

INFLATION ACCOUNTING

Inflation accounting is the process of adjusting the financial statements for the effects of inflation. It ensures that the financial statement is calculated in the closest way to the purchasing power at the date of the financial statement. Thanks to this calculation, the inflation effect on the financial statements is minimised, the most realistic statements are reached and the quality of the statements is preserved. Accordingly, more accurate forecasts and reports are prepared for the future. This calculation is made by multiplying the amounts of non-monetary values to be taken into account in the inflation adjustment by the adjustment factor. The resulting adjusted value is reflected within the financial statements.

The inflation adjustment is applied by Income and Corporate Taxpayers who keep their books on a balance sheet basis. Inflation adjustment is applied if the increase in the price index in the last 3 accounting periods including the current accounting period is above 100% and the increase in the price index in the current accounting period is above 10%. If these conditions are not met at the same time, inflation adjustment is not applied to the financial statements.

In Turkey, this practice was applied for the first time for the 2003-2004 accounting periods. Recently, the conditions for inflation adjustment have been met as of December 2021. However, with the 'Provisional Article 33' added to the legislation with Article 1 of the Law No. 7352 dated 20 January 2022 and numbered 7352, it has been stipulated that the financial statements will not be subject to inflation adjustment in the 2021 and 2022 accounting periods, including the provisional tax periods, and in the provisional tax periods of the 2023 accounting period, regardless of whether the conditions for inflation adjustment within the scope of the repeated Article 298 are met.

Apart from inflation adjustment, there are also methods and practices that eliminate the effect of inflation in the financial statements. These methods are the declining balances method and financial expense restriction. The declining balances method prevents the depreciation of the Turkish Lira and enables the revaluation application as of 31.12.2022. The financing expense restriction method prevents unnecessary expenditures. There is also revaluation as an application. Revaluation is a voluntary practice applied to depreciable economic assets (e.g. real estates, tools and equipment). Inflation adjustment is a mandatory practice applied to all non-monetary assets.

There are several stages in the application of inflation adjustment. These stages are explained hereunder:

1. Determination of non-monetary assets: Non-monetary assets that are not affected by the depreciation of TL are identified. These assets can be listed as inventories, plant-machinery-devices, fixtures, accumulated depreciation, capital, positive difference of capital adjustment, tangible fixed assets, provision for recognised commodities, legal reserves and retained earnings.
2. Determination of adjustment amounts and dates of adjustment:
3. Determination of adjustment factors: It is determined by dividing the price index for the month to which the financial statements belong to the price index of the month that includes the date of adjustment (the base index is D-PPI).

4. Calculation of adjusted values: The amounts subject to adjustment are multiplied by the calculated coefficients.
5. Recognition of inflation differences:
6. Presentation in the financial statement: Non-monetary assets are recognised at restated values and monetary assets are recognised in the financial statements without restatement.

When applying inflation adjustment, if there is an asset subject to revaluation, the dates and values after revaluation are taken into consideration. If it is a fixed asset (i.e. an item that the entity will not consume, sell or convert into cash within the next calendar year), the date of recognition is taken as a basis. If there is an investment in progress, the finalised expenditure amount is subject to adjustment at the end of each month. If an asset that is not subject to restatement is disposed of, the related inflation adjustment differences are recognised as cost.

In the restatement of inventories, there are two different methods, namely the detailed method and the aggregated method. The method selected among these cannot be changed until the end of the next three accounting periods, including the accounting period in which the selection is made.

Accumulated depreciation is adjusted by taking into account the increase in the value of the asset at the balance sheet date after the adjustment. According to the Tax Procedure Law (TPL), depreciation amounts that have not been allocated in previous years are not taken into account in this adjustment since they can be changed today. However, if there are economic assets that have completed their useful life yet their value has not been completely destroyed, they should also be subject to inflation adjustment.

When evaluating the capital, companies should evaluate the capital differences arising from inflation adjustment based on the capital amount registered in the trade registry. When adjusting the capital account, the capital account is not increased; instead, capital adjustment positive differences account with the code 502 is used and the date on which the capital is increased is taken as the basis. Legal reserves are also adjusted as of the date of appropriation of profit.

Positive differences arising from inflation adjustment, losses and internal resources in excess of negative differences can be added to share capital together with other equity resources. However, negative differences may be subject to capital reduction or offsetting with positive differences by the decision of the general assembly.

Today, due to the separation of WPI and PPI rates, the question of which index will be used in the inflation adjustment process has arisen. To date, WPI has been used, however the Ministry of Treasury and Finance believes that PPI and the Public Oversight Authority believes that CPI should be taken into account. International standards are based on different indices.

Tax Effect of Inflation Adjustment:

If the adjustment differences of non-monetary assets are higher than the adjustment differences of non-monetary liabilities in 2024, the tax base will be increased since there will be a 'high adjustment profit'

If the restatement differences of non-monetary liabilities are higher than the restatement differences of non-monetary assets, a 'restatement loss' will be incurred, resulting in a decrease in the tax base.

While the application of inflation adjustment is reasonable for companies with strong equity since it will not cause a profit, it is thought that it will cause a profit for companies with weak equity and will negatively affect those companies since this profit will be subject to taxation.

Persons and situations to which inflation adjustment will be applied:

1. Balance sheets of business partnerships which are Income and Corporate Taxpayers and which determine their earnings on the balance sheet basis, including collective, ordinary limited partnership and ordinary companies,
2. Economic state-owned enterprises and public organisations and the enterprises and concessionary enterprises within their establishment that meet the necessary requirements,
3. Public economic enterprises affiliated to public institutions and organisations and economic enterprises affiliated to associations and foundations,
4. Newly started taxpayers (since it does not matter when the business was started when the necessary conditions are met for the last three and the last accounting period including the current accounting period),
5. Self-employed taxpayers who determine their earnings on the basis of business account or who keep a self-employment income book cannot make inflation adjustment, but their economic assets subject to depreciation are adjusted according to the general communiqué of TPL No. 555,
6. Companies whose liquidation decision is finalised after the 2023 accounting period,
7. Balance sheets for the 2023 accounting period of those who quit the business within the 2024 accounting period,
8. After the 2023 accounting period, the balance sheet of the companies that are subject to transfer, change of type, merger, partial-full spin-off after the 2023 accounting period shall be subject to inflation adjustment.

Persons and situations to which inflation adjustment will not be applied:

1. Taxpayers who are permitted to keep their records in a currency other than Turkish currency,
2. Income and corporate taxpayers who do not keep books on balance sheet basis,
3. Taxpayers who are exempt from corporate tax and keep books on the balance sheet basis (they can apply if they wish),

4. Inflation adjustment is not applied to the real inflation cost (not taken into account unless long-term strategic decisions are taken), which expresses values that cannot be measured as cash flow in the process of providing financing.

However, income and corporate taxpayers who are active as of 31.12.2023 and switch to the balance sheet basis for the first time in the 2024 calendar year or later will make inflation adjustment according to the provisional article 33 and the third part of the general communiqué of the Tax Procedure Law No. 555; and will make the subsequent corrections according to paragraph A of the recurrent article 298 and the fourth part of this communiqué.

In addition, taxpayers who switched from keeping their books on a balance sheet basis as of 31.12.2023 to an operating account basis on 01.01.2024 must apply inflation adjustments, provided they meet the necessary conditions as of 31.12.2023. They are also required to correct the balance sheet dated 31.12.2023 and base their new records on the corrected values.

A group of people are dissatisfied with the inflation adjustment application. However, the true impact of this application will become evident at the end of the 2024 accounting period, as companies will then be taxed on inflation-driven value increases."

Currently, profits gained due to inflation are not taxed, so companies have not fully felt the impact of inflation. However, once firms begin to be taxed in this scenario, they may not be fully aware of the potential reflections and effects. Nevertheless, firms with strong equity will be less affected by this unexpected tax burden.