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Value Relevance of Mandatory IFRS Reporting for Private Companies in Turkish Financial Markets

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Abstract

A new Turkish Commercial Code was enacted in Turkey in 2011 by Law # 6102, introducing several radical changes in a broad range of legal, organizational, administrative, and operational fields in corporate life in the country. Among the most critical of these changes were the newly introduced legal requirements for companies to produce IFRS-based audit reports regardless of the size of the firms or whether they are publicly or privately held companies. We examine the issue of mandatory of IFRS reporting from the perspective of the Economic Theory of Networks with respect to creating and enhancing corporate value as well as net social benefits of "network externalities." We look at a review of the international examples of "value relevance" of mandatory IFRS reporting in a number of markets though there exists quite a limited array of research and data on unlisted/private companies in the literature. However, the paper argues that considering; a) the importance of the private companies in the economy, b) the impact of audited statements on the companies' ability to access higher quality financial resources and higher levels of management efficiency and, c) the resulting outcome in more efficient allocation of capital in the economy, implementation of IFRS reporting in Turkey on as broad a scale as technically possible would constitute an important "value driver" at micro as well as macro economic levels.

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1. Introduction

We frequently refer to the general concept of IFRS as the language of financial reporting, kind of a foreign language that facilitates clear and effective communications among the industry professionals, investors and the interested public in financial markets at a truly global level. IFRS provides a common set of conceptual tools and principles that help accountants, auditors, analysts and regulators derive internally consistent, verifiable, independently testable as well as practicable information on the activities of firms, operating under infinitely economic, social and political environmental condition in a wide range of markets in the world. As such, IFRS

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enables the effective and accurate measurement of corporate performance, thus, contributing greatly to the level of confidence and reliance in the valuation of economic enterprises.

Mandatory IFRS reporting has already become an industry norm in nearly 123 countries in the world. Regulators generally agree that public firms must present audited financial statements based on IFRS. Langli and Svanström (2013) suggest that one important reasons that underlie this broad consensus is the belief that IFRS-based audited statements help capture the welfare effect of reliable and high quality financial information on the activities of the public companies. These reports tend to enhance the effectiveness of financial markets by "providing relevant and reliable firm-specific information that enables more precise forecasts of future cash flows and reduced uncertainty, leading to higher access to capital and higher level of investments and growth in the economy." (Langli and Svanström, 2013:2) Therefore, it is a generally accepted proposition in the financial markets that the benefits of statutory audit reports based on IFRS outweight the costs of preparing and maintaining them.

On the other hand, the same level of consensus does not exist when it comes to IFRS-based statutory audit reports by private companies. In several countries, including the U.S., Japan and others, private firms operate without any requirements to disclose financial statements to the public or to related public agencies, (Arrunada, 2011) Yet, in some other countries, e.g. in EU members, private firms must prepare financial statements and must disclose them publicly. However, even though the regulations make it mandatory to prepare and disclose financial statements for all private firms, there exists ample room for member states to create exceptions to the rule based on size of the firms, sales volumes and number of employees.[2]

Turkey is one of the countries where mandatory IFRS reporting as presented in audit reports for private companies was legislated into the law in 2011. A new Turkish Commercial Code was enacted in Turkey in 2011 by Law # 6102, introducing several radical changes in the broad range of legal, organizational, administrative, and operational fields in corporate life in the country. Among the most critical of these changes were the newly introduced legal requirements for companies to produce IFRS-based independent audit reports regardless of the size of the firms or whether they are publicly or privately held companies. The objectives of the law-maker, here, were a) to ensure transparency and consistency in the financial reporting practices of the companies, b) to enhance accountability to the shareholders, c) to attain reliable and consistent tax reporting systems, and, d) to enhance stakeholder value in these companies. Once a well-intended legislative initiative, the mandatory IFRS reporting and independent audit requirements have been gradually relaxed since 2014, to the point of being completely overlooked at the present.

This paper is designed much in the form of a policy-oriented study, starting with a review of the previous works that focus on value relevance of IFRS reporting for private companies in the economy, in general, and in Turkey, in particular. The paper draws on the case of international practices to argue that "true and fair" reporting is the sole basis of understanding and capturing the corporate value created in the market, enabled only through systematical adoption of IFRS-based independent audit practices in the market. The paper also argues that IFRS-based independent audit works is the "necessary condition" for the Public Oversight Board in Turkey in the proper and fair fulfillment of its regulatory duties and responsibilities.

The paper is constructed in four main parts. The first part provides a review of the existing body of research on value relevance of IFRS-based audit on listed as well as unlisted firms as studied in a number public and private markets in the world. This review reveals that mandatory IFRS reporting unveils ciritical issues in the functioning of the respective firms. Agency problems, corporate governance problems, financial efficiency issues will be some of these problems to be discussed in the related sections of this paper. This review also highlights, once again, the

[2] The European Commission issued its 4th Directive under Art. 51 in 1978, setting the minimum requirements for the preparation, content and disclosure rules of annual accounts for private and public firms. These rules have, since, made it possible for member states to interpret them in accordance with their policy goals and expectation in a broad range of requirements, from full disclosure even for firms with no sales in Denmark, Malta, Sweden to disclosure for firms with a certain volume of sales like in Germany, the Netherlands, etc.