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**SUPERVISION/EXAMINATION ACTIVITIES
IN THE TURKISH BANKING SYSTEM
WITH SPECIAL EMPHASIS ON ACCOUNTING PRACTICES**

A Thesis Presented

by

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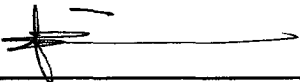
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ABSTRACT

SUPERVISION/EXAMINATION ACTIVITIES IN THE TURKISH BANKING SYSTEM WITH SPECIAL EMPHASIS ON ACCOUNTING PRACTICES

**TUNABOYLU, ALI NAILI
MASTER OF BUSINESS ADMINISTRATION
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The recent developments in the international political and economic relations have produced important changes in the political and economic structure of Turkey especially during the last decade. As a result of these developments, Turkish Banking System has entered into the structural transformation process. The vitally important functions of banks in the economic and commercial life of Turkey necessitate the realization of strict and effective banking supervision/ examination activities.

Parallel to developments that occurred in the banking business, there have been drastic improvements in the banking supervision/examination activities in Turkey during the 1980s. The aim of this study is to investigate such recent developments, to identify current problems, and to develop recommendations based on the theoretical framework. This paper develops an approach to the banking supervision/examination through emphasizing accounting practices, and attempts to emphasize in the development of efficient, reliable banking supervision/ examination activities and the importance of accounting practices.

The initial parts of this study consist of a literature survey followed by an empirical study based on the results of a

series of interviews made with experts. The interviews were made with Sworn-in Bank Examiners, the authorities of the Banking Supervision Department of the Central Bank, independent external auditors and academicians. The questions asked in the interviews are given in the Appendix 1.



ÖZET

TUNABOYLU, ALİ NAİLİ

TÜRKİYE'DE BANKACILIK DENETİM/GÖZETİM FAALİYETLERİ

EYLÜL, 1990

Uluslararası politik ve ekonomik ilişkilerde son yıllarda ortaya çıkan değişimler, Türkiye'nin de ekonomik ve politik yapısında, özellikle son 10 yılda, önemli değişiklikleri beraberinde getirmiştir. Bu gelişmelerin bir sonucu olarak, ülkemizde bankacılık sektörü büyük bir yapısal değişim sürecine girmiş bulunmaktadır. Bankaların ülkemiz ekonomisi ve ticaret yaşamındaki büyük önemleri bu kuruluşların çok sıkı ve etkin bir denetim/gözetim altında bulunmasını gerektirmektedir.

Türkiye'de bankaların denetim/gözetimi konusunda -bankacılık sektöründeki gelişmelere koşut olarak- 1980'lerde büyük gelişmeler kaydedilmiştir. Bu çalışmanın amacı; son yıllardaki sözkonusu gelişmeleri ortaya koymak, şu andaki mevcut sorunları tespit etmek ve (çalışmanın ilk bölümlerinde çizilen teorik çerçeve doğrultusunda) çözümler önermektir. Bu tez, bankaların denetim/gözetimi sürecine muhasebe uygulamaları açısından yaklaşmaya çalışmakta; banka denetim/gözetimlerinin etkin ve güvenilir yapılması ile muhasebe uygulamaları arasında bir bağlantı kurmayı hedeflemektedir.

Tezin teorik kısmını literatür taraması; ampirik kısmını ise ülkemizde, bu konuda uzman sayılan taraflarla yapılan

mülakatların sonuçları oluşturmaktadır. Ampirik bölümde yapılan mülakatlarda; Bankalar Yeminli Murakıpları, Türkiye Cumhuriyeti Merkez Bankası Bankalar Gözetim Dairesi yetkilileri, bağımsız dış denetim kuruluşları çalışanları ve bu konuda uzman üniversite öğretim üyeleri ile görüşülmüştür. Yukarıda belirtilen taraflarla yapılan mülakatlarda sorulan başlıca sorular Ek:1'de sunulmuştur.



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TABLE OF CONTENTS

	<u>PAGE</u>
ABSTRACT.....	iii
OZET.....	v
ACKNOWLEDGEMENTS.....	vii
INTRODUCTION.....	1
CHAPTER 1. THE NATURE OF BANKING BUSINESS.....	8
1.1. Banks As Financial Intermediaries.....	8
1.1.1. Special Characteristics of Commercial Bank.....	11
1.1.2. Functions of Commercial Banks....	13
1.1.3. The Recent Trends in the Banking Industry.....	14
1.1.4. The Services and Operations of Banks.....	15
1.2. Introduction to Bank Financial Statements.....	18
1.2.1. Financial Statemets: A General View.....	21
1.2.2. Bank Balance Sheet.....	22
1.2.2.1. Bank Assets.....	23
1.2.2.2. Bank Liabilities.....	30
1.2.2.3. Bank Capital.....	32
1.2.2.4. Some Terms Used in Analyzing Bank Balance Sheet.....	33
1.2.3. Bank Income Statements.....	35
CHAPTER 2. REGULATORY ACTIVITIES IN THE BANKING INDUSTRY.....	38
2.1. Bank Regulatory Framework.....	38

2.2. Bank Supervision and Basic Supervisory Means.....	40
2.2.1. Field Examination.....	41
2.2.2. Off-site Supervision.....	44
2.2.2.1. Financial Analysis of Banks As a Means for Off-site Supervision.....	47
2.2.3. Other Means of Bank Supervision..	53
 CHAPTER 3. THE IMPORTANCE OF ACCOUNTING PRACTICES ON BANKING SUPERVISORY ACTIVITIES.....	 55
3.1. The Quality of Financial Information in Bank Supervision.....	55
3.2. Problems of Bank Supervision in LDCs...	58
3.2.1. Inadequate Supporting Structures.....	59
3.2.2. Structural Problems.....	60
3.2.3. Weaknesses in Supervision.....	61
3.3. The Environmental Factors for the Effective Bank Supervision: With Special Emphasis on Accounting Practices.....	64
3.3.1. GAAPs.....	65
3.3.2. Accounting Standards and Practices.....	65
3.3.3. Uniform Chart of Accounts and Financial Statements.....	68
3.3.4. Internal Control.....	69
3.3.4.1. The Review of Internal Control by Examiners.....	74
3.3.5. External Audit.....	75
3.3.5.1. The Review of External Audit by Examiners.....	80

CHAPTER 4. THE TURKISH CASE.....	84
4.1.Regulatory Activities in the Turkish Banking System:A General Framework.....	84
4.1.1.Recent Developments.....	84
4.1.2.Internal Regulatory Authorities..	85
4.1.3.External Regulatory Authorities..	87
4.1.3.1.Public Regulatory Authorities.....	87
4.1.3.2.Independent External Audit Firms.....	92
4.2.Supervisory Activities in the Turkish Banking System.....	97
4.2.1.Supervisory Activities of the Central Bank of Turkey.....	97
4.2.2.Supervisory Activities of the Board of Sworn-in Bank Examiners.....	102
4.2.3.General Problems of Supervisory Structure in the Turkish Banking System.....	109
4.3.Accounting Practices in Turkish Banking Supervisory Activities.....	117
4.3.1.Current Situation About the Accounting Standards and Practices in the Turkish Banking System.....	118
4.3.2.Current Situation About the Uniform Chart of Accounts and Financial Statements in the Turkish Banking System.....	122
4.3.3.Current Situation About the Internal Control Practices in the Turkish Banking System....	124
4.3.4.Current Situation About the Independent External Auditing Practices in the Turkish Banking System.....	129

CONCLUSION.....	135
APPENDICES.....	141
Appendix 1.....	142
Appendix 2.....	147
BIBLIOGRAPHY.....	149



INTRODUCTION

Banks are financial intermediaries which have vitally important functions in the economy. In a developing country like Turkey which has scarce resources and faces with the problem of capital insufficiency, the functions of banks have become considerably important. Capital accumulation and allocation of this capital towards productive areas is of paramount importance for any economy, more so for Turkey. Compared to other sectors, the banking sector is subject to stricter control by the state regulatory authorities charged with this task. There are various tools of banking regulation. Supervision/ examination -the primary concern of this study- is one of the most important means of banking regulatory activities.

The broad goal of bank supervision is to promote a safe, stable, and efficient financial system. The need for supervision/examination by the state regulatory authorities arises from the special role banks play in the economy; banks hold an important part of the money supply, create money; they are the main means of implementing monetary policy, and intermediate between savings and investments. Public confidence is also a key factor to the smooth operation of the financial sector.

There are two basic means for the banking supervision/examination activities: Field examination (on-site supervision) and off-site supervision. Field examination is a form of supervision that is almost unique to banking. Examiners

regularly visit the banks to control their operations. The primary reason for this practice is that the principal asset items in which banks invest -loans- do not have readily ascertainable market values. Examination of documents is necessary to determine the quality of assets. Off-site supervision includes the financial analysis of banks by using basic financial and statistical techniques. It aims to determine the problems of banks and to take specific actions accordingly to solve them at an early stage of supervision.

The vitality of an effective and efficient supervisory mechanism for Less-Developed Countries (LDCs) is the basic reference point of this study, because increasing emphasis has been given to improving and strengthening the supervision/examination of banks in LDCs. This is primarily because of the shift in policy toward liberalization of financial markets and the fact that in many LDCs the banking system is in a state of crisis requiring rehabilitation or restructuring. In recent decades the number of operating banks and their volume of business have drastically increased, and the type of operations performed and services offered by banks have become extremely sophisticated. Therefore, banking has become a relatively more complex industry. Contrary to these developments, the supply and availability of examiners -both in terms of quantity and quality- has been scarce especially in LDCs like Turkey. In addition to these, in these countries the lack of structural prerequisites and inadequate supporting structures -infrastructural elements- have also influenced the workload of bank examiners and their

quality of work in an adverse manner.

Inadequate infrastructural elements for an effective and efficient banking supervision/examination mechanism includes the following dimensions: legal system, accounting practices, availability of sufficiently trained and experienced supervisors and financial opportunities of supervisors. On the other hand, the insufficient structural framework includes: institutional weaknesses in banking regulatory authorities and weaknesses in supervision itself.

The primary purpose of this study is to analyze the general situation of banking supervision/examination in Turkey by considering the factors -both infrastructural and structural- listed above through emphasizing the accounting aspect in a more detailed manner. As far as the supervision/examination activities are concerned, the accounting applications in the Turkish banking system which will be analyzed in this study primarily include the following factors:

- GAAPs,
- Accounting standards,
- Accounting practices,
- Uniform Chart of Accounts and Uniform Financial Statements,
- An effective and reliable internal control,
- An effective and reliable external audit.

Each factor can be accepted as a component of a whole process. These factors will be examined specifically in addition

to providing a general view of the overall supervisory situation in Turkey.

In Turkey, supervision/examination activities have been performed primarily by the Sworn-in Bank Examiners Board and the Central Bank of Turkey. Especially during 1980s, there have been certain developments in this area. However, there are still some problems in banking supervisory activities. For example, there are some inconsistencies among legal regulations about the banking supervision/examination. Lack of legal harmonization has caused some supervisory deficiencies. In addition to this, supervisory activities -by different state authorities- have been performed in an uncoordinated and completely independent way. This causes a waste of a substantial amount of time and resource. Furthermore; the recording and reporting of financial information, and the preparation of financial statements of banks used in supervisory activities have not been performed in a manner that provide a convenient basis to make an accurate, valid and comparable analysis. Hence, accounting practices which produce the primary inputs of supervision/examination activities have not been appropriate and convenient to perform an effective and efficient supervision.

Considering the development, problems, and deficiencies about the bank supervision/examination in our country, more comprehensive and advanced studies are essential. In spite of this necessity, up to now there have been very limited studies in this area. The basic purpose of this study is to overcome this deficiency. However, it is useful to indicate the fact that this

study is to overcome this deficiency. However, it is useful to indicate the fact that this study is just an introductory attempt which aims to provide some familiarity to the subject and to illustrate the current situation and problems in Turkey. This study will try to establish a relationship between supervisory activities and accounting practices, and to determine how these can be harmonized in the most effective way. The final objective is to identify the problems and to develop a set of recommendations and summarize the conclusions.

This study will consist of four chapters. The first and second chapters aim to clarify the nature of banking business and the regulatory activities in banking industry from a theoretical viewpoint. Chapter three deals with establishing the linkage between accounting and bank supervision/examination. The present conditions and practices concerning our topic in Turkey are taken up in Chapter Four. Finally; the conclusions, recommendations and summary make up the substance of the last section.

1.1. METHODOLOGY OF RESEARCH

Research Approach: Survey

Research Instrument: Open-end interviews

Sample Frame: - Turkish independent external audit firms.
- Accounting executives and internal auditors of commercial banks
- Officials of the banking supervision department of the Turkish Central Bank
- Sworn-in Bank Examiners

First of all, an attempt to create a comprehensive picture of current practices in Turkey necessitates primarily a study on secondary sources. We use books, periodicals, documents of governmental bodies (such as examination procedures and techniques used by the Central Bank of Turkey and the Board of Sworn-in Bank Examiners), and financial statements of commercial banks (their Balance Sheets and Income Statements).

In addition to secondary data collection and analysis, primary sources of data have been utilized by using "open-end interviews". As the performance analysis for banks and other related subjects in this study are relatively new concepts and are not widely known topics in Turkey, there are not so many experts in these subjects. This fact has caused the preference of interviews rather than using questionnaire as a tool of collecting primary data. Also, since our research topic is relatively a technical subject which requires technical knowledge, in-depth interviews are expected to facilitate the gathering of more detailed and reliable primary data.

Furthermore there are some theoretical reasons for the use of "open-end" interviews. Open-end interviews are designed to permit a free response from the subject rather than one that is limited to stated alternatives. The respondents are given the opportunity to answer in their own terms and in their own frames of reference. Thus, while their content is dictated by the research problem they impose no other restrictions on the content and manner of respondent answers. It enables the interviewer to ascertain a respondent's lack of knowledge and to detect

ambiguity. Its use also has another advantage: the responses to open-end questions can suggest possibilities of relations and hypotheses. Respondents will sometimes give unexpected answers that may indicate the existence of problems, relations or solutions not originally anticipated by the researcher.

Because of these theoretical and practical reasons, we prefer to use "open-end interviews" as an instrument at the primary data collection stage. The questions which have been used in interviews are given at Appendix 1.

Our sampling frame is stated above at the beginning of this part. The different aspects and stages of the performance evaluation process have been reviewed by these parties. Consequently an attempt is made for the integration of their responses in order to identify current situation and problems and to develop necessary recommendations.

The questions presented below which will be used in the interviews have been asked to the involved parties who are competent in related fields. Thus every question has not been asked to each object of our sample. Objects are required to answer only questions about which they have sufficient knowledge. The details of this are stated within the end of each question.

Within the framework of this study, I interviewed with 14 people. The composition of this interviewees is as follows: three sworn-in bank examiners, three experts from the Central Bank, three external auditors and four internal auditors of private banks.

CHAPTER 1 THE NATURE OF BANKING BUSINESS

1.1 Banks as Financial Intermediaries

Before all, banks are primarily financial intermediaries, therefore it is first necessary to analyze the financial intermediaries in order to acquire a basic understanding of the functions and characteristics of commercial banks and to examine the financial markets in which these intermediaries operate.

Financial markets are the transmission mechanism between savers-lenders and borrowers-spenders. Through a wide variety of techniques, instruments and institutions, financial markets mobilize the savings of millions and channel them into the hands of borrowers-spenders who need more funds than they have on hand. The existence of highly developed, widely accessible and smoothly functioning financial markets is of crucial importance in transmitting savings into the hands of those desiring to make investment expenditures (Ritter & Silber, 1986).

From the historical viewpoint, the evolution of financial markets can be summarized as follows (Pulsinelli & Miller, 1985): First, in a barter economy, the purchase of productive equipment can be undertaken through personal saving. When an economy evolves from a barter to a money standard, it becomes easier for people to separate the act of saving from the act of investment. Investors do not have to save personally; rather they can obtain money from the savers. As economies moved from barter to money, the stage was set for a new business: banking. By connecting savers with investors, banks could facilitate the transferal of

purchasing power. As the economy and the financial system developed, other financial institutions - intermediaries - emerged. Today commercial banks, savings and loan associations, mutual savings banks, credit unions, insurance companies, pension funds and mutual funds are all in this business. The process of financial intermediation has spawned a variety of financial assets such as stocks, bonds, mortgages, mutual funds, purchase agreements, etc.

Although some of the transfers of funds from surplus units to deficit units are made directly through borrowing or equity contracts, the different desires of surplus and deficit units create the need for financial intermediaries. Such differences might include the following dimensions: (Hempel et al. ,1986)

- Size
- Maturity
- Legal character
- Marketability
- Liquidity
- Divisibility
- Redeemability
- Risk

Thus financial intermediaries have tried to meet the diverse desires of the surplus and deficit units. They acquire funds by issuing their own liabilities to the public (savings deposits, savings and loan shares) and then turn around and use this money to buy primary securities (stocks, bonds, mortgages) for themselves. By holding a diversified portfolio of assets,

many intermediaries can reduce risk beyond the reduction available to individual units. They also assist the deficit units in finding funds in the desirable amount and form.

After this brief examination of the financial intermediaries, now it will be useful to take a closer look at one of them in particular: commercial banks. Commercial banks are the primary financial intermediaries that supply some special financial services. Most bank assets are financial in nature consisting primarily of money owed by non-financial economic units such as households, businesses and government. In general terms, they issue contractual obligations -primarily in deposit or borrowing form- in order to obtain the funds to purchase the financial assets. A bank's capital results from the sale of stock and the accumulation of retained earnings as in many other kinds of businesses but it represents a relatively minor source of funds. This is very vital for many parties -especially for bank examiners- in analyzing the financial condition of a commercial bank.

U.S. Legislators define bank as an organization which:

- accepts deposits that the depositor has a legal right to withdraw on demand, and

- engages in the business of making commercial loans

(Lewis & Davis, 1986).

Corrigan, who is the ex-president of the Federal Reserve Bank of New York has identified the special characteristics of banks. These are:

- the issue of transactions accounts,
- acting as a transmission belt for monetary policy,
- the backup source of liquidity for all other institutions and markets.

According to Corrigan, banks' central position in the financial markets comes about on the asset side of their balance sheets and the commercial banks give entree to firms and entities which do not enjoy stand-alone direct access to the securities markets. Their capacity to act as the source of backup liquidity depends on the "high degree of public confidence" which is contingent on the quality of banks' assets. One of their essential characteristics is their ability to create credit because banks, amongst financial institutions, have a special ability to create credit and thus are more important for the conduct of monetary policy.

1.1.1 Special Characteristics of Commercial Banks

Banks perform certain functions which give them a special role in the economic system. Taft (1986) states these functions through analyzing the factors specific to the banking business :

(1) Liability characteristics: Financial intermediaries create a multitude of liabilities, differing in terms of maturity and capital certainty. Maturity is important because, in the absence of perfect capital markets, having funds "at term" rather than "at call" constraints a wealthholder's flexibility to adapt to changing circumstances. Capital certainty refers to the degree of risk exposure to movements in the asset markets; for

example bank liabilities (such as deposit liabilities) provide an "ex ante" specification of their future nominal value but leave the real value uncertain. In contrast, non-bank liabilities (such as mutual funds liabilities) determine the future nominal value "ex post" and thus expose holders fully to developments in certain asset markets. However, safety is another vitally important dimension which constraints and creates the specific characteristics of the banks' products. Since the commercial banks have higher degree of leverage, they should be more careful and be controlled in a tighter manner.

(ii) Asset characteristics: The primary securities which intermediaries purchase vary widely in characteristics such as size, maturity, default risk and marketability. Intermediaries differ also in the extent to which they "acquire" or "create" the assets they hold. Non-banks deal with existing securities with predetermined characteristics, whereas depository institutions also create new financial instruments (such as loans) tailored to the individual needs and the characteristics of the borrower.

(iii) The nature of intermediation: Intermediation can vary in terms of size, maturity and risk as well as in terms of the assets, in that, non-bank assets are usually marketable securities whereas for depository institutions, the primary assets are in a non-marketable form such as loans.

(iv) The joint provision of other services: The depository institutions -in addition to intermediation- provide a wide variety of services compared to non-banks, an example of which is the payments services. Also non-banks can provide joint services which may be extremely different in characteristics and variety.

(v) Special relationships with the authority: Banks have privileged access to the central bank liquidity support, exclusive rights to provide certain services (agents for government securities), and government guaranties of safety. However, they are also subject to various constraints on their activities compared to the non-depository institutions. The differences in terms of regulatory restrictions will be examined in more detail in the subsequent parts of this study.

1.1.2 Functions of Commercial Banks

According to Oztin Akguc, primary functions of commercial banks can be summarized as follows: (Akguc, 1987)

(i) Intermediation: This is the primary function of banks. Banks try to link the deficit and surplus units in the economy.

(ii) Providing liquidity to financial resources: Banks aim to channel the funds in the international and national perspective.

(iii) Optimization of financial resources utilization: Banks aim to improve the economic conditions of the country through channeling the excess funds towards efficient and profitable investments and sectors although they do not create a new value or wealth. Through this function the commercial banks serve as catalysts of economic development.

(iv) Converting short term/ small amounts of funds to long-term funds: This function can also be called "transformation" function which improves the efficiency of financial intermediation.

(v) Creating Paper Money: Commercial banks can create a

purchasing power through borrowing (deposit funds). Paper money has no physical value but it can be used as a payment and exchange instrument by debiting or crediting the accounts of the banks.

(vi) Improvement of efficiency of monetary policy: All instruments and methods used by Central Banks to control monetary policy can only be effective if there is an efficient and developed banking system. The basic instruments of the monetary policy are the determination of reserve ratios, selective credit control and credit ceilings.

(vii) Development of international trade: Banking system can improve international trade through various payment and credit methods -such as factoring, forfeiting- both in terms of quality and quantity.

(viii) Improvement of income and wealth allocation: This function can be performed through an effective and efficient credit policy.

1.1.3 The Recent Trends in the Banking Industry

The recent developments and trends in the financial system have caused to slightly important effects which changed the financial markets drastically. Especially in the last decade, the separation of commercial banks from non-bank financial institutions has been no longer clear if we look at the distinction on the basis of product line. Traditionally a bank was distinguished from a non-bank in terms of two activities: accepting demand deposits and engaging in commercial lending activity. Commercial banks were the only financial institutions

authorized to offer checking accounts and made various loans. While that traditional definition still works well to describe most commercial banks in the developing countries, today it also describes many other financial institutions. Especially in the developed countries -such as the U.S.A. and the U.K.- which have more sophisticated financial system the commercial banks no longer uniquely offer those products because these two activities currently describe the mutual saving banks, savings/loan institutions and money market mutual funds. According to Johnson & Johnson (1985) the only difference between banks and non-banks on product line basis is the extent to which the institutions are involved in lending and deposit services. The commercial banks' primary business is characterized by securing funds from depositors and using those funds to make commercial and consumer loans, in contrast for other institutions such as brokerage firms, such services are not the primary services offered. While the central activity of banking remains the securing of deposit funds and making consumer/commercial loans. However, a typical commercial bank's products will be broadened if the current trends remain the same. In addition to the new services being offered, traditional services will be offered in different packages together with the developments in technology which will lead to greater automation in deposit and lending services.

1.1.4 The Services and Operations of Banks

As it was mentioned earlier, there are three primary services of commercial banks: deposit-securing, loan-making, and payments and collection. It is useful to examine the primary

services in more detail.

(i) Depository Services: Deposits account for approximately 80 to 90 % of a bank's sources of funds. Commercial banks hold different kinds of deposits in a variety of forms as the demand, time and savings deposits. According to Crosse & Hempel (1973), the demand deposits represent working balances; time deposits (other than savings deposits) usually consists of the liquidity reserves of corporations, other banks or individuals. In contrast, savings deposits represent a combination of accumulated savings and investment funds or liquidity reserves of individuals. One of the most important reasons for becoming a bank depositor is to use the payment facilities of the commercial banking system. Thus, banks offer a service for depositors to utilize the payment facilities. Other motives for the depositors are to accumulate savings for non-specific purposes and to accumulate funds for specific purposes over a predetermined maturity .

(ii) Credit Creation Services: For a typical bank, loans account for approximately 55 to 60 % of the total assets. A large part of the deposits received by a bank is used to finance other people's activities and borrowers of many types seek assistance from it in financing a wide range of projects. As professional lenders, banks provide finance in a variety of ways -by discounting bills, by advancing money to customers, by granting loans in various forms and by overdrafts. However, loans are the primary instrument and through this function, banks may finance production, distribution, investment, consumption, and the needs of government (Mason, 1979).The most commonly used

kinds of loans are commercial loans, industrial loans and consumer loans. In addition to these there are real estate loans, agricultural loans, loans to other financial institutions and lease financing.

(iii) Payments and Collection Services: The commercial banks play a vital role in establishing the payments and collection mechanism. This is the system through which checks, primarily, but also notes, drafts, coupons and money transfers by letter are made each day and ever-increasing volume (Crosse & Hempel,1973).

As a summary, the essential features of a commercial bank are that they safeguard people's deposits, grant advances to those wishing to borrow, and provide a money transmission service. However, during the last decades, the business of banking has changed and developed (Kane, 1984). For example, the source of bank deposits has been broadened in a way that a high proportion of deposits is taken on a time basis rather than at sight; a large sum is received against certificates of deposits; the interbank market provides an important service of deposits. The commercial banks no longer consider that short-term lending is their main task, also banks began to increase their medium-term lending greatly. Income from the provision of non-credit services is now of great importance for the large banks and is obtained by direct commission or other charges rather than from interest payments on outstanding advances (Taft, 1986)

It is possible to list the recently-developed, relatively-new services offered by the commercial banks as follows:

- Executor and Trust Services (Administration of funds for households, estates or pension funds)
- Taxation services
- Installment credit
- Leasing
- Factoring and Forfeiting
- International services
- Merchant banking
- Payroll preparation.

1.2 Introduction to Bank Financial Statements

A background in the details of operations and understanding of the bank financial statements construction are necessary before one can analyze or examine the banks' financial reporting practices for regulatory purposes. Also, the nature of banking business and bank management can be further understood by analyzing the financial statements of a typical commercial bank. Especially bank balance sheets consist of basic features and key factors about the operations and financial condition of a bank. Thus the financial statements summarize activities in each of the functional areas: the balance sheet represents a summary of past management decisions in the functional areas, and the income statement measures the profitability of management decisions over a specific period of time (Hempel et al. 1986).

Interest rates in recent years have become extremely volatile, and the banking industry have been operated increasingly in a more competitive environment. To manage a bank

profitably in such an environment requires a thorough and complete understanding of the bank's financial statements. As Pettway & Sinkey (1980) states that these statements not only represent a summary of information for use by shareholders and management but also represent the central source of information for bank regulators and examiners. However, in today's sophisticated environment, a bank cannot be examined and controlled with basic statements; it is essential that these statements must be broken down into component systems for further in-depth analysis.

Today, the users of banks' financial statements cannot simply rely upon balance sheet and income statement -basic and most commonly used statements- as reporting vehicles. These parties must also understand bank accounting methods and operational procedures. For instance it is one thing to know what a loan is by definition, it is another thing to understand the composition of the loan portfolio of a bank, its valuation, and the accounting for income and related expenses (Pettway & Sinkey, 1980).

The financial results of operations vary among banks, depending on the size, location, and type of business in which each bank engages. Certain banks may show the same rate of Return-on-Asset and Return-on-Equity as other banks but may differ significantly from other banks in terms of asset, liability and capital structure and in terms of mix of earnings from interest and non-interest income. Accounting policies may also vary significantly among banks, and this fact results in

different financial statement presentations for essentially the same type of transactions. As a matter of fact, it is necessary to gain an understanding of banks' accounting practices, their financial statements and also how these statements are prepared.

Even though, each bank is organized differently, certain transactions are basic to all banks. Johnson & Johnson (1985) shows a simplified description of the types of transactions that flow to the general ledger from operating departments of a commercial bank. It is based on the assumption that the bank has three functional divisions:

- loans,
- deposits, services, and support
- investments in securities.

Transactions are created by the functions and are accumulated in the proof department. The proof departments sorts and balances the transactions on a daily basis. The daily transactions include checks, deposits, and tickets for entries to the general ledger system. Checks and deposits are sorted for keeping customer accounting records, and the tickets are used to make entries to the general ledger. The entries are added to the previous day's balances for a preparation of an updated balance sheet and income statement for management.

According to Johnson & Johnson (1985), the general ledger system is important for preparing the basic financial statements information; however, it provides limited information for the detailed disclosures required for auditing financial statements

and for the supervisory activities of regulators. Subsidiary accounting records provide the information for internal analysis and external reporting requirements. For example, information regarding maturities and interest rates of the various loans and securities and the amounts of deposits, their interest rates and maturities can be obtained only from subsidiary reports. Therefore, it is extremely important that a bank give sufficient consideration to the structure of subsidiary systems for the preparation of external reports. For the purpose of compiling information for statements required by the regulatory authorities and for other financial reporting requirements, considerable attention should be given below to the structure of the information contained in the commercial loan, consumer loan, industrial loan, other loans, investments, and deposits and other subsidiary systems. Regulatory authorities view subsidiary records as an important source of information for management purposes. A certain degree of time and effort should therefore be taken to construct and analyze these records (Wilcox, 1973)

Another view is to gain understanding of accounting standards which creates a basis for bank accounting practices. This aspect will be covered in more detail in subsequent part of the study.

1.2.1 Financial Statements: A General View

Financial statements are a central feature of financial reporting. They are principal means of communicating financial information to those outside an enterprise. But it must be

indicated that some useful information is also better provided by notes to financial statements or other means of financial reporting. Financial statements individually and collectively contribute to meeting the objectives of financial reporting. No one financial statement is likely to provide all the financial statement-information that is useful for a particular kind of decision (Statement of Financial Accounting Concepts, No: 1 , Objectives of Financial Reporting by Business Enterprises , FASB, November 1978)

As far as the framework of this study is concerned, the two primary financial statements -balance sheet and income statement- which have specifically extraordinary items and structure in the banking industry will be examined. The remaining financial statements are very similar to those which are used in other types of business enterprises.

1.2.2 Bank Balance Sheet

According to Statements of Financial Accounting Concepts No.3 (Elements of Financial Statements of Business Enterprises, December 1980), balance sheet provides information about an entity's assets, liabilities and equity, and their relationships to each other at a moment in time. This statement delineates the entity's resource structure, major classes and amounts of liabilities and equity. Important uses of information about an entity's financial position include helping users to assess factors such as the enterprise's liquidity, financial flexibility, profitability, and risk.

In the banking business, at the balance sheet, a typical bank's assets represent a bank's uses of funds it has been able to attract. The bank's liabilities and net worth record the specific sources of funds. Liabilities are non-owner claims on the bank's assets. The net worth is the value of the bank's assets minus the value of its liabilities (Hempel et al. 1986).

1.2.2.1 Bank assets

(i) Cash and due from depository institutions: This account composes the bank's primary reserves. They include four categories of cash assets in general sense: (Mayer et al. 1984)

- Currency and coin held in the bank's vault,
- Deposits with the central bank (which are used to meet legal reserve requirements and may also serve as a balance in account for checking clearance, transactions in treasury securities),
- Deposits with correspondent banks (all banks can use to compensate their correspondents for services performed),
- Cash items in process of collection (deposited in the central bank or the correspondent banks for which credit has not been received).

Since a bank does not earn interest on any of these, they are called "non-earning assets" and banks generally exert considerable effort to minimize their cash assets.

Banks have to keep a certain percentage of their transactions accounts (deposits transferable by checks) plus a lower percentage of their time deposits as "reserves". The

Central Bank may require from banks to transfer a certain percentage of deposits in its own accounts. The reserve percentages and ratios are usually determined by the Central Bank according to the type and other characteristics -such as maturity- of deposit accounts. The primary purpose of the reserve requirement is to control the supply of money. The central bank has considerable power to vary the reserve requirements and banks cannot receive any interest on normal reserves. In this respect it functions as a tax (Hempel et al. 1973).

(ii) Securities: These are earning assets. Some part of these earning assets compose bank's secondary reserves. These are assets that are not quite as liquid and safe as primary reserves, but still are very liquid. They provide the bank with a second line of defense if its primary reserves are insufficient. Banks are obliged to set apart certain percentage of their period (net) income as a legal reserve. These reserves are usually invested in government securities or other securities invested in stock-exchanges. The fiscal and monetary authorities -especially the Central Bank and the ministry of finance- determine how these reserve funds should be employed. When potential losses must be covered from these sources, state authorities may give back these fund to the bank. But, in most cases, it is difficult to identify secondary reserves on a bank's balance sheet since the items constituting the secondary reserves are classified together with other items (Hempel et al. 1986). The process of identification of these secondary reserves are closely related to the comprehensiveness and efficiency of

subsidiary ledger systems as it is indicated previously.

As Klein et al. (1987) states that banks must place some of their funds into securities rather than into loans, because too high ratio of loans to deposits may be dangerous.

Some items included in the secondary reserves are short term government reserves, bankers acceptances, commercial papers (short term promissory notes issued by large and sound corporations). Securities may be short-, intermediate- or long-term. Short-term securities provide liquidity to meet the depositors' withdrawals or loan demand. Intermediate and long-term securities produce a base of income for banks.

Short-term securities include interest-bearing short-term assets such as interbank funds sold (excess reserves that one bank lends to another), securities purchased under agreement to sell (selling certain of our investment securities to a liquid bank. The purchasing bank agrees to sell the securities back to the borrowing bank within a specific period) and other bank certificate of deposits.

Investment securities are interest-bearing debt securities that a bank owns. They may be any maturity and usually include government securities, treasury bills, notes and bonds, corporate debts. Some securities can be considered as trading account securities in nature -thus, they are held primarily for resale within relatively short periods.- These are usually treasury securities.

In the recording of securities portfolio of banks into books, the lower of cost-or-market rule must be applied to the securities held by commercial bank. There may be differences between the market prices and acquisition costs of bank's securities portfolio. In such a case, lower of cost-or-market price should be shown at the balance sheet and an allowance for the securities must be established. Such an account can be called as Valuation Reserve for Securities (Commercial bank Examination Manual (1985)

(iii) Loans: Loans are the primary assets of most commercial banks. The bank lends funds to a customer and in return gets a note from the customer promising to pay interest at either a fixed or a variable rate, and to repay the loan. The basic types of loans are:(Hempel et al. 1986)

-Commercial Loans: Short or intermediate term loans to businesses typically for seasonal build-up of accounts receivable or inventory and for permanent working capital or plant and equipment.

-Consumer Loans: Most commonly used types of consumer loans aimed to finance the personal expenditures of the households are automobile loans, consumer durable loans, home modernization loans, credit card loans, and other installment and single-payment loans to finance personal expenditures.

-Real Estate Loans: Temporary contraction financing; long-term loans to finance residences, office buildings, retail outlets, and factories.

-Other Loans: Agricultural loans, loans to banks and other financial institutions, loans to brokers and dealers, leases etc.

Most loans are subject to some degree of default risk. Estimates of potential losses are computed at financial reporting dates. All banks must maintain a loan loss reserve which is created through charges to income and maintained at a level adequate to absorb expected losses in a bank's loan portfolio. The management of bank must evaluate the collectability of the loan portfolios, including any accrued and unpaid interest and make appropriate entries to bring the balance of the allowance on the balance sheet to a level adequate to absorb anticipated losses. These entries must be made to the allowance for loan losses. This amount is deducted from gross loans in presenting estimated net collectable loans (Commercial Bank Examination Manual, 1985) .

In recent years, a new method -called direct lease financing- has been one of the important services offered by bank. In most countries, this item is included into the loans portfolio account. Direct lease financing consists of the outstanding balances on all types of leases on property acquired by a bank for the purpose of lease financing. A proper allowance account may be set for the possible losses in leasing operations of the bank. The procedure followed in setting such an allowance account is very similar to that of loans.

(iv) Premises and Equipment: It includes land, building, furniture and fixtures, and other equipment, either owned or leased, and any household improvements. These can be considered as a non-earning asset since they usually do not directly create an income stream. According to Commercial Bank Examination

Manual(1985) bank premises and equipment should be recorded cost and cost is determined by the method of acquisition. They are subject to depreciation like all other fixed, operational assets. Bank's total expenditures for, or investment in, premises and equipment should be appropriate relative to its earnings, its total capital structure or the nature and volume of its operations (Hempel et al. 1986).

(v) Other Real Estate Owned: These exist in some exceptional cases. It refers to all real estate actually owned by the bank excluding bank premises and equipment. A major item included under this category is real estates acquired through foreclosure. As Stated in Commercial Bank Examination Manual(1985) real property becomes other real estate owned through:

- Purchases at sales under judgements, decrees or mortgages when the property was security for debts previously contracted,
- Conveyance in satisfaction of debts previously contracted,
- Purchase to secure debts previously contracted,
- Relocation of banking premises,
- Abandonment of plants to use real estate acquired for future expansion for banking premises.

All other real estate owned should be accounted for individually at the lower of recorded investment in the loan satisfied or its fair value on the date of transfer to that category.

(vi) Equity Participations: Commercial banks -especially in developed countries- assign very limited funds into operations other than the ones which are accepted as their primary functions. However, in Turkey, banks allocate considerable amount of funds into the capital structure of corporations established by themselves or those whose the majority of capital stock is held by these banks. Consequently because of important amount of funds are assigned into these areas, it is necessary to disclose it as a separate -and important- balance sheet item in Turkey. Also it is useful to establish an allowance account -contra account- for the depreciation -declines in market prices- of the stocks of these corporations at the balance sheet (Karacan,1983).

(vii)Other Assets: This a catchall category of other assets not large enough to warrant a separate account, such as customer liability to the bank on acceptances, and balances with other financial institutions. The possible account titles that can be included in this category are unlimited.Types of other assets frequently found in banks are the various temporary holding accounts such as suspense, interoffice, teller,transit and bookkeeping differences having debit balances. General categories of other assets common to banks also includes prepaid expenses and income earned but not yet collected . Prepaid expenses represent cash outlay for goods and services the benefits of which will be realized in future periods. Income earned but not yet collected results from the recognition of income on assets, not received as of the reporting date.

If the items become significant, they will appear as a separate balance sheet item. Often, such accounts may be quite insignificant in the overall financial condition of the bank. However, significant subquality assets may be uncovered in banks lacking proper internal controls and procedures. Banks may wish to camouflage some asset items which may cause some problems or may be accepted as substandard into this account. So, it is useful to require further detailed disclosures and footnotes to financial statements about this account. Bank examiners must pay considerable attention to this account and must design and develop specific procedures for review and testing to fit the particular account and situation (Commercial Bank Examination Manual, 1985).

1.2.2.2 Bank Liabilities

(i) Deposits: Deposits represent funds which bank customers have advanced and the bank is obliged to repay on demand or after a specific period of time, or after expiration of some required notice period. Deposits are the major source of employable funds available to a bank, therefore it is important for a bank's management to implement programs to retain and expand the bank's deposit base and to monitor its character and volatility (Hempel et al. 1986).

According to Karacan (1983) the categories used can be based on the form of organization supplying the funds, such as individual, partnership, and corporate deposits versus public deposits. This classification can also be called horizontal

category. Alternatively, second classification can be based on the form of the contract such as demand deposits versus certificates of deposit. This classification can also be called vertical category. Simply, it depends on the classification of the maturity date: time and sight (demand) deposits. Time deposits have specified maturity dates (usually one month to one year) and also have predetermined interest rate which will have to be paid at a specified date. In contrast, demand deposits can be considered as interest-bearing checking accounts of individuals, partnerships or corporations, and governmental units. These are very short-term deposits and usually do not have a specified maturity date. The majority of funds in these accounts generally come from businesses because businesses are forced to leave compensating demand deposits balances with the bank in order to get loans.

(ii) Short Term Borrowing: These items may consist of Interbank-Funds purchased (deficit reserves that one bank borrows from another), securities sold under agreement to repurchase, discount borrowings from the Central Bank, commercial papers by other financial institutions, mortgages payable, due bills and securities borrowed, customer paper rediscounted, or assets sold with the bank's endorsement or guarantee. These instruments are utilized to meet legal liquidity requirements and to improve liquidity positions of banks (Mason, 1979).

(iii) Other Liabilities: This is a catchall category for remaining liabilities. Items usually found in this category include accrued taxes and expenses, dividends payable, liabilities on acceptances, trade payables and other

miscellaneous liabilities. Like the "Other Assets category", there should be further detailed disclosures like footnotes to the financial statements for the items included in "Other Liabilities" account.

(iv) Long-term Debt: Long-term debt is generally issued in the form of subordinated notes and debentures or capital notes with maturities exceeding one year and it may also be treated as a part of capital by regulatory bodies if the debt meets certain requirements. These requirements usually include subordination to deposits and other liabilities, minimum average maturity when issued or minimum remaining maturity.

Also international borrowings may exist both on a direct and indirect basis. Common forms of international division borrowing include direct borrowings short term call money from foreign banks and borrowings from the Export-Import Bank. Indirect forms of borrowing include notes and trade bills rediscounted with the Central Banks of various countries; notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; and acceptance pool participations (Commercial Bank Examination Manual, 1985)

1.2.2.3 Bank Capital

In general terms, bank capital accounts consist of common and preferred stocks, surplus, undivided profits, contingency and other capital reserves. As Hempel et al. (1986) states that a typical commercial bank's capital accounts include the following items:

- Paid-up Capital (Nominal)
- Unpaid Capital
- Legal Reserves
- Secondary Reserves
- Bank's Fixed Assets Re-evaluation Fund
- Income(Loss)
- Previous Years' Income (Loss)

1.2.2.4 Some terms used in analyzing bank balance sheets (Hempel et al. 1986)

Earning assets refer to all assets earning an explicit interest return. Cash and due from banks, and bank premises and equipment are the two major asset categories that are not earning.

Risk assets are earning assets subject to either credit risk or interest rate risk. Sometimes it is calculated as earning assets less all government securities.

Maturity of securities classifies the book value of a bank's securities into certain maturity categories. This information is helpful in understanding the interest sensitivity of the securities portfolio and the potential appreciation or depreciation of this portfolio if interest rates decline or increase.

Market to book value of securities shows what percentage of the book value of the bank's securities, as shown on the bank's balance sheet, is represented by the market value of these

securities. The difference between the market value and the book value of the securities represent the unrealized appreciation or depreciation in the securities portfolio.

Past-due loans are loans on which interest or principal payments or both have not been paid at the contracted time. Usually a bank allows a short grace period (For example 15 or 30 days) before it classifies a loan as past-due. Past-due loans differ from classified loans, provisions for possible loan loss, and loan losses, although all of these categories give some idea of the credit quality of a bank's loan portfolio.

Interest rate sensitivity refers to the sensitivity of cash flows on either assets or liabilities to changes in interest rates. Interest sensitive assets are any category of assets on which interest income will change in the specified time period in response to interest rate changes. Interest sensitive liabilities are any category of liabilities on which interest expense will change in the specified time period in response to interest rate changes. The time period of this sensitivity should be identified. Many banks measure rate sensitivity for several time periods -for example, 30 days, 90 days, 6 months, and 1 year- because of sizable time differences in sensitivity between assets and liabilities. A gap between sensitive assets and sensitive liabilities or the ratio of sensitive assets to sensitive liabilities may be calculated.

1.2.3 Bank Income Statement

This is the second important and commonly used financial statement in banking business. Income statement reflects a great deal about the profitability of an entity during a period, but that information can be interpreted most meaningfully or compared with that of the entity for other periods or that of other entities. It reflects the extent to which and the ways in which the equity of the entity increased or decreased from all sources. It gives information about the causes of changes in an entity's asset and liabilities -including results of its ongoing major or central operations (Statement of Financial Accounting Concepts No.5, December 1984).

As Johnson & Johnson (1985) state, in banking business, income statement consists of primarily interest income and interest expense. Interest income on a bank's earning assets is the primary source of bank income whereas the interest expense required to obtain the funds employed by the bank is usually the primary cost category for a bank. Using the accounts, it is useful to describe the income statement items.

(i) Interest income: This is the major source of earnings for a typical commercial bank. This may be on short term instrument, taxable securities, tax-exempt securities, commercial loans, industrial loans, consumer loans and other loans. It is the interest the bank receives on each of these specific asset categories. All interest income, less associated expenses, is taxable with the exception of the interest income on tax-exempt securities.

(ii) Service charges and fees, and other non-interest income:

This item includes income from maintenance fees and that most banks charge on their deposit accounts. Also all other non-interest income may be included into this category. This account also consists of net income from the bank's trust area (if it has), commissions on insurance premiums, income from direct lease financing, trading-account income, safe-deposit rental fees, and other miscellaneous non-interest income sources.

(iii) Interest expenses: This is the major account category which leads to outflows of bank's funds. It may be basically on deposits accounts. Also interest expense arises from other liabilities such as short term borrowing or long term debt. Every category of the interest expense on each of these specific deposit or liability categories is a deductible expense for determining a bank's income taxes.

(iv) Provision for loan losses: It is the amount charged against earnings to establish a reserve sufficient to absorb expected loan losses. Regulatory agencies set the maximum amount that can be a tax deductible expense and be placed in the valuation of the reserve account on the balance sheet. Management determines this amount on the income statement by using information about the quality of the loan portfolio and opinions and reports of the regulatory authorities (Hempel et al. 1986).

(v) Personnel expenses: This account represents the total compensation paid to all officers and employees of the bank. This compensation includes not only salaries and wages but also social security taxes paid, contributions to retirement or pension plans, cost of medical and health services, and other

fringe benefits provided to officers and employees.

(vi) Operating expenses: This is a general category for a bank's operational expenses. This account usually includes such expenses as advertising, premiums for deposit insurance, directors' fees, supplies and postage. It may also include security gains or losses from the sale, exchange, redemption, or retirement of investment securities above or below the value these securities are carried on the bank's books. Additionally, occupancy expense which consists of depreciation on premises and equipment, the rental or leasing cost of offices and machines, and taxes on premises and equipment must be included into this general category.

(vii) Other expenses: This is a catchall category in which we can include numerous accounts that can be considered as not large enough to warrant a separate expense account.

CHAPTER 2 REGULATORY ACTIVITIES IN THE BANKING INDUSTRY

2.1 Banking Regulatory Framework

As stated by Kaufman et al. (1986) " Commercial banking has been a highly regulated industry. While the extent and the type of regulation imposed on banks have historically and nationally varied significantly, the importance of banking to the general performance of the economy necessitates regulation in order to provide the healthy functioning of the economy in the overall sense."

Banks are subject to a variety of regulations and restrictions. Entry into business is restricted. There are limitations on the type of operations a bank can engage in. Also limits on the rates of interest subject to deposits are of concern. Balance sheets are subject to constant financial ratios -such as capital or liquidity ratios.- The size of individual loans is limited to some fraction of the capital. A variety of operations are designed to protect consumers in their dealings with these institutions. While most of the regulation -including supervision and examination- exist to reduce the risk of failure for banks, some are designed to affect the allocation of resources in the economy in a particular way. All of the regulations evolved historically from real economic needs and each legislation required the designation of some governmental agency or official to oversee its enforcement (Kalish ,1973).

In retrospect, it is clear that there are some principal policy goals which have shaped the regulatory system for

banks (Johnson & Johnson, 1985):

(i) Protection of Monetary Stability: The stability of the banking system is necessary to allow the monetary authorities to control the volume of money circulating in the economy. A stable payment system is necessary to promote economic progress, development and to avoid financial panics associated with periods of economic recession.

(ii) Protection of Depositors : If banks are regulated, depositors are not required to investigate banks as extensively.

(iii) Protection of Consumers: Related to depositor protection, banking regulation also has its purpose to protect consumers. Specific goals in this area include protection against unfair lending practices, fair disclosures of charges for loans, and assurance of equal opportunity for credit services.

(iv) Development of an Efficient and Competitive Financial System: A goal of regulation is to develop a regulatory framework which encourages the development of a competitive system in which consumers are able to secure efficient banking services at reasonable costs.

Bank regulation encompasses a wide variety of technical functions relating to the operations of banks. These can be listed as follows (Hempel et al. 1986):

- (1) The issuance and enforcement of regulations.
- (2) The chartering of banks.
- (3) The periodic examination of banks and the requirement that bank management take steps to correct unsatisfactory or unsound conditions found through such examinations.

- (4) The review and analysis of periodic reports of conditions, earnings and expenses.
- (5) The rendering of counsel and advice, when requested, on bank operating problems, particularly in the case of smaller banks.
- (6) The approval of proposed changes in the scope of corporate functions exercised by individual banks and of proposed changes in their capital structures.
- (7) Authorization for the establishment of branches and for the exercise of trust powers.
- (8) The approval of bank mergers and consolidations.
- (9) The organization and regulation of bank holding companies.
- (10) The regulation of bank service corporations.
- (11) The liquidation of banks.

The third and fourth functions can be considered as directly related to the scope and aim of this study. Thus they are the primary concern of this study. Hempel et al. (1986) also state that the regulatory authorities are concerned with such supervisory activities and they administer the banking laws, promulgate and interpret regulations issued thereunder, and exercise impersonal and objective judgements with respect to the bank policies in order to protect the public interest further.

2.2 Banking Supervision and Basic Supervisory Means

Supervision refers to the oversight of banking organizations and their activities to ensure that they are operated in a safe, sound, and law-abiding manner. (Benston et al. 1986). The regulatory agencies are charged with the

supervision of banks.

According to Commercial Bank Examination Manual (1985) within the general framework of supervisory operations, banks must find a large number of report, including reports of condition, reports of income and dividends, and periodic (usually annual) reports on trust department activities, international operations, foreign exchange activities, executive officers' and principal shareholders' stock ownership and indebtedness to the bank, past due loans, and foreign country lending exposure. These reports include a great deal of detail, including memorandum items, such as average amount of daily loans and deposits.

There are numerous means for supervisory activities to obtain the information needed to do their jobs. This study basically covers the two fundamental methods as a means for supervision: Field examination (On-site supervision), and off-site supervision.

2.2.1 Field Examination (On-site supervision)

Field examination is a primary means for bank supervisors to obtain information. Examiners visit banks for the purpose of reviewing their records and procedures, interviewing their managers, determining whether the banking laws are being complied with, and evaluating the banks' financial conditions and performance. The examiners report their findings to the banks' senior officers and board of directors, as well as to their superiors (Benston et al. 1986). In most countries, the

examination reports are confidential -thus are not permitted to be made available to the public.

Field examination is a form of supervision that is almost unique to banking. Examiners usually make regular visits to other types of enterprises only when questions of public safety and health are involved -such as restaurants or nuclear power plants-. But banks are periodically visited by field examiners, even if they are believed to be conducting their affairs properly. (Benston et al. 1986)

As stated by Flannery et al. (1980) the fact that banks handle large sums of money and credit is primary -but not only- reason for this practice. Another reason mentioned by Flannery et al. (1980) for field examination is that the principal assets in which banks invest -loans to companies and individuals- do not have readily ascertainable market values. Therefore, examination of documents may be necessary to determine that assets are good. Also as stated in another article of Flannery (February 1982) the experience that the failure of one bank resulted in the loss of confidence in others is another reason, although deposit insurance has invalidated justification for field examinations. Another reason is related to the nature of the financial intermediary role of the banks fulfill in the economy. Banks received deposits that are highly liquid and invest these deposits in other less liquid assets. To prevent a liquidity crisis, banks must hold some more liquid assets. The actual liquidity situation of the bank can be most efficiently

identified through field examination (Benston et al. February 1974).

Field examination would be used for four purposes basically: (Benston et al. 1896)

(i) To audit the numbers reported by banks: Those figures that are found to misreport significant numbers may be subject to further immediate and extensive examinations.

(ii) To uncover fraud: Specially trained auditors should be able to discover most frauds. This purpose is vitally important because researchers found that the primary reason of bank favors is fraud and malfeasance.

(iii) To determine whether specific laws had been broken: Law-breakers would be unlikely to report their transgressions voluntarily. This necessitates a depth knowledge of laws related to banking industry.

(iv) To determine whether reported numbers were correct and to guard against the troubled institution's temptation to "bet the bank": This goal will be accomplished by sending examiners when the statistical, financial and economic analysis indicated that a bank was coming close to using up its capital.

The detailed analysis of the procedures used in field examination is far beyond the scope of this study. So we can summarize the basic procedure used in field examination in a very general sense as follows: (Commercial Bank Examination Manual, 1985)

(1) The principal purpose of the usual field examination remains to evaluate a bank's loan portfolio and management. The

examiners look at the documentation, collateral, and payment records of most large loans and a sample of small loans. The loans may be classified as good, substandard, doubtful, or loss.

(2) The bank's internal control system and managerial practices are reviewed and evaluated; the amounts of recorded assets, liabilities, and off-balance sheet accounts (such as security and loan commitments and guarantees) are verified.

(3) The bank's compliance with laws should be determined.

Emphasis is placed on laws that prohibit or restrict dealings between the bank and its officers, directors, stockholders, and that limit loans to individuals and related borrowers.

As stated by Benston et al. (1986) at the very ultimate stage, it can be summarized the final aims of field examination into four broad categories:

- Prediction of loan losses
- Identification of excessive risk takings
- Identification of fraud and malfeasance
- Prediction of failures.

2.2.2 Off-site Supervision

Off-site supervision aims basically to make a detailed financial analysis of banks, based on bank reports (and other relevant information). Off-site supervision should assess the developments in the key financial ratios, supplemented by trend and peer-group analysis. It should aim to identify problems in banks and take specific actions to tackle them at an early stage of supervision (Benston et al. 1986).

If necessary, banks can be required to report some of the required numbers on a monthly or even weekly basis. As mentioned by Kane (1981) " Increasingly, inexpensive communications equipment is likely to make earlier or real-time transmission of the desirable data." The transmitted data may include deposits; repos bought and sold; futures or options contracts or other contingent liabilities; total loans and large loans; interest and other income; interest, operating and other expenses. Data on loans by industry may be reported depending on the value and cost of the data. Banks may be required to schedule their own loans. This exercise would provide a timely report of substandard loans to both the banks' managers and to the supervisory authorities. Estimates of maturity gaps or durations and other analysis may be required quarterly. The numbers could be reported via communication devices in computer readable form. The supervisory authorities thus would have very early warnings of potential problems and could more effectively target their limited examination and supervisory resources according to the results of off-site models (Gardener, 1986).

As a means, off-site supervisors utilize basic statistical analysis techniques and models. As stated in Bovenzi et al.'s article (1983) these models have been available for use by the supervisory agencies in the world -especially by the developed countries- particularly for recent decades. The models appeared to be used primarily as a means of aiding the examiners and writing up their reports rather than for evaluating banks and deciding which institutions should be examined more intensively

or more often. Thus, it has usually a limited support function to field examination activities.

However, these models alone appear to do as well as examinations in identifying problem banks. Furthermore, the models tend not to identify banks as problems that are not actually problems. Sinkey and Pettway used two simple statistical models (through multiple discriminant analysis) to predict bank failures by utilizing basic financial accounting data in 1980. Also Bovenzi, Marino and McFadden reviewed and updated a large body of similar research in 1983. Based on the results of these researchers, it can be seen that the more costly and time-consuming field examinations have only a slight advantage over the statistical models in predicting bank failures, and evaluations by the banking supervisors are not as effective as statistical models in using examination and publicly available data.

Statistical analysis of bank financial data -enhanced by relevant market data, if available- can substitute for a large number of field examinations. The specific numbers analyzed can be derived from theoretical and empirical studies of the factors that predict bank failures and financial distress. Such studies have been done and the models are available. The most widely known "early-warning models" used by authorities are as follows: (Senver, 1988)

MODEL BY	RATIOS
Daniel Martin	<ol style="list-style-type: none"> 1. Net income/Total assets 2. Loan losses/Net operating income 3. Total expenses/Operating revenues 4. Total loans/Total assets 5. Commercial loans/Total loans 6. Total capital/Risky assets
Edward Altman	<ol style="list-style-type: none"> 1. Working capital/Total assets 2. Total Reserves/Total assets 3. (Interest revenue+Pretax income)/ Total assets 4. Market value of paid in capital/ Total liabilities 5. Total revenues/Total assets
David Stuhr and Rober van Wicklen	<ol style="list-style-type: none"> 1. Problem loans/Total capital 2. Total capital/Total assets 3. Net operating income/Total assets 4. Total liabilities/Total capital 5. Asset growth rate 6. Leasing expenses/Net income
Korobow, Stuhr and Martin	<ol style="list-style-type: none"> 1. Total loans and leases/Total liabilities 2. Total capital/Risky assets 3. Total operating expenses/Total operating income 4. Loan losses/(Net income+Provisions for loan losses) 5. Commercial and industrial loans/ Total loans

2.2.2.1 Financial Analysis of Banks As a Means of Off-Site Supervision

The off-site supervision activities basically involves analysis of the basic financial and other relevant information -other means of financial reporting- and construction of the ratios supplemented by other financial analysis techniques. In general sense, the common analyses used by banking supervisory authorities include:(Johnson & Johnson, 1985)

- Comparative statements from period to period,
- Common-size statements relating each asset item, and liability and capital items to total assets and each income statement item to total operating income,
- Indexed financial statements measuring growth or contraction in key financial accounts,
- Ratio analyses developing meaningful relationships between accounts.

Johnson & Johnson (1985) state that procedures for generating bank operating statistics include the development of comparative spreadsheets leading to the preparation of common-size statements and index comparisons, preparation of financial ratios, development of maturity and yield schedules, and analysis of changes in specific accounts such as allowance for loan losses and capital.

(i) Comparative statements illustrate absolute changes in accounts from one period to another, which explain certain results of bank operations. This analysis serves to pinpoint major areas that require additional analysis to explain significant trends. Since comparative statements indicate absolute changes, the analysis gives the supervisor a quick indication of significant changes within the balance sheet and income statement but does not present the degree of significance of the change.

(ii) Common-size statements express individual balance sheet accounts as a percentage of total assets and individual income statement accounts as a percentage of total operating income.

These relationships measure composition or mix expressed as a percentage distribution. If a change in proportion represents a departure from current and past trends, we should trace the events that may have lead to change. The purpose of common-size statement analysis is to narrow the bank examiner's review to the key areas impacting profits, return on assets, and return on equity.

(iii) Indexed financial statements identify the magnitude of increases or decreases in individual balance sheet and individual income statement accounts. Indexed financial statements form a horizontal analysis whereas common-size statements form a vertical analysis. When considered together, a change in composition may explain the degree of increase or decrease in an account balance. If the change in composition is unexpected, then the examination of trend becomes important. A significant change in composition should be confirmed by a significant change in trend.

(iv) Ratio analysis extends the overall analysis into greater detail for examining account relationships presented in the balance sheet and income statement. As far as the bank regulators' viewpoint is concerned, basic dimensions of ratio analysis in the banking industry are primarily capital adequacy and liquidity associated with the depositors safety objective (Sinkey,1978). Other basic dimensions must be also taken into consideration by supervisory authorities. At this stage, it is necessary to take a further detailed look at the dimensions of the bank's overall performance because supervisory authorities analyze and measure the performance of banks within the framework

of off-site analysis. The basic components of the performance of a typical commercial bank includes (Johnson & Johnson, 1985):

(1) Business mix: It includes the composition of assets and the composition of liabilities and equity and interest margin.

(2) Income production: This represents the earnings potential of bank and includes the examination of interest margin, provision for loan losses, non-interest expenses, other income items, securities gains and losses, income taxes paid and net income. This dimension is basically related to income statement accounts.

(3) Quality of assets: This dimension primarily includes the review of asset account especially the loan-mix. It also captures the examination of securities-mix, securities maturity distribution, loan maturity distribution, the loan loss ratios, and yield analysis.

(4) Capital adequacy: It represents the relation between assets and equity capital of the bank. It has created a contention between bank managers and supervisors, because banking is a highly leveraged business and bank profits depend basically on maximizing the amount of earning assets per capital paid-in by owners -return on equity-. But, in order to achieve this objective, bank management should not take abnormal risk. Risk is measured according to the paid-in capital of bank. If the risky assets are exceptionally large relative to capital, then a greater potential burden falls on the depositors. Consequently, the safety of depositors which is one of the primary aims of the regulatory authorities can be maintained through a fair supervisory efforts.

(5) Liquidity: This represent the degree to which bank can meet unforeseen demand for reserve balances or meet financial claims, and the degree to which liquidity in non-earning assets is minimized to maximize earnings potential. Because of the liquidity constraint, banks are unable to optimize revenues. A bank must be concerned with the appropriate amount of liquidity. Too much liquidity means a sacrification in earnings, too little impose borrowing requirements in an unknown interest rate environment, which means so much risk.

After the examination of basic performance dimensions, then it is necessary to look at the basic ratios which are covered within the scope of off-site supervision in a very general sense (Johnson & Johnson, 1985).

(1) Income statement ratios: These relate and compare the income statement items to basic balance sheet accounts.

(i) Compared with average assets

Interest income / Average Assets

Interest expense / Average Assets

Net interest income / Average Assets

Loan loss provision / Average Assets

Noninterest income / Average Assets

Salaries & Benefits / Average Assets

Occupancy, furniture, & equipment expense /
Average Assets

Other noninterest expense / Average Assets

Securities gains (losses) / Average Assets

Tax provision / Average Assets

Net Income / Average Assets

(ii) Compared with gross average earning assets

Interest income / Gross Average Earning Assets

Interest expense / Gross Average Earning Assets

Net interest income / Gross Average Earning Assets

(2) Investment Policies : These ratios indicate income potential and give further details for investment policies of banks.

(i) Earning Asset Ratio: Average Earning Assets / Average
Total Assets

(ii) Loans to Deposits Ratio: Average Loans / Average
Deposits

(iii) Loans to Total Purchased Funds Ratio: Average Loans /
Average Total Purchased Funds

(iv) Securities Mix

(v) Securities Maturity Distribution

(vi) Loan Mix

(vii) Loan Maturity Distribution

(3) Funding and Leverage Ratios:

(i) Deposit Mix

(ii) Deposit Maturity Distribution

(iii) Leverage Ratios

(4) Capital Adequacy Ratios

Risk Assets / Capital

Capital / Assets

(5) Liquidity Ratios

Average Cash / Average Demand Deposits

Average Cash / Average Total Deposits

Cash & Short-term Government Securities / Average
Total Deposits

- (6) Return on Equity: $\text{Net Income} / \text{Average Capital}$
- (7) Loan Loss Ratios: $\text{Allowance for Loan Losses} / \text{Loans (Year-end)}$
 $\text{Net Charge-offs} / \text{Average Loans}$
 $\text{Loan Loss Provision} / \text{Average Loans}$
- (8) Capital Formation Ratio: $\text{Net Income minus Cash Dividends} / \text{Beginning Capital}$
- (9) Breakeven Yield: $\text{Non-interest income minus Non-interest expense} / \text{Average Assets}$

Then the next and the final step in the ratio analysis is the selection of peer banks for comparison. The analyst should carefully select those banks that display similar characteristics for peer group analysis. The analyst must be concerned with first identifying the type of bank. Several ratios indicated above will assist in characterizing the bank and its appropriate peer group (Benston et al. 1986).

2.2.3 Other Means for Bank Supervision

Alternative ways to two supervisory tools explained above can be considered as indirect supervisory tools which aim to avoid potential problems at the very early stages of supervision process. According to Sinkey (1978) they have only limited support function to field and off-site supervision. They should be consistent to general banking regulatory objectives and policies. These alternative supervisory tools can be explained as the following (Sinkey, 1978):

(i) Imposition of risk-related insurance premiums and ex post settling up -which makes shareholders additionally responsible for the cost of insolvency- reduce considerably the need for regulations to limit excessive risk taking. Changes in the regulations and in the approach taken by supervisors in this direction may decrease the bank supervisors' needs for field examinations and close supervision.

(ii) A required level of capital -or capital standard- can absorb most losses that a bank may incur under situations other than a massive general economic collapse. Therefore, the more strict determination of regulations related to capital adequacy may facilitate and lessen the efforts of bank supervisor.

(iii) A diversification requirement related to loans portfolio, deposit mix and securities portfolio of a bank would enable a bank's portfolio of assets and liabilities to reduce the effect of most expected losses to the amount that would be covered by the bank's capital.

CHAPTER 3 THE IMPORTANCE OF ACCOUNTING PRACTICES ON BANKING SUPERVISORY ACTIVITIES

3.1. The Quality of Financial Information in Bank Supervision

As it has been indicated at the previous chapters, the broad process of bank supervisory activities includes primarily the off-site supervision and on-site inspections (examination). The basic task of off-site supervisors is to make a comprehensive financial analysis of banks, based on banks' reports, and other relevant information and statements. They should develop and evaluate basic financial ratios, supported by other financial analysis techniques. They must identify problems in banks and take specific actions to tackle them at an early stage. However as stated by Benston et al. (1986) off-site supervision must be completed by on-site inspections. Certain important aspects of banking can only be studied on-site. These activities include: compliance with laws and regulations, the assessment of the quality of assets, the evaluation of accounting and management control systems, the assessment of the quality of management. Also, on-site inspections can be used to gain detailed information about problem areas in a bank identified by off-site supervision. External auditors can be requested to cooperate with the supervisors, thus, complementing or partly substituting for inspections (Benston et al. 1986).

Although the most important component of off-site supervision is advanced, valid and multi-dimensional analysis techniques, this is not alone sufficient in order to obtain

reliable results in the analysis. In addition to valid analysis techniques, it is necessary to use "accurate" information in the off-site supervisory efforts to achieve reliable results (Senver,1988). According to Gardener (1986) the examination (on-site inspection) activities can check themselves the accuracy and the reliability of information used in the analysis through various procedures, the off-site supervision does not have an opportunity to test directly the accuracy and reliability of financial and other relevant information. Thus even when the most advanced techniques -such as multi-dimensional statistical early warning systems- are used in the analysis process, if the figures -information-used in the analysis have been misreported, it is impossible to obtain reliable results. Because of this fact, the accuracy of information used in supervisory activities should be considered as an infrastructural problem. Senver (1988) states that the accuracy of financial information used in the analysis of bank supervisors are closely related to and even they are based on the accounting practices and their implications on bank's statements, since these accounting practices produce the primary inputs of bank's financial statements which are used as basic reference points in supervisory efforts.

The determination of objectives of the analysis, the decision about the methods used in the analysis, the determination of the type of the data required to make a comprehensive analysis according to previous steps, the identification of sources of required data, and the examination of data used in the analysis -to decide whether they are accurate

or not- are the vitally important steps which influence the quality of the accounting information in supervisory process(Benston et al. 1986).

First, it is necessary to determine the objective and the content of the analysis. Then the gathering of the relevant data in order to perform a comprehensive analysis is the second stage. The gathered data should be appropriate and convenient to the objective and the type of analysis performed. For example, whether the data will be used in the trend analysis or in the common-size statement analysis may have direct influence on the types of data gathered. The relevance of data is another dimension; for instance, it is inappropriate to gather data related to the uncollectible loans if the aim of the analysis is to identify the liquidity position of the bank. Then the next stage is the identification of the sources of data. According to the content of the analysis, more-detailed data can be required. If detailed data is required, the basic financial statements of the bank may not be sufficient. The required data can be obtained from the general ledger records or from the subsidiary account records.

Furthermore, it is necessary to control the accuracy of the data. This is the responsibility of the examination function of the supervisory process. This step is vitally important because banks can manipulate their own accounts and consequently their financial statements through numerous methods, and they may obtain different balance sheet and income statement figures by overstating or understating their accounts. Simply, there are

certain ways to manipulate accounting records for banks. These can be summarized as follows: (Akguc, 1987)

- i. To disguise the doubtful or uncollectible loans in the normal loans account
- ii. To assign insufficient allowances for due loans,
- iii. To overstate the volume of deposits through unfair accounting practices,
- iv. To ignore to maintain allowances for the decline in the market value of bank's securities portfolio,
- v. To overstate their premises and equipment and their equity participations,
- vi. To disclose their off-balance sheet liabilities inadequately (such as endorsements, acceptance credits, letter of guarantees),
- vii. To capitalize revenue expenditures and to show them as an asset,
- viii. To violate the periodicity and matching principles (not to assign accrued revenues and expenses to the related period).

3.2. Problems of Bank Supervision in Less Developed Countries

The extent of accuracy of financial and other relevant information presented by banks to supervisory authorities and to the public can be determined through examiners' review -together with the activities of internal and external auditors- at the final stage. However, although the number of operating banks, their volume of business have been drastically increased, and the type of operations performed and services offered by banks have

become extremely sophisticated in recent decades, and banking has become relatively a more complex industry; the supply and availability of examiners -both in terms of quantity and quality- has been scarce especially in less-developed countries like Turkey. In addition to these, the lack of structural prerequisites and inadequate supporting structures -infrastructural elements- have also influenced the workload of bank examiners and their quality of work in a negative manner in less developed countries. As stated by Snoek's (1989) article " In these countries, the task of bank supervisors becomes quite difficult in the context of the adverse impact on the banks of directed credit, administered interest rates and the credit control measures through unremunerated reserve requirements. The bank supervisors should point out to their authorities the consequences of the government policies on the sound functioning of the banking system. Moreover, there should be a close coordination between bank supervisors and the authorities in charge of the monetary and credit policies so that the effects of the monetary policy measures on the banks will be taken into account at an early stage. Such a great responsibility has increased the workload and the content of the job of the bank supervisors."

3.2.1 Inadequate Supporting Structures:

Banking and bank supervision in developing countries are often complicated because of the inadequate supporting structures for the financial sector in the overall sense. These inadequacies rise especially from the accounting practices and

the legal systems of the less-developed countries(Snoek,1989). The detailed analysis of the problems related to the lack of the accounting standards, the unstandardized accounting practices, and the inadequate accounting methods will be carried out in the next part of this chapter.

Snoek (1989) also states that important gaps in the legal systems that affect the financial system is another potential problem. This includes regulations regarding financial contracts, property rights, bankruptcy and procedures to seize collateral in case of a default on a loan. The credibility of the borrower will greatly increase if the rights of the banks in the case of bankruptcy are adequately protected and if the borrower can provide collateral. In this respect, it is very important that property rights are adequately registered and easily transferable, while procedures for the sale of collateral of the bank loans must be prompt and efficient. However, these procedures should be counterbalanced by the 'truth-in-lending' regulations, forcing banks to disclose their loan conditions in full to their borrowers.

3.2.2 Structural Problems:

The other problems in the bank supervision in developing countries arise because of institutional and structural weaknesses in the banks and in the banking supervision itself. Basicly, adequate accounting method is directly related to the efficiency of the internal structures of the banks. This topic will also be analyzed in the next part.

According to Peterson et al. (1985) the single most important reason for the bank failures is weak management. It is certain that risks are inherent in banking: loans may not be repaid, deposits may not be withdrawn, interests and exchange rates may fluctuate and the external environment -the state of the economy, legislation and so on- may change. The management of all of these risks, therefore, requires technical and organizational skills, good judgement and adequate internal controls. When management is weak, the bank will not be able to control its risks and is likely to make wrong decisions that lead to losses. A special problem concerning bank management is often the inadequacy of internal supervision and control as a result of the lack of experienced staff, poorly designed procedures and a too rapid expansion, leading to the loss of control over branches. The evaluation of bank management is an important task of the bank supervisors. Bank inspectors have to assess the adequacy of management, management control procedures and the decision-making process in the bank. Supervisory authorities should be able to enforce these recommendations to improve management and, ultimately, to remove inadequate managers, including the members of the board of directors (Commercial Bank Examination Manual, 1985).

3.2.3 Weaknesses in Supervision:

Problems in bank supervision in less developed countries relate not only to weak banking systems, but also to gaps in organization and techniques of bank supervision, and inadequate rules and regulation, and the lack of well-trained and

experienced supervisory staff (Snoek,1989).

As Snoek (1989) states, the organization and techniques of bank supervision in many developing countries are not well-established, hence, the information available to supervise banks is neither timely nor complete. Common deficiencies include inadequate reporting by the banks to the supervisor and limited or non-existent off-site supervision and on-site inspections. The regular reports of banks, including an annual audited income statement and balance sheets, are the main sources of information for a supervisor. Such reports should provide all information needed for a thorough financial analysis of the banks. These reports should include an overview of bank solvency, liquidity, and profitability; they should also provide an assessment of bank exposure to risks such as credit risk, off-balance sheet risk, foreign exchange risk, interest rate risk, investment risk, and concentration risk (Pettway et al. 1980).

In many developing countries, off-site supervision is limited only to controlling banks' adherence to monetary and prudential policy regulations (Snoek,1989). In fact, the basic task of off-site supervisors is to make a detailed financial analysis of banks, based on bank reports and other relevant information. They should assess the developments in key financial ratios and should identify problems in banks and take specific actions to tackle them at an early stage.

According to Gardener (1986) prudential regulations play an important role in bank supervision in that they force banks to

follow sound practices. These practices prevent excessively risky behavior by lenders and include balance sheet ratios, such as minimum solvency and liquidity ratios; limits on bank exposure to stockholders, personnel, and large borrowers; and limits on foreign exchange exposure. Mismanagement and speculative behavior persists, however, because prudential regulations are deficient in many countries. These deficiencies, relating to capital adequacy and loan classification, provisioning, and interest accrual have contributed importantly to the banking crisis in a number of developing countries.

One of the key areas for improvement in developing countries is related to the adequacy of enforcement and intervention options, including mergers and liquidation. For bank supervision to be effective, it must adequately enforce compliance with its recommendations and regulations. Enforcement powers should range from warnings and monetary penalties to the removal of a bank's management. Finally, the supervisor has to be able to withdraw the banking license and merge or liquidate a bank when necessary (Kalish, 1973). These measures assume greater importance in countries facing banking crisis.

Even if all of the above-mentioned impediments to good supervision are eliminated, the need for sufficiently trained and experienced supervisors still remains (Benston et al. 1986). There is a general shortage of skilled man-power, and uncompetitive government salaries provide no incentive for qualified persons to become bank supervisors in many developing countries. Supervisors' pay is generally based on government pay

scales, which often are lower than those offered by private banks for the same skills. It is essential, therefore, for the supervisory institution to have its own independent and competitive personnel and salary policy. The lack of an experienced staff is a more intractable problem. Supervisors may cooperate with the banks having a common training facility for their staffs. Some of the training needs may be met from international institutions as well as the national institutions of some developed countries. The effectiveness of a limited number of skilled staff can be increased by using computers for the analysis of bank returns, by allowing the banks to do more analysis themselves -for example, by issuing more detailed guidelines that can be monitored by off-site supervisors- and by the use of external auditors (Snoek , 1989).

3.3 The Environmental Factors for the Effective Bank Supervision: With Special Emphasis on Accounting Practices

At the final stage -as far as the basic scope of this study is concerned- it is useful to summarize the fundamental factors which contribute to the solutions of this problem. The most convenient solution to the problem of working conditions of supervisors is to create an environmental and structural framework -context- facilitating the activities of the examiners as well as improving the quality of their works. In order to create such a supervisory structure and environment, following factors -as the steps of a general process- must be analyzed.

3.3.1 Generally Accepted Accounting Principles

Generally accepted accounting principles (GAAP) are a guide to the accounting profession in the choice of accounting techniques and in the preparation of financial statements in a way considered to be good accounting practice. They are general decision rules, derived from both the objectives and the theoretical concepts of accounting, which govern the development of accounting techniques (Belkaoui, 1981). Accounting principles are developed in relation to what we consider to be the most important objectives of financial reporting. GAAPs include accounting concepts, measurement techniques, and standards of presentation used in financial statements (Meigs, 1981).

The development of GAAPs in one country cannot be considered as a duty of bank supervisors. Rather, it is the general structural problem which involves in all areas of business life. Therefore, GAAPs should be determined by accounting authorities -not necessarily by bank supervisory authorities specifically.

3.3.2 Accounting Standards and Practices

These two concepts are primary elements of the supporting structure of bank supervisory process and can be considered as infrastructural elements. According to Harvey & Keer (1978) basically a standard in accounting is the method of preparing accounts which has been chosen and established by the bodies overseeing the profession. It is different than the accounting principle because clearly a standard is more pragmatic. Standards can be accepted as working regulations of accounting.

There are several reasons to establish standards in accounting profession (Statement of Accounting Standards in the 1970s, ICAEW, 1970):

- i. To encourage uniformity of practice in accounts,
- ii. To ensure the disclosure of the accounting bases,
- iii. To disclose any departure from an accounting base or policy.

Business enterprises, even in the same industry, have sometimes chosen to adopt different reporting methods for similar circumstances. By externally imposing standards for such events, there may be a gain from the greater comparability and consistency. Also there may be a gain in credibility because the public is naturally skeptical about the reliability of financial reporting if two enterprises account differently for the same accounting phenomena.

In establishing accounting standards, the primary criterion of choice between two alternative accounting methods involves asking which method produces the better -that is, the more useful- information.

The vitality of accounting standards lies behind the idea that they form the primary base in developing accounting applications and practices in business life both at the recording accounting events and preparing the financial statements stages.

As far as the banking supervisory activities are concerned, in more specific terms, the lack of accounting standards makes it difficult to appraise and evaluate the financial position of bank

clients as well as the quality of bank assets. Such a situation prevents banks from evaluating properly the creditworthiness of the customer, and therefore bank supervisors are unable to make a satisfactory evaluation of the quality of a bank's assets. Thus, standardized accounting practices -as a result of accounting principles and standards- for banks are necessary. In the lack of effective accounting standards, supervisors have to inspect and analyze reports from banks with different accounting systems. These differences complicate the work of bank inspectors, requiring lengthy transformations to ensure that prudential guidelines are being followed (Snoek,1989).

Adequacy of accounting methods may directly influence the internal structures of banks and it can be accepted as a structural problem. Inadequate accounting methods may lead to a serious and common deficiency leading to weak internal structures in all banks. This most oftenly relates to the valuation of assets, and the inclusion of unearned interest in profits. The task of an accounting system should not only be to record all transactions of the bank, but it must also facilitate interpretation of the data, and permit continuous and accurate monitoring of the financial situation of the bank (Pettway & Sinkey,1980). Assets have to be measured at their actual value (market value or expected present value), and not at their nominal or face value as in the case of other ordinary businesses. To assess the true financial position, banks should estimate for each loan the amount that will actually be repaid. The difference between the nominal and the actual value is a -

potential- loss and should be deducted from earnings and included in provisions. The accounting procedures should include policies for determining the classification of loans, the timing and magnitude of provisions to be made, and the timing of the suspension of interest that is not received. Without such policies, earnings would be overestimated, and taxes and dividends would be paid out on bank earnings not actually received, thus eroding liquidity and capital adequacy, and hence the financial health of the bank.

3.3.3 Uniform Chart of Accounts and Financial Statements

Uniform Chart of Accounts can be considered as one of the primary means for the classification of accounting information and recorded transaction in the most proper and convenient way. It identifies the account items and recording procedures -in conformity with the GAAP, accounting standards and the general objective of the preparation of the most useful financial statements- and determines the transactions which must be included -or excluded- into certain predetermined accounts. Thus, uniform chart of accounts can be accepted as a vital means for achieving to " uniform financial statements" objective.

In banking sector, uniform chart of accounts must be designed and created by banking regulatory authorities specifically. It should be based on GAAP, accounting standards and must be convenient by regarding the operations of commercial banks. It can be considered as an indirect means for facilitating the supervisory activities. According to Tekduzen

Hesap Plani ve Izahnamesi by TBB (1989) a uniform chart of accounts aims to provide:

- i. The uniformity for accounting records and other means of financial recording in the banking sector,
- ii. A convenient structure for the preparation of uniform financial statements -basically balance sheet and income statement,
- iii. All financial information used by the banking supervisory authorities in a more direct and accurate way,
- iv. The statistical-oriented information utilized by the banking supervisory authorities in statistical early-warning models.

3.3.4 Internal Control

At the preexamination stage, the examiners must review the efficiency and the quality of external audit and internal control. Internal control system of one bank may directly influence the workload of a bank examiner at the examination stage. The analysis of technical details and procedures used in internal control process is far beyond the scope of this study, so these technical details will not be covered, rather the primary emphasis will be given to the importance of the quality of an internal control system in one bank for the bank examiners.

The responsibilities of internal auditors include the appraisal of the soundness and the adequacy of accounting, operating and administrative controls. Such appraisal is intended to ensure that these controls provide for the prompt and

accurate recording of transactions and the proper safeguarding of assets. In addition, internal auditors often have the responsibility of participating, when appropriate in the formulation of new, and the revision of existing, policies and procedures. Such participation ensures that adequate safeguards and controls, including appropriate evidential matter and audit trails, are provided during the planning and implementation process(Howard,1988). Additional responsibilities of internal auditors include determining the bank's compliance with applicable laws and regulations; evaluating the effectiveness of administrative controls and procedures; and evaluating the efficiency of operations. The latter responsibility is often referred to as operational auditing. As part of the audit program, internal auditors perform tests and other procedures that enable them to reach these determinations (Robertson & Davis,1985).

According to Commercial Bank Examination Manual (1985) the major factor that must be considered by the examiner in reviewing and evaluating the internal audit function are the independence and competence of the internal auditors, and the adequacy and effectiveness of the audit program. Consequently, the factors explained below are vitally important in order to create a convenient contextual working environment for the bank examiners.

(1) Independence of Auditors:

The ability of the internal auditing function to achieve its objectives depends primarily on the independence maintained by the audit personnel. In most circumstances, the internal audit

function is under the direction of the board of directors rather than the management. The auditor should be given the authority necessary to perform the job. That authority should include free access to any records necessary for the proper conduct of the audit (Robertson & Davis,1985).

(2) Competence of Auditors:

The responsibilities of internal auditors and their qualifications will vary depending on the size and complexity of a bank's operations and on the emphasis placed on the audit function by the directorate and management. In many banks the internal audit function is performed by an individual or group that has no other responsibility. The manager of an internal audit department should have qualifications that may not be found in all the members of the audit staff. According to Benston et al.(1986) all auditors must have professional education in their area. In addition to prior education they should be committed to a program of continuing education that may include attending technical meetings and seminars and reviewing current literature on auditing and banking. Technical skill may be improved through the use of techniques such as internal control and other questionnaires, testing (including statistical sampling), flowcharting, and computer programming. The examiner should review the educational and experience qualifications required by the bank for the position to be filled in the audit department and the training available for that position (Commercial Bank Examination Manual,1985). The final measure of the competence of the internal auditor is the quality of work performed and the

ability to communicate the results of that work.

(3) Program Adequacy:

The factors that should be considered in assessing the adequacy of the audit program are: scope and frequency of the audit work, content of the audit programs, documentation of the work performed, conclusions reached and the reports issued (Commercial Bank Examination Manual, 1985).

The scope of the program of internal audit must be sufficient to attain the audit objectives. The frequency with which the audit procedures are performed should be based on an evaluation of the risk associated with each area of audit interest. For the examiner to have a sound basis upon which to evaluate the adequacy of the internal audit program, there must exist a documented record of the work performed. Such a record is best created through the completion of audit work papers. These work papers must contain audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached. Although audit work programs are an integral part of the work papers, separate attention should be given to these programs. They serve as the primary evidence of the audit procedures performed, and they should be written and cover all areas of a bank's operations. Each program should provide a clear, concise description of the audit work required. Most of the programs include procedures such as: surprise examinations, maintenance of control over records selected for audits, review and evaluation of the bank's policies and procedures and the system of internal

control, verification of selected transactions and balances through procedures such as physical inspection and direct confirmation.

Completion of the specific procedures included in all work programs should enable the internal auditor to reach conclusions that will satisfy the related audit objectives. Audit reports must be consistent with such conclusions (Howard,1988).

(4) Program Effectiveness:

The effectiveness of any internal audit program depends on a variety of factors. The adequacy of the audit program is one of those factors like proper planning. Another factor is the supervision and review of the audit work performed which should be appropriate to the competence of auditors, and the difficulty of the individual areas of audit interest and their degree of risk. The examiner should also analyze the reporting process because the required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. Thus, the auditor must communicate all the findings and recommendations in a clear, concise manner, pinpointing problems and suggesting solutions. The auditor must submit reports as soon after completion of the related work as practicable and the report must be routed to those officials who have both responsibility and authority to implement suggested changes. Prompt and effective management response to the auditor's recommendations is the final measure of the effectiveness of the audit program.

3.3.4.1 The Review of Internal Control by Bank Examiners

The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis. The adequacy of the effectiveness of the audit program, however, should be determined separately for each area of examination interest (Commercial Bank Examination Manual, 1985).

Based on the evaluation of the relevant factors, the examiner should conclude whether the work performed by the internal auditors is acceptable, partially acceptable, or not acceptable. Often it is more efficient for the examiner to determine the independence and competence of the internal auditor before addressing the adequacy and effectiveness of the audit program. For example, if the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the audit work becomes automatically as unacceptable. Accordingly, a further review may not be necessary.

There may be situations in which the examiner detects certain weaknesses in the overall audit function or in the auditing procedures applicable to a specific area that are not of such magnitude as to lead to a conclusion that the audit function is not acceptable. In such situations, the examiner must conclude that the audit function is partially acceptable. For example, if the internal auditor is independent and has performed

the appropriate audit procedures for commercial laws within the past year, but has little experience or training in auditing, the examiner could properly conclude that the audit function was partially acceptable.

3.3.5 External Audit

External auditors are employed to examine the year-end financial statements of the banks and to render a report based on such examination. Thus, the bank directors and examiners are able to receive an outside assurance of the validity of bank's financial position and the result of the operations, and the examiners can include the auditors' report in their examination reports (Benston et al. 1986).

External auditors and consultants are often engaged to conduct in-depth reviews of the operations of specific departments, such as commercial loans or data processing. Such reviews might focus on operations procedures, personnel requirements or other specific areas of interest. Services provided by external auditors are performed at various times during the year. Financial statements are examined annually and generally commence in the latter part of the year with the report issued shortly after the start of the new year. Other types of examinations and reviews are performed at various dates on an "as required" basis.

As Crosse et al. (1973) states, the objective of an external audit is different from the objectives of an internal audit or a bank examination. In general, external audits are aimed at

enabling the accountant to express an opinion on financial statements. The accountant describes the procedures performed and the related findings. According to Commercial Bank Examination Manual (1985) the examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise where internal audit work is not being performed or where such work is deemed to be of limited value (partially acceptable) or no value (unacceptable) to the examiner. Second, the work performed by the external auditors may affect the amount of testing the examiner must perform. Third, the reports rendered by external auditors often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating work of external auditors are similar to those applicable to internal auditors, namely, the competence and the independence of the auditors and the adequacy of the audit program. As in the case of internal control, those factors may facilitate the working conditions of the bank examiners and consequently may improve the quality of work performed by them. The work of external auditing has been performed by certified public accountants (CPAs). CPAs must have certain qualifications in order to meet competency and independency requirements. All CPAs must follow professional standards adopted by their respective state societies or the state agency issuing their licenses. They should be independent of those they serve. Independence has been defined as the ability to act with integrity and objectivity.

The independence of external auditors must be considered to be impaired if, during the period of their professional engagement, they or their firms had any direct or material indirect financial interest in the enterprise (Howard,1988). External auditors must perform their examinations with the framework of generally accepted auditing standards. Generally accepted auditing standards are grouped into three categories: general standards, standards of the field work, and standards of reporting (Robertson & Davis,1985).

The general standards require that the examination must be performed by a person or persons having adequate technical training and proficiency, that an independence in mental attitude must be maintained, and that professional care must be exercised in the performance of the audit and the preparation of the report.

Field work standards include requirements that:

- the work must be adequately planned,
- assistants (if any) must be properly supervised,
- a proper study and evaluation of existing internal controls must be made as a basis for reliance thereon for the determination of audit scope and audit procedures, including the extent of testing,
- sufficient evidence must be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit.

The reporting standards deserve particular attention, because examiners must understand auditors. Reporting standards require that the auditors state whether the financial statements are presented in accordance with GAAP and whether such principles have been consistently applied in the current period in relation to the preceding period. In addition, the informative disclosures in the financial statements must be reasonable adequate or the auditor must state otherwise in report (Commercial Bank Examination Manual, 1985).

The report must contain an expression of opinion regarding the financial statements taken as all or an assertion to the effect that an opinion cannot be expressed. Any reasons for the auditor being unable to express an overall opinion on the financial statements also must be stated in the report. Although the reports issued by the auditors at the conclusion of their examinations of financial statements vary, for the purposes of this discussion they have been limited to two general types: short-form report and long-form report.

i. Short-form report: It consists of two paragraphs; the first or scope paragraph identifies the financial statements and describes generally the work performed, and the second paragraph contains an expression of the auditor's opinion. Generally the following form is used for the short-form unqualified opinions (Commercial Bank Examination Manual, 1985):

" We have examined the balance of the First State Bank of Anytown as of December 31, 19XX, and the related statements of

income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with Generally Accepted Auditing Standards and, accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the First State Bank of Anytown as of December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with GAAP applied on a basis consistent with that of the preceding year."

As stated by Woolf (1979) departure from the auditor's standard report may be required by the following circumstances:

- the scope of the audit has been restricted by the bank or has been affected by condition that do not permit the application of auditing procedures considered necessary in the circumstances,

- Inadequate disclosure or lack of conformity with GAAPs affect the financial statements in that they do not fairly present financial conditions, results of operations, or changes in the financial position,

- Accounting principles have not been applied consistently,

- Uncertainties exist as to the outcome of future events, and their effect of the financial statements cannot be reasonably estimated.

When the exception is material, but not so material as to negate an opinion on the financial statements taken as a whole, a

qualified opinion is appropriate. What is sufficiently material is a matter of judgement in the circumstances.

An adverse opinion is issued by the auditor when the matter taken exception to is so pervasive in effect that the financial statements do not prevent fairly the financial position, the results of operations, or change in financial position, and are not in conformity with GAAPs.

A disclaimer of opinion is issued when the scope of the auditors' examination has been restricted in important respects either by the bank or by circumstances, or when the financial statements are affected by uncertainties.

ii. Long-form report: In its use in the banking industry, this type of report generally includes a more detailed description of the scope of the auditor's examination than is found in the short-form report. Suggestions for improving the bank's internal controls, accounting procedures and other matters may be included in the long-form report or may be the subject of a separate letter report.

3.3.5.1 The Review of External Audits by Bank Examiners

In view of the objectives regarding the reliance to be placed on work performed by auditors, and in view of the professional and ethical standards of the public accounting professions, only in unusual situations the examiner should conduct an indepth review of the competence and independence of the auditor or the adequacy of the auditor's control. One

situation that the examiner should investigate would be a recent change in external auditors by a bank, particularly if the change was made after an audit was commenced (Commercial Bank Examination Manual, 1985).

It ordinarily will not be necessary to make specific tests to determine independence. However, there may be occasions when the examiner may have sufficient reason to question the independence of an auditor or the quality of his work. For example, the examiner may become aware that, during the period of an auditor's professional engagement, which includes the period covered by the financial statements on which the auditor has expressed an opinion, the auditor or a member of his firm:

- had a direct financial interest in the bank,
- was connected with the bank in a capacity equivalent to that of a member of management or was a director of a bank,
- maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records,
- had an unsecured loan from the bank that was considered to be material relative to the net worth of the borrower.

In such instances, the auditor would not have complied with professional standards. Accordingly, the examiner should not rely on any work performed by the auditor without a review of the procedures followed in performing the audit. Such a review may require the examiner to request, through the bank, that the auditor make available appropriate work papers. The auditor's

work papers should be reviewed in the light of the applicable criteria discussed under the internal control part of this study. If the procedures satisfy the examiner's requirements, he may rely on the work performed. The examiner may conclude, however, that the circumstances, and their attendant risks, preclude the acceptance of the work performed by the auditor. In such cases, no reliance should be placed on the auditor's examination (Commercial Bank Examination Manual, 1985).

The examiner should determine the scope of the auditor's examination by reviewing the most recent report issued by the auditor and, if the audit is in progress or is planned to commence in the near future, any engagement letter to the bank from the auditor should be reviewed. The examiner also should obtain and review any adjusting journal entries suggested by the auditor at the conclusion of his examination to determine if such entries are normal recurring accruals or if the entries indicate inadequate accounting records. There will be situations where the examiner finds that the auditor was instructed to omit certain procedures that are required by generally accepted auditing standards and that are included in the examiner's guidelines. In that situation, the examiner should place no reliance on the auditor's examination for the procedures omitted (Commercial Bank Examination Manual, 1985).

Under certain circumstances, an auditor may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of

opinion issued. If the matters involved affect specific areas of the bank's operations, the examiner may be in a position to rely on the procedures performed by the auditor in all other areas of interest. If the examiner is not able to relate the matters involved to specific areas, no reliance should be placed on the procedures performed by the auditors.

There will be situations in which the external auditing is performed by individuals who are not certified public accountants. Such auditing may afford the examiner the same reliability as auditing performed by the CPAs. The principal difference, as far as the examiner is concerned, is the lack of circumstances requiring the auditor to maintain the confidence of the public, as well as various regulatory authorities, in his role as an independent agent. Accordingly, the general criteria is very similar to the criteria for reviewing and evaluating internal audits.

CHAPTER 4. THE TURKISH CASE

4.1. Regulatory Activities in the Turkish Banking System: A General Framework

In Turkey, examination of banks have traditionally been conducted by the internal auditors of banks and public supervisory authorities in a very superficial way until recent years. As a result of the recent developments in banking business new studies have been undertaken also on the subject of bank examination during the last 4-5 years. The new approach giving weight to the importance of banks in national economy and in development of international trade, economic and financial politics of recent years, and activities related to our country's integration to the international economic and financial system may be regarded as catalyst of these studies.

4.1.1. Recent Developments

As a consequence of the bank failures of early 1980's, investors have begun to give thought to the analysis of the profitability of their banks. Meanwhile public agencies have begun investigating the efficiency of the banks and checking whether they are operating in conformity with legal regulations. Besides, international financial institutions and companies are normally interested in knowing whether the banks with which they have business contacts are credible and stable.

In 1986, a uniform chart of accounts has been drawn up in order to render the accounts, reporting techniques, and financial statements of the banks understandable, comparable and standard.

Uniform chart of accounts and uniform financial statements -an output of uniform chart of accounts- have facilitated the analysis and studies of both public supervisory authorities and private analysts. In addition to these, banks have been obliged to publish their financial statements in the uniform format. Besides, they have the obligation to submit their financial statements and any other pertinent financial and accounting information to the Central Bank. While the Central Bank was performing the supervision of banks as a staff function in previous years, it has begun performing this task much more directly and actively in recent years. The Central Bank is currently performing off-site financial analysis by utilizing the financial information collected from banks, and nowadays they also are studying the feasibility of developing an early-warning model for the banks. Another vital development in this sphere is the Central Bank's requirement that the banks have their financial statements audited by an independent external audit firm before they are submitted to the Central Bank. In addition to these, sworn -in bank examiners of the Undersecretariat of Treasury and Foreign Trade have traditionally been conducting the supervision activities for a long time.

At this point, it is useful to take a look at the legal establishments that are charged with the task of supervising the banks.

4.1.2. Internal Regulatory Authorities

1. Board of Directors:

According to the Banking Law and other regulations

about banking, the most important body in a bank is Board of Directors (BD). The BD has the authority to appoint auditors, and to control the activities of the bank whenever they decide to make decisions concerning the direction of the activities or to make corrective actions. From this point of view, we may regard BD as an auditing body.

2. Auditors:

i. Auditors appointed by the BD: These auditors have the obligation to perform tasks which are imposed upon them by the Commercial Law and Banking Law. According to the Banking Law, these auditors are responsible to report the situation of the bank in conformity with the articles of Banking Law and other regulations once every three months and to send these reports to the Undersecretariat of Treasury and Foreign Trade and BD within one month following this report's period of time.

ii. Auditors of the Ministry of Finance: The Ministry may assign work to auditors related to those banks which collect deposits. These auditors carry out their work in accordance with the Banking Law and the Commercial Law.

iii. Inspectors: According to Statutory Decree No. 70, the banks are obliged to employ inspectors as a compulsory body. The inspectors are responsible to examine whether the operations of the bank are in accordance with the banking regulations and principles. Also banks have the obligation to employ an adequate number of inspectors by taking into account the volume of business and the size of the bank. These inspectors generally are directly supervised by the BD or the president.

4.1.3. External Regulatory Authorities

4.1.3.1. Public Regulatory Authorities

1-Sworn-in Bank Examiners: Sworn-in Bank Examiners (SBE) make on-site examinations on behalf of the public. SBEs have the authority to apply the rules and provisions of Banking Law and other related laws, to make examinations of all kinds of banking operations, to determine and analyze all factors affecting the financial structure of banks, and to search for the composition of banks' assets, liabilities, capital accounts, income statement accounts (Akguc, 1985). According to the Banking Law, if the SBEs find any behavior of the president or members of the BD or directors or officers in breach of the Banking Law or foundation contract, they have the obligation to report such behavior to the authorized bodies by a report enclosed with the documents (Erez, 1975). This report will also have to be sent to the Undersecretariat of Treasury and Foreign Trade.

i. Duties of SBEs:

- To check if the provisions and rules of laws and other legal regulations concerning the operations of banks and their subsidiary companies are adhered to,
- To determine and analyze the balance and relation between balance sheet and income statement accounts, and transactions affecting the financial structure of banks,
- To conduct the studies required by Development Plans, Annual Programs and Execution Plans related to Banking,
- To contribute to the formation and improvement of legal and financial regulations,

-To conduct analyses and research regarding the application of legal regulations, and to make recommendations on any subject related to banking business.

ii. Authorities of SBEs:

-To require any information within their subject matter from banks, their participations and subsidiary companies and from other related public and private organizations,

-To investigate the banks which act in contrary to related legal regulations and laws,

-To perform tax audit,

-To obtain information that is considered confidential by public bodies.

2. The Undersecretariat of Treasury And Foreign Trade and its Ministry: The Undersecretariat (UTFT) and the superior ministry has an effective and central position in the application of Banking Law and the examination of the banks. SBEs work under the supervision of UTFT. UTFT and the Ministry have a broad range of authority through the Banking Law. Some of their tasks and authorities -within the scope of this study can be listed as follows.

-To approve the directives about the application and preparation of uniform chart of accounts and uniform financial statements drawn up by the Banks' Association of Turkey which the banks are obliged to adhere to,

-To determine the basis for and the form of quarterly reports required from banks by public authorities,

- To take administrative measures related to the banks, and to take other special measures to strengthen their financial structures, and to make closer examination of the banks which has weakened financially,
- To require schedules, reports and any other financial information from the banks in order to follow the application of the Banking Law in the operations of the banks, and to determine the standard ratios about the financial structure and resource utilization of banks, to determine the basis about the publishment of these statements and ratios to the public,
- To demand from the financially weakened banks to take necessary the measures which have been stated in the Banking Law.

3. Superior Ministry: According to the Statutory Decree No. 233, the Ministry is under the responsibility of seeing to it that the banking activities are being performed in accordance with the legal regulations. With this purpose, the Ministry has authority to examine the accounts, operations and the transactions of the banks, and to investigate their economic and financial position, whenever necessary.

4. The Central Bank of Turkey: The Central Bank of Turkey carrying a broad range of authority about money and credit has significant power over the commercial banking system. Supervision and examination of banks are also within this range of authority. The authorities -in addition to the classical central banking functions- can be summarized as follows:

- To make on-site examination of the banks on matters under their authority (this authority has been granted by recent legal arrangements),
- To check whether the legal provisions are met by banks, and to require any information and report which may be useful in making statistical analysis and off-site examinations,
- To follow up and analyze the financial situation of the banks through this information and reports,
- To require any detail about the balance sheet and income statement accounts and any other information about loans, foreign currency transactions, deposits whenever necessary.

The Central Bank may inform the Prime Ministry of its impression of the banks and suggestions concerning improvements after examining the financial situation of the banks. The Central Bank may also make suggestions about determining the standard ratios related to the financial structure and operations of banks, and preparing the form of quarterly reports (account summaries), required by public authorities. Besides, the Central Bank has the responsibility of managing and representing the Deposit Insurance Fund.

5. Banks Association of Turkey: All banks operating in Turkey are obliged to be a member of this association and to observe the decisions made by the Association. The purpose of foundation of this Association is to develop banking business, to prevent unfair competition among the banks, and to provide the banks to

operate within a reasonable profit level and discipline.

The main legal missions of the association are; to take necessary measures to achieve its objectives, to represent the banking sector of Turkey on international platforms, to develop opinions about any subject in banking business, to appoint arbiters for disputes among the banks. Other tasks which can be considered here -within the scope of this study- are: to draw up the uniform chart of accounts, the uniform balance sheet and income statement which the banks have to use; to prepare the implementation and preparation principles of those; to develop opinions about the quarterly reports which the banks must send to the Central Bank.

The Association has begun to use the uniform chart of accounts in 1986 in order to provide uniformity in recording the transactions of banks, to facilitate the supervisory activities, and to provide conformity to the international standards. In fact, Banks Association of Turkey is not directly authorized and competent on supervision/examination activities, rather it is just a body which has a coordinative function in the banking industry.

6.The Council of Ministers: The Council of Ministers has a broad range of authority in controlling banks but the supervision/examination function is not directly carried out by the Council. Its supervisory authorities are realized indirectly by the other competent and authorized bodies. Generally, the Council directly uses its authority at the post-supervision stage. For example, it has the authority to assemble or to

nationalize the banks whose financial positions are declared to have been weakened by the other authorized bodies.

7. The Supreme Board of Audit (Yuksek Denetleme Kurulu) (YDK): By the Statutory Decree No. 233, YDK has been given the authority to audit the State Economic Enterprises and their subsidiary organizations in financial, administrative and technical terms. YDK has to submit the results of its analysis -on the annual activities of banks-to the Parliament until the end of the next year's October. This board has jurisdiction only over the state banks and it rarely engages in financial analysis.

8. The Turkish National Assembly (The Parliament): The annual operations and accounts of Iller Bankasi and Vakiflar Bankasi are subject to the audit of the Parliament. Besides this, the Parliament examines the reports sent by the YDK and takes the necessary measures.

4.1.3.2. Independent External Audit Firms

In Turkey, the recent trends towards industrialization and liberalization necessitate the full disclosure of reliable and accurate information on business enterprises to the public. In their business relations with foreign countries, financial statements that have been examined according to the international standards have being required both from the industrial and commercial enterprises as well as from the banks. Such financial statements and information have been instrumental in shaping international business relations and have given support for the development of international trade. Moreover, the positive effect of the externally audited financial statements on the

reliability and effectiveness of the banking supervisory activities has been another incentive that has accelerated the recent developments on this subject in Turkey. As in other countries, independent external auditing firms are not directly effective on bank supervision in Turkey but the effective activities of these firms are one of the important prerequisites for providing accurate and reliable information and financial statements which are being used as an input in banking supervisory activities.

In Turkey, there are two arrangements regarding the independent external auditing. One of these is the "Pronouncement on the independent external audit firms" which has been issued by the Central Bank, and the other is the "Regulation about the independent external audit in the capital market" which has been issued by the Capital Market Board.

Regarding the independent external audit firms, the principles and conditions concerning the foundation and practices of the independent external audit firms were published in the Official Gazette No.19343, dated January 16, 1987 (in compliance with the Article 43 of the Turkish Central Bank Law No.1211, dated November 14, 1970 amended by Law No. 3098). The aim of this pronouncement is to determine the principles of and conditions for the establishment of the independent external audit firms -in order to provide the basis for more effective and efficient supervision/examination of the banks by the Central Bank. From the content of this pronouncement, one may infer that its sole aim is to help and improve the supervision/ examination

activities by the Central Bank. However not only the Central Bank but also the other public authorities, bank management and partners, private researchers, and the public -in the most general terms-must utilize the results of the activities of external audit firms. The Central Bank -in addition to this pronouncement- has published another pronouncement called "Pronouncement on the bank audits made by independent external audit firms" in the Official Gazette No. 19674, dated December 24, 1987. This pronouncement has enumerated the key points about the reports of the auditors and the below topics have also been covered:

(i)General principles concerning the Auditor's Report: In this section, the general guidelines that have to be followed in the auditor's report are delineated, and the content of the report -in general terms- are indicated. The following information are required to be covered in this report: a comprehensive and understandable statement about the financial structure of the bank, the vital structural changes which influence the financial structure of the bank, the explanations on the results of the audit work, the approved copy of the auditor's report, and the audited and approved financial statements of banks.

(ii)The Content of the Auditor's Report: In the said pronouncement, it is required that the auditor's report must cover the information on the following topics:

- the capital structure, legal status, and management of the bank,
- auditing principles followed during the audit work,

- whether the recording of transactions are made in accordance with legal regulations and GAAPs, and whether other obligations have been fulfilled or not,
- the adequacy, accuracy and reliability of information which the banks have to send to the public supervisory authorities,
- the capital adequacy of bank (compared to assets and liabilities), the reserve policy of bank (both primary and secondary reserves),
- the ability to pay short term liabilities and other debts of banks,
- whether the loan policy and the placement of funds are performed in accordance with legal regulations, the reasons and the results of mistakes in security investment operations, and the possible and actual corrective actions that have been taken to remedy these problems.

In addition to these, detailed information on the following topics are also required: the recording of foreign exchange transactions, the professional qualifications of bank executives, the risks of off-balance sheet operations, loans granted to participations and related subsidiary enterprises, fixed assets and their depreciation transactions, revaluation transactions, the accruals and discounts for interest and other types of revenues, and the discounts for interest and other types of expenses.

(iii) The investigation of Internal Control Activities of the Bank: The external auditor must investigate the adequacy of the

internal control activities and the accuracy of the reports prepared by the internal auditors. For the weak points that are identified during the external audit, the recommendations for taking corrective actions have to be made to the management of bank by external auditors.

(iv)Extraordinary Audit: The Central Bank has the authority to force the bank to be audited their financial statements for a second time.

This pronouncement states that banks are obliged to disclose any information required by the external audit firms and this information has to be held in strict confidentiality.

While the first pronouncement of the Central Bank mainly covers the personal and professional qualifications of the owners and auditors of the external audit firms, second pronouncement primarily emphasizes the basic points about the report of the auditors.

Another related legal regulation on the external audit is the "regulation about the independent external audit in the Capital Market" of the Capital Market Board published in the Official Gazette No. 19663, dated December 13, 1987. However, since this regulation is concerned only with the intermediation operations of the banks -not all operations-it has not had a direct and strong influence on the banking supervisory activities. It can be considered as an incentive for the formation of environment that would facilitate performing external audit activities.

4.2. Supervisory Activities in the Turkish Banking System

4.2.1. Supervisory Activities of the Central Bank of Turkey

The Central Bank of Turkey has begun to attach more importance to the bank supervision function -one of the classical functions of central banks- in the last decade, especially after 1985. A separate department dealing with bank supervision was founded within the body of the Central Bank towards the end of 1985. Currently, this department is dealing primarily with off-site supervision. Based on this supervision, on-site examination may seldomly be performed -if necessary. However the qualifications and work experience of the bank personnel working on this subject are more appropriate to the off-site supervision.

The Central Bank receives from the banks their balance sheets and income statements and the information which includes the details of the subsidiary accounts of these statements. Additionally, in some special cases, the Central Bank can also demand the reports of the board of directors and auditors of the bank, and all other kinds of information concerning the deposits, loans, foreign exchange transactions and other operations. Furthermore, since 1988, the Central Bank has required the banks to have their annual financial statements audited by an independent external audit firm.

At this stage, it is useful to look at the procedures and methods used in the financial analysis of the Central Bank: Central Bank has prepared some standard forms to be used as an input in off-site analysis. These are called "Uniform

Reporting Package". This package includes 50 forms and these forms take two basic financial statements -income statement and balance sheet- as a base, and contain the detailed information about the subsidiary accounts of these statements. Banks have to send these forms to the Central Bank monthly. These forms are prepared in such a way that 2 of them comprise annual, 5 of them contain monthly, and 43 of them contain quarterly information.

The analysts determine the financial position of the bank by using fundamental financial analysis techniques. One of the most important stages of the analysis is the peer-group determination. Formally, the Central Bank classifies the banks according to their legal status (State banks, private banks, foreign banks, development and investment banks). However, since this simple classification is not sufficient to make reliable and comprehensive comparisons among banks, the experts state that they also make a classification according to the total assets of the banks, and they make the final analysis according to this classification.

The analysis techniques used by the Central Bank include most of the basic financial techniques. Their studies are primarily based on ratio analysis. The Central Bank has a ratio package including 59 ratios. These ratios are obtained through the comparisons of fundamental balance sheet and income statement items. The ratios which are obtained as a result of the analysis are first compared with industry averages, and then with peer-group averages. On the other hand, by supporting these ratios

with other financial analysis techniques, a more detailed and extensive analysis can be performed. The balance sheet and income statement items of each bank are compared with its own previous figures first in the short-run (last 3 months or last 3 quarters) and then in the long-run (last 3 years). This common-size analysis is then supported by both the trend analysis and the percentage analysis. Therefore, the trend of each ratio and/or account of each bank (horizontal analysis), and the percentage of each account on the balance sheet and income statement (vertical analysis) are being investigated and then are compared with those of other banks. These comparisons are conducted both on industrial and peer-group basis. Next, in general terms, it is investigated that whether there is an important structural change in the asset, liability, revenue, expense and cost structures of the bank (searching for a change compared to industry and peer-group averages, and searching for a periodical change). If an important deviation is identified in any one of the accounts and/or ratios of a bank, further in-depth analysis (even on-site examination) can be made.

The qualitative considerations are one of the most important factors influencing the analysis. It is not easily possible to say that there is a strict uniform analysis procedure in the Central Bank. Although all analysts utilize similar methods and techniques, they can use their personal subjective initiatives for each case (bank).

It has not been possible to obtain the analysis procedures, ratios and other detailed information used by the Bank

Supervision Department of the Central Bank during this research. We have only obtained the "uniform reporting package" (input data) and this package is given in Appendix 2. The central bank authorities have stated that these data are strictly confidential and unavailable to the public. For this reason, the present researcher has been unable to perform a more detailed and comprehensive analysis of the topic.

The results of the analyses mentioned above are summarized in the performance reports. These reports are prepared for each bank on a quarterly basis. Moreover, in addition to these comprehensive and detailed reports, another report - performance rating report similar to the CAMEL system used in the USA - is prepared. In this brief report, there are some fundamentally important ratios and their explanations. These ratios contribute the performance evaluation of the banks by considering four different performance dimensions: Capital adequacy, asset quality, earnings, and liquidity. This rating includes the same dimensions as in the CAMEL model of the USA, but a review of bank management is not taken into consideration because of the impossibility of evaluating the bank management through the off-site activities in the current structural conditions of the Turkish banking system. As a result of this fact, the analysts evaluate the management of banks according to the reports of external audit firms in a more simple and indirect way.

The Central Bank in addition to the analysis mentioned above, is in the process of developing an "early-warning system"

in recent years. This system will be able to support both on-site examination and off-site supervision activities. Thus it has a supportive function. In the broadest sense, the aim of the system which the Central Bank tries to develop is to determine the bank whose financial positions have deteriorated and to concentrate the activities of the supervisory personnel on certain banks according to the result of this system. The Central Bank has been conducting preliminary feasibility studies for this system. The final form of the model has not yet been achieved. In the currently-used initial model, the ratios which are obtained through the previously made ratio analysis are being compared with averages -industry and peer-group for each bank. Consequently, if a ratio is better than or same with the average, it is given a value of zero; if it is below than the average, it is given a value of one. Then a final total is obtained by taking the sum of this process for all ratios for each bank. Although it is not quantitatively incorporated into the model, for the ratios below the average, the extent of the deviation is being subjectively considered. The Central Bank authorities continue their activities, especially by consulting the experts from the USA, in order to transform this simple model into a more comprehensive, valid and reliable form.

Finally, it is useful to look at the authorities of the Central Bank at the post-analysis stage. The Central Bank does not have a direct power of sanction -after the examination stage- on financial and legal subjects. The Undersecretariat of Treasury and Foreign Trade is the primary authorized body in this

area. The Central Bank is just able to propose alternative sanctions and recommendations to the Undersecretariat according to the results of the analysis. Furthermore, based on its own analysis results and the reports of the external audit firms, Central Bank may offer proposals to the bank management -when it believes there is a necessity for this-by arranging meetings to which the external audit firm and bank management join. In addition to these, the Central Bank can impose certain indirect sanctions on banks. For example, it may propose a bank to take corrective actions for improving his position, however if the bank does not follow this proposal, the Central Bank might not give rediscount credit or might demand heavier requirements for these credits. In another case, the Central Bank might not allow the banks to enter the interbank market or even if it allows to enter, it might provide lower limits compared to other banks.

4.2.2. Supervisory Activities of the Board of Sworn-in Bank Examiners

SBE Board is a specially-founded public organization which primarily performed the on-site examination of banks in Turkey. SBE Board operates under the supervision of the Undersecretariat of Treasury and Foreign Trade.

SBEs make the on-site examination of the banks periodically. Until recent years, only a limited portion of the banks were examined on-site each year; however at present all banks are examined each year according to the decision made at the beginning of 1990. Also the content of the analysis of SBES has been changed. While SBES' supervisions primarily included

the tax audit and legal control until recent years, they have also begun to give emphasis to the "financial analysis" dimension. Broad structural changes in the Turkish economy in general and the changes in banking business in particular, can be considered as primary catalysts for this trend in 1980's while the loosening and broadening of provisions in the Banking Law and in other related laws provide banks to operate in a more flexible and sophisticated environment. On the other hand, the expansion of the variety of the services offered by banks has also supported the need for the multidimensional examination of banks. In their analysis, SBEs basically investigate whether the banks fulfill the obligations of the provisions of the Banking Law. The following factors are taken into consideration in the analysis of SBEs:

- To analyze the financial position and operations of the bank and to investigate any unusual fluctuations, if any,

- To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual fluctuations,

- To determine the bank's adherence to safe and sound banking practices,

- To determine compliance with laws and regulations of each operation of the bank,

- To identify major changes in the financial condition of the bank between examinations,

- To determine whether bank officers and employees are conducting the bank affairs in conformance with the established guidelines in general and for each major account included in balance sheet and income statement in particular,

-To determine whether the policies, practices, procedures and internal controls regarding major accounts are adequate,

-To assist in determining the reliability of the bank's financial information and the consistency of the application of the accounting principles,

-To determine whether required reports are being prepared on time and contents of these reports are accurate,

-To check the validity of the data being reported by the bank,

-To investigate areas where an in-depth review is indicated,

-To explore other areas where information is not available through normally reported data,

-To determine whether internal and external audit functions exist,

-To evaluate the independence and competence of those who provide the internal and external audit functions,

-To determine the scope and adequacy of the procedures performed by the internal and external auditors.

As seen above, sworn-in bank examiners, first of all, look at whether the records are being held correctly, timely, comprehensively, and in accordance with laws and regulations; and then they examine the effectiveness and reliability of internal control and external audit. At the following stage, the financial structure of the banks is being analyzed. Next "the financial structure reports" are prepared according to the results of the examinations, including a detailed financial

analysis of banks which emphasize on the liquidity dimension. Furthermore, detailed analysis of balance sheet accounts, financial statistics, ratios, and deviations from legal regulations and accounting principles are being held in these reports. Finally, the problems of banks are stated and solutions to these problems are proposed (Hancerli, 1987).

At the analysis stage, the main technique used by the sworn-in bank examiners -a technique peculiar to the banks- is the detailed examination of the financial statements of bank. Within this framework, analyses are performed through emphasizing the liquidity, capital adequacy, asset quality, and earnings position of banks. This step is also supported with ratio analysis. Basic activities realized at this step can be stated as follows:

- To evaluate the overall quality of the investment portfolio and how that quality relates to the soundness of the bank,

- To evaluate the overall quality of the loan portfolio and how that quality relates to the soundness of the bank,

- To evaluate the loan portfolio for credit quality, performance, collectibility, and collateral sufficiency,

- To determine the existence of any concentrations of credit,

- To determine whether any concentration of credit represents a hazard to the soundness of the bank,

- To determine that concentrations on credit do not violate applicable banking statutes,

-To evaluate the deposit structure and to determine its character and volatility,

-To evaluate the propriety and consistency of the bank's present and planned level of capitalization and dividend policy in light of existing conditions and future plans,

-To evaluate the bank's investment in and loans to its subsidiaries and the propriety of those carrying values,

-To determine the relationships between the bank and its related organizations and the effect of these relationships upon the affairs and soundness of the bank.

The procedural order of these analyses is as follows: Examiners fill the standard forms (80 forms) according to the results of their examinations. These forms provide the standardization of the analysis. According to the results of the examination; an in-depth, more-detailed analysis is conducted for each bank -if necessary-. At this point, an important change which has been effected in January 1990 about the frequency of the examiners' analysis must be mentioned. Since 1990 sworn-in bank examiners now begin to conduct their examinations for each bank at the same time. Previously, these examiners used to make irregular and unannounced visits to the banks on a random basis (i.e. all banks were not examined each year regularly, rather the examiners visited some banks, and other banks were not examined at the same time).

In most general terms, the content of the standard forms consists of the following information gathered at the analysis stage: the qualifications of the management staff, the relations

of bank with other banks, the details about the balance sheet account, risk ratios indicating the earnings position of the bank, details about the capital accounts and the deposit structure of the bank. In addition to these, one of the most important forms are related to the quality and composition of the loan portfolio of the bank. In this form, it is investigated whether the bank fulfills the requirements of "decree for allowances" (karsilik kararnamesi). Also the possible risks and collectibility of the bank's loan portfolio and the details about each loan account- the current condition of maturity, interest collectibility and other factors affecting the quality of each individual loan- and the personal interpretation of the examiner about the quality of the loan portfolio have to be included in this form.

These forms are then sent to the evaluation board which operates within the body of the Undersecretariat, and this board makes inferences about the general structure of the banking system; this board also evaluates the loan quality, capital adequacy, earnings, liquidity and risk position of each bank specifically according to the forms filled as a result of examinations (Sungur,1990). At this point the functions of the sworn-in bank examiners come to an end. In our interviews with sworn-in bank examiners, they have stated that their analysis are typically notnot being taken into consideration at the post-supervision stage due to same external, uncontrollable reasons. They have asserted that they not only make the legal control and financial analysis efficiently and accurately but also are

generally able to identify the banks whose financial positions have been deteriorated and the banks that have violated the laws and legal regulations. According to these examiners, the major problem emerges at the post-examination stage because the authorized bodies at this stage -the Undersecretariat and its superior ministry -cannot take the corrective actions and other necessary measures effectively.

Finally, some space must be devoted to the personnel policy and composition of the Sworn-in Bank Examiners Board. Sworn-in Bank Examiners Board employs university graduates. These personnel are hired based on a written and oral examination. They must work as an assistant-examiner and must pass another exam in order to be promoted to the position of examiner. One of the factors which influences the employment of a qualified, experienced and competent personnel is the competitive government salaries which can provide incentive for qualified persons to become a bank examiner. Examiners' pay is currently based on government pay scales which are lower than those offered by private banks for the same skills. It is essential for the Sworn-in Bank Examiners Board personnel to have a satisfactory remuneration policy. Another consideration that influences the quality of the examiners' work is the adequacy of training facilities. The training opportunities and programs of Sworn-in Bank Examiners Board have not been sufficiently arranged so that the examiners could follow and learn recent developments in their profession. In this subject, the board may cooperate with the banks in having a common training facility for their staffs.

Also some of the training needs may be met from international institutions such as the World Bank, IMF etc.

4.2.3. General Problems of Supervisory Structure in the Turkish Banking System

The duties, authorities and responsibilities concerning the supervision/examination of banks by public bodies are being primarily delegated to Sworn-in Bank Examiners and the Central Bank. While Central Bank carries out the off-site supervision, Sworn-in bank examiners basically perform the on-site analysis and legal control of banks. At the post-examination stage, the Undersecretariat of Treasury and Foreign Trade and its superior ministry are authorized to take corrective actions and to impose sanctions -according to the results of the supervision/examination activities.

There have been important developments concerning the bank supervision/examination especially during the second half of the 1980s. However, these developments have been realized in an uncoordinated and irregular way so that the efficiency and effectiveness of the supervision/ examination mechanism has not been improved so much(Tuncer, 1988). The major reason for these inconsistencies is that the arrangements related to the supervision/examination of banks originate from different laws which results in inharmonious and nonuniform arrangements. The complexity and the inconsistency of such arrangements are mainly observed at the following three points: the duty, the authority and the responsibility of the Sworn-in Bank Examiners Board and the Central Bank. The abnormal and irrelevant delegation of the

authorities and responsibilities to the jobs causes serious problems in practices.

Although the Central Bank performs many functions in the banking system, most of these function are only indirectly related to supervision/ examination. The Central Bank has limited authority concerning supervision/examination activities. Furthermore, the statutory decree No. 70 puts further limitations on these authorities. For example, while the Central Bank is authorized by the statutory decree No.70 for the management and representation of the Deposit Insurance Fund, it is not given the authority to take precautions for the protection of the deposits and to evaluate the possible risks (Canbas and Erol,1984). Therefore, in recent years, although the duties of the Central Bank about bank supervision have been relatively increased, the authority and responsibility of the bank have not been augmented in a proportional manner. On the other hand, while important duties are given to the Sworn-in Bank Examiners for Supervision, they are not authorized to take precautions at the post-supervision stage and such authority is held by the Undersecretariat of Treasury and Foreign Trade and its superior ministry. In Turkey, the major weight of bank supervision is primarily given to the ministry under which the Undersecretariat acts in order to impose corrective actions. According to Canbas and Erol (1984), the authorities of the Ministry are sufficient to take corrective actions for preventing the banks from financial crisis but due to some political pressures and considerations, such authorities could not be used effectively.

Parallel to this view, the Central Bank authorities and the sworn-in bank examiners point out that primary problems in the supervision of the banking system arise not at the analysis stage of the banks but from the passive attitudes of the decision-making bodies that hold the authority.

It would be appropriate, at this point, to say a few words about the new Banking Draft Law which brings drastic changes in some of the applications. In most general terms, the draft solves the authority contradictions between the Central Bank and the superior ministry in favor of the ministry (Finans Dunyasi Dergisi,1990). The best example for this is the establishment of the "Deposit Insurance Board". According to the Draft, this new board replaces the Deposit Insurance Fund which is now being managed by the Central Bank and the duties related to the management of this board are taken from the Central Bank and given to the Ministry. Another important change brought about by this new draft law is the inclusion of the external auditing concept to the Banking Law. Moreover, Article 64 of the Banking Law -which is related to the precautions proposed to the banks that have a weak financial structure- is also amended by the draft and the authorities of the superior ministry on this issue are enhanced. In summary, the new draft law brings important changes while the main points of the statutory decree No.70 and a law No.3182 are preserved. The changes concentrate mainly on the matters of external audit, deposit insurance fund, increase in the authorities of the ministry, and the decrease in the authorities of the Central Bank.

In this study, it is demonstrated that there are important problems related to the process of authority delegation mainly in the precautions that are to be taken (i.e. the application of Articles No.62, 63, and 64 of the Banking Law) at the post-supervision stage rather than the technical and procedural problems in the supervision/ examination system of the banks. The most important reason for this problem is the concentration of the delegation of the authority to a political body - the Ministry. In contrast, the new law draft proposes the widening of the authorities of the ministry. However, the authorities for the supervision/examination stage and the post-supervision stage may be granted to a more autonomous central bank. By this way, the supervision/examination activities would be purified from external effects especially political pressures -and be carried out more effectively.

Following the foregoing legalistic approach to the problems, the evaluation of the activities of the Sworn-in Bank Examiners and the Central Bank authorities are now in order. The Central Bank does not have equivalent authority commensurate with its duties. The Central Bank is concerned not only with the off-site supervision but also with the issues such as the realization of the external audit effectively, the development of the early warning system, and management of the Deposit Insurance Fund. In spite of this wide range of duties, its authorities remain unchanged. The experts interviewed during this study have mentioned that the bank supervision department of the Central Bank -although established recently- employs qualified personnel,

makes systematic studies, and is willing to make coordination and cooperation with other authorities.

There are other criticisms directed at the Sworn-in Bank Examiners Board by some experts. For example, Canevi (1990) states that the Sworn-in Bank Examiners Board is isolated and could not have been reorganized in a fashion parallel to the dynamics of the system. In their view, this Board -now employing 40 to 50 analysts- should be upgraded both quantitatively and qualitatively. According to Canevi(1990), the solution is to make the board a semi-autonomous body like the Capital Market Board. There are other criticisms coming from the Undersecretariat authorities. One expert mentions that the bank examiners' supervision and the reports lack standardization which, in turn, makes it impossible to make any meaningful interpretation and comparisons about the whole system in the short run (Sungur,1990). Such inefficiencies of the analysis of bank examiners have been tried to be overcome by the "standard evaluation form" published in early 1990 which also can be considered as an indicator of the inefficiency of the works of sworn-in bank examiners.

Another general problem in the supervision/ examination system of banks in Turkey is the lack of coordination between the two important public authorities, namely the Sworn-in Bank Examiners Board and the Central Bank. In the historical evolution, there were no coordination between these two bodies until the department of bank supervision was established within the body of the Central Bank. Even in the current situation,

there is minimum coordination and it can not by any measure be considered as adequate. Also, a legal framework of arrangements which can lead to coordination between these two authorities is nonexistent. Currently, both authorities work independent of each other and they take into consideration the results of the analysis made by the other only in some exceptional cases. During this study, it is also observed that both authorities have unwilling approaches to coordination with each other. For example, the sworn-in bank examiners state that there is no need to coordinate the studies of these two bodies and their own work is satisfactory by itself.

There are several alternatives proposed for the coordination of these two public authorities. For example, Hancerli(1987) asserts that merging these two under a single body would yield faster and more efficient results. He makes three suggestions:

- (i) Giving all duties and authorities about the bank supervision/examination to the Central Bank,
- (ii) Giving all duties and authorities about the bank supervision/examination to the Undersecretariat while the Undersecretariat is reorganized and improves the supervision/examination activities,
- (iii) Establishing a "Banking Board"(like in West Germany, France, Italy, Belgium, Luxembourg) as a single authority.

Hancerli(1987) states that the third alternative is the most appropriate to the current conditions of Turkish Banking

system. The counterargument to the Hancerli's view could be the continuation of the current system by making the necessary adjustments. In other words, bank supervision/ examination could be carried out by the two bodies but the responsibilities and lines of demarcation of authorities should be -legally- drawn more precisely while the coordination of the two could be provided by law.

Based on the above evaluations, general solutions to these -general- problems are could be stated as follows: First of all, the problems related to the supervision/examination of banks result from the lack of legal coordination and consistency. A legal harmonization is necessary to overcome this problem. Such a harmonization attempt should intend to integrate the regulations related to this subject and to reorganize the statements which are scattered in different articles of laws and statutory decrees in order to establish consistency. Moreover, the duties of the Sworn-in Bank Examiners Board, the Central Bank, the Undersecretariat and its superior ministry should be revised and their authorities and responsibilities should be restated parallel to the duties given. At this point, it is proposed that -by considering the fact that the authorities delegated to the Ministry and the Undersecretariat could not be realized effectively due to some political considerations- the delegation of authority should be effected so that more weight is given to non-political bodies; such as a more autonomous, independent and authorized central bank. The problem related to the lack of coordination between different bodies could be solved

by either establishing a new, single board under which these authorities are gathered or forming more coordinated relations among the current authorities.

In addition to these general proposals about the structure of the system, secondary proposals could be the following: First of all, early-warning system -which the Central Bank is presently trying to develop- should be established and accordingly a risk-rating institution must be formed for evaluating the banks (Canevi, 1990). The banks could be classified according to their risk levels using international criteria which is best exemplified by "CAMEL" (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity) established in the USA in 1980s. As an integral part of such an approach, the financial condition and structure of the banks could be disclosed to the public in a more detailed manner -consistent to full disclosure principle. However, the information currently publicized by the banks (balance sheet, income statement, the report of independent external auditing firm) are not adequate for the private analysts to make a comprehensive analysis. The following information are essential for making a comprehensive analysis: The Flow of Funds statement and footnotes to financial statements. The detailed recommendations about this issue are discussed in the following sections of the study.

4.3. Accounting Practices in Turkish Banking Supervisory Activities

In Turkey, the infrastructural attempts to decrease the workload of the supervisory authorities and to increase the quality of their work has been realized especially in the last decade. Such attempts towards making the supervision/examination of the banking system more effective and efficient can be summarized as follows (Akguc,1985):

- (i)Preparation and application of Uniform Chart of Accounts for Banks,
- (ii)Obtaining uniformity in the financial statements of banks (obligation for preparing uniform balance sheet and income statement),
- (iii)Determination of the specific rules in the accounting practices of banks:
 - finalizing the balance sheet after obtaining accounts'uniformity with the correspondent banks,
 - establishing the specific rules about determining the allowances for doubtful or due loans,
 - obligation to use certain valuation bases in the valuation of banks' asset and liability accounts,
- (iv)Submission of the financial statements of banks to the supervision/examination authorities,
- (v)Obligation to disclose the financial statements of banks to the public,
- (vi)Correction of financial statements of banks by the Undersecretariat and disclosure of the corrected form of financial statements to the public,

- (vii) Establishment of a comprehensive internal control system for banks,
- (viii) Obligation to make external audit by independent auditors.

4.3.1. Current Situation About the Accounting Standards and Practices in the Turkish Banking System

Considering the fact that relatively uniform, comparable and consistent accounting practices, in addition to accounting standards for banking industry, are very important in both upgrading the quality of the work and decreasing the workload of the supervisory authorities, in this section the current situation in Turkey will be overviewed and the relevant problems will be discussed.

In many countries, the accounting concepts and GAAPs are determined with a general frame of mind rather than being determined for each industry specifically. In Turkey, the accounting concepts and GAAPs that form the basis of the accounting framework have not been determined by law. Only the experts and academicians have made definitions of the relevant concepts in their studies. On the other hand, the State Economic Enterprises' (SEE) Revaluation Commission which was established for the purpose of standardizing the accounting practices in SEEs has determined the rules and principles for the recording of transactions and preparation of financial statements by using the practices of other countries (especially the USA) (Karacan, 1983). Although this is the case, these rules and principles remain contextually inadequate to arrange the accounting practices for

private and public sectors in the current situation.

As far as the accounting standards are concerned, it can be observed that until 1980, no formal and legal development have taken place in this respect. The preliminary studies on accounting standards have started in 1981 through the enforcement of the Capital Market Law. Then, the Capital Market Board has prepared accounting standards which could be used in all business sectors. However, only the companies registered with the Capital Market Board are imposed to use these standards in their accounting practices. Although these standards can be considered as a reference point for the accounting practices of banks, they have not eliminated the need for developing accounting standards for the banking industry specifically. There is no obligation of the banks -in all kinds of operations- to adopt themselves to these accounting standards determined by the Capital Market Board. In fact, since the Capital Market Board has a limited scope of controlling the banks' intermediary operations in the capital markets, it never aimed to define any accounting standards for banks in the general sense. Some of the rules that the banks have to follow for their accounting practices are defined through the arrangements of the Council of Ministers. The best known arrangements about these standards date back to 1985 and 1987 which determines the main points for establishing the allowances for due loans. The valuation bases to be used in the evaluation of assets and liabilities of banks are also determined by these arrangements. Accordingly banks have to show: their assets -which have been acquired through foreign

exchange -on exchange offer rate, their liabilities -which have been occurred through foreign exchange-on exchange bid rate, and their securities on their market values.

A more important issue -other than the accounting standards- that has to be mentioned in relation to the uniformity and comparability of accounting practices is the uniform chart of accounts which is prepared by the Banks Association of Turkey. According to the Uniform Chart of Accounts (UCA) Directory, the overriding purpose of the UCA is to obtain uniformity in the accounting records and reports of banks (Tekduzen Hesap Planı ve Izahnamesi,1989). While the preparation of UCA in a very detailed manner causes some problems in practice, it compensates indirectly -to some extent- the results of the lack of accounting standards (i.e. existence of a different accounting system in each bank and consequently the lack of uniformity and comparability). However it should not be forgotten that, for obtaining the real uniformity and comparability among banks' accounting systems, specific accounting standards for banking industry have to be developed because unless the principles about the recording and realization of transactions of the banks are determined as a whole with respect to the current regulations, the applications of UCA will result in other problems since the UCA is only one component of the uniform accounting system.

Another important prerequisite for understanding and analyzing the accounting practices of banks for both public and private analysts is the addition of relevant footnotes to the financial statements, something which have not been used in

Turkey until now (Senver, 1988).

One other issue to encourage and motivate the development of accounting standards and principles, and consequently uniform accounting practices is the auditing of banks' financial statements by independent external audit firms which has been realized in the recent years. In the near future -for the determination of the standards specific to the banking industry- the expertise and know-how of the international independent external audit firms can be used.

The proposals for obtaining more uniform accounting practices by determining accounting principles and standards in the Turkish banking system can be restated as follows: GAAPs must be determined in such a way that covers the whole business life and this should legally be announced. As a second step, the accounting standards for the banking industry should be determined, legislated and announced and these standards must be determined through the participation and involvement of all parties related to supervision/examination (public authorities, banks management, independent external audit firms, academicians and experts). In determining such standards, instead of applying the standards used in other countries; the structure of UCA, Turkish banking system, and other specific conditions should be considered.

In determining the accounting standards for banks, the application of footnotes to financial statements should be considered, and for this application, the legislative and

technical arrangements should be realized. Such a practice would also increase the realization of the full disclosure principle in the banking system.

4.3.2. Current Situation About the Uniform Chart of Accounts and Financial Statements in the Turkish Banking System

The Turkish banks have been using the uniform chart of accounts and preparing the uniform financial statements since 1986. One of the first steps to be taken in the Turkish banking system was to improve and standardize the recording and reporting systems of the banks because the origin of the problems in banking supervision/examination was the unstandardized practices in recording and reporting the transactions, and in the preparation of financial statements. The Sworn-in Bank Examiners state that previously each bank had its own and unstandardized accounting practices; they did not obey the basic rules of GAAPs and even some could not maintain the "Assets = Liabilities + Stockholders' Equity" equation. Naturally, this situation prevented the identification of the violations of banking operations against legal regulations, identification of financial situation of banks efficiently and taking the necessary corrective actions timely. To solve these infrastructural problems, the basic authorized bodies of the Turkish banking system (Ministry of Finance, the Undersecretariat, Sworn-in Bank Examiners Board, the Central Bank and the Banks Association of Turkey), in cooperation with one of the private auditing/consulting firms, developed a reporting system and a uniform chart of accounts in 1986. This development is hoped to

realize the purpose of having records, reports and financial statements to be in harmony with the international standards and GAAPs; obtaining a nation-wide standardized accounting practices; and providing more convenient context for the public regulatory authorities to supervise banks (Aktan, 1986). According to Canbas and Erol (1984), the statutory decree No.70 -which imposes the application of UCA and uniform financial statements- provides the supervision of banking activities in a more convenient and efficient manner. However, since the new system is much more different and detailed than the old one, this results in some problems in terms of legal harmonization and personnel adaptation. Since 1986, based on the problems encountered in implementation, UCA has been continually -whenever necessary- updated, improved and modified.

It is clear that UCA has many positive consequences in the studies of Sworn-in Bank Examiners and Central Bank analysts. It has facilitated the job of Sworn-in Bank Examiners directly; these examiners mentioned that they faced with the problems of unstandardization and different accounting practices before the UCA applications; however, today, the UCA has facilitated their job and increased the quality of work done. On the other hand, UCA is advantageous to central bank analysts indirectly, because, since they make off-site supervision, they do not directly investigate the accuracy of financial information received from banks. Since UCA can be considered as an indirect incentive to record transactions accurately, it also facilitates to make more reliable comparisons and analyses among banks.

The Sworn-in Bank Examiners, while accepting the advantages of the UCA, mention the problems in applications. In their opinion, the current UCA is too detailed and difficult to apply. Moreover, another important deficiency is the application of a single UCA for all banks in the sector -such that both a single branch foreign bank and Agricultural Bank (Ziraat Bank) use the same UCA. They point out that a more general UCA would be more practical but such a UCA may result in easier manipulation of the financial information. On the other hand, the Central Bank authorities assert that, though there have been problematic practices during the initial years of application, the UCA is currently used by the banks more effectively and there are only minor problems now. Both authorities agree that the most important problem about the UCA is the "regulatory accounts" because there are not still completely standard practices about this account. If regulatory accounts can be made more understandable and precise, and also can be disclosed in more detail; the effectiveness of the UCA would be increased.

4.3.3. Current Situation About the Internal Control Practices of Banks in the Turkish Banking System

First of all, it is vitally important to indicate the fact that it has not been possible to obtain detailed information from any of the involved parties about the internal control activities of banks in Turkey. None of these parties -Sworn-in Bank Examiners, Central Bank authorities, accounting and auditing executives of banks, and external auditors- were willing to give any information on this subject. Also the researcher has been

surprised by the scarcity of secondary sources -such as books and articles on this subject. Because of this fact, it has not been possible to make a comprehensive and detailed analysis of this subject. Consequently, in this Section, there is an attempt to make a limited and general evaluation of the internal control system in the Turkish banking industry -rather than an in-depth analysis of banks' internal control activities.

In Turkey, the internal control process of banks traditionally is carried out by three main bodies. At the top - hierarchically- there is a board of directors (BD) which is authorized to control the policies, strategies and operations of banks broadly. Next, there is a "controllers' committee" (denetçiler kurulu) appointed by BD which operates according to the Commercial Law. The controllers periodically prepare reports concerning the activities of banks emphasizing the legal aspect. These reports are sent to BD and the Undersecretariat of Treasury and Foreign Trade. Ministry of Finance can appoint its own controllers to this committee -if necessary. The third body concerning the internal control activities of banks is "Auditing Committee" (Teftis Kurulu). Internal control activities -most suitable and compatible to the professional standards and definitions- have actually been conducted by this committee in Turkey (Tuncer, 1988).

Among these 3 bodies, BD does not conduct internal control; rather it broadly controls the policies, strategies and operations of banks from the managerial view point. Controllers' committee does not perform a functional and operational internal

control activity in terms of our definitions, it either only prepares annual reports at the yearend just to fulfill legal obligations or makes private investigations about legal or personnel issues. In Turkish banking system, the internal control activities have operationally been conducted by Auditing Committees. According to the 27th article of the Banking Law, it is compulsory for each bank to found an auditing committee. The auditors working for this committee are obliged to control whether the operations of banks are realized in accordance with applicable legal regulations and with the principles of banking. In this section of the study, the activities of auditing committee are primarily emphasized.

The auditing committees of banks are directly supervised by BDs or presidents in many banks. These auditors do not have any duty, authority and responsibility other than internal control. They are also given the sufficient authority necessary to perform their jobs effectively -including free access to any record. It is possible to say that the personal and professional qualifications of these auditors are appropriate and sufficient to make an effective and efficient audit compatible to international standards. However, there are variations and differences among banks in this respect. Especially the larger banks have employed the more qualified auditors, and have more developed training facilities and programs compared to those of smaller banks.

After reviewing these infrastuctural prerequisites, it is useful to look at the current situation in Turkey from the bank

examiners' viewpoint. As it has been indicated in the previous parts of this study, 4 basic factors -independence and competence of the auditors, program adequacy and program effectiveness- are vital in creating a convenient contextual environment for bank examiners. With the available information, it is possible to conclude that the competence of auditors -although there are variations among banks in terms of the quality of auditors- are sufficient to make an efficient and reliable internal control work. About the program adequacy and program effectiveness factors, it has not been possible to obtain direct -primary- data from banks; but the authorities mention that the content of the audit program, the scope and the frequency and the documentation of audit work are sufficient to identify the problems and violations in the banking activities. However, the basic problem on this subject lies behind the factor of independence. There are some doubts about the independence of internal control practices in banks. Some violations or illegal applications which can be identified through internal control activities have been disguised by internal auditors especially due to some intra-organizational considerations such as promotion or directives of top level executives etc. Furthermore, bank auditors also mention that these violations and illegal applications can be concealed from external parties such as external auditors and bank examiners. In addition to these, in this study, it is observed that the internal control activities of smaller banks - in terms of volume of business and number of branches- are conducted in a more informal, loose and inefficient manner; it is even possible to say that these activities are performed just

formally not operationally and functionally in some few-branch banks. The major reason for this is the decentralized organizational structure of those banks (auditors are not sufficiently authorized, rather other top executives -such as branch managers- are granted excessive authority about controlling the operations), and relatively new and sophisticated products offered by these banks (with which the auditors are not familiar and cannot inspect the operations related to these products effectively). Thus, since bank auditors have not been able to work completely in an independent manner due to some intra-organizational factors -although they seem to be authorized sufficiently to make a reliable and efficient internal control- the violations and illegal applications in banking business become more difficult to be identified by external parties (i.e. external auditors and bank examiners).

In spite of these difficulties and problems, it is possible to conclude that there have been certain improvements about the internal control activities of banks in recent years in Turkey, however relatively limited developments compared to those in other areas covered in this study. Such developments are attributable to the uniform chart of accounts, uniform financial statements and uniform reports used in banks that are send to public authorities; the external audit of banks' financial statements; and -partially- the more strict controls exercised by the Capital Market Board.

Finally, it is useful to indicate the fact that it is not logical to expect completely efficient, reliable and effective

realization of internal control activities in banks because these activities are internally conducted in nature and it is impossible to avoid certain inconsistencies and manipulations that is still prevail no matter how effectively these internal control activities are imposed externally. However, these manipulations may still be minimized through more carefully designed rules and precautions. The most important precautions may be the development of accounting and auditing standards for banking industry as a whole. More frequent and comprehensive examinations by public authorities, and more effective and efficient external auditing practices can be considered as other important measures.

4.3.4. Current Situation About the Independent External Auditing Practices in the Turkish Banking System

As it was mentioned earlier, the audit and control of banks' financial statements by independent external auditing firms -according to two pronouncements published by the Central Bank and Capital Market Board in 1987, have been actually realized since 1988. There have been two primary reasons for such a practice; the efficient and reliable realization of off-site supervision of banks, and providing funds from international banks and other financial institutions more easily by disclosing their financial situations in a more accurate way (Senver,1984) (Uragun,1988).

From the historical perspective, there have been a series of legal regulations. The first development on this subject was "the pronouncement about the independent external auditing firms"

of the Ministry of State published in the Official Gazette No.19343, dated January 16, 1987. Then, the Central Bank published "the pronouncement about the bank audits made by independent external audit firms" on December 24, 1987. It is possible to say that these two pronouncements are consistent and complementary of each other(Tuncer,1988). While the first pronouncement has specified the general guidelines of external auditing process, the second one includes the details about the auditing techniques and the guidelines about the reporting of the results of audit. The last legal development about this subject is the Law about the CPA profession No.3568.

As stated above, the external auditing activities of banks have actually been realized for the last 2 years. Thus, such practices have been completely carried out for the years 1988 and 1989. In the first year -1988- audit works and reports of most of the independent external audit firms were superficial and insufficient. This deficiency has been tried to eliminate by the Central Bank through the preparation of a more detailed and comprehensive audit work program. The Central Bank authorities have indicated that in 1989 the reports of the independent external audit firms have been prepared accordingly in a more detailed, comprehensive and understandable manner. They also claim that these reports are compatible with the international auditing standards and the GAAPs. According to the Central Bank authorities, the independent external audit firms -most of them are operating internationally- have prepared accurate and reliable reports even if their relations with their clients might

be jeopardized due to these practices. In contrast, the sworn-in bank examiners do not agree with the Central Bank authorities concerning the reliability and effectiveness of the activities of the independent external audit firms. In their opinion, the reports of these firms are still superficial, incomprehensive and misleading. According to the sworn-in bank examiners, the main reason for this deficiency is the lack of the independence and competence of the auditors. Sworn-in bank examiners indicate that independent external audit firms have prepared biased and misleading reports for the sake of good personal relations with the clients. These firms have been reluctant to disclose the deficiencies in the financial position and operations of their clients. Also, sworn-in bank examiners claim that the amount and qualifications of the auditors -working for the independent external audit firms- are not competent in order to make a comprehensive and effective audit work. For instance, it is said that one of the largest banks of Turkey has been audited in 1989 in 15-20 days by only 3-4 auditors.

After reviewing the past practices, we must now analyze the current conditions of major factors -providing the efficient and reliable external auditing of banks. First of all, an efficient external audit -compatible with the international auditing standards- must be performed by the Certified Public Accountants (CPAs). However the CPA accountancy profession could not be established in our country for a long time although it has been on the agenda since 1932. In 1989 -with the Law No. 3568- the legal framework for the CPA profession has been constructed.

According to the Central Bank authorities and sworn-in bank examiners, the quality and the efficiency of the external audit practices -both for banking business and in general-will be improved through the establishment of the CPA profession. They also mention that the most important development towards the realization of external auditing in the long run is the Law No.3568. However, it is early to evaluate this law since it has not been shaped into its final form and it has not been possible to observe its real-life applications yet. But it is useful to indicate that this law must be consistent and harmonized with the other applicable pronouncements about external auditing.

Another factor influencing the quality of the external audit work is the competence and independence of CPAs. CPAs must have certain qualifications in order to perform reliable audit work. The issue of the competence of the auditors have been legally specified through the 4th article of the pronouncement published in Official Gazette No.19343,dated January 16, 1987. In this article, the personal and professional qualifications of the external auditors have been mentioned. However, the professional qualifications have not been covered in detail, rather the law preferred to put some general -minimum- guidelines and limitations for this topic. For instance, it is sufficient for a person to have an experience in the areas of banking, law, economics, accounting or management in order to be external auditor. Alternatively, top-level executives and university staffs in these fields have a right to become an auditor. Through these arrangements, it is possible for a person -who has

no direct relation with banking and accounting- to become an external auditor(Uragun,1988). Another subject -independence of auditors- have been covered in Article 6 of the same pronouncement. In general terms, it is possible to conclude that the arrangements about the subject of independence of auditors are sufficient to provide a convenient context for the realization of reliable and efficient audit work.

The next point which must be considered here is the adequacy of the audit program. Adequacy of the audit program depends on the techniques used in the audit work and the frequency of the audit work. In Turkey, the arrangements about the scope of the audit program can not be accepted as sufficient. The legal regulations pertaining auditing techniques have been stated in general terms in the pertinent pronouncements.

Broadly, the reference point for the improvement of the quality, efficiency and reliability of the external auditing practices is the Generally Accepted Auditing Standards (GAASs) since external auditors must perform their audits within the framework of GAASs. These standards include general, field-work and reporting standards in the most broadest sense. In Turkey, there has not been any legal regulation about the GAASs for the banking sector. Currently, two pronouncements mentioned earlier ,dated January 16, 1987 and December 24, 1987, serves as substitutes to fulfill the functions of the GAASs. While the first pronouncement emphasizes the general standards, the second one is primarily related to the reporting standards. However these pronouncements cannot be considered as auditing standards

for the banking industry, rather they can only be used as general guidelines.

At this point, it is useful to look at the pertinent sections of the draft Banking Law. Through this draft the concept of external audit is incorporated into the Banking Law of Turkey. According to this draft, banks are obliged to have their financial statements audited by an independent external audit firm and send these audited documents to the Central Bank as well as to the Undersecretariat of Treasury and Foreign Trade. External audit work is considered as a commercial activity in this draft whereas it would have been more appropriate to accept external auditing as an independent profession -like in bars. New draft proposes that the working directives of independent external audit firms must be prepared by the Undersecretariat - through considering the recommendations and suggestions of the Central Bank authorities. Additionally, the legal framework of the responsibility of the independent external audit firms is constructed in this draft. Accordingly, in case of any damage of any party -which results from misinformation given in the auditors' reports- the independent external audit firms are held responsible for this damage. In addition, when public authorities identify misleading reports of the auditors, new draft imposes the re-publishment of the corrected forms of bank's financial statements and auditor's reports (Finans Dunyasi Dergisi,1990).

CONCLUSION

In line with the trend towards liberalization of financial markets and industrialization, and the new approach giving emphasis to interdependent economic relations for the development of international business and trade; banking business has begun to play a more critical role in the economic structure of Turkey. Parallel to these developments, the number of banks and their volume of business have drastically increased while the variety of operations performed and services offered by them have become extremely complicated. Consequently, banking has turned into a relatively more complex industry in Turkey. In such a sophisticated and multi-dimensional environment, the activities for the supervision/examination of banks by public authorities have been performed in an unsatisfactory manner especially in the last decade. While as a result of structural changes during the 1980s, there have recently been important changes and improvements in bank supervision in Turkey, much remains to be done in this field.

In Turkey, while on-site examinations have been primarily conducted by the Sworn-in Bank Examiners Board (SBEB), off-site supervision is typically undertaken by "the Bank Supervision Department" of the Central Bank. The Central Bank is concerned not only with the off-site supervision but also with other issues such as the realization of the external audit effectively, the establishment of the early-warning system, and management of the Deposit Insurance Fund. Despite the wide range of duties assigned to it, authorities granted to the Central Bank are

relatively limited. SBEB is generally more criticized on this issue compared with the Central Bank. According to the interviewees, this board must be upgraded both quantitatively and qualitatively. A reorganization is necessary which should result in an SBEB which would operate more autonomously -or semiautonomously- like the Capital Market Board. One of the basic barriers against effective and efficient banking supervisory activities is the lack of coordination between the public supervisory authorities. In our opinion, the most appropriate solution may be the establishment of a "Banking Board" which can replace the functions of all other public supervisory authorities. The continuation of the current system by making the necessary adjustments may be another alternative. In other words, bank supervision/examination can be carried out by the 2 main bodies -the Central Bank and SBEB- but the duties, responsibilities and the authorities of each body should be -legally- specified more precisely while the coordination of them can be imposed by law.

As far as the accounting practices in the Turkish banking supervisory system are concerned, the most important development towards facilitating the works of public supervisory authorities has been the formation and application of uniform chart of accounts (UCA) and uniform financial statements for banks. However, although problems in the current applications are not quite severe, there still is a need for further improvements in the structure and form of UCA. Additionally, as long as the GAAPs and accounting standards (specific to the banking

industry) have not been developed, the benefits of the UCA -from examiners' point of view- would be limited. Currently, the most important problem within the framework of banking supervisory activities is the development of specific accounting standards for the banking industry. Together with the UCA, the development of GAAPs, and specific accounting standards will provide a more suitable environment for the bank examiners so that they can perform their activities more effectively.

Other factors facilitating the jobs of banking supervisory authorities are the effective and reliable internal control of banks' operations, and external audit of banks' financial statements. In Turkey, there is sufficient evidence that the internal control activities in banks are not being performed in a completely independent manner. Because of the nature of internal control activities, it is very difficult to force the banks to adopt a reliable and effective internal control system. However, through some indirect incentives -especially through heavy penalties and sanctions- the manipulations made by banks to render internal control ineffective can be avoided or minimized to some extent. Also adherence to accounting standards will help minimization of the manipulations indirectly. Furthermore, more frequent and comprehensive examinations of public authorities, and more effective and efficient external auditing practices may force internal auditors to operate more accurately.

As far as external auditing practices in banking business are concerned, it is possible to conclude that there have been extremely important developments during the last decade,

although, there are still some problems in this area. In order to provide an effective and reliable external audit, the certified public accountancy (CPA) profession should be established so that external auditing will have to be performed by these CPAs.

Through Law No. 3568, the legal framework for the CPA profession has been initially constructed. Although it is somewhat early to evaluate this law, it can be stated that it must be consistent and harmonious with the applicable legal regulations. Other factors influencing the quality of external audit work are the independence and competence of auditors, and the adequacy of the audit program. These factors should be specified in a detailed manner in the CPA Law No. 3568 and in other related regulations.

As a result of this study, it has been observed that there are some disagreements about the competence and independence of external auditors. The next CPA Law No. 3568 is a real opportunity to improve the conditions affecting these factors.

As far as the program adequacy is concerned, the legal arrangements are not sufficient to impose external audit firms to realize adequate audit programs. The legal arrangements on this subject will have to specify the techniques used -during the audit program- in a more detailed manner. Another vitally important factor improving the quality of the external auditing work and facilitating the jobs of public supervisory authorities is the development of Generally Accepted Auditing Standards (GAASs) for the banking industry per se -together and harmonious with accounting standards for banks. This can be accepted as a stepping stone for effective and reliable external auditing. It is necessary to indicate a fact that all parties involved -the

Central Bank, the Sworn-in Bank Examiners Board, the Undersecretariat, Ministry of Finance, external audit firms, bank management, academicians and other private experts- must participate in the efforts for the development of GAAPs, accounting standards and GAASs; and also during these attempts, standards and principles must be developed through considering the specific characteristics and structure of the Turkish banking system and Turkish business life in general.

After reviewing the infra structural factors influencing the quality and quantity of work of banking supervisory authorities, it is time to take a look at the legal side of the subject. The recent developments concerning the bank supervision/examination process have been realized in an uncoordinated and irregular way so that the effectiveness and efficiency of banking supervisory mechanism has not been upgraded to an expected level. The primary reason for this deficiency is the inharmonious and non-uniform legal arrangements coming from different laws. The complexity and inconsistency of these legal arrangements is concentrated on the matter of delegation of authority -commensurate with the duties and responsibilities- to the public supervisory bodies. Thus the abnormal and irregular delegation of authority to the jobs leads to important problems in practice. These problems can often be seen at the post-supervision stage (precautions taken after the supervision/examination activities' results) because of the inability of the public bodies -such as the Undersecretariat and its superior ministry- to use their authorities.

Suggested Solutions to these general problems can be stated as follows; First, since the major cause of these problems is the lack of legal coordination and consistency, a legal harmonization is necessary to overcome these difficulties. Such a harmonization effort must aim to integrate the applicable legal arrangements about this subject and to reorganize the statements which have been scattered in different laws in order to maintain consistency. Furthermore the duties of SBEB, the Central Bank, the Undersecretariat and its superior ministry should be revised; and their authorities must be restated in a fashion to make them parallel to the duties given. The delegation of authority should be made so that more weight is given to non-political bodies such as a more autonomous Central Bank. By this way, the supervision/examination activities would be purified from external effects and be carried out more effectively.

Finally -in addition to the above-stated problems and recommendations- it is useful to cover some of the secondary (indirectly related to the main subject of this study) problems: First of all, an early-warning system must be established as soon as possible, and to go along with this a risk-rating institution for banks should be founded for evaluating the financial condition and structure of banks. As a natural prerequisite for the realization of the full-disclosure principle, the financial structure and condition of banks must be disclosed to the public in a more detailed and comprehensive way because the information currently disclosed by the banks and the reports of the independent external audit firms are not adequate for the private analysts to make a comprehensive analysis.



APPENDIX 1 INTERVIEW QUESTIONS

1. Are the supervision/examination activities performed by both private analysts and public authorities (Central Bank officials and Sworn-in Bank Examiners) sufficient in determining the true financial positions of the commercial banks in Turkey and in disclosing these to the public?

In general terms, most of the interviewees indicated that Central Bank officials and sworn-in bank examiners have been able to identify the true financial positions of commercial banks. However they also mentioned that the techniques and procedures of sworn-in examiners need to be standardized. In contrast, the activities of the Central Bank can be considered as more systematic and efficient.

2. How well do the financial statements (Balance Sheet and Income Statement) disclosed by banks to the public in Turkey reflect their true financial positions? Are these statements sufficient for comprehensive analysis? Would you name any other financial statements which the banks should also disclose to the public?

The interviewees indicated that financial statements of banks have become more uniform and have reflected the true financial positions of banks in a more reliable manner especially after the Uniform Chart Accounts applications. However these statements are still not sufficient to make a comprehensive analysis. The most necessary improvement may be the application of "footnotes to financial statements" (especially for loans accounts).

3. To what extent do the accounting systems and practices employed by commercial banks for internal purposes provide accurate and valid results? What are the bottlenecks faced during costing phase of the bank services? Have the automation activities undertaken by banks in the recent years been effective in this sense?

It is possible to see a great inconsistency and irregularity in the accounting systems and practices of banks. Larger banks have more standardized and formal accounting systems, whereas the accounting systems of smaller banks are not very effective.

4. How effective would you say the uniform chart of accounts, (utilized by banks since 1986) has been in practice? What are some of the problems faced as a result of this practice? Any suggestions? (Only to accounting executives of commercial banks)

According to the interviewees, the UCA is currently used by the banks more effectively and there are only minor problems though there have been problematic practices during the initial years of application. Both authorities agree that the most important problem is the "regulatory accounts". It should be more understandable and precise and will have to be disclosed in a more detail. Also the current UCA is considered as too detailed and difficult to apply for all banks.

5. To what extent the internal auditing practices of the banks are efficient, and provide accurate and reliable results?

As a result of interviews, it is possible to conclude that the competence of auditors are sufficient to make an effective internal control work. The content of the audit program, the scope and the frequency and the documentation of audit work are sufficient to identify the problems and violations in the banking activities. However there are some doubts about the independence of internal control practices in banks. There are great variations among banks in terms of the quality of auditors.

6. Is the independent external audit of the commercial banks' financial statements performed in an efficient way?

Do the financial statements, approved by independent external auditing firms reflect the true financial position of the bank?

Are the audit practices employed by these firms harmonious with international auditing standards?

There have been different opinions about the efficiency and quality of the external audit of banks. According to Central Bank officials, external audit of banks have been conducted efficiently and in conformity with the international auditing standards. In contrast, sworn-in bank examiners do not agree with this opinion and they claim that financial statements approved by independent external audit firms do not reflect the true financial position of the bank.

7. Do the techniques employed for performance evaluation within the framework of supervisory and regulatory activities of the

public authorities suffice in reflecting the financial position of the banks and in identifying the conformity of their operations with legal regulations?

Could the above techniques be utilized as an early warning system for a potential financial crisis/failure? (Only to Sworn-in Bank Examiners and Central Bank officials)

The supervisory techniques and procedures of banking regulatory authorities can be considered as comprehensive to identify true financial positions of banks. The Central Bank is presently trying to develop an Early Warning System in coordination with some international institutions.

8. Are the supervision/examination activities undertaken by both the Sworn in Bank Examiners and the Central Bank independently from each other, performed in an efficient manner?

To what extent are you informed about the supervision/examination procedure of the other involved institution? Are the evaluation results of the body sent to you? Do you have a checking/comparison mechanism about the results of the other body? (Only to Sworn-in Bank Examiners and Central Bank Officials)

There have been no coordination between these two bodies and the lack of coordination causes the inefficiency in the supervisory activities. Currently, both authorities work independent of each other and they do not take into consideration the results of the other institution's analysis

except in some unusual cases.

9. How much contribution would the recent development toward the recognition of accounting as a separate and independently-organized profession make to help improve the current bank accounting practices and to insure more accurate and reliable financial statements?

According to the interviewees, the quality and efficiency of banking supervisory activities may be improved through the Law No. 3568. However it is early to evaluate this law at this step.

ENDIX 2

IB BANKALAR GÖZETİM SİSTEMİ TEKDUZEN RAPORLAMA PAKETİ LİSTESİ

FORM NO	KAPSADIGI DÖNEM	GÖNDERİLME SÜRESİ	FORM ADI
1	1 AY	1 AY	BİLANÇO
2	3 AY	1 AY	KAR-ZARAR HESABI
3	1 YIL	1 AY	ÖZKAYNAKLAR TABLOSU
101	3 AY	1 AY	KASA VE BANKALAR
102	3 AY	1 AY	MALİ KESİM İLE İLİŞKİLER-AKTİF HESAPLAR
110	3 AY	1 AY	MENKUL DEĞERLER CUZDANI-DÖNEM İÇİ HAREKETLER
120	1 AY	1 AY	KREDİLER DETAYI
121	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-ÖZEL, İDARİ VE KANUNİ TAKİPTEKİ NAKDİ KREDİLER
122	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-İDARİ VE KANUNİ TAKİPTEKİ GAYRİNAKDİ KREDİLER VE YÜKÜMLÜLÜKLER
123	1 AY	1 AY	YENİDEN ÖDEME PLANINA BAĞLANAN ALACAKLAR
124	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-ÖZEL TAKİPTEKİ KREDİLER VE KARSILIKLARI
125	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-İDARİ TAKİPTEKİ KREDİLER VE KREDİLER ÖZEL KARSILIGI
126	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-KANUNİ TAKİPTEKİ KREDİLER VE KREDİLER ÖZEL KARSILIGI
127	3 AY	1 AY	TAKİPTEKİ ALACAKLAR-ÖZEL/İDARİ/KANUNİ TAKİP AYIRIMI
128	3 AY	1 AY	KREDİLER-BÜYÜKLÜKLER VE MÜŞTERİ SAYISI
129	3 AY	1 AY	İDARİ TAKİPTEKİ ALACAKLAR-MÜŞERİLER İTİBARIYLA
130	3 AY	1 AY	KANUNİ TAKİPTEKİ ALACAKLAR-MÜŞTERİLER İTİBARIYLA
131	3 AY	1 AY	ÖZEL TAKİPTEKİ ALACAKLAR-MÜŞTERİLER İTİBARIYLA
140	3 AY	1 AY	İSTİRAKLER VE KURULUŞLAR-DÖNEM İÇİ HAREKETLER VE DETAY
141	1 YIL	1 AY	İSTİRAKLER VE KURULUŞLAR-ÖZKAYNAK BİLGİLERİ
142	3 AY	1 AY	İSTİRAKLERE KULLANDIRILAN KREDİLER
150	3 AY	1 AY	SABİT KIYMETLER
209	1 AY	1 AY	DEĞİŞKEN FAİZLİ MEVDUAT-VADELERE GÖRE AYIRIM
210	1 AY	1 AY	MEVDUAT-TÜR VE VADELERE GÖRE AYIRIM
211	3 AY	1 AY	MEVDUAT-TÜR VE BÜYÜKLÜK DİLİMİNE GÖRE AYIRIM
212	3 AY	1 AY	MALİ KESİM İLE İLİŞKİLER-PASİF HESAPLAR
220	3 AY	1 AY	KULLANILAN TP KREDİLER-FAİZ ORANLARI VE DÖNEM İÇİ HAREKETLER
221	3 AY	1 AY	KULLANILAN TP KREDİLER-GERİ ÖDEME PLANI
230	3 AY	1 AY	TAHVİLLER-DETAY
231	3 AY	1 AY	TAHVİLLER-GERİ ÖDEME PLANI
240	3 AY	1 AY	HİSSEDARLAR
310	3 AY	1 AY	AKTİF VE PASİF HESAPLAR-VADELERE GÖRE AYIRIM
320	3 AY	1 AY	KARSILIKLAR DETAYI-AKTİF HESAPLAR
321	3 AY	1 AY	KARSILIKLAR DETAYI-PASİF HESAPLAR
330	3 AY	1 AY	BÜYÜK MÜŞTERİLERLE İLİŞKİLER ÖZETİ-TOPLAM NAKDİ KREDİLERE GÖRE SIRALAMA
331	3 AY	1 AY	BÜYÜK MÜŞTERİLERLE İLİŞKİLER-TOPLAM GAYRİNAKDİ KREDİLER VE YÜKÜMLÜLÜKLERE GÖRE SIRALAMA

350	3 AY	1 AY	SEÇİLMİŞ AKTİF VE PASİF HESAPLARIN DETAYLARI
410	3 AY	1 AY	FAİZ VE KOMİSYON GELİRLERİ VE GETİRİLİ AKTİFLER DETAYI
420	3 AY	1 AY	FAİZ DIŞI GELİRLER DETAYI
510	3 AY	1 AY	FAİZ GİDERLERİ VE MALİYETLİ KAYNAKLAR DETAYI-MEVDUAT
511	3 AY	1 AY	FAİZ GİDERLERİ VE MALİYETLİ KAYNAKLAR DETAYI-KULLANILAN KREDİLER, TAHVİLLER VE DİĞER MALİYETLİ KAYNAKLAR
520	3 AY	1 AY	FAİZ DIŞI GİDERLER DETAYI
710	3 AY	1 AY	YP HESAP DETAYLARI-PARA CİNSLERİNE VE ÜLKELERE GÖRE
720	3 AY	1 AY	KULLANILAN YP KREDİLER-FAİZ ORANLARI VE DÖNEM İÇİ HAREKETLER
721	3 AY	1 AY	KULLANILAN YP KREDİLER-GERİ ÖDEME PLANI
730	3 AY	1 AY	GAYRİNAKDİ KREDİLER, YÜKÜMLÜLÜKLER VE TAAHHÜTLER-TP
731	3 AY	1 AY	GAYRİNAKDİ KREDİLER, YÜKÜMLÜLÜKLER VE TAAHHÜTLER-PARA CİNSLERİNE VE ÜLKELERE GÖRE
732	3 AY	1 AY	VADELİ DÖVİZ ALIM/SATIMLARI
810	3 AY	1 AY	AKTİFLER ÜZERİNDEKİ ÜÇÜNCÜ SAHİS HAKLARI
820	3 AY	1 AY	MUHTELİF BİLGİLER

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