluyla örtülü sermaye

2.5. Yorumlar/İlaveler...

3. Bankalar

3.1. Yabancı paraların kur değerlemesi

3.2. Vadeli mevduatın faiz geliri

3.3. Reponun faiz geliri

3.4. Faiz gelirlerinin muhasebeleştirilmesi

3.5. Yorumlar/İlaveler...

4. Diğer hazır değerler

4.1. Yoldaki yabancı paraların kur değerlemesi

4.2. Kredi kartı ile satışlar ve fatura bilgilerinin karşılaştırılması

4.3. Yorumlar/İlaveler...

5. Hisse senetleri

5.1. Hisse senetlerinin değerlemesi

5.2. Hisse senetlerinin değer düşüklüğü karşılıkları; şayet karşılık ayrılmışsa mali kar için düzeltme yapılıp/yapılmadığı

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5.3. İlişkili kişilere hisse senedi satışları

5.4. Sermaye artışı nedeniyle iktisap edilen hisse senetlerinin satış kar zararının tespiti

5.5. Yabancı hisse senetlerinin değerlemesi

5.6. Yorumlar/İlaveler...

6. Hisse senetleri dışında kalan menkul kıymetler

6.1. Tahvil ve bonoların değerlemesi

6.2. Yabancı fon olarak değerlendirilen ancak gerçekte yabancı olmayan fonlar

6.3. Fon katılma belgelerinin değerlemesi

6.4. Futures, forward ve opsiyonların vergi ertelemesi için kullanılması

6.5. Yorumlar/İlaveler…

7. Alacaklar

7.1. Yabancı paraya dayalı alacakların değerlemesi

7.2. Alacakların reeskontu

7.3. Şüpheli alacaklar

7.4. Değersiz alacaklar

7.5. Alacaklar vasıtasıyla örtülü sermaye

7.6. Alacaklar vasıtasıyla transfer fiyatlandırması

7.7. Yorumlar/İlaveler…

8. Stoklar

8.1. Stok fazlalık ve noksanlıkları

8.2. Stok hataları

8.3. Satılan malların maliyetinin tespiti

8.4. Maliyet bedeli ya da emsal bedelin düşük olanının uygulanması

8.5. Değerlemede emsal bedel uygulamasının doğruluğu

8.6. Fire oranları ve ürün rasyolarının uygunluk testi

8.7. Stokların değer düşüklüğü karşılıklarının ayrılması

8.8. Yorumlar/İlaveler…

9. Maddi duran varlıklar

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9.1. Satın alınan, üretilen ya da inşa edilen maddi duran varlıkların maliyet bedelinin tespiti

9.2. Gayrimenkullerin özel maliyet bedellerinin aktifleştirilmesi ya da doğrudan gider yazılması

9.3. Gayrimenkul satışları vasıtasıyla transfer fiyatlandırması

9.4. Finansman giderlerinin ve/veya kur farklarının aktifleştirilmek yerine doğrudan gider yazılması

9.5. Amortismanların uygunluğu

9.6. Amortisman süresini dolduran ve halen kayıtlarda gözüken maddi duran varlıkların hurda satışlarının kaydedilmemesi

9.7. Yenileme fonunun uygunluğu

9.8. Takdir komisyonu kararına dayanmayan zayi olan mallar

9.9. Binek oto iktisabında ödenen KDV

9.10. Yorumlar/İlaveler…

10. Leasing İşlemleri

10.1. Leasing işlemleri vasıtasıyla transfer fiyatlandırması

10.2. Kiracı için amortisman uygulamasının doğruluğu (borsa rayici ya da kira ödemelerinin net bugünkü değerinin düşük olanı ile değerleme)

10.3. Kiracı için kira ödemelerinin faiz giderleri

10.4. Operasyonel leasing'de kira ödemelerinin eşit dağıtılmaması

10.5. Özel maliyet bedellerinin kira dönemi süresince eşit tutarlarda amorti edilip/edilmediği

10.6. Yorumlar/İlaveler…

11. Maddi olmayan duran varlıklar

11.1. Maddi olmayan duran varlıkların değerlemesi

11.2. Maddi olmayan duran varlıkların amortismanı

11.3. Maddi olmayan duran varlıkların transfer fiyatlandırması

11.4. Yurt dışından maddi olmayan duran varlık kiralanması; brüt ödemeler üzerinden KDV ve stopaj yapılıp/yapılmadığı

11.5. Bilgisayar yazılımlarının aktifleştirilip/aktifleştirilmediği

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11.6. Aktifleştirilen kuruluş ve örgütlenme giderlerinin doğrudan gider yazılması

11.7. Yorumlar/İlaveler ...

12. Özel tükenmeye tabi varlıklar

12.1. Özel tükenmeye tabi varlıkların değerlemesi

12.2. Yorumlar/İlaveler ...

13. Peşin ödenen giderler ve gelir tahakkukları

13.1. Peşin ödenen giderler; doğru tutarların ilgili gider hesaplarına kaydedilip/kaydedilmediği

13.2. Gelir tahakkukları; doğru tutarların ilgili gelir hesaplarına kaydedilip/kaydedilmediği

13.3. Yorumlar/İlaveler…

14. İndirilebilir KDV

14.1. KDV ye tabi olmayan yada muaf tutulan işlemlerle ilgili alış faturalarında gösterilen KDV

14.2. Binek otomobillere ait faturalarda gösterilen KDV

14.3. Çalınan ya da kaybolan malların KDV

14.4. GVK ve KVK'na göre indirilmesi kabul olunmayan giderlerin KDV

14.5. Yorumlar/İlaveler …

15. Hesaplanan KDV

15.1. KDV'nin doğru hesaplanıp/hesaplanmadığı

15.2. Bedelsiz mal ve hizmet teslimleri

15.3. Satın alınan malların iadesi

15.4. Gerçekleşmeyen yada iptal edilen işlemler

15.5. Zayi olan malların KDV

15.6. Yorumlar/İlaveler …

16. İş avansları

16.1. Avansların değerlemesi

16.2. İş avansları vasıtasıyla transfer fiyatlandırması

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16.3. Yorumlar/İlaveler...

17. Banka kredileri
17.1. Banka kredilerinin değerlemesi
17.2. Yabancı paraya dayalı banka kredilerinin değerlemesi
17.3. Banka kredileri vasıtasıyla transfer fiyatlandırması
17.4. Banka kredileri vasıtasıyla örtülü sermaye
17.5. Yorumlar/İlaveler...

18. Çıkarılmış tahvil ve bonolar
18.1. Çıkarılmış tahvil ve bonoların değerlemesi
18.2. Çıkarılmış tahvil ve bonolar vasıtasıyla transfer fiyatlandırması
18.2. Çıkarılmış tahvil ve bonolar vasıtasıyla örtülü sermaye
18.3. Yorumlar/İlaveler …

19. Ticari borçlar
19.1. Borçların reeskontu
19.2. Ticari borçlar vasıtasıyla örtülü sermaye
19.3. Ticari borçlar vasıtasıyla transfer fiyatlandırması
19.4. Ortaklar cari hesabı vasıtasıyla örtülü sermaye
19.5. Yorumlar/İlaveler …

20. Gelecek dönemlere ait gelirler ve gider tahakkukları
20.1. Gelecek dönemlere ait gelirler; döneme isabet eden kısmın gelir kaydedilip/kaydedilmediği
20.2. Gider tahakkukları; döneme isabet eden kısmın gider kaydedilip/kaydedilmediği
20.3. Yorumlar/İlaveler …

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Gelir Tablosu Kalemleri

1. Satışlar ve alışlar
1.1. Brüt hasılata dahil edilmeyen vade farkları
1.2. KDV matrahı olarak brüt satış hasılatı yerine net satış tutarının esas alınması
1.3. Dönem karına ilave edilmeyen satış primleri
1.4. Satış maliyetlerinin tespiti
1.5. Belgesiz satın alınan mallar
1.6. Faturasız satışlar
1.7. Satışların transfer fiyatlandırması
1.8. Serbest bölgedeki/vergi cennetlerindeki firmalara yapılan satışlar
1.9. Sahte belgeye dayalı alışlar
1.10. Alışların transfer fiyatlandırması yoluyla satın alınan mallar
1.11. Kaydedilmeyen alış iskontoları
1.12. Yorumlar/İlaveler...

2. İthal edilen mallar
2.1. İthal edilen malların değerlemesi
2.2. İthal edilen malların vade farkları
2.3. İthal mallarda transfer fiyatlandırması
2.4. Emsale uygun olmayan iskontolar
2.5. Yorumlar/İlaveler...

3. Araştırma ve geliştirme giderleri
3.1. Araştırma ve geliştirme giderlerinin doğrudan gider yazılması
3.2. Araştırma ve geliştirme giderlerinin %40'dan fazlasının gider kaydı
3.3. Yorumlar/İlaveler...

4. Kuruluş ve örgütlenme giderleri
4.1. Aktifleştirilen kuruluş ve örgütlenme giderlerinin doğrudan gider yazılması
4.2. Yorumlar/İlaveler...
5. Pazarlama, satış ve dağıtım giderleri

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5.1.Pazarlama, satış ve dağıtım giderleri olarak kaydedilen uygun olmayan giderler

5.2. Dönem sonunda stokta bulunan mallara ait pazarlama, satış dağıtım giderleri

5.3. Yorumlar/İlaveler...

6. Genel yönetim giderleri

6.1. Genel yönetim giderleri olarak kaydedilen uygun olmayan giderler

6.2. Yüksek işletme giderleri

6.3. Özel harcamaların işletmeye gider kaydedilmesi

6.4. İşletmeye dahil ya da kiralık olmayan ya da işletmede kullanılmayan araçların giderleri

6.5. Aracın değerini artıran giderler

6.6. Yorumlar/İlaveler...

7. Ücretler

7.1. Türkiye'de yerleşik bir Türk şirketinin yurt dışı ücret ödemeleri

7.2. Sosyal güvenlik ödemelerini aşan özel sigorta giderleri

7.3. Çalışanlara ödenen her türlü faydaların brüt tutarları

7.4. Yorumlar/İlaveler ...

8. Bağlı ortaklıklar ve iştiraklerden kar payları

8.1. Hisse senetleri satış karlarının temettü geliri olarak kaydedilmesi

8.2. Yorumlar/İlaveler …

9. Faiz gelirleri

9.1. Vadeli mevduatın döneme isabet eden kısmının gelir yazılmaması

9.2. Reponun döneme isabet eden kısmının gelir yazılmaması

9.3. Faiz gelirlerinin gayri safi tutarlarla gelir kaydedilmemesi

9.4. Yorumlar/ilaveler...

10. Menkul kıymet satış karları/zararları

10.1. Yorumlar/ilaveler …

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11. Kambiyo karları/zararları

11.1. Kambiyo kar/zararlarının doğru olarak değerlenip vergiye tabi kara dahil edilmesi

11.2. Yorumlar/İlaveler …

12. Reeskont faiz gelirleri/giderleri

12.1. Reeskont faiz gelirleri/giderlerinin doğru olarak değerlenip vergiye tabi kara dahil edilmesi

12.2. Yorumlar/İlaveler …

13. Karşılık giderleri

13.1. Menkul kıymet değer düşüklüğü karşılıkları

13.2. Şüpheli alacaklar karşılıkları

13.3. Stok değer düşüklüğü karşılıkları

13.4. Yorumlar/İlaveler …

14. Finansman giderleri

14.1. Finansman giderlerinin uygun hesaplanmaması

14.2. Holding şirketlerde finansman giderlerinin dağıtımı

14.3. Diğer işletmelere kullandırılan borçlara ilişkin finansman giderleri

14.4. Yatırımların finansmanında kullanılan borçlanmalara ilişkin finansman giderleri ve yabancı krediyle ithal edilen maddi duran varlıkların ithali nedeniyle oluşan kur farkları

14.5. Satın alınan hisse senetlerine ilişkin finansman giderleri

14.6. Örtülü sermaye vasıtasıyla finansman giderleri

14.7. Transfer fiyatlandırması vasıtasıyla finansman giderleri

14.8. İşletmeyle ilgili olmayan finansman giderleri

14.9. Satın alınan yada üretilen mallara ilişkin finansman giderlerinin uygun hesaplanmaması

14.10. Yorumlar/İlaveler ………………

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Sorular

1- Araştırmada belirlenen vergi kayıp ve noksanlıkları listesi sizce vergi incelemelerinde fayda sağlar mı?

Evet_____ Hayır____

Yorumlar …

2- Standartlara dayalı vergi incelemesi sizce mümkünmüdür. Mümkün değil ise neden?

Evet_____ Hayır____

Yorumlar …

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APPENDIX 3: Table of Tax Deficiencies and Discrepancies

	A	B	C	D	E	F	G	H	I	J	Tot.	Av.
BALANCE SHEET ITEMS												
Cash on hand												
Large or unusual cash disbursement	5	5	5	5	5	5	5	5	5	5	50	5.0
Valuation of foreign currency	2	2	1	2	2	2	2	2	2	2	19	1.9
Cash on hand with credit balance	1	1	1	1	1	1	2	1	1	1	11	1.1
Excessive balance of cash on hand	5	5	5	5	5	5	5	5	5	5	50	5.0
Cash overages and shortages												
Checks received												
Discounting of checks	3	3	3	3	2	3	3	3	4	2	29	2.9
Valuation of checks denominated in foreign currency	2	2	2	2	1	2	3	1	2	2	19	1.9
Transfer pricing using bartering checks	3	3	4	3	4	5	2	4	3	2	33	3.3
Thin capitalization using bartering checks	2	3	3	4	3	4	2	5	3	2	31	3.1
Cash in banks												
Exchange rate valuation of foreign currencies	3	2	2	2	2	2	3	2	2	2	22	2.2
Interest income of time deposits	3	3	4	3	3	3	3	3	3	3	31	3.1
Interest income of repurchase agreements	2	1	2	2	4	2	1	2	2	1	19	1.9
Recognition of interest income	2	2	2	3	2	2	1	3	2	1	20	2.0
Other liquid assets												
Valuation of foreign currency in transit	1	1	1	1	1	1	1	1	1	1	10	1.0
Checking credit card sales and their invoices	1	1	2	1	1	2	1	1	2	1	13	1.3
Stock certificates												
Valuation of stock certificates	3	4	4	4	4	3	5	4	4	4	39	3.9
Allowances for value decreases of stock certificates	1	1	2	2	2	2	2	1	2	1	16	1.6
Stock share sales to related parties as transfer pricing	4	4	5	5	4	5	4	5	5	4	45	4.5
Determination of sale profit for shares acquired due to capital increase	2	3	3	3	3	3	4	2	2	4	29	2.9
Valuation of foreign stock shares	4	5	5	4	5	5	4	5	4	5	46	4.6
Marketable securities other than stock shares												
Valuation of bills and bonds	4	4	5	4	4	3	4	3	4	4	39	3.9
The funds considered to be foreign but in fact Turkish	5	5	4	4	5	5	4	5	4	5	46	4.6
Valuation of fund participation certificates	4	4	5	4	5	4	4	3	4	5	42	4.2
Futures, forward contracts and options used for tax deferral	5	4	5	5	5	5	5	4	4	5	47	4.7
Receivables												
Valuation of receivables based on foreign currency	2	2	2	2	2	2	1	2	2	2	19	1.9
Discounting of receivables, if properly adjusted	3	3	3	2	3	4	3	4	2	2	29	2.9
Doubtful receivables, if properly adjusted	3	3	4	2	4	3	3	2	3	4	31	3.1
Uncollectible receivables, if properly adjusted	3	3	2	3	3	3	4	3	2	4	30	3.0
Thin capitalization through receivables	5	5	4	5	5	4	4	5	4	4	45	4.5
Transfer pricing through receivables	5	5	4	5	5	4	5	4	5	4	46	4.6
Inventories												

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Inventory overages and shortages	1	1	1	1	1	2	1	1	1	1	11	1.1
Inventory errors	4	3	4	5	4	5	4	3	3	4	39	3.9
Cost of goods sold; whether calculated properly	4	4	5	4	4	4	4	5	4	4	42	4.2
Lower of cost or market rule, if properly applied	2	1	3	2	2	3	1	2	2	1	19	1.9
Equivalent value in valuation, if properly applied	3	3	2	4	3	3	2	3	3	3	29	2.9
Appropriateness test of output ratios and wastage ratios	4	4	5	5	4	4	4	5	4	4	43	4.3
Allowances for value decrease of inventories	2	2	2	2	1	2	2	2	2	2	19	1.9
Tangible fixed assets												
Determination of the cost value of tangible fixed assets	3	4	4	3	2	2	4	4	4	3	33	3.3
Improvements that increase the cost of real estates	3	3	4	3	3	4	3	3	3	3	32	3.2
Transfer pricing through real estate sales	5	5	4	4	5	5	4	5	5	4	46	4.6
Loan interest and/or exchange differences	4	3	4	4	5	4	4	4	4	5	41	4.1
Depreciations, whether allocated appropriately	4	5	5	4	4	5	4	5	5	4	45	4.5
Unrecorded sales of tangible fixed assets as scrap	1	2	1	1	1	2	1	1	1	1	12	1.2
Renewal fund; whether allocated properly	3	2	3	3	2	4	1	3	3	4	28	2.8
Assets in casualty losses not to be based on appraisal commission decision	3	3	2	3	4	3	3	2	4	3	30	3.0
Value Added Tax paid at the acquisition of automobiles	1	2	2	2	2	1	2	2	2	2	18	1.8
Leasing transactions												
Transfer pricing through leasing transactions	5	5	5	5	4	5	4	5	5	4	47	4.7
For lessee, depreciations whether allocated appropriately	3	4	5	4	4	4	4	4	3	4	39	3.9
For lessee, interest expenses for lease payments	1	1	2	2	1	1	1	1	2	1	13	1.3
For operational leasing, whether lease payments recorded as expenses equally	4	4	5	4	4	4	4	4	5	4	42	4.2
Leasehold improvements; whether depreciated over the term of the lease in equal amounts	2	3	3	3	3	3	2	3	3	2	27	2.7
Intangible assets												
Valuation of intangible assets	4	4	5	3	4	4	5	3	4	4	40	4.0
Amortization of intangible assets	4	3	4	4	5	5	4	4	4	5	42	4.2
Transfer pricing of intangible assets	5	5	5	5	5	5	5	5	5	5	50	5.0
Leasing of intangible assets abroad	5	5	5	5	4	5	5	5	5	4	48	4.8
Computer software costs, whether capitalized or not	4	4	5	4	4	3	4	4	5	4	41	4.1
Capitalized establishment and organization expenses written off expenses directly	2	2	2	2	3	2	2	2	2	2	21	2.1
Depleteble assets												
Valuation of depleteble assets	1	1	1	2	1	2	1	1	1	2	13	1.3
Prepaid expenses and income accruals												
Prepaid expenses, whether correct amounts recorded in related expense account	4	4	4	4	4	5	3	4	4	3	39	3.9
Accrued revenues,whether correct amounts	4	3	4	4	5	4	4	4	4	5	41	4.1

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recorded in related income accounts												
VAT Credit												
VAT on purchase invoices related to transactions which are non-taxable or exempted from VAT	1	1	1	2	1	1	2	1	1	2	13	1.3
Value added tax on invoices for the purchase of automobiles	2	2	3	3	2	3	2	2	2	2	23	2.3
Value added tax of the goods which are lost or stolen	2	2	2	3	2	2	3	2	2	2	22	2.2
Value added tax paid for expenses deemed non deductible per IITL and CITL	1	2	1	1	2	1	1	1	2	2	14	1.4
VAT Received												
VAT received; if calculated properly	1	1	1	1	1	1	1	1	1	1	10	1.0
Goods delivered and services rendered without charges	3	4	4	4	4	3	4	4	3	4	37	3.7
Returns of goods purchased	1	1	1	1	2	1	1	1	2	1	12	1.2
Transactions not realized or abandoned	1	1	1	1	1	2	1	1	1	1	11	1.1
Value added tax of the goods in casualty losses	2	3	2	2	3	3	3	3	2	3	26	2.6
Work advances												
Valuation of advances	4	4	5	5	3	4	4	5	3	5	42	4.2
Transfer pricing through work advances	4	5	5	4	4	3	4	4	4	4	41	4.1
Bank loans												
Bank loan valuation	2	3	3	3	3	4	2	2	4	3	29	2.9
Valuation of bank loans in foreign currencies	2	3	3	3	3	3	2	3	3	3	28	2.8
Transfer pricing through bank loans	5	5	5	5	5	5	5	5	5	5	50	5.0
Thin capitalization through bank loans	5	5	5	5	5	5	5	5	5	5	50	5.0
Bonds and notes issued												
Valuation of bonds and notes issued	5	5	5	5	5	5	5	5	5	5	50	5.0
Transfer pricing through bonds and notes issued	5	5	5	5	5	5	5	5	5	5	50	5.0
Thin capitalization through bonds and notes issued	5	5	5	5	5	5	5	5	5	5	50	5.0
Trade payables												
Discounting of payables	2	3	2	2	2	2	3	2	2	2	22	2.2
Thin capitalization through trade payables	4	4	4	5	5	5	5	4	5	4	45	4.5
Transfer pricing through trade payables	5	4	5	5	5	5	4	4	5	4	46	4.6
Thin capitalization through partners' current account	5	5	5	5	5	5	5	5	5	5	50	5.0
Unearned revenues and accrued expenses												
Accrued expenses; whether recorded as expenses in the related term	3	3	3	2	4	3	3	2	3	3	29	2.9
Unearned revenues; whether recorded as revenues in the related term	3	2	3	3	4	4	3	4	3	3	32	3.2
INCOME STATEMENT ITEMS												
Sales and purchases												
Financing element on deferred settlement not included in gross sales	3	3	3	3	4	3	3	3	4	2	31	3.1
Net sale amount taken as VAT base instead of gross amount	4	3	3	3	3	2	4	3	3	2	30	3.0
Sales remium income not added to the term profit	4	4	5	4	4	3	3	4	4	4	39	3.9
Determination of cost of sales	5	4	4	4	4	4	5	4	5	4	43	4.3

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Purchased goods without documentation	4	4	5	3	4	3	4	5	5	5	42	4.2
Sales without invoices	5	5	5	5	5	5	5	5	5	5	50	5.0
Transfer pricing of sales	5	5	5	5	5	5	5	5	5	5	50	5.0
Sales to companies in free zones/taxhavens	4	5	4	4	3	5	4	4	4	4	41	4.1
Purchases with fake invoices	5	5	5	5	5	5	5	5	5	5	50	5.0
Transfer pricing of purchases	5	5	5	5	5	5	5	5	5	5	50	5.0
Unrecorded purchase discounts	3	4	4	4	3	4	4	4	3	3	36	3.6
Imported goods												
Valuation of imported goods	4	5	5	5	3	5	5	5	5	5	47	4.7
Financing elements on deferred settlement for imported goods	4	5	5	5	5	5	3	4	5	5	46	4.6
Transfer pricing of imported goods	5	5	5	5	5	5	5	5	5	5	50	5.0
Discounts not suited arm's length principle	5	5	5	5	5	5	5	5	5	5	50	5.0
Research and development expenses												
Research and development expenses written off as expenses directly	3	2	2	4	4	4	4	3	3	4	33	3.3
More than 40% of research and development expenses written off as expenses	3	2	2	3	4	4	4	3	3	4	32	3.2
Establishment and organization expenses												
Capitalized establishment and organization expenses written off expenses directly	2	2	3	2	2	2	1	3	2	2	21	2.1
Marketing, sales and distribution expenses												
Inappropriate expenses recorded as marketing, sales and distribution expenses	3	3	4	3	3	5	3	3	3	3	33	3.3
Marketing, sales and distribution expenses belonged to the goods in inventories	4	4	4	4	5	4	5	4	5	4	43	4.3
General administration expenses												
Inappropriate expenses recorded as general administration expenses	3	3	3	2	4	3	3	4	2	3	30	3.0
High business expenses	3	3	3	4	2	5	3	3	4	3	33	3.2
Transfer of private expenses to business	3	5	2	2	3	2	3	3	4	5	32	3.2
Expenses for vehicles which are not part of an entity or leased, or used in the business	4	5	5	5	4	5	3	4	4	5	44	4.4
Expenses made to increase the value of a vehicle	4	2	5	5	5	4	3	4	4	5	41	4.1
Wages												
Wages paid abroad from Turkey by a Turkish company	4	5	5	4	3	4	4	5	5	4	43	4.3
Private insurance expenses more than social insurance	2	4	2	3	3	2	4	2	2	2	26	2.6
Finance expenses												
Finance expenses not properly calculated	4	4	4	4	4	5	5	4	4	5	43	4.3
Distribution of finance expenses in holding companies	5	4	4	5	5	3	5	4	5	4	44	4.4
Finance expenses concerning loans utilized by other entities	4	4	4	4	3	4	5	4	5	4	41	4.1
Finance expenses related to loans used for investment financing and exchange differences arising due to import of assets	4	4	4	3	4	4	5	5	4	4	41	4.1
Finance expenses concerning the purchase of stock shares	3	4	3	5	4	4	5	4	3	4	39	3.9
Finance expenses involved thin	5	5	5	5	5	5	5	5	5	5	50	5.0

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capitalization												
Finance Expenses involved transfer pricing	5	5	5	5	5	5	5	5	5	5	50	5.0
Finance expenses not related to the business	4	4	3	4	5	3	4	4	5	3	39	3.9
Improper allocation of finance expenses concerning goods purchased or produced	4	4	5	3	4	3	5	5	5	4	42	4.2

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