Preparation of Non-listed Companies for External Auditing: Policy Recommendations for Turkish SMEs towards New Turkish Commercial Code

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Received: January-2012, Accepted: April 2012

Abstract

Through recent developments, including the new Turkish Commercial Code, Basel II and IFRS for SMEs; External Auditing is quickly becoming a current issue that is expected to add value to all non-listed companies. Turkish Commercial Code requires all companies whether listed or non-listed to comply with Turkish Accounting Standards (TAS) and Turkish Financial Reporting Standards (TFRS) and requires all companies to be audited by an independent external auditor. The first section of the current study goes over the external auditing concept and its potential benefits. Following sections deal with country specific factors and developments that highlight external auditing. The fifth section, in line with current study, makes suggestions towards the preparation process of non-listed companies for external auditing.

The first aim of this paper is to examine what kind of costs that companies may face in the case of non-compliance to the OHS regulations on the overall dimensions. Another aim is to show how OHS regulations work in a packaging company named Amcor which operates in 43 countries around the world, and looking to OHS with the employees’ point of view by applying a survey research.

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Early version of this study was presented in the symposium named “3rd International Accounting Symposium” which was held by Istanbul Chamber of Accountants, on 12-13 October 2009, in Istanbul
Keywords: auditing, SMEs, external auditing

JEL Codes: M40, M41, K22

1. Introduction

Small-and-Medium Sized Enterprises (SMEs) represent the most important group within national economies; as depicted in Table 1. SMEs play a predominant role in most developed and developing economies not only because of their number and variety but also due to their involvement in all segments of the economy.

Table 1: Percentage of SMEs

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>% 70</td>
</tr>
<tr>
<td>Spain</td>
<td>% 80</td>
</tr>
<tr>
<td>USA</td>
<td>% 96</td>
</tr>
<tr>
<td>Italy</td>
<td>% 95</td>
</tr>
<tr>
<td>England</td>
<td>% 75</td>
</tr>
<tr>
<td>Switzerland</td>
<td>% 85</td>
</tr>
<tr>
<td>Sweeden</td>
<td>% 90</td>
</tr>
<tr>
<td>Turkey</td>
<td>% 95</td>
</tr>
</tbody>
</table>

Resource: (Genc et al., 2004: 23)

The purpose of external auditing is to verify the reliability of financial statements and communicate this information to interested parties. In the last few years this purpose has gained crucial importance, especially for non-listed companies. The increase of the importance of information as a strategic input, the globalization of capital markets and money markets and the current global financial crisis has led to the development of External Auditing for non-listed companies.

2. External Auditing- Theoretical Basis

2.1. Definition and Types of External Auditing

AICPA defines auditing as a systematic process of objectively obtaining and evaluating accounts or financial records of economic units based on established criteria. Major types of audits conducted by external auditors
include the financial statements audit, the operational audit, and the compliance audit (Guredin, 2007: 16).

Financial statements audit: The review of the financial statements of a company or any other legal entity, resulting in the publication of an independent opinion on whether or not those financial statements are relevant, accurate, complete, and fairly presented (Messier et al., 2008).

Compliance audit: Every company sets its own plans, procedures, tactics and route to achieve pre-determined goals. A compliance audit determines whether or not an organization is following established procedures or rules (Erdogan, 2006: 5).

Operational audit: An operational audit examines an organization's activities in order to assess performances and develop recommendations for improved use of business resources. This type of audit uses a kind of non-accounting data (Uysal, 2004). Table 1 summarizes the types of audits based on criteria and user perspectives.

Table 2: Type of Audit and Criteria used relationship

<table>
<thead>
<tr>
<th>Type of audit</th>
<th>Criteria used</th>
<th>Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Statements Audit</td>
<td>GAAP, IFRS</td>
<td>Partners, creditors, governmental agencies</td>
</tr>
<tr>
<td>Compliance Audit</td>
<td>Related contracts</td>
<td>Sides to the agreement</td>
</tr>
<tr>
<td>Operational Audit</td>
<td>Budgets, performance measures</td>
<td>Top management</td>
</tr>
</tbody>
</table>


2.2. Functions of External Auditing

Informing Function: Information carries importance for all parties that participate in capital markets. Informing is one of the most important functions of external auditing. That function gives chance to investors to make reasonable and objective decisions (Kudret&Halil, 2004: 55).

Protective Function: Errors in recording results, falsified financial statements lead to misguided investment decisions and decreases the value of
portfolios. External auditing protects investors from these kinds of errors by discovering and correcting them (Guredin, 2007: 16).

**Deterrent Function:** Conflict of interest between preparers and users of financial statements is always probable. Audit reports deter potential manipulative efforts in the early stages by managers, employees and partners (Usul et al., 2002: 110).

**Economic Function:** There are many players in the economic system that use auditor reports as a base for their economic decisions. Through the trust generated by auditing reports investors invest in the economy and that in turn leads to an increase in the overall welfare of the country. This is especially true for emerging economies, such as Turkey. Openness and transparency of the market is crucial for attracting foreign investors. Financial statements are the fundamental starting point for investment decisions and are only useable because of external auditing (Kiraci, 2005: 104).

### 2.3. Benefits of External Auditing

The literature investigates the benefits of external auditing for the company, related parties and partners of the company. Reports produced by external auditors present the positive and negative aspects of the company to the management. When financial statements are audited, they are viewed as reliable, transparent and fair enough to support economic decisions.

A report disseminated by Australian Auditing and Assurance Standards Board (AUASB, 2007) lists the benefits of independent audit for SMEs as;

- fraud/misappropriation deterrent;
- preparation of annual financial report in compliance with the applicable accounting framework;
- independent health check especially the consideration of going concern;
- enhancement of reporting skills of organizations;
- exposure to a range of independent experts on matters such as risk management, information systems, internal control and corporate governance; and
- enhancement of corporate governance where a management letter on control deficiencies was issued.
Financial statements play an important role in the decision process of the company’s customers, suppliers and potential partners. When companies make decisions, these decisions lead to the allocation of limited economic resources. Thus, audited financial statements play a crucial role in the economy.

In an audited company, the rights of partners and shareholders are well protected (Imhoff, 2003: 117). Weaknesses, errors and fraud are quickly discovered and the financial structure of an audited company is much stronger than non-audited company (Farooqi-Lindt, 2008).

3. Current Developments Related to External Auditing

The developments covered in this section of the study are important due to their relation to external auditing of non-listed companies. These environmental developments motivate non-listed companies towards change and improvement (Mariani, 2010).

3.1. The New Turkish Commercial Code

The new Turkish Commercial Code, which will significantly improve corporate law and will also introduce new financial reporting requirements will come into effect on 1 July 2012. In 2000, a Commission of 40 experts appointed by the Ministry of Justice started preparing a new Commercial Code. The draft Code was released in February 2005 for comments.

The new Turkish Commercial Code brings out a system for the auditing of the firms that is completely new. Through the new regulation, the audit currently included among the mandatory organs of the companies, and exercised through an auditor who does not necessarily have expertise in the subject matter, is replaced by the independent audit mechanism which should be conducted by independent audit firms. The scope of audit includes the audit of financial statements and/or consolidated financial statements and the annual report. The audit is required to be performed in accordance with Turkish Auditing Standards which are identical with International Auditing Standards.

Turkish Commercial Code consists of six main chapters: Enterprise Law, Company Law, Securities Law, Transportation Law, Maritime Commercial Law and Insurance Law. One of the most remarkable reforms of the code is enforcing modern accounting rules and new norms for commercial books. In this framework, code prescribes that all the accounting systems of Turkish enterprises shall be arranged in conformity with Turkish accounting standards,
which have been and will be further enforced according to internationally accepted financial standards (IFRS).

3.2. Basel Accords

Basel II and Basel III are the second and third of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004 and will be effective for Turkish Banking system in June 2012, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Basel III is also includes some amendments to Basel II that are needed after the global crisis faced by most of the countries (Balthazar, 2006).

With adoption of Basel II external auditing will be a must for SMEs for the credit taking process. In line with these new opportunities will arise for external auditing firms and rating agencies and they will play more effective role in Turkey as well (Emir & Kerse, 2010). Financial information systems will gain importance during this process. Companies with high credit scores will have lower interest rates in the borrowing agreements and this will result in an awareness in institutionalization.

3.3. IFRS for SMEs

The primary feature of the new Turkish Commercial Code is the introduction of international standards for SMEs and can be named as major revolution for accounting and auditing tradition of Turkish Republic (Dalkilic & Limoncuoglu, 2011). There is no consensus on the definition of small and medium-sized enterprises (SMEs) and different definitions exist.

The International Accounting Standards Board (IASB) issued an International Financial Reporting Standard (IFRS) designed for use by small and medium-sized entities (SMEs) in July 2009 which roughly represents more than 95 per cent of all companies. The standard is a result of a five-year development process with extensive collaboration between SMEs worldwide. The IFRS for SMEs is a self-contained standard of about 230 pages long, tailored for the needs and capabilities of smaller businesses. Many of the principles in IFRSs for recognizing and measuring assets, liabilities, income and expenses have been simplified, topics not relevant to SMEs have been omitted,
and the number of required disclosures has been significantly reduced (Sayar&Okur, 2007).

Poroy and Sipahi (2007) make a SWOT analysis for adaptation of IFRS in Turkey as depicted in Table 3 below.

**Table 3 : SWOT analysis for adaptation of IFRS**

<table>
<thead>
<tr>
<th><strong>Strengths</strong></th>
<th><strong>Opportunities</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• SMEs will be able to perform internationally comparable, accurate and transparent financial reporting.</td>
<td>• The SMEs will have opportunity to perform financial reporting according to the needs of financial statement users.</td>
</tr>
<tr>
<td>• IFRS for SMEs will increase lending opportunities of SMEs.</td>
<td>• The financial reports of the SMEs will be comparable in sectors at international level.</td>
</tr>
<tr>
<td>• IFRS for SMEs will ease the transition to IFRS for the growing SMEs.</td>
<td>• The SMEs will be able to reach cross border markets.</td>
</tr>
<tr>
<td>• IFRS for SMEs will provide SMEs to perform financial reporting according to Turkish Commercial Code and Basel II Criteria.</td>
<td>• The SMEs will have opportunity to be in business combinations or cooperation agreements with foreign entities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Weaknesses</strong></th>
<th><strong>Threats</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• The SMEs in Turkey will not be willing to adopt IFRS for SMEs because of their widespread unregistered accounts.</td>
<td>• The cost of adopting IFRS for SMEs will exceed the benefits of them.</td>
</tr>
<tr>
<td>• The SMEs will not be willing to adopt IFRS for SMEs because “financial reporting for tax purposes” approach is adopted instead of “financial reporting for information” in Turkey.</td>
<td>• The transition to the IFRS for SMEs will be difficult because of the low corporate level of SMEs.</td>
</tr>
<tr>
<td>• The SMEs in Turkey will not be able to employ accountants that are qualified in IFRSs.</td>
<td>• While generating the IFRS for SMEs not recognizing the Turkish uniform system of accounts make them difficult to adopt.</td>
</tr>
<tr>
<td>• The translation weaknesses will make the adoption of IFRS for SMEs difficult.</td>
<td>• The differences between tax legislation and IFRS for SMEs will make the standards difficult to adopt.</td>
</tr>
</tbody>
</table>

Source: Poroy and Sipahi (2007: 41)

The adoption of IFRSs would provide the following benefits to SMEs: (PWC, 2006: 5-6, IASB 2007: 3)
a. Adoption of IFRS for SMEs will improve the comparability of financial information of SMEs at either national or international levels.

b. Adoption of IFRS for SMEs will make easier to implement planned cross-border acquisitions and to initiate proposed partnerships or cooperation agreements with foreign entities.

c. Adopting IFRS for SMEs can help SMEs to reach international markets.

d. Adoption of IFRS for SMEs will have a positive effect on the credit rating scores of enterprises, this will strength SMEs’ relationships with credit institutions.

e. Vendors want to evaluate the financial health of buyers before they sell goods or services on credit. The adoption of IFRSs will enhance the financial health of the SMEs.

By applying IFRS for SMEs all small and medium sized enterprises in Turkey will have an effective financial reporting system. SMEs will attract new investors, will have lower interest rates for borrowing and in the future will easily be able to open to the public.

4. External Auditing in Turkey

Authorization to perform tax audits is determined according to the Law on “Independent Accountants, Independent Accountants and Financial Advisors, and Sworn-In Financial Advisors,” which was enacted in 1989. Accountancy services are a regulated activity in Turkey. Law 3568 stratified the profession in Turkey into two groups with different educational requirements for licensing and specific allowed activities for each group:

• SMMMs, may conduct general audits but not tax audits and provide consulting services.

• YMMs, may conduct tax audits and “certify” the tax financial statements and tax returns in addition to all the services provided by SMMMs except for bookkeeping. YMMs have joint responsibility with the audited company for errors and misstatements in the financial statements they have certified.

5. Preparation for External Auditing

This part of the study is devoted to important headings through the preparation process for external auditing. The obstacles faced are also
highlighted and will give some clues to what can be done to prevent these problems.

5.1. Changes in Accounting Mentality

This part of the study is devoted to important headings through the preparation process for external auditing. The obstacles faced are also highlighted and will give some clues to what can be done to prevent these problems.

One of the major problems of Turkish accounting culture in SMEs is its close relation to taxation. Since the financial statements are used as a basic indication for income tax, many businesses tend to minimize this result and thus income tax base. The improvement of the external auditing process in non-listed companies is a natural result of switching to modern financial reporting implementations. SMEs in Turkey generally have a tax based accounting mentality. The majority of current SMEs that use the traditional accounting implementations do not benefit from the basic functions of accounting, have problems finding educated accounting personnel and suffers from a lack of a sound financial reporting system (Deloitte, 2007: 3).

The first step towards external auditing is changing the organizational culture and understanding the strategic importance of accounting. Accounting departments and managers are the primary responsible parties for that step.

Today’s challenging competitive environment forces owners and managers to be knowledgeable about accounting, finance and tax issues. Companies do not pay enough attention to accounting because of its perception of tax related issues. Bankruptcy is unavoidable for companies which are not able to use accountants and auditors as management advisers (Uzay, 2007: 166).

From a contemporary point of view accounting is a language that can give important clues about future of any business. Accounting basically is a system that provides economic units strategic information about theirselves (Bushman&Smith, 2001). In this manner, it is an important source that gives crucial information to financial statement users, especially to investors. Financial reports directly affects the resource allocation within the economy as it appears in dividend payout policy.

Capital markets are dependent on and closely linked with each other. In this environment financial information is a strategic advantage. In order to produce
this information in a most effective and efficient way, a sound financial reporting system is a must (Erhan, 2004: 17).

To build up such an accounting system, accountants should analyze the sector that the company takes place and they should build accounting policies in accordance with them. Accountants should wear workers suit and discover every step of the process within the company if necessary.

5.2. Forming an Internal Auditing System

The primary purpose of internal auditing is helping organizations achieve their stated objectives. It does this by using a systematic methodology for analyzing business processes, procedures and activities with the goal of highlighting organizational problems and recommending solutions. Although internal auditing is an integral part of management, it has an independent mechanism in line with its objectives (ECIIA, 2005: 27).

An internal auditing function increases the external audit quality and decreases the cost of auditing if it is coordinated with an external auditing function. Establishing this coordination is a step towards successfully preparing the company that has an internal auditing function for the external auditing process. According to our view, companies without this function should immediately establish an internal auditing function.

Coordination of an internal and an external auditing function will result in (Uzay, 1999: 68):

• The auditing report prepared by internal auditors is a reliable reference for external auditors.

• Internal auditing enables external auditors to easily carry out auditing procedures.

• Internal auditing provides information about the organizational structure of the company and helps solve auditing problems.

• External auditors can explore the non-financial aspects of a company and its effects on financial statements.

• Common planning, exchanging the working sheets will result a mutual confidence and will reduce the sample sizes and re-takings while decreasing auditing cost.
5.3. Establishing an Audit Committee

An Audit Committee is compulsory for listed companies. Even though the Audit Committee has the word “Audit” in its title, they do not actually conduct auditing activities and have no direct responsibility for auditing operations. An Audit Committee supervises the internal and external auditing process behalf of the management. An Audit Committee creates value by forming a bridge between management and auditors. Selecting the auditing firm, preparing audit contracts, watching and controlling the auditing process are the duties of audit committee.

Although it is not compulsory, non-listed firms should form an Audit Committee; so they will be able to increase effectiveness and efficiency of external audits and will solve audit related problems. Management can benefit from an Audit Committee while adapting the auditing culture within the company.

The roles and responsibilities of an Audit Committee in selecting and monitoring audit firms are summarized below (Deloitte, 2009: 7):

- The existence of possible conflict of interest that can result from the employment of relatives should be analyzed.
- Audit firm should only report to the Audit Committee; rotation, evaluation, pricing and performance issues should be handled.
- Audit Committee members should be capable of monitoring the auditing process.
- There should be open and effective communication between the Audit Committee and external auditing firm.
- The Audit committee should be competent enough to oversee the auditing process.

5.4. Enlightenment of an Auditor

Suggestions that were mentioned above are steps the company should take in order to prepare for the upcoming auditing process. The following suggestions in this study should be implemented in coordination with the company and the auditor firm. Auditing firms evaluate potential customers based on certain criteria and then accept or refuse them. These evaluations are
far from profit considerations. This evaluation process is crucial since it provides ‘independence’ for external auditing.

Unstructured companies in terms of management and organization, companies with insufficient accounting systems and untrustworthy firms are usually refused since completing the audit is impossible. To reach a sound and well-functioning external audit, the company should be ready for evaluation and should enlighten the auditors about every aspect that they need. Some steps that will be taken by auditors are listed below (Erdogan, 2006: 76);

• The financial structure of the company must be understood.
• Information must be gathered from banks, creditors and third parties that are doing business with the proposed customer.
• Before signing an agreement with the potential firm that will be audited, previous auditors that have worked with the company should be visited and any information on special circumstances should be collected.
• Should estimate the audit risk based on potential conflict areas related to the company.
• Should be sure about the fact that the company will provide all necessary and requested documents during the auditing process
• Should be sure that the company will never force the auditor to violate any of the rules and norms.

As can be depicted from the above items auditing firms should conduct a detailed investigation within the company. The company should educate employees about giving accurate and timely information that is requested by the auditing firm. Some employees can regard that as a violation of privacy and resist giving truthful information. Thus, the external auditing philosophy and benefits to the company should be well communicated in an organizational level.

5.5. Preparing an Audit Contract

After selecting an audit firm the company should negotiate with and determine the type of the audit, purpose, scope and duration of the auditing process. This negotiation should be conducted by the Audit Committee that was suggested before. In the negotiation process accounting policies and possible conflict areas must be discussed.
At the end of the negotiation process issues should be documented and a contract must be prepared. A contract including the responsibilities, the price and the working principles shall prevent future trouble. A written contract must be included in the preparation process for external auditing.

5.6. Problems and Suggestions

Audit in SMEs by small audit companies and individual auditors has its specifics; it is recognized by international and domestic audit regulators. On one side there is an effort to minimize administrative load, on the other side there is an effort to maximize audit quality (Mullerova, 2011). The analysis of prior problems faced during the external auditing process of various companies will help other companies towards the preparing for external audit. A recent survey conducted by auditing firms in Turkey shows that %84 of the auditing firms think that companies do not pay enough attention and do not give importance to external auditing (Donmez&Ersoy, 2006: 85).

Listed below are fundamental problems faced by auditing firms (Aslan, 2007; Aysan, 2008; Carikcioğlu, 2004; Kutlu, 2007)

• Most Turkish companies view external auditing only as a legal requirement.
  • Family owned businesses are very difficult to audit.
  • There is a high degree of shadow economy.
  • External audit is used as a tool for credit analysis.
  • There is a lack of separation between owners and professionals,
  • The capital market characteristics are usually inefficient,
  • There is a lack of budget for external auditing,
  • Companies are unwilling to comply to external auditing principles.

6. Conclusion

External auditing is not a compulsory concept mandated by regulators, indeed it is irrevocable need for today`s corporate world. Un-audited financial statements are in fact `unexisting` things. When we analyse the global crisis that started in the last quarter of 2008 –and still in effect- and it is clear that financial
statements are far from transparent and reliable (Dalkilic, 2008: 164). As these suggestions are put into effect reliable, true and fair by auditing can be achieved (Brumen & Bogdan, 2008: 4).

Besides these macro level benefits, the external auditing function also results in micro level benefits to audited companies as well. Accounting is a decision making tool for companies and this function can be maintained by only reliable financial information. The International Financial Reporting Standards and the International Standards on Auditing are crucial tools for the business world.

Examination of non-listed companies within Turkey shows that companies face problems regarding accounting systems. That’s why auditing firms generally give advisory services for establishing sound and proper accounting systems.

Non-listed companies should serious start the process of altering their organizational culture towards external auditing. System failures and shortcomings about accounting and documentation should be repaired immediately. Re-organization of the accounting department must be realized. As discussed in detail in the study, a supportive environment for auditors within the company is a crucial and an essential step towards external auditing. With the help of all these recommendations, companies will have a sound, cost effective auditing process that is highly qualified.

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