

Exploring The Effect Of Foreign Currency Volatility On Foreign Capital: The Case Of Turkey

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This paper, explores devaluation as a reason for the lack of long term foreign capital investments in countries such as Turkey. It touches the application of International Accounting Standards in Turkish Capital Market as Turkey's being a candidate for European Union. The detrimental consequences of applying existing taxation rules on the financial statements of foreign invested capital in Turkey is investigated by means of a case study. Suggestions are made for tax rule change in order to attract more foreign investment flow to Turkey.

Key words: Inflation, devaluation, foreign currency, foreign exchange loss

Introduction

Economic volatility affects of Foreign Direct Investments in developing countries, and alternative presentations of foreign currency denominated accounts of subsidiaries in foreign countries rather than by consolidation has been the subject of many studies(e.g. Ghose, 2004; Holt, 2004;). Documents such as SSAP 20 (for Canada and the U.K.) and FASB 52 (for the U.S.) are code of standards dealing with foreign currency exchange rates (Peter Selinger, 2007). Changes in exchange rates may have a significant effect on the performance of firms. This effect is determined by whether the firm has a long or short economic position in foreign currency. For example, with a net long economic position in foreign currency, a US firm will benefit (suffer) from a depreciation (appreciation) of the dollar as changes in the exchange rate influence expected future cash flows and revenues of a firm. (Bazaz and Senteney, 2001). Exchange rate changes affect both companies and consumers. Large changes in real exchange rates cause governments to consider protectionist policies, offer tax breaks for new (possible foreign) investment, or place controls on capital and exchange flows. This development may in turn effect the country's receiving of foreign capital investments (Bodnar, Bartov, 1995).

Extant literature, however, does not give an explanation of a real life experience that a foreign subsidiary operates in a country in the face of continued devaluations. Significant losses may occur as a consequence of devaluation of local currency. Likewise the effects of local tax laws on foreign subsidiaries' income or attracting foreign direct investment are not addressed. Exchange rate fluctuations is an ongoing issue around the Globe. For example, Angola's Kwanzas-AON jumped to 58.17 in 2002 from 30.92 in 2001 (a 88% increase). Argentina's Peso, and Colombian Peso are among many other examples (more information is available from www.oanda.com/interbank rates). These statistics points that devaluations continuously occur in different countries on different parts of the Globe. A foreign operation locally subject to either sharp or gradual devaluations may incur losses in terms of its presentation currency while making profits on its functional-local currency. If the country of operation of the foreign subsidiary do not have incentives taking into account this phenomena as it is explained in this article and do not adjust its national tax laws to prevent the possible losses of the foreign companies, may not be able to attract foreign direct investments. After having portrayed the problem now let's consider a specific country, Turkey who experienced this problem of devaluation for many years and still not attracting enough Foreign Direct Investment (FDI) to beef up her economy.

Historical Background

Turkey has been a candidate to enter the European Union [formerly the European Economic Community (EEC)] since the Ankara Agreement signed on September 12, 1963. In this regard, the government has been changing and updating its accounting rules and taxation regulations, in addition to its economic criteria. As far the accounting issues are concerned, the Capital Market Board of Turkey has adopted International Financial Reporting Standards (IFRS) to those companies whose shares are traded in the Istanbul Stock Exchange.(Capital Market Board of Turkey, Decree, serial: XI, no:25). As far as tax issues are concerned, Turkey has applied International Accounting Standard 29 (IAS 29), Financial Reporting in Hyperinflationary Economies, on all balance sheets as at December 31, 2003, and 2004. (Turkish Law number 5024 and related Procedural Tax Application Law decree no:328). Inflation adjustments for 2003 on balance sheets did not have any tax consequences, but inflation adjustments for 2004 did.

In accordance with IAS 29, the standard should be applied when the cumulative inflation rate over three years is approaching or exceeding 100%. (International Accounting Standart No: 29, more information can be available at www.iasplus.com). This is one of the signs that hyperinflation exists in the economy and, as a consequence, IAS 29 requires the financial statements to be restated. This application has been useful, as many large-size companies have updated their balance sheets, which were not showing the current purchasing power values of non-current assets-liabilities and shareholders' equity that were initially recorded on historical cost principle. My point here is to determine the consequences the inflation would have on financial statements if inflation

remains below 100% over the three-year period but may well be at or above 1% per month, which was recently the case with wholesale prices (the annual Wholesale Price Index annual increase is 11.6% as of December 2006).. According to the current Turkish tax law application, since this annual inflation increase is below the required level for restatement of accounts, there will not be any restatement of the financial statements to show the effects of inflation on financial statements as required by IAS 29,. In this case, even with 10–15% inflation and/or devaluation in the economy, the financial statements will be distorted again and will not be able to reflect their current purchasing power values.

Years	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Inflation	90.9	54.2	62.9	32.6	88.5	30.8	13.9	13.8	2.7	11.6
Devaluation	91.5	52.9	72.1	23.4	119.9	11.8	-15	-4	0.5	4.7
Interest rates	80	80	80	70	70	64	43	38	23	27

Table 1 (www.tcmb.gov.tr)

In an ideal situation, devaluation and inflation should run parallel. But in real life, due to high interest rates prevailing in the market and flow of foreign transitory investments, the parallel run of inflation and devaluation may not be the case as is shown on Table 1 for Turkey. From a different point of view, it may be considered that depressed currency devaluation enhances imports and helps stabilize inflation. On the other hand, it widens the foreign exchange deficit, which is financed by the foreign investments attracted by the higher interest rates. This is not a sign of a healthy economy because foreign investments are quite sensitive to fluctuations in the local economy and can leave the country within hours in case of an economic downturn. If foreign investors leave, it may leave the foreign currency equilibriums way above their level before the crisis. This in turn may fuel inflation due to higher imported costs but may gradually close the foreign deficit gap as imports will become more expensive and exports will increase due to currency devaluation.

I propose here that foreign companies-FDI providers in Turkey should be allowed to keep their records in the original hard currency and should be taxed accordingly. This will enable them to understand whether they have really incurred a loss or profit at the end of their financial periods. There may be periods during which they would not experience any devaluation at all due to high interest rates prevailing in the market. However, there may be periods of high or gradual devaluations running parallel to inflation. Applying IAS 21, The Effects of Changes in Foreign Exchange Rates, best solves this problem. Actually, Turkey's current Procedural Tax Law does not fully prohibit foreign companies from keeping their accounting records on a TL basis. According to item 215 of the Procedural Tax Law, "foreign companies may be allowed to keep their records other than the TL on the basis of cabinet decision and with the provision of their paid-up capital not being lower than 100 million USD." I consider that the criteria are high and getting a cabinet decision per company basis may require a considerable amount of time due to bureaucratic reasons.

IAS 21, The Effects Of Changes In Foreign Exchange Rates

International Financial Reporting Standards (IFRS), including International Accounting Standards (IASs), are issued by the International Accounting Standards Board (IASB), which represents all member countries. IAS 21, The Effects of Changes in Foreign Exchange Rates, deals with double currency reporting of financial statements. The objective, key definitions, and currency translation rules of IAS 21 which would shed light to my case study are summarized below in the following excerpt from the International Accounting website (www.iasplus.com):

Objective of IAS 21

The objective of IAS 21 is “to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.”

Key Definitions:

Functional currency: The currency of the primary economic environment in which the entity operates.

Presentation currency: The currency in which financial statements are presented.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

Basic Steps for Translating Foreign Currency Amounts into the Functional Currency:

Steps apply to a stand-alone entity, an entity with foreign operations (such as a parent with foreign subsidiaries), or a foreign operation (such as a foreign subsidiary or branch). The reporting entity determines its functional currency. The entity translates all foreign currency items into its functional currency. The entity reports the effects of such translation in accordance with paragraphs 20–37 and 50.

Foreign Currency Transactions

A foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction (use of averages is permitted if they are a reasonable approximation of actual).

At each subsequent balance sheet date: Foreign currency monetary amounts should be reported using the closing rate. Non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction. Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in profit or loss in the period.

Translation from the Functional Currency to the Presentation Currency: The results and financial position of an entity whose functional currency is not the currency of a

hyperinflationary economy are translated into a different presentation currency using the following procedures:

Assets and liabilities for each balance sheet presented (including comparatives) are translated at the closing rate at the date of that balance sheet.

Income and expenses for each income statement (including comparatives) are translated at exchange rates at the dates of the transactions

All resulting exchange differences are recognised as a separate component of equity.

Special rules apply for translating the results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy into a different presentation currency. Where the foreign entity reports in the currency of a hyperinflationary economy, the financial statements of the foreign entity should be restated as required by IAS 29, Financial Reporting in Hyperinflationary Economies, before translation into the reporting currency.

Growing International Operations Adopt IFRS

Although business operations in foreign countries have existed for centuries, we have entered an era of unprecedented activity of worldwide production and distribution. Many examples exist of the growing importance of international operations for U.S. companies. Mobile Oil, Texaco, Gulf Oil, Dow Chemical, and Coca Cola earn more than 60% of their total operating profits in international operations. U.S. multinational companies such as Mobile, IBM, and American Express do business with more than 50 countries around the world. U.S. exports and imports have increased more than ten times in the last two decades. U.S. direct investments abroad have increased from \$32 billion in 1960 to \$600 billion in 1992. International finance has also become increasingly important as it serves world trade and foreign investment. International earning assets for the Bank of America, for example, represent more than half its total earning assets. Citibank maintains more than 250 overseas branches in over 100 countries. (A.D. Guithues, 1994).

Turkey is not the only country that wants to adopt IFRS as its reporting base. In Canada, according to the Accounting Standards Board's (AcSB) Strategic Plan, Canada is converging its accounting standards with IFRS. (More information on this matter is available at www.asbcanada.org). In the U.S., similar convergence activities are underway. The Financial Accounting Standards Board (FASB) says, "joint projects are those that standard setters have agreed to conduct simultaneously in a coordinated manner. Joint projects involve the sharing of staff resources, and every effort is made to keep joint projects on a similar time schedule at each Board. Currently, the FASB and IASB are conducting joint projects to address Revenue Recognition and Business Combinations." (More information on this matter is available at fasb.org). Based on the rules of IAS 21, the effects of devaluation are best explained by numerical examples. The following case study has been inferred from my past accounting management

experience with foreign companies in Turkey. The case study indicates that, a Canadian parent company whose subsidiary operates in Turkey keeps its accounts in TL for local tax purposes and also reports in CAD in order to be consolidated with the parent company's financial statements on IAS principles.

The 11 transactions in the case study start with the establishment of the company and include merchandise purchases, exports, imports, buying of non current asset-machinery, its depreciation calculation, and calculation of cost of goods sold (COGS). All rules with regard to the application of accounting rules are the same in both TL and CAD accounts; that is, inventory valuation, useful life of the machinery, and its amortization method have all been applied in the same manner on both TL and CAD accounts. Every transaction is converted from TL to CAD at the exchange rate prevailing at the date of the transaction. Devaluation of TL against CAD is assumed to be 1% per month; the total cumulative (compound) devaluation rate is 12.7% per annum.

Case Study

Assumptions

The company (subsidiary) is located in Turkey and subject to consolidation in Canada. It is assumed that the Canadian Parent Co. is consolidating on IFRS basis for international reporting purpose.

All accounting treatments are the same in both countries.

Inventories are valued on FIFO method.

Reporting (presentation) currency to the parent company is CAD.

It is assumed that TL rate depreciates against CAD on monthly basis as 1%.

Annual compound devaluation is 12.7%.

The economic life of the machine in accordance with IFRS and Local Tax Law is 10 years and

Straight Line amortization on pro-rata basis is applied.

Pro rata amortization is calculated both for Local and IFRS side.

All records have been revised at year end and necessary closing entries have been made.

Journal entries have been separately recorded at TL and CAD general ledgers.

Monthly VAT (GST) accruals have been made but no payment has been realised.

VAT:Value Added Tax same as GST:Government Services Tax

All figures on TL Journal Book is denominated in "million TL"

Transactions

	Date & Event	Journal Entry	DEBIT (TL)	CREDIT (TL)	CAD/TL RATE	DEBIT CAD	CREDIT CAD
	31/01/2006						
	Company XYZ has been established with 100 billion TL capital paid as cash						
1		Bank	100,000		687,000	145,560	
		Capital		100,000	687,000		145,560
	28/02/2006						
	100 Pieces of goods have been purchased on credit 100						
2		Inventory	10,000		693,870	14,412	

	million TL each + GST (18 %)						
		Deductable GST	1,800		693,870	2,594	
		Suppliers		11,800	693,870		17,006
	31/03/2006						
3	Machinery purchase in cash for 50 billion TL + GST (18 %)	Machinery & equipment	50,000		700,809	71,346	
		Deductable GST	9,000		700,809	12,842	
		Bank		59,000	700,809		84,188
	30/04/2006						
4	100 Pieces of goods have been purchased on credit 120 million TL each + GST (18 %)	Inventory	12,000		707,817	16,954	
		Deductable GST	2,160		707,817	3,052	
		Suppliers		14,160	707,817		20,005
	31/05/2006						
5	100 Pieces of goods have been sold to customer A on credit 220 million TL each + GST (18 %)	Customer A's account	25,960		714,895	36,313	
		Domestic sales		22,000	714,895		30,774
		GST payable		3,960	714,895		5,539
	30/06/2006						
6	Payment to suppliers for the first purchase (transaction 2)	Suppliers	11,800		722,044	16,342	
		Bank		11,800	722,044		16,342
	31/07/2006						
7	50 Pieces of goods exported to customer C in Canada for 120 CAD each (on credit)	Customer C's account	4,376		729,264	6,000	
		Export sales		4,376	729,264		6,000
	Receivable from customer C in CAD 6,000	6,000					
	31/08/2006						
8	25 Pieces of goods exported to customer D in Germany for 120 Euro (€) each (on credit)	Customer D current account	2,104		736,557	2,857	
		Export sales		2,104	736,557		2,857
	CAD/TL rate	736,557					
	CAD/€ parity (1 CAD = 1.05 €)	1.05					
	CAD is stronger against €	701,483					
	Euro/TL rate	3,000					
	€ equivalent of the export	2,104,448,534					
	TL equivalent of the export	2,857					
	CAD equivalent of the export						
	30/09/2006						
9	Payment received from customer A (transaction 5)	Bank (TL)	25,960		743,923	34,896	
		Company A's account		25,960	743,923		34,896
	31/10/2006						
10	Payment received from customer C (6,000 CAD)	Bank CAD account (con. TL)	4,508		751,362	6,000	
		Company C's current account		4,508	751,362		6,000
	30/11/2006						
11	Payment received from customer D (3,000 €)	Bank Euro account (con. TL)	2,475		758,875	3,261	

transaction 8)

	Company D's current account	2,475	758,875	3,261
CAD/€ parity (1 CAD =0.92 €)				
€ is stronger against dollar	0.92			
CAD/TL rate	758,875			
Euro/TL rate	824,865			
€ equivalent of the export	3,000			
TL equivalent of the export	2,474,593,696			
CAD equivalent of the payment	3,261			
TOTALS OF THE JOURNAL BOOK BEFORE THE YEAR END ADJUSTMENTS		262,143	262,143	372,430 372,430

TI Ledger Accounts

ABBREVIATIONS:

YEA : YEAR END ADJUSTMENT

B : BALANCE

BAYEA : BALANCE AFTER YEAR END ADJUSTMENT

GAFS : GOODS AVAILABLE FOR SALE

EI : ENDING INVENTORY

COGS : COST OF GOODS SOLD

BANK			
1	100,000	3	59,000
9	25,960	6	11,800
10	4,508		
11	2,475		
B	62,143		

CAPITAL			
	1		100,000
		B	100,000

INVENTORY			
2	10,000	YEA 2	19,000
4	12,000		
		B	22,000
		BAYEA	3,000

MACHINERY			
3	50,000		
		B	50,000

DED. GST			
2	1,800		
3	9,000		
4	2,160		
		B	12,960

GST PAY.			
		5	3,960
		B	3,960

CUSTOMER A			
5	25,960	9	25,960
		B	0

CUSTOMER C			
7	4,376	10	4,508
YEA 8	133		
		B	133
		BAYEA	0

CUSTOMER D			
8	2,104	11	2,475
YEA 9	370		
		B	370
		BAYEA	0

SUPPLIERS			
6	11,800	2	11,800
		4	14,160
		B	14,160

COGS			
YEA 2	19,000		
		BAYEA	19,000

F/X GAIN			
		YEA 8	133
		YEA 9	370
		BAYEA	503

DOMESTIC SALES			
		5	22,000

EXPORT SALES			
		7	4,376
		8	2,104

AMORT. EXP.			
YEA 1	4,167		

B	22,000	B	6,480	BAYEA	4,167
ACCUM. AMORT.					
YEA 1	4,167				
BAYEA	4,167				
TOTAL OF DEBIT BALANCES		<u>151,270</u>		TOTAL OF CREDIT BALANCES	
				<u>151,270</u>	

CAD Ledger Accounts

ABBREVIATIONS:

YEA : YEAR END ADJUSTMENT

B : BALANCE

BAYEA : BALANCE AFTER YEAR END ADJUSTMENT

GAFS : GOODS AVAILABLE FOR SALE

EI : ENDING

INVENTORY

COGS : COST OF GOODS SOLD

BANK				CAPITAL				INVENTORY			
1	145,560	3	84,188	1	145,560	2	14,412	YEA 2	27,127		
9	34,896	6	16,342			4	16,954				
10	6,000	YEA 3	8,109								
11	3,261										
B	89,186			B	145,560	B	31,365				
BAYEA	81,077					BAYEA	4,238				
MACHINERY				DED. GST				GST PAY.			
3	71,346	2	2,594	YEA 4	1,579	YEA 6	373	5	5,539		
		3	12,842								
		4	3,052								
B	71,346	B	18,488					B	5,539		
		BAYEA	16,909					BAYEA	5,167		
CUSTOMER A				CUSTOMER C				CUSTOMER D			
5	36,313	9	34,896	7	6,000	10	6,000	8	2,857	11	3,261
		YEA 7	1,417					YEA 9	404		
B	1,417			B	0					B	404
BAYEA	0									BAYEA	0
SUPPLIERS				F/X LOSS				F/X GAIN			
6	16,342	2	17,006	YEA 3	8,109					YEA 5	2,194
YEA 5	2,194	4	20,005	YEA 4	1,579					YEA 6	373
				YEA 7	1,417					YEA 9	404
		B	20,669	BAYEA	11,105					BAYEA	2,971
		BAYEA	18,474								
DOMESTIC SALES				EXPORT SALES				AMORT. EXP.			
		5	30,774			7	6,000	YEA 1	5,946		
						8	2,857				
		B	30,774			B	8,857	BAYEA	5,946		

ACCUM. AMORT.		COGS	
YEA 1	5,946	YEA 2	27,127
BAYEA	5,946	BAYEA	27,127

TOTAL OF DEBIT BALANCES 217,749

TOTAL OF CREDIT BALANCES 217,749

Year End Adjustments

TOTALS OF THE JOURNAL BOOK CARRIED FORWARD BEFORE THE YEAR END ADJUSTMENTS

		262,143	262,143	372,430	372,430
		DEBIT (TL)	CREDIT (TL)	DEBIT USD	CREDIT USD
	12/31/2006				
	Year end adjustment entries				
1	Machinery's annual depreciation of 10 % according to straight line method calculated on pro-rata basis 50,000,000,000 / 10 / 12 X 10 = 4,166,666,667 TL	Depreciation expense	4,167		
		Accumulated depreciation		4,167	
	Machinery's annual depreciation of 10 % according to straight line and economic life method On IFRS 21 side it is also calculated on pro-rata basis. March - December 10 months	Depreciation expense		5,946	
	Machinery cost in CAD	Accumulated depreciation			5,946
	Amortization of the year : Cost / 10 / 12 X 10	71,346			
		5,946			
2	Calculation of cost of Goods Sold (COGS)	COGS	19,000	27,127	
		Inventory		19,000	27,127
3	TL balance of Bank account (in million TL)	62,143			
	\$/TL closing rate at year end	766,464			
	CAD equivalence of TL balance of Bank account from closing rate	81,077			
	TL bank account balance in CAD before the adjustment	89,186			
	Adjustment entry on CAD ledger for bank TL balance	8,109			
		F/X difference loss		8,109	
		Bank account			8,109
4	GST deductible account balance in (million TL)	12,960			
	CAD equivalent of GST deductible account before the adjustment	18,488			
	\$/TL closing rate at year end	766,464			
	CAD equivalent of GST deductible account from year end closing rate	16,909			
	Adjustment entry for deductible GST on CAD ledger	1,579			
		F/X difference loss		1,579	
		GST deductible account			1,579
5	Year end balance of suppliers account in (million TL)	14,160			
	Suppliers account balance in CAD before the adjustment at year end	20,669			
	\$/TL closing rate at year end	766,464			
	Suppliers account balance in CAD adjusted from the year end closing rate	18,474			

Adjustment entry for suppliers account on CAD ledger	2,194			
	Suppliers			2,194
		F/X gain		2,194
6 GST payable account balance in (million TL)	3,960			
CAD equivalent of VAT payable account before the adjustment	5,539			
\$/TL closing rate at year end	766,464			
CAD equivalent of VAT payable account from year end closing rate	5,167			
Adjustment entry for payable GST on CAD ledger	373			
	GST payable			373
		F/X gain		373
7 Company A TL account balance	0			
Company A's account balance in CAD before the adjustment	1,417			
Company A's account should be nil balance as of year end 31/12/2001 on CAD ledger	0			
Adjustment entry to Company A's account on USD ledger	1,417			
	F/X difference loss			1,417
	Company A account			1,417
8 Company C (Canadian importer) TL account balance before the year end adjustment (in million TL)	133			
Company C's account balance in CAD ledger	0			
Company C's account should also be nil balance as of year end 31/12/2001 on TL ledger	0			
Adjustment entry to Company C's account on TL ledger	133			
	Company C's account	133		
		F/X income	133	
9 Company D's (German importer) account balance in (million TL) before the adjustment	370			
Company D's account balance in CAD before the adjustment	404			
Company D's account balance in Euro	0			
Company D's account should also be nil balance as of year end 31/12/2001 on TL ledger	0			
Company D's account should also be nil balance as of year end 31/12/2001 on CAD ledger	0			
Adjustment entry to Company D's account on TL ledger	370			
Adjustment entry to Company D's account on CAD ledger	404			
	Company D's account	370		
		F/X gain	370	
	Company D's account			404
		F/X gain		404
Journal book totals		<u>285,813</u>	<u>285,813</u>	<u>419,578</u> <u>419,578</u>

Adjusted Trial Balances TI And CAD

Adjusted balances in year end trial balance	TL	TL	CAD	CAD
Bank TL account	62,143		81,077	
Capital account		100,000		145,560
Inventory	3,000		4,238	
GST deductable	12,960		16,909	
GST payable		3,960		5,167
Machinery (F/A)	50,000		71,346	
Machinery accumulated amortization		4,167		5,946
Yearly depreciation expense	4,167		5,946	
Suppliers' account		14,160		18,474
Company A's account	0		0	
Company C's account	0		0	
Company D's account	0		0	
Cost Of Goods Sold	19,000		27,127	
Domestic sales		22,000		30,774
Export sales		6,480		8,857
F/X difference loss	0		11,105	
F/X difference gain		503		2,971
Rounding error	0	0	0	0
Adjusted trial balance totals	<u>151,270</u>	<u>151,270</u>	<u>217,749</u>	<u>217,749</u>

Income Statements In TI And CAD

01/01/2006 - 31/12/2006 Income Statement	TL	CAD
Domestic sales	22,000	30,774
Export sales	6,480	8,857
Total sales	28,480	39,631
COGS	-19,000	-27,127
Gross profit	9,480	12,504
Amortization expense	-4,167	-5,946
F/X difference gain	503	2,971
F/X difference loss	0	-11,105
Rounding error	0	0
Income / loss (-) before tax	<u>5,816</u>	<u>-1,576</u>

Balance Sheets In TI And CAD

Balance Sheet as of 31/12/2006	TL ASSETS	TL LIAB.& EQ.	CAD ASSETS	CAD LIAB.& EQ.
Bank	62,143		81,077	
Inventory	3,000		4,238	
Account receivable	0		0	
GST deductable	12,960		16,909	
Non-current assets (machinery)	50,000		71,346	
NCA accumulated amortization	-4,167		-5,946	
NCA (net)	45,833		65,401	
Suppliers account		14,160		18,474
GST payable		3,960		5,167
Capital account		100,000		145,560

Income statement		5,816	-1,576
Balance sheet totals	123,936	123,936	167,625

Inventory Calculations In TI And CAD

CALCULATION OF COST OF GOODS SOLD IN ACCORDANCE WITH FIFO (FIRST IN FIRST OUT) (MILLION TL)

DATE	EXPLANATION	QUANTITY	PURCHASES		QUANTITY	SALES		QUANTITY	REMAINDER	
			UNIT COST	TOTAL		UNIT COST	TOTAL		UNIT COST	TOTAL
28/02/2001	GOODS IN	100	100	10,000	-	-	-	100	100	10,000
30/04/2001	GOODS IN	100	120	12,000	-	-	-	100	120	12,000
31/05/2001	GOODS OUT				100	100	10,000	0	100	0
31/07/2001	GOODS OUT				50	120	6,000	50	120	6,000
31/08/2001	GOODS OUT				25	120	3,000	25	120	3,000
COST OF SALES AT 31/12/2001					175		19,000			
VALUE OF GOODS REMAINED AT 31/12/2006					25		3,000			

CALCULATION OF COST OF GOODS SOLD IN ACCORDANCE WITH FIFO (FIRST IN FIRST OUT) (CAD)

DATE	EXPLANATION	QUANTITY	PURCHASES		QUANTITY	SALES		QUANTITY	REMAINDER	
			UNIT COST	TOTAL		UNIT COST	TOTAL		UNIT COST	TOTAL
28/02/2001	GOODS IN	100	144.12	14,412	-	-	-	100	144.12	14,412
30/04/2001	GOODS IN	100	169.54	16,954	-	-	-	100	169.54	31,365
31/05/2001	GOODS OUT				100	144.12	14,412	0	144.12	16,954
31/07/2001	GOODS OUT				50	169.54	8,477	50	169.54	8,477
31/08/2001	GOODS OUT				25	169.54	4,238	25	169.54	4,238
COST OF SALES AT 31/12/2001					175		27,127			
VALUE OF GOODS REMAINED AT 31/12/2006					25		4,238			

Tax Effects On CAD

Since the company operating in Turkey it will be subject to local tax rules.

Let's assume that the effective tax rate is 25% in Turkey.

Income before tax in TL	5,816
Tax expense in TL	1,454
Net income in TL	4,362
Equity at the beginning of the year in CAD	145,560
Tax paid in CAD	1,897
Equity at the end of the year in CAD	
Paid in capital in CAD	145,560
Loss of the period in CAD	-1,576
Tax paid in CAD	-1,897
Equity at the end of the year in CAD	142,087
Loss on equity in CAD due to depreciation of TL	-3,473

Results Of The Case Study And Possibility Of Hedging

The case study at the appendix shows that due to devaluation effect on the TL side, the company is incurring an income before tax and therefore paying the income tax. Whereas on the CAD side the company is incurring a loss. In order to hedge against the income tax to be paid on the TL side, the company needs to create a liability in a foreign currency and incur foreign exchange losses. The income before tax figure in TL is 5,816 (TL figures are expressed in million TL). I.e. In order to create as much foreign exchange loss as TL 5,816, let's assume that the company borrows CAD 80,110 at February 28 and converts it to TL. The TL equivalent of this amount is 55,586. Without considering the interest on this loan, the company will incur a foreign exchange loss of TL 5,816 at year end when the exchange rate is TL 766,464 per CAD $((80,110 \times (766,464 - 693,870))$). By incurring a foreign exchange loss on the loan, the Canadian subsidiary will not pay any taxes on TL since its income before tax is zero. Let's see what will happen on the CAD side. On the CAD side the TL equivalent of CAD 80,110 as at February 28th is TL 55,586. TL 55,586 at December 31 is equal to CAD 72,523 $(55,586,000,000/766,464)$, the CAD loss of the company due to foreign exchange loss on the loan 7,587 and the total loss on the CAD side is $(7,587 + 1576)$ 9,163. It may be argued that CAD 9,163 loss can partly be eliminated by investing the TL equivalent of the amount in government bonds or time deposits. But in our assumption above we did not consider any interest on the loan either. Considering the borrowing interest rates are greater than the interest rates on government bonds, the company's loss of 9,163 on the CAD side can be considered as minimum.

Conclusion

The result of the case study is that even if the same accounting rules on both sides of the reporting currencies are applied (in our case the local currency is TL and reporting-presentation currency is CAD) there can be totally different or even contradictory results. In the case study it is clearly shown that the company is incurring a profit before tax figure on its TL books and paying income tax. On the other hand on its CAD books the company is incurring a loss. If there had been a chance for this subsidiary to present its financials in CAD in stead of TL, it would not have paid tax. Due to operating in Turkey and being subject to Turkish Tax Legislation, the subsidiary has incurred a loss in real terms (in a medium where no devaluation occurs-namely in a CAD environment) and still paid taxes and consequently lost a portion of its equity. Its beginning equity at January 1, 2006 is CAD 145,560 and its ending equity as at December 31, 2006 is CAD 142, 087, the subsidiary in real terms (in CAD) has lost its equity by CAD 3,473 (2.4%). My calculations on the CAD side did not include deferred tax (future income tax) effect due to temporary differences between CAD and TL applications, calculation of deferred tax would even increase the loss on the CAD side. Under these conditions any foreign company with long term investment attitudes can hardly be attracted. Existing tax rules can only give way to a foreign investment to keep its records in its functional (presentation) currency on the provision of investing at least USD 100 million and with the approval of the Turkish Cabinet. USD 100 million is not a small amount, even a one USD million can bring value added to the economy, provide a few jobs that may lead to

the absorption of unemployed. The best solution, in my opinion to this problem is changing the item of 215 of the Procedural Tax Law and allowing all long term foreign investments coming for production and/or merchandising purposes without any minimum capital requirement and without seeking the approval of the Cabinet. The case study has particularly been prepared on Turkey whose current account balance is around USD 33 billion (about 8% of its GNP), and its economy has been stabilized since 2001 on IMF's stake. The greater the amount of current account deficit the more the possibilities that the country may face devaluations. Therefore any country who is running proportionately high current account deficits, facing continued devaluations can alleviate its problems by attracting more foreign direct capital which would in turn cure the current account deficit problems and stabilizes the economy. As it has been referred in the above paragraph, countries like Turkey and the ones who face current account deficit problems and devaluation risks are advised to take into account the accounting and tax problems of foreign companies and attract more foreign direct investment as an important solution to cure their current account deficit problems and therefore avoid sudden or gradual devaluation risks.

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