CONVERGENCE OF LAWS AND ITS LIMITS: A CASE STUDY OF TURKISH AND EU LAWS ON AUDITING

HUKUKTA YAKINSAMA VE SINIRLARI: TÜRK VE AB BAĞIMSIZ DENETİM YASALARININ ÖRNEK OLAY İNCELEMESİ

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ABSTRACT

Classifications on the world's legal systems have long been the subject to studies in comparative law. The modern comparative approach however, no longer relies solely on the classic categorisation of common-civil law countries. This general classification fails to consider that legal systems can change through time and not all areas of law share the same patterns. For instance, firms (and countries) adopt international rules and standards voluntarily. This kind of convergence can mostly appear in the field of commercial law, including the field of auditing where the effect of economic integration of markets is in place. In this respect, in order to be a part of the global economy and to attract foreign direct investment, Turkey reformed its commercial law and capital markets law. In addition, there are political forces for convergence such as the EU requirement for Turkey to adopt EU laws. This paper critically investigates the forces for convergence and questions to what extent the laws on auditing are converging between EU and Turkey. It concludes that despite the formal convergence, actual convergence has not been achieved fully and differences still persist due to the institutional disparities.

Keywords: *Corporate governance, External audit, Convergence.*

ÖZ

Dünya'da hukuk sistemlerindeki sınıflandırmalar karşılaştırmalı hukuk alanındaki çalışmalara uzun zamandan beri konu olmuştur. Bununla birlikte, modern karşılaştırmalı yaklaşım, artık sadece Anglo-Sakson ve Kıta Avrupası Hukuk sistemleri klasik sınıflandırmasına dayanmamaktadır. Bu genel sınıflandırma, yasal sistemlerin zaman içinde değişebileceğini ve hukukun bütün alanlarının aynı kalıpları paylaşmadığını dikkate almaz. Örneğin, şirketler (ve devletler) gönüllü olarak uluslararası kural ve standartları benimseyebilirler. Bu tür bir yakınsama, piyasaların ekonomik entegrasyonunun etkisinin olduğu bağımsız denetim alanı da dahil olmak üzere çoğunlukla ticaret hukuku alanında ortaya çıkabilir. Bu bağlamda, küresel ekonominin bir parçası olmak ve doğrudan yabancı yatırımları çekmek için Türkiye ticaret kanununu ve sermaye piyasası kanununu yeniden düzenledi. Ayrıca, Türkiye'nin AB mevzuatını benimsemesi gerekliği gibi politik güçlerden de bahsedilebilir. Bu makale, yakınsama kuvvetlerini eleştirel bir şekilde incelemekte ve bağımsız denetim yasaları açısından AB ile Türkiye arasında ne derece yakınsama olduğunu sorgulamaktadır. Makalede, resmi yakınsamaya rağmen, gerçek anlamda bir yakınsamaya tam olarak ulaşılamadığı ve kurumsal uyumsuzluklar nedeniyle farklılıkların görüldüğü sonucuna varılmıştır.

Anahtar Kelimeler: *Kurumsal Yönetim, Bağımsız denetim, Yakınsama.*

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I. INTRODUCTION

The world's legal systems are commonly grouped under common and civil law countries in terms of legal history, legal thinking and positive rules.[1] However, this core division might also 'overemphasise' differences (and similarities) and hence, it can lead to misleading conclusions about a country's legal environment.[2]

This paper starts with questioning whether there is an approximation on legal systems and how this affects laws on auditing internationally. In this respect, the first section looks at the debates on legal systems differences and questions whether traditional grouping on legal systems are valid for laws on external auditing. It will be suggested that, in the field of auditing, the classification of legal families matter less due to the adoption of international standards and global integration of markets.

The second section sets the framework for a possible convergence of auditing between Turkey and the EU through identifying the forces for convergence, and the methods and feasibility of convergence. Turkey, as a candidate for the EU membership, is required to align its laws with the EU *acquis*.[3] In 2012, both commercial law and capital markets law were reformed presenting new requirements for the statutory audits of companies. This raises the question to what extent, Turkey has successfully been adopting EU laws on auditing. The theoretical underpinnings of regarding drivers and obstacles for auditing convergence will be based on Hansmann & Kraakman's explanation of important economic forces for convergence with respect to the drivers of convergence, as well as Bebchuk & Roe's path dependency theory with respect to obstacles for convergence. Berkowitz et al.'s 'transplant effect' theory will also be applied to explain whether legal families could be obstacle for auditing convergence. In this respect, in addition to the comparison of the 'law in context', this paper considers the historical, social, cultural and economic circumstances and background in evaluation of the law in order to understand Turkey's receptivity of the imported laws. Exploring the convergence level between the EU and Turkish laws on auditing could be a good basis for the future legal reforms for further harmonisation.

Lastly, the paper will conclude that the EU membership aspiration, integration of capital markets, and the need for improvement of laws are drivers for convergence while weak legal environment, multi-headed supervision mechanism, and functional dissimilarities still stand in the way of actual convergence between EU and Turkish laws on auditing.

II. DIFFERENT LEGAL SYSTEMS AND EXTERNAL AUDITING

Traditionally, the world's legal systems are grouped under common (Anglo-Saxon) and civil (Romanic-German) law families.[4] This broad classification is made in accordance with the core differences in legal ideology, structural system of law, structure of court system, sources of law, and legal method and procedure.[5] According to this broad classification, it is said that countries belonging to the common-law family group show the patterns of US and English laws while countries belonging to the civil-law family group show the typical features of French and German laws.[6]

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1 **René**, D. & **Brierley**, J. E. C. (1985) Major Legal Systems in The World Today: An Introduction to The Comparative Study of Law, London, Stevens; **La Porta**, R. et al. (1997) 'Legal Determinants of External Finance' Journal of Finance 52:3, p. 1131.

2 **Siems**, M. (2014) Comparative Law, Cambridge University Press, pp. 80-82. See also **Örücü**, E. 'A General View of "Legal Families" and of "Mixing Systems"' in Örücü, E. & Nelken, D. (Editors) (2007) Comparative Law: A Handbook, Hart, p. 169.

3 The EU *acquis* includes EU legislation to date, as well as additional standards set by the courts and practices developed by the institutions.

4 There are also other approaches in the taxonomy of legal systems, such as cultural taxonomy, which distinguishes four broad cultures: the African, the Asian, the Islamic and the Western (Europe, America, and Oceania). See **Hoecke**, M. & **Warrington**, M. (1998) 'Legal Cultures and Legal Paradigms: Towards a New Model for Comparative Law 'International and Comparative Law Quarterly, 47, p. 495.

5 **Husa**, J. (2011) 'The Method is Dead. Long Live the Methods! European Polynomia and Pluralist Methodology' Legisprudence 5:3, 249 in Siems (2014) pp. 74-78.

6 **Siems** (2014) p. 75.

It is believed that legal systems change through time and not all areas of law share the same patterns within a particular legal family. To be sure, there are differences in legal systems in different parts of the world; these differences might be derived from geographical, social, economic, traditional, historical, or other differences that might have affected the course of a country's history and the way its legal system works. This could be war, revolution, colonisation, or other factors originating from religion, ethics, or the influence of the interest groups and parties.[7] Although there might be a direct impact of these factors on the characteristics of a country's legal system, sharing a particular historical or geographical element does not automatically suggest parity between two countries' legal systems. Some geographical taxonomy might be true in terms of a shared cultural history. However, social, political, and economic developments through time might have different influences on countries that share the same geography. Therefore, their legal systems might remain distinct or, alternatively, come closer over time.

In this vein, on the one hand, legal family classifications could be a useful tool to understand foreign laws better by identifying similarities and differences. However, on the other hand, a general categorization of legal systems does not always provide a fair picture. To give an example, all continental European countries classified as civil law family, yet there is great diversity in some fundamental legal areas.[8] Similarly, underlying the role of culture and customs in Eastern countries' legal systems in order to emphasise differences from the Western countries could be misleading in the era where there has been influence of legal ideas, especially in the field of commercial law.[9]

Moreover, a kind of taxonomy based on geographical or regional similarities does not necessarily apply to different areas of law within a particular legal system. For example, Arabic countries belong to Islamic law tradition with respect of family law; however there is a great influence from European jurisdictions, namely France and Italy, in terms of commercial law due to their colonial history in those countries[10] (i.e. Algeria; Tunisia). Alternatively, although African countries stayed under British rule, the rules of customary African law in effect are especially in the areas of family and succession law.[11] Apart from geographical, religious, or colonial influences, there might be a voluntarily reception of foreign law, as it is the case in Turkish legal system. For instance, at the beginning of the 20th century, with the establishment of the Turkish Republic, Turkey voluntarily adopted Swiss civil law under the reformist package of Mustafa Kemal Ataturk, and abandoned Islamic law. Furthermore, the current legal system of Turkey has been shaped by different European legal sources, mainly German, Swiss, French and Italian over the period 1850-1927.[12] For instance, the Commercial Code of 1926, the first modern commercial code of Turkey, was based on the German Code of 1897.[13]

Turkey is a transplant country and the legal system in Turkey can be categorised as a hybrid (mixed) system where both legal and socio-cultural transmission is still on-going.[14] Ogus approached this transition of Turkey from a legal and economic perspective, explaining that Turkey needed to import legal cultures from abroad to provide a more "*sophisticated legal input*" for industrialization and commercial development.[15] Moreover, in the pursuit of full membership of the EU, Turkey has begun harmonising its law with the EU *acquis*. In this respect, Turkey is in the process of modernization in

7 **Zweigert**, K. & **Kötz**, H. (1998) An Introduction to Comparative Law, 3rd edition, Oxford University Press (translated by Tony Weir), p. 36.

8 Similarly, the Scandinavian countries are classified as Germanic civil law, yet their welfare state model indicates uniform Nordic legal family. See *ibid*, p. 79.

9 *ibid*, p. 89.

10 **Zweigert** & **Kötz**, p. 65.

11 *ibid*, 230.

12 The Civil Code of 1926 from the Swiss Civil Code and the Code of Obligations, the Penal Code of 1926 from the Italian Code of 1889, the Code of Civil Procedure of 1929 from the Swiss Canton of Neuchatel, the Code of Criminal Procedure of 1929 from the German Code of 1877 and others again from Swiss and German sources. See **Örücü** E. (2000) 'Turkey facing the European Union- old and new harmonies' European Law Review, 25:5, pp. 523, 524. See also; **Berkowitz** D. et al, (2003a) 'The Transplant Effect' American Journal of International Law, 51:1, p. 199

13 **Örücü** (2000) p. 525.

14 **Örücü** (2007) p. 181.

15 **Ogus**, A., 'The Economic Approach: Competition between Legal Systems' in Örücü, E. & Nelken, D. (Editors) (2007) Comparative Law: A Handbook, Hart, p. 165.

improving its legal system. It is likely that the process of the EU membership will also have an impact on legal transmission in Turkey.

The above examples may suggest that one should not rely solely on the classic 'legal family' categorizations.[16] Örücü sees all legal systems as mixed and overlapping, meaning that all legal systems are combinations of various legal sources.[17] Moreover, in the current conditions of the 21st century, with worldwide globalisation of systems occurring, categorising legal systems into strict groups is not valid anymore. Although reasons and intentions can differ, the "*legal systems are crosses*".[18] An approximation of legal systems can be seen, especially in commercial law due to internationalisation of economy around the world (e.g. cross-listings and cross-border investments).[19] Therefore, whether similar approximations are possible in terms of external auditing regulation will be examined.

The governance function of external auditing is closely linked to the ownership structures of firms. Before going into detail, it might be useful to review the literature on the different legal systems and the use of external auditing.

Based on the common-civil legal families theory, a number of studies carried out by La Porta et al. controversially argued that differences in legal systems have influenced the economic development of these countries and their governance functions.[20] In short, La Porta et al. established a general distinction of family groups arguing that capital markets in countries that belong to the civil law legal systems are less developed because of their weak legal protection of minority shareholders,[21] whereas common law legal systems offer more protection of minority shareholders, and therefore the legal environment is more suitable for market growth in these countries.[22] La Porta et al. argued that concentrated systems are associated with weak legal environment (e.g. a lack of sufficient legal rules and enforcement mechanisms).[23] Based on these findings, Francis et al. suggested that countries with stronger investor protection are more likely to have higher quality auditing, while countries with weak investor protection have a lower demand for external audits.[24] However, this conclusion cannot be fully accepted for a number of reasons. First, the relevance of legal families has been challenged. For example, it is argued that the UK law on shareholder protection is closer to the Continental European legal system than it is to US law.[25] Secondly, such categorization of dispersed and concentrated ownership structures with strong and weak legal systems is misleading, since controlling shareholders may exist in countries with good laws (e.g. Sweden).[26] Thirdly, the effects of legal systems on the quality of accounting might not be that clear. Instead of a common *versus* civil law distinction, other factors (e.g. language, ownership concentration, management powers and incentives, auditor quality, regulation, enforcement, and other institutional factors) may have a greater effect on accounting quality.[27] Moreover, cultural factors might also have an influence on accounting standards and practices.[28] Fourthly, the

16 **Zweigert** & **Kötz**, p. 41.

17 **Örücü** (2007) p. 177.

18 **Örücü**, E.,'Family Trees for Legal Systems: Towards a Contemporary Approach': Hoecke, M. (Editor) (2004) Epistemology and Methodology of Comparative Law, Oxford, Hart, p. 359.

19 **Siems**, M. (2008) Convergence in Shareholder Law, Cambridge University Press, pp. 250-296.

20 **La Porta** et al. (1997). See also **La Porta**, R. et al., (1999) 'Corporate Ownership around the World' Journal of Finance, 54:2, p. 471.

21 **La Porta** et al. (1997) p. 1142.

22 **La Porta**, R. et al., (1998) 'Law and Finance' Journal of Political Economy, 106:6, p. 1113; La Porta, R. et al., (2000) 'Investor Protection and Corporate Governance' Journal of Financial Economics, 58:3; **La Porta**, R. et al., (2002) 'Investor Protection and Corporate Valuation' Journal of Finance, 57, p. 1147.

23 **La Porta** et al. (1998) pp. 1141, 1146.

24 **Francis** J. R. et al., (2003) 'The Role of Accounting and Auditing in Corporate Governance and The Development of Financial Markets Around the World' Asia-Pacific Journal of Accounting and Economics, 10:1.

25 **Lele**, P. P. & **Siems**, M. M. (2007) 'Shareholder Protection: A Leximetric Approach' Journal of Corporate Law Studies, 7: 17.

26 Sweden is a good example of controlling shareholder structure and effective monitoring mechanisms that prevent the exploitation of minority shareholders. See **Gilson**, R. J. (2006) 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' Harvard Law Review, 119:6, p. 1641.

27 **Lindahl**, F. & **Schadéwitz**, H. (2013) 'Are Legal Families Related to Financial Reporting Quality' Abacus, 49:2, p. 242. For empirical evidence on cultural differences on international accounting practices see **Nobes**, C.W. (2011) 'IFRS Practices and the Persistence of Accounting System Classification' Abacus, 47:3, p. 267–283 (showing national influence on accounting practices in eight countries). See also **Hellman** et al. (2015) 'The Persistence of International Accounting Differences as Measured on Transition to IFRS' Accounting and Business Research, 45:2, pp. 166-195.

28 **Gray**, S. J. (1988) 'Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally'

distinction between common and civil law is becoming less relevant after increased regulatory scrutiny over auditing (and securities) regulation and harmonisation forces, in particular at EU level. Lastly, developments in the international economy might eventually lead to a convergence between legal systems, including in auditing. This approximation is explained as 'convergence through congruence',[29] and will be detailed in section III-A below.

Nevertheless, the role of external auditing might still vary in different market systems, mainly due to the different ownership structures of firms. For instance, in market-based governance systems (outsider systems), such as in the US and UK, high-quality public financial disclosures and reporting are much more developed because public disclosure plays a more central role in these systems.[30] In contrast, in civil law legal regimes (insider or concentrated systems), where political influences are greater, financial reporting is much more focused on taxation.[31] In market-based systems, companies are more likely to be subject to agency costs due to asymmetric information.[32] Here, external auditing can function as a monitoring mechanism on the management and can help to reduce the agency cost by mitigating information asymmetry.[33] The role of auditing in outsider systems is more to check on managers.[34] It is said that the incentives to commit fraud are different in insider corporate governance systems, where controlling shareholders have a tendency to make use of the corporate assets for their personal benefits.[35] This was notably seen in the Imar Bank[36] scandal in Turkey. Large private benefits of control, for example illegally transferring assets to other corporations, can be seen as a proof of weak corporate governance. Investors would be reluctant to invest in those companies. Thus, here - with greater problems of private benefits of control[37] – companies may have incentives to improve their corporate governance to attract outside investors. In concentrated systems, firms tend to use external auditing as an assurance of the credibility of the information in the financial reports and subsequently gaining public confidence to attract investors.[38] It can be claimed that high-quality audits would tell an outsider investor that the financial reporting is credible and the information asymmetry is reduced that will provide less room for managers' opportunistic behaviours.[39]

In conclusion, these analyses may imply that although the original demand might differ, external auditing does have an important governance function in dispersed systems as well as in concentrated systems. Yet, these findings do not suggest that different corporate governance systems cannot approximate in terms of laws in auditing. The effects of

Abacus, 24:1, p. 1 (explaining four dimensions of accounting values based on cultural influence). See also section III-D below.

29 See **Siems** (2008) pp. 250-296.

30 **Ball**, R. (2001) 'Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure' Brookings-Wharton Papers on Financial Services, p. 127.

31 *ibid*, 146.

32 **Jensen**, M. C. & **Meckling**, W. H. (1976) 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' Journal of Financial Economics, 3:4, p. 305.

33 **Ashbaugh**, H. & **Watfield**, T. D. (2012) 'Audit as a Corporate Governance Mechanism: Evidence from the German Market' Journal of International Accounting Research, 2, p. 1.

34 **Watts**, R. L. & **Zimmerman**, J. L. (1983) 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' Journal of Law and Economics, 26:3, p. 613.

35 **Coffee** J. C. Jr., (2005) 'A Theory of Corporate Scandals: Why the USA and Europe Differ' Oxford Review of Economic Policy, 21:2, pp. 198, 204.

36 For the Imar Bank case, see also section III-D below.

37 This does not imply that corporate scandals occur only in concentrated ownership systems. In fact, accounting scandals evidenced in dispersed systems as well (e.g. the Enron scandal) but the nature of the fraud and thus the role of the gatekeeper (i.e. the auditor) was different. See **Coffee** (2005), p. 200.

38 Empirical studies also found that companies which are in needs of external capital tend to choose to appoint Big Five auditors. See **Fan**, J. P. H. & **Wong**, T. J. (2005) 'Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia' Journal of Accounting Research, 43:1, pp. 35, 44; **Copley** P. et al., (1995) 'Simultaneous estimation of the supply demand of differentiated audits: evidence from the municipal audit market' Journal of Accounting Research, 33:1, p. 137; **Johnson**, W. B. & **Lys**, T. (1990) 'The market for audit services: evidence from voluntary auditor changes' Journal of Accounting and Economics, 12:1-3, p. 281.

39 **Guedhami**, O. & **Pittman**, J. A. (2006) 'Ownership Concentration in Privatized Firms: The Role of Disclosure Standards, Auditor Choice, and Auditing Infrastructure' Journal of Accounting Research, 44:5, pp. 889, 895.

international developments on accounting and auditing are enormous because of their growing importance in international markets. Public financial reporting is crucial for global markets in terms of ensuring trust in the markets via ensuring the accuracy of financial information.[40] For a country that seeks to be a part of the global investment area it is essential to keep up with international developments and provide a secure and trustworthy investment environment for foreign investors. Regardless of its legal origin, a country might like to voluntarily adopt laws on auditing in line with the highest standards, as in the US and UK. How successful this adoption will be, depends on a number of factors related to the country's economic adaptability, reception of legal rules, and historical and cultural elements. This paper takes Turkey as a case example in the adoption of laws in auditing with the EU *acquis*. In this respect, this paper will investigate the obstacles for a successful adoption of these rules, and will illustrate the limitations of and forces for convergence in the law of auditing between EU and Turkey.

III. CONVERGENCE OF AUDITING BETWEEN EU AND TURKISH LAWS

There are a number of justifications for the convergence of auditing in Turkey with EU laws. These are the EU membership aspiration, globalisation and capital market integration, and the reformation of commercial and capital markets laws. These in fact are closely linked to each other.

A. FORCES FOR CONVERGENCE

This section will adopt Hansmann & Kraakman's[41] explanation of important economic forces on convergence to auditing convergence with respect to Turkish and EU laws. Apart from the important economic forces, this paper submits harmonisation with EU law as another force for auditing convergence. These two principal forces for auditing convergence will be explained respectively.

1. Important Economic Forces

International mergers, foreign investors, and cross-listings prompt internationalisation of the economy, and therefore result in more integrated financial markets. On the one hand, the integration of financial markets results in legal similarities, in particular in securities regulation and corporate governance regimes.[42] In case of cross-border mergers and acquisitions, the home country's securities regulation and governance structures can affect the governance practices of an acquired firm or, alternatively, new models may be imported from other systems and two models may co-exist. Therefore, convergence through cross-border mergers and acquisitions is possible.[43]

On the other hand, global capital markets prompt firms and jurisdictions to adopt more efficient governance mechanisms. For example, most of advanced economies require listed firms to make regular financial disclosure and to have audit committees.[44] In global capital markets, to compete with other jurisdictions, lawmakers may choose to demand less in order to make the law easier for businesses and to attract new investors. This may lead

[40] See also **Shapiro**, S. P. (1987) 'The Social Control of Impersonal Trust' American Journal of Sociology, 93:3, p. 623.

[41] They also noted (i) failure of alternative models and (ii) the rise of shareholder group as the other drivers for convergence. See **Hansmann**, H. & **Kraakman**, R. (2001) 'The End of History for Corporate Law' Georgetown Law Journal, 89, pp. 443-451. The reference to this article is not meant to endorse all views presented by Hansmann & Kraakman (such as that of 'the end of history for corporate law').

[42] *ibid*.

[43] **Yoshikawa** T. & **Rasheed**, A. A. (2009) 'Convergence of Corporate Governance: Critical Review and Future Directions' Corporate Governance: An International Review, 17:3, p. 388.

[44] To give an example, the Securities and Exchange Commission (SEC) in the United States requires every public company to have an audit committee or its equivalent as part of its board of directors and to disclose certain types of financial and non-financial information on a regular basis. See The Sarbanes-Oxley Act, 107th Congress, H.R. 3763 (The SOX), respectively section 301(2) and section 401.

to a "*race to the bottom*".[45] In terms of disclosure and best practice (e.g. effective protection of shareholder rights[46]), it seems that regulatory competition leads in the opposite direction.[47] It is said that if domestic law or domestic firms fail to sustain the application of the best governance mechanism, investment capital can flow to other jurisdictions that can offer better standards.[48] For example, more than one-half of the Fortune 500 firms choose to incorporate in Delaware, a small state in the US.[49]

A similar justification can also apply to auditing. Investors would not invest in a company whose external audit mechanism does not assure investors in terms of reliability of the financial statements. In such case, investors would choose other companies in an alternative country who offer better auditing standards. As a result, public companies that seek to attract investors would voluntarily adapt the highest auditing standards in their home country. Alternatively, public companies may voluntarily choose to bind themselves to comply with the highest standards by listing on a foreign exchange.[50] Firms choose to list on foreign stock exchanges because of the expectation of the so-called 'bonding effect': it is believed that listing abroad increases the share value of the firm.[51] The other reasons for listing abroad might be to reach a broader range of investors, to easily acquire foreign firms, and/or to increase the prestige of firms.[52] Thus, public companies that seek to be listed on foreign exchanges and seek to raise external capital have to improve their governance and disclosure practices to gain advantages in the global market. Similarly, jurisdictions that seek to attract foreign direct investment would promote the best governance mechanisms, including the adoption of the highest auditing standards.

The other force for convergence is the advantages of having a single set of standards in global capital markets. Having a single set of standards would reduce companies' transactions costs and offer them the advantage of comparability.[53] International investors who seek to reduce transaction costs and benefit from comparability advantage might prefer to invest in countries that have adopted professional standards (e.g. international standards on auditing - ISAs[54]). Listing on a foreign market with higher standards would increase the reliability of audited financial reports, and investors would therefore be ensured that their investments were secure.

These economic factors may force firms and jurisdictions whose auditing standards and regulations are weaker to make their standards and regulations similar with advanced governance mechanisms. In short, internationalisation of the economy can lead to the integration of capital markets. This can be via cross-listing and/or acquisitions and mergers. Both prompt the use of uniform auditing

[45] **Kraakman** R. et al., (2009) The Anatomy of Corporate Law: A Comparative and Functional Approach, *2nd* edition, Oxford, Oxford University Press, pp. 25-27.

[46] As Armour suggested, regulatory competition will lead to a 'race to the top' because businesses will choose a state whose laws are most protective in terms of the rights of shareholders. See **Armour**, J. (2005) 'Who Should Make Corporate Law? EC Legislation *versus* Regulatory Competition' Current Legal Problems, 58, p. 369.

[47] **Rasheed**, A. A. & **Yoshikawa**, T., 'The Convergence of Corporate Governance: Promise and Prospects': Rasheed, A. A. & Yoshikawa, T. (Editors) (2012) The Convergence of Corporate Governance, Palgrave Macmillan, p. 7.

[48] **Easterbrook**, F. H. & **Fischel**, D. R. (1991) The Economic Structure of Corporate Law, Harvard University Press, pp. 212-218.

[49] **Black**, L. S. Jr, (2012) 'Why Corporations Choose Delaware' Delaware Department of State Division of Corporations. Available at https://corpfiles.delaware.gov/ whycorporations_web.pdf accessed March 29, 2019.

[50] **Hansmann** & **Kraakman**, pp. 463-464.

[51] **Coffee**, J. C. Jr., (1999) 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' New York University Law Review, 93:3, p. 641.

[52] **Licht**, A. N. (1998) 'Regulatory Arbitrage for Real: International Securities Regulation in A World Interacting Securities Markets' Virginia Journal of International Law, 38, p. 563.

[53] **Geiger**, U. (1997) 'The Case for the Harmonization of Securities Disclosure Rules in the Global Market' Columbia Business Law Review, p. 241. See also **White**, L. J. 'Competition versus Harmonization-An Overview of International Regulation of Financial Services': Barfield, C. E. (Editor) (1996) International Financial Markets: Harmonization Versus Competition, AEI Press, pp. 5-48.

[54] ISAs are issued in 1992 by an international private organization; the International Federation of Accountants (IFAC). ISA is also accepted on capital markets as a reference for international auditing standards by the International Organization of Securities Commissions (IOSCO).

standards and regulations. This may suggest that integrated markets facilitate the use of uniform standards that can lead to convergence in auditing.

These theoretical underpinnings can be applied to auditing convergence between Turkish and EU law, explaining the economic forces for Turkey to adopt similar rules with EU laws in terms of auditing. Turkey is considered an emerging market economy that seeks investment from other countries. If Turkey wants to use its growing market advantage and to be an attractive venue for foreign direct investment, it should use an international language that anybody who is interested to invest can understand for business in Turkey. Today, major states in the world, including EU Member States, have adopted ISAs.[55] Uniform accounting and auditing standards are advantageous for all major economies in terms of comparability, but they are much more crucial for emerging economies, such as Turkey. Through the adoption of international standards, investors in Turkey will benefit from the same standards as are applied in other major countries. Moreover, the use of improved laws on auditing would be a signal for foreign direct investment, as it will increase the reliability of financial reports.

2. Harmonisation with EU Law

Harmonisation with EU law, such as the adoption of the Audit Directive 2014/56/EU, and also of some recommendations (e.g. auditor independence[56] and liability limitation[57]) can also be a driver for convergence. Approximation of the laws on auditing will help Turkey to move its law closer to the EU *acquis* and may help to adopt other areas of law more easily.

Turkey is a candidate country to the EU since 1999 and accession negotiations opened in 2005. Throughout accession negotiations, the European Commission monitors the candidate country with regards its alignment with the EU *acquis*.[58] Although the EU suspended negotiations in 2006, the screening process continues. [59]

Turkey aspires to be a part of the world economic, investment, and trade communities. Full EU membership for Turkey is an important pillar in the pursuit of this objective. In this respect, the new Turkish Commercial Code[60] came into force in July 2012 with more harmonised provisions with EU law, especially in auditing and financial reporting fields.[61] In short, the new Code expands the application of external auditing, authorising public oversight authority of Turkey (the POAT) to oversee the audit profession,[62] requiring the use of Turkish Financial Reporting Standards (TFRS)[63] in the financial reports of public interest entities (PIEs)[64] and to have audited those reports by an independent external auditor (SMMM or YMM)[65] in accordance with Turkish Auditing Standards (TAS).[66]

One could question the efficiency of a possible convergence of Turkish laws in auditing with the EU *acquis*. There are a number of advantages of approximation with EU law. First, it is believed that harmonisation of disclosure standards would miti-

[55] EU law requires that audit reports shall indicate that the statutory audit was conducted in accordance with the ISAs. See Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, art. 26(1).

[56] Commission Recommendation of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles 2002/590/EC OJ L 191/22.

[57] Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms 2008/473/EC OJ L 162/39.

[58] See European Council, 'Conclusions of the Presidency' DOC/93/3, Copenhagen, 21-22 June 1993.

[59] **Engert**, S. (2010) EU Enlargement and Socialization Turkey and Cyprus, Routledge, New York, p. 51.

[60] Turkish Commercial Code (TCC) No. 6102, Official Gazette No. 27846 (January 13, 2011).

[61] In fact, reforming laws and regulations came on to Turkey's agenda in the mid-1990s. Although one of the incentives was to catch up with the privatization trend in Europe, the main motivation behind reforms was joining the EU. See Draft Turkish Commercial Code General Justification. See also **Baç**, p.17.

[62] Statutory Decree on the organization and duties of the public oversight, accounting and auditing standards No. 660, Official Gazette No. 28103, (April 6, 2011).

[63] In 2006, Turkish Accounting Standards Board translated the IFRS and named as Turkish Financial Reporting Standards. Since 2011, the responsibility to issue accounting and auditing standards is overtaken by the public oversight authority of Turkey: the POAT.

[64] Statutory Decree No. 660, art. 23.

[65] SMMMs are the Certified Public Accountants and YMMs are the Sworn-in Certified Public Accountants in Turkey.

[66] TCC No. 6102, art 397(1).

gate transaction costs while providing a comparability advantage. Second, an improved legal environment would provide greater protection for minority shareholders and other investors, while the risk of expropriation by insiders would be reduced.[67] This is particularly important for Turkey, where controlling shareholders are dominant and can potentially use company assets for private benefits.[68] Due to the lack of legal protections for minority shareholders, investors would depend on relationships, not law. As a consequence, the governance of companies would be based on relationships that would discourage new investors.[69] Therefore, advanced auditing laws are crucial, especially for the protection of (minority) shareholders and investors.

The combination of these forces may result in a market-driven convergence. However, it needs to be examined whether Turkish laws on auditing have actually converged with EU law. The evidence of this will be detailed in Section III-D below. Before that, the methods of convergence will be discussed next.

B. METHODS FOR CONVERGENCE

In Turkey, harmonisation with EU laws on auditing has been through the adoption of international accounting and auditing standards and recent law reforms issued in the field of company and capital markets law. The Capital Markets Board of Turkey (the CMB), the regulatory authority in capital markets, issued a regulation requiring public companies in Turkey to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) as of 2005.[70] Since 2005, public companies are required to report according to the CMB's IFRS-compatible accounting standards. In terms of auditing standards, for the first time in 2006, the CMB introduced ISAs to Turkish capital markets by the Communiqué Series: X, No: 22.[71] Also, the new TCC requires audits of financial reports to be conducted in accordance with TAS: the Turkish translation of ISAs.[72] Before the TAS was introduced to the capital markets in 2006, there had been no uniform standard in external auditing. This situation was especially difficult for international audit firms who were not familiar with the accounting system in Turkey. TAS are compatible with ISAs, and therefore both international audit firms and international users of the audit reports can take advantage of that compatibility - not only the foreign and/or multinational firms who aspire to invest in Turkey, but also Turkish companies, who will benefit from the use of those uniform standards. Therefore, the adoption of international standards through TFRS and TAS can be considered an effective tool for convergence.

With the regulatory improvements made in 2012 under the TCC, statutory audits can only be assigned to professional and independent auditors whose requirements are set by law.[73] In this respect, the public oversight auditory body of Turkey, sets specific requirements for the audits of (PIEs).[74] Second, the independence requirements were strengthened. A maximum 7-year period for auditors performing audits for the same client was introduced.[75]

Furthermore, the establishment of the POAT can also be considered as tools for convergence. In this respect, the European Commission considered the establishment of the POAT as a good progress for Turkey as regards complying with the EU *acquis*.[76] According to the Commission, the establishment of the POAT improved the legal and institutional framework in auditing in Turkey.[77]

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67 **Coffee** (1999) p. 705.

68 **Yurtoğlu**, B. B. (2000) 'Ownership, Control and Performance of Turkish Listed Firms' Empirica, 27, p. 193.

69 **Coffee** (1999) p. 706.

70 Communiqué Series: XI, No: 25 on accounting standards in capital markets, last amended by Communiqué II-14.1.a on financial reporting standards in capital markets (February 03, 2017).

71 Communiqué Series: X, No: 22 regarding Independent Audit Standards in Capital Markets, last amended by Communiqué Series: X, No: 28 (June 28, 2013).

72 TCC No. 6102, art. 397.

73 *ibid,* art. 400.

74 Regulation on independent auditing, Official Gazette No. 28509 (December 26, 2012), art. 11.

75 TCC No. 6102, art. 400(2).

76 European Commission Staff Working Document Turkey 2012 Progress Report accompanying the document Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012-13 Brussels October 10, 2012 SWD (2012) 336 final.

77 *ibid*.

C. THE FEASIBILITY OF CONVERGENCE

So far it is submitted that auditing convergence is necessary for Turkey especially regarding its EU membership objective and the aim to be a part of global financial markets. The latest law reforms under TCC No. 6102 and Capital Markets Law No. 6362[78] are the methods using for auditing convergence.[79] Despite these reforms and formal approximation of laws and regulations on auditing, actual convergence may still not be possible.

This part will explain the feasibility of auditing convergence between Turkish and EU law according to the path dependency theory of Bebchuk & Roe[80] and the transplant effect theory of Berkowitz et al[81] Within this context, this section will question Turkey's adoption of EU law on auditing with respect to first, reasons arising from the initial conditions with which countries started (i.e. its path dependencies) and second, its institutional capacity to receive the imported law (i.e. the transplant effect).

To begin with, Turkey and the countries of the EU are at different levels of economic development. The adoption of EU law may be hindered due to institutional differences resulted from unequal economic development. Less developed institutional infrastructure, such as insufficient capacity of economic institutions, e.g. deficient budget and expertise, can be seen in less economically developed countries. Ineffective institutional frameworks can also be found in other countries than Turkey. Pistor et al. found that the failure of the former Soviet Union countries' legal reform on the protection of shareholder and creditor rights was caused by the absence of effective legal institutions.[82] Despite the fact that these countries have adopted advanced laws on the protection of shareholder and creditor rights, ineffective legal institutions failed to enforce these laws.[83]

Political incentives as well as the incentives of interest groups also play a role in understanding a country's legal development. As public choice theory notes, politicians, namely governments and bureaucrats, do not often pursue to increase the social welfare when law-making.[84] Instead, politicians are self-interested and pursue, for example, political power, re-election, and rent-seeking.[85] In addition, other interest groups, for example, lawyers and auditors, may have political influence in the law-making process through lobbying.[86] There might also be other influential actors, such as the EU that might have role in the law-making process, as in the case in Turkey.

Institutional transformation is considered as one of the issues that challenged most the political economy of Turkey in terms of forming the country's institutional structure.[87] Institutional reform in Turkey has mainly started following the crisis of 2000 to 2001; only the Capital Markets Board of Turkey (the CMB) was already established in 1981. International influence through the IMF and World Bank has also encouraged Turkey to reform its economic institutions.[88] The main principle of institutionalising in Turkey is isolating the regulatory process from political influence.[89] To achieve this, independent regulatory authorities are established to operate in respective sectors, such as banking, finance, energy, and telecommunications.[90] A

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78 Capital Markets Law (CML) No. 2499 amended with Law No. 6362, Official Gazette No. 28513 (December 6, 2012).

79 See section III-A above.

80 **Bebchuk**, L. A. & **Roe**, M. J. (1999) 'A Theory of Path Dependence in Corporate Governance and Ownership' Stanford Law Review, 52:127, p. 157.

81 **Berkowitz**, D. et al., (2003b) 'Economic Development, Legality, and the Transplant Effect' 47 European Economic Review, 47, p. 167.

82 **Pistor**, K. et al., (2000) 'Law and Finance in Transition Economies' Economics of Transition, 8:2, p. 325.

83 *ibid*, p. 356.

84 **Siems** (2008) p. 235.

85 **Baldwin**, R. & **Cave**, M. (2012) Understanding Regulation Theory, Strategy, and Practice, 2nd edition, Oxford University Press, p. 41.

86 **Siems** (2008) p. 239.

87 **Onis**, Z. & **Kutluay**, M. (2013) 'Rising Powers in a Changing Global Order: The Political Economy of Turkey in the Age of BRICS' The Washington Quarterly, 34:8, p. 1417.

88 **Atiyas**, I. (2012) 'Economic Institutions and Economic Change in Turkey during the Neoliberal Era' New Perspectives on Turkey, 14, p. 54.

89 *ibid*, p. 60.

90 For the development of regulatory agencies in Turkey, see **Ozel** I. & **Atiyas**, I. 'Regulatory Diffusion in Turkey: A Cross-Sectoral Assessment': Cetin, T. & Oguz, F. (Editors) (2011)

rule on independence ensures that these agencies are given financial autonomy and their decisions cannot be overturned by the ministries, but are subject to appeal mechanism undertaken by the Council of State (*Danıştay*).[91] There is controversy regarding the level of independence and delegation of the authority of economic institutions in Turkey. For example, it is argued that the independence of telecommunication regulatory institution of Turkey has been impaired and institutional quality of the regulatory agency in the electricity sector has been insufficient.[92]

In line with the institutional independence policy, in the field of auditing, the public oversight authority of Turkey was established as an independent body that is free from political pressure. However, it has been argued that political intervention on the regulatory authorities has been the case in Turkey.[93] Politicians and bureaucrats have been involved in the control of the regulatory agencies, for example, through the appointment of the board members of these bodies as these agencies are 'affiliated' to the respective ministries,[94] e.g. POAT, as well as CMB are affiliated to the Ministry of Treasury and Finance of Turkey. This arrangement may suggest that operations of these institutions cannot be separated from the incentives and politics of the politicians and bureaucrats since there is a link between these institutions and the political institutions, i.e. ministries.

In addition to the independence issue, the fragmented institutional structure is the other shortcoming in auditing sector in Turkey. Before the establishment of the POAT, the supervision of audit firms had a multi-headed structure. The CMB used to govern audit firms that audited firms listed on the Borsa Istanbul[95] and the Banking Regulation and Supervision Agency (BRSA), the regulatory and supervisory body in the banking sector, used to govern firms that audited banks and financial institutions.[96] Regarding oversight mechanisms, oversight of those who are excluded in the list of CMB and BRSA is the responsibility of the POAT. To put it differently, while the CMB and the BRSA govern audits in their subject areas (i.e. respectively financial markets, and banking sector), the POAT governs the audit firms and auditors that fall outside of the scope of CMB and BRSA (e.g. the audits of non-listed firms). As regards the certification of auditors, since 2013, auditors and audit firms are required to be certified by the POAT initially, in order to perform audits in financial markets.[97] Yet, the CMB has the right to withdraw approval of an audit firm approved by the POAT[98] and the POAT receives opinions from the CMB and the BRSA on the approval of audit firms that audit PIEs.[99] These provisions reserve the rights of the CMB and the BRSA as to external audits of PIEs in the sectors that they are authorised to regulate and supervise. So, the POAT carries out its duty in coordination with the CMB and the BRSA.

It can be concluded that the establishment of the POAT has not terminated the multi-headed regulatory structure entirely, since the CMB and BRSA still have supervisory rights over audits in their regulatory area. Having more than one regulatory in the field of auditing may cause obstruction, in particular with respect to the application of the standards and investigations over audit firms. However, one should take into account that it would be politically and economically difficult to abolish the roles of the other institutions. This would make existing institutional and professional

The Political Economy of Regulation in Turkey, New York, Springer, pp. 51-73.

91 **Atiyas**, p. 61.

92 **Atiyas** p. 65.

93 **Ozel**, I. (2012) 'The Politics of De-delegation: Regulatory (In)dependence in Turkey' 6 Regulation and Governance, 6, p. 122.

94 *ibid,* p. 124.

95 Capital Markets Law No. 6362, art. 35 (1) (c). With the enactment of the Capital Markets Law No. 6362 on 30 December 2012, the Istanbul Stock Exchange was renamed as Borsa Istanbul (BIST) and started to operate on 3 April 2013.

96 Banking Law No. 5411, Official Gazette No. 25983 (December 1, 2005), art. 15, 33, and 36.

97 Communiqué Series: X, No: 28 amending communiqué on independent audit standards in capital markets, Official Gazette No. 28691 (June 28, 2013), s. 2, art. 3.

98 CML No. 6362, art. 62.

99 Also, the Capital Markets Law and Banking Law provisions with respect of the regulation of external auditing and audit firms are reserved. See Statutory Decree No.660, art. 23(2)-(4).

infrastructure ill-fitting and clearly would require new investments. Overall, the Turkish government has chosen to avoid these costs however, in turn; this has resulted in a fragmented supervisory framework in the field of auditing.

Furthermore, Turkey is not yet a member of the EU. In terms of the implementation and enforcement of the rules, Turkey therefore does not have the same options and choices as current Member States. For instance, other areas of law show that differences and institutional infrastructure of other institutions are not at the same level as in the EU Member States. In addition, practices and relations prevailing in the business environment might be another reason for differences that still persist after the adoption of EU law.

So far, this section argued that the insufficient institutional structure in Turkey could be the basis for differences that still persist. One could also question the reasons for these institutional impediments. Berkowitz et al. acknowledged that there would be social, economic, and institutional differences between an origin and the transplant country. To reduce the effects of these differences in the adoption of the new law, a transplant country has to meet with familiarity and/or adaptability. In their explanation, they claimed that countries with familiarity (who share a legal history or belong to the same legal family) and/or adaptation would have more effective institutions compared those who do not share a common legal history with the transplanted concepts or have not made necessary modifications to adapt its initial conditions with the origin country.[100] If the necessary modifications were not made to adapt the local conditions, there would be "*a substantial mismatch between pre-existing and the imported legal order*" causing the "*transplant effect*".[101] The 'transplant effect' would cause the malfunction of the imported legal order and legal intermediaries (e.g. judges, lawyers, politicians) would also be affected negatively in terms of reception of the new law.[102] These findings may suggest that the transplant effect theory can be used to explain the ineffective institutions in a transplant country.

In terms of Turkey's adoption of EU law, it is necessary for Turkey to make the appropriate modifications. To give an example, the EU requirement for the establishment of a public oversight body should not be attributed only to the mere establishment of such body. Adequate resource allocation, including an adequate budget for inspections, and the employment of sufficient number of experts for these inspections, and the continuing training of the member staff are important pillars for the efficient functioning of such body. They are also crucial for serving the ultimate objective to form such body, i.e. increased audit quality and improved investor protection.

Another example is the rule on private litigation in terms of auditor liability. Although, the law on auditor liability has now been improved with the enactment of the new TCC[103] and Capital Markets Law[104], private litigation in terms of auditor liability in Turkey has not yet been applied as it has been in other countries, such as the UK.[105] However, it is said that for imported rules to be functional, there should be a demand for it in the first place and legal intermediaries (e.g. judges, lawyers, politicians) should understand the real meaning of the law.[106] Accordingly, for the private litigation on auditor liability to be functional in Turkey, first, there should be a demand for it; second, investors should be informed with the new

[100] **Berkowitz** et al. (2003b) pp. 180-181.

[101] *ibid*, pp. 167-168.

[102] *ibid.*

[103] TCC governs civil liability rules for auditors based on fault principle. See TCC No. 6102, art. 554. The POAT also provides rules related to auditor liability under Statutory Decree No. 660.

[104] CML imposes liability on auditors (together with other issuers) for misleading prospectuses and other disclosure requirements. See CML No. 6362, art. 10, 32. In addition, in line with ISA 240, CMB Communiqué Series: X, No: 22 governed the responsibility of auditors with respect of fraud and material misstatement detection in financial accounts. See Communiqué Series: X, No: 22, art. 7.

[105] The UK common law rules specify the elements of civil liability action for auditors with cases dated back to 19th century, e.g. Re London and General Bank (No. 2) [1895] 2 Ch. 673, Court of Appeal; Re Kingston Cotton Mill Co. (No. 2) [1896] 2 Ch. 279, Court of Appeal; Caparo Industries plc v Dickman [1990] 2 A.C.

[106] **Berkowitz** et al. (2003b) pp. 173-174.

rule, and third both the investors and the legal intermediaries should be able to understand the meaning of the private litigation on auditor liability and its relevance with the cases in capital markets. If necessary, lawyers could be trained in the application of the private litigation. If the real meanings of the auditor liability rules were not understood properly, there is a risk that these rules would not be applied at all or could be applied in a way that is against its principal intention.[107] Nevertheless, before drawing a direct conclusion, it should also be acknowledged that some time might be required after the enactment of the new laws for the society in Turkey to understand and to observe their meaning and to apply them when necessary.

From another perspective, it may be also questionable to what extent Turkey is subject to the transplant effect. Berkowitz et al. categorised Turkey as an "*unreceptive*" transplant.[108] However, they made this categorization based on the findings from data collected during 1980-95. This is the period when Turkey was in the process of transmission, and had therefore not completed its economic and legal development. After this period, Turkey's legal environment developed rapidly and shifted to another era, the so-called 'Europeanization period' that helped Turkey make breakthroughs in economic and political developments. After the Customs Union agreement between Turkey and the EU in 1995, the European Council granted Turkey EU candidacy status in 1999. Since then, Turkey has issued major reforms and adopted a number of adjustment packages under the National Programme for the Adoption of the EU *acquis*.[109] The regulatory measures in the fields of business law and financial markets under the Europeanization process have helped Turkey to move its legal system closer to EU law. Thus, a categorization that places Turkey as '*unreceptive*' cannot be applied today, if one takes into account Turkey's on-going financial and legal development ever since.

Furthermore, the 'transplant effect' might be less valid for auditing convergence between the EU and Turkish laws. It is because there is also a strong effect of market-driven convergence namely through the integrated audit market and acceptance of international auditing standards. It can be expected that the audit and business society would be eager to support and also to adapt the reforms on auditing in the expectations of positive economic outcomes of integration of financial markets. Yet, it should be highlighted that necessary adaptations will still be required for the law and institutions to be operated effectively.

D. A CONCEPTUAL FRAMEWORK FOR THE CONVERGENCE BETWEEN THE EU AND TURKISH LAWS ON AUDITING

Turkey has made good progress in the areas of company law and financial markets over the last twenty years in terms of increasing the level of its law and regulations to world standards. In this respect, the alignment of company law regulations with the EU *acquis* is almost complete, as the European Commission has stated that Turkey is "*advanced*" in the company law area with "*significant progress in auditing*".[110] It appears that Turkey made distinctive changes in its laws in auditing similar to EU Directive 2014/56/EU.[111] This could probably result in formal convergence that requires a political support and a change in legal infrastructure.[112]

In the previous section, three factors, namely the EU membership aspiration, the objective of the integration of capital markets, and the need for improvement of laws were discussed in justifying the need for convergence.[113] These three factors can also be considered as drivers for convergence between EU and Turkish laws on auditing. Nevertheless, there could still be differences in terms of legal mentalities in national preferences.

[107] *ibid,* p. 174.
[108] **Berkowitz** et al. (2003a) p. 195.
[109] **Baç**, M. M. (2005) 'Turkey's Political Reforms and the Impact of the European Union' South European Society and Politics Journal, 10, p. 17.
[110] European Commission Progress Report p. 50.
[111] See section III-A(2) above.
[112] Siems called convergence through international or regional organizations (i.e. here, the EU Audit Directive) as "*convergence from above*". See **Siems** (2008) p. 375.
[113] See section III-A above.

For instance, a weak legal environment, a multi-headed supervision mechanism, and functional dissimilarities (e.g. not being an EU member country)[114] may stand in the way of actual convergence. As the Table below details, there are four dimensions of audit convergence that need to be considered when evaluating convergence between Turkish and EU laws on auditing. The following will show that there are reasons that support each of those four dimensions; thus, overall, it will be concluded that the Turkish situation is a mixed one.

		Convergence in law	
		Yes	**No**
Convergence in practice	**Yes**	**Level 1** Harmonisation with the EU *acquis*, e.g. adoption of ISAs, and aim to integrate markets	**Level 2** Path dependencies of law (including case law), e.g. reflecting differences in the role of courts
	No	**Level 3** Differences in practice, e.g. due to 'multi-headed supervision', ineffective monitoring mechanisms and cultural factors	**Level 4** Functional dissimilarities: Turkey being a candidate country and having a less developed capital market, as well as costs of harmonisation

Table 1: Dimensions of auditing convergence between EU and Turkish laws

On the Table above, at level one, harmonisation attempts are carried out through two general factors: the EU membership process and the integration of markets. Turkish law is harmonising with the EU *acquis* as a requirement for EU membership. Also, the integration of markets forced Turkey to adopt international professional standards in accounting and auditing. At this level, the influence of EU membership and internationalization of the economy on convergence is very high.

At level two, path dependencies may stand in the way of legal convergence despite harmonisation attempts, in particular as regards the relevance of 'case law'. To begin with, Turkey is a transplant country whose legal order is based on a civil law legal system. Therefore, there might be differences in the application of laws and rules. For instance, in the field of auditing, laws are applied mainly through statutory laws and regulations, e.g. the provisions of the TCC, CML, and POAT regulations, and CMB communiqués. Although the effects of this may not directly obstruct the convergence of auditing rules, this may generate institutional and legislative issues that may indirectly result in differences in rules or its application. For instance, due to institutional and legislative differences, private litigation practice has not developed well in Turkey. Although the law issued liability on auditors to third parties under CML No. 6362,[115] there is currently no common practice in redressing auditor liability.

As in other countries, in Turkey courts deal with commercial disputes. Even though their application is rare, alternative dispute resolution methods, such as arbitration and mediation are also available in Turkey. For instance, the Union of Chambers and Commodity Exchanges of Turkey offers arbitration services under the Arbitration Council (*TOBB Tahkim Kurulu*) to ensure the settlement of economic, commercial and industrial disputes among the firms.[116] Mediation is another alternative method.[117] The number of commercial disputes settled with mediation has increased in the past few years since the mediation process becomes

[114] See also section III-C above.

[115] CML No. 6362, art. 10, 32.

[116] For more information, see TOBB Arbitration website available at http://www.tobb.org.tr/HukukMusavirligi/Sayfalar/Eng/Arbitration.php accessed February 06, 2019. Istanbul Arbitration Centre (ISTAC) also provide arbitration and mediation services both domestic and foreign commercial matters. See ISTAC website at https://istac.org.tr/en/dispute-resolution/arbitration/ accessed March 25, 2019.

[117] In order to make the application more effective Turkey has initiated recent legislative changes with the enactment of the Code of Mediation in Legal Disputes No. 6325 that is available for disputes arising from business operations, including those having a foreign element. See The Code of Mediation in Legal Disputes No. 6325, Official Gazette No. 28331 (June 7, 2012), art. 1.

mandatory before initiating a lawsuit for commercial disputes regarding payment of a certain amount of money and compensation claims as of December 2018.[118] Besides, the new TCC assigns commercial courts, e.g. Commercial Courts of general jurisdiction (*Asliye Ticaret Mahkemeleri*) to deal with auditor liability claims. However, it is said that the capacity of these courts is not sufficient to handle this task.[119] For instance, the average number of judges per 100.000 persons is below to the average rates in European countries.[120] in terms of efficiency of the courts, it was reported that the clearance rates [121] of civil and commercial litigious cases in 2016, was below of the European average indicating that the courts handle fewer cases than they receive.[122] The workload of the courts results in long trials and lengthy procedures in the courts and subsequently creates a cumbersome judicial system in Turkey.[123]

In addition to the capacity of the courts, court fees and the duration of the trials are the main obstacles that might hinder the wide application of private litigation in Turkey. A claimant has to pay 44,40 Turkish Liras (TL) (approximately €7,48) for filling an action in Commercial Courts of general jurisdiction (*Asliye Ticaret Mahkemeleri*) and 6.831 TL per cent relative fee of the dispute value for written judicial decree. Another 218,50 TL (approximately €36,84) has to be paid to file an appeal in Court of Cassation (*Yargıtay*).[124] There will be attorney fees and other expenses during the court proceedings as well, such as expert fees and other charges that the claimant needs to pay.[125] This can create a burden on investors who seeks justice. As a result, they may choose not to sue. To conclude, inadequacies in institutional setting of Turkish judiciary system, for example the number of judges, the structure of courts, the cost of litigation, and long trials and lengthy procedures could be the factors that affect the low litigation rates in Turkey. In addition, the reason for the non-application of auditor liability rules in Turkey could be the lack of understanding of the law by the lawyers and investors.[126]

On the Table above, differences in practice are seen at level three. Some of these differences are related to the failure of the Turkish law-maker to consider the practicality of new laws. For instance, prior to the adoption of the new TCC no regulatory impact analysis was carried out in order to foresee the effects of the rules and predict the outcomes.[127] If carried out, such assessment would have been beneficial in order to understand whether the rules are appropriate in the present institutional framework. Lack of such prior assessment may result in non-application of the rules, or rules that are applied differently than intended. Instead of carrying out such regulatory impact analysis, the law-makers set different dates for the enactment of the law and for their application. For instance, the new TCC was issued in January 2011 while rules on external auditing were only applicable as of January 2013. The law-makers made an assumption that two years would be enough for adjustments of the existence

[118] TCC No. 6102, art. 5/A.

[119] Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012 -13 Brussels, October 10, 2012 COM (2012) 600 final, 69.

[120] In 2016, the number of professional judges that fall into 100.000 people was 14.1 in Turkey; while it was 24,2 in Germany; 10,4 in Italy; and 25,8 in Greece. See High Council of Judges and Prosecutors (HCJP), Annual Report 2018 edition (2016 data), October 2018, p. 16.

[121] Clearance rate is a ratio, obtained by dividing the number of resolved cases with the number of incoming cases that shows how a judicial system cope with the flow of cases, *ibid*, p. 48.

[122] *ibid,* p. 50.

[123] Imar Bank case can be given as an example of the slow judicial system of Turkey. In this case, the lawsuit against auditors is time-barred since no conclusion can be reached after seven years and six months of that the scandal was revealed to the markets between the years 2000-2003.

[124] The law determines the litigation fees and updates them each year. See Fees Act General Communication No. 82, Official Gazette No. 30642 (December 31, 2018).

[125] The claimant has to meet the litigation cost. However, if the claims were successful, the defendant must compensate the costs that the claimant was subject to during the litigation proceedings.

[126] See also section III-C above.

[127] An impact analysis was carried out at EU level regarding the proposals for amending Directive 2006/43/EC and Regulation for the audits of PIEs. See Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities [COM (2011) 778 COM (2011) 779 SEC (2011) 1385] SEC (2011) 1384.

institutions (e.g. increasing the capacity and adequacy of commercial courts) With regard to differences in practice (i.e. level 3 on the Table), one should also consider the enforcement efficiency. The enforcement mechanism in Turkey is already weak and unwieldy. For instance, CMB monitoring over audit firms seems to be ineffective in terms of the number of investigations issued to audit firms.[128] To give an example, as the annual activity reports revealed, only a small number of audit firms investigated each year. For example, the number of investigations carried out by the CMB into the audit firms in 2017 was only 18, and 24 in 2016.[129] As a result of these investigations, the total number of sanctions was 7 in 2017 (8 in 2016) composed of audit activity sanctions and administrative fines.[130] These reports indicate that only a small number of audit activities are investigated by the CMB. This situation is a drawback for the law in action. In such circumstances, the function of the law would be hindered by an inefficient enforcement mechanism. Therefore, at level two, differences in practice are likely to obstruct an actual convergence.

Last but not least, cultural differences may stand in the way of convergence in practice. Coffee remarked that cultural norms might help managers to refrain from the expropriation of minority shareholders' interests.[131] This influence is said to be more relevant where the legal rules on minority shareholder protection are weaker.[132] As Coffee claims, in civil law regimes where the law is weaker, the influence of cultural norms can be more relevant than legal rules on the business.[133] It is because in common law countries where legal rules provide more protection for minority shareholders[134] cultural norms become less important.[135] Similarly, Hofstede suggested that cultural values might influence managers' decisions and behaviours.[136] To give an example from Turkey, in the Imar Bank case the family connections and government contacts played a great role in the bank's businesses. The Uzan family members had a great control over the managers and they had close relations with the political actors of that time.[137] They expected that having close relations with the powerful bureaucrats at that time would provide them a greater comfort for their illegal transactions.[138] The family members had the absolute control over the bank's management and had no incentives to disclose business information to the public or government's officials, including the BRSA auditors. It seems clear that the cultural values that play a role in business relations could influence managers' behaviours. One could also question the relation between cultural values and auditors' behaviours. To put as a question, did cultural factors affect the work of the auditors,[139] for instance in Imar Bank case?

Societal factors might explain differences in accounting values in different countries. The accounting system of a country is shaped by its economic, historical and technological development as well as its legal system, capital market development and education. The list is not exhaustive. It has shown that cultural values also have a say on the development of accounting profession in a country. Thus, even if the law is formally converged, cultural

[128] The CMB can launch inspections of audit firms as a form of regular routine or as a result of a complaint or a denouncement. The CMB shall report to the POAT about these inspections. See CML No. 6362, art. 62(1), (2).

[129] According to the CMB's annual activity reports, the number of audit firms investigated by the CMB was 2 in 2017, and it was 6 in 2016.

[130] CMB's Annual Activity Reports are available online at http://www.spk.gov.tr/indexcont.aspx?action=showpage&menuid=7&pid=5 accessed February 06, 2019.

[131] **Coffee**, J. C. Jr., (2000) 'Do Norms Matter? A Cross-Country Evaluation' University of Pennsylvania Law Review, 149:6, p. 2155.

[132] *ibid*, p. 2175.

[133] Coffee noted that differences in corporate behavior could be explained by the existence of compliance of strong social norms in a society. See *ibid*, pp. 2156-2165.

[134] **La Porta** et al (2000) p. 8.

[135] **Coffee** (2000) p. 2175.

[136] Hofstede identified four societal value dimensions when explaining cultural differences: power distance, uncertainty avoidance, individualism, and masculinity. See **Hofstede**, G. (1980) Culture's Consequences, Sage, p. 11.

[137] **Omurgonulsen**, M. & **Omurgonulsen**, U. (2009) 'Critical thinking about creative accounting in the face of a recent scandal in the Turkish banking sector' Critical Perspectives on Accounting, 20, p. 659.

[138] *ibid.*

[139] The intention of asking this question is not to start a discussion on behavioral analysis of auditors. The aim here is to point out how can cultural factors in business relations – other than law – affect the work of the auditor.

values may still be effective on the business relations and practices, and thus might result in differences in practice.

The quality of the audit work highly depends on auditors' professional judgement that should be exercised with a questioning mind. As important as the professional expertise, it is important that auditors adopt an independent attitude when performing the audit work. Auditors' ability to exercise their individual and independent professional judgement depends on the development of the accounting profession in a country.[140] In societies with high professionalism there is more emphasis on independence in individual decisions.[141] For instance, countries such as the UK, adopt a principle-based accounting regulation and the concept of 'a true and fair view' heavily depends on auditors' judgement on the financial accounts.[142] In addition, the role of the professional associations in standard setting also helped the development of accountancy as a profession in the UK. As far as the period of the Imar Bank case in Turkey is considered, contrary to the UK standards, neither professional associations nor accountancy as a profession were highly developed. Instead, audit work used to be concerned primarily with the implementation of prescriptive legal requirements in terms of, for example tax compliance.[143] This audit work definition did not allow auditors to use freely their professional judgement in any case.

Furthermore, as suggested, secrecy (or confidentiality) in business relations also influences the accounting values.[144] According to Gray,[145] managers in less secretive societies (i.e. more transparent ones) tend to disclose information whereas they tend to be more confidential in secretive environments and share business information only to those who are closely linked to the management.[146] For instance, in the Imar Bank case, as required by law, auditors checked the company's financial accounts whether they were prepared and presented in accordance to the law. Auditors however, did not critically question the accuracy of the financial accounts. Instead they completely relied on the information presented by the management who in fact designed the internal control system to ensure that the bank was run in accordance to the major shareholders' interests. The auditors' verification of the financial reports without critically questioning their accuracy may be related to lack of professionalism in the auditing society in Turkey at that time. Professionalism requires independence and expertise. However, in Turkey, auditors were involved as an organ within the companies during the time, thus not able to conduct an independent audit but worked as an employee of the management.[147] Auditors in the Imar Bank case also did not ask for more information from the management because of the likely influence of the cultural value of secrecy on auditors' work. The management's reluctance to disclose adequate financial information was not seen inappropriate by the auditors, as they perceived non-disclosure as normal.

The Imar Bank case was important in terms of illustrating a large scale of accounting fraud, audit and corporate governance failure. However, it happened more than a decade ago. Reforms, especially in the banking sector were enacted shortly after the case was revealed.[148] Moreover, since the last de-

[140] Gray identified that accounting values in a country can be related to the professionalism dimension of the society in question. Gray's accounting sub-culture values are professionalism, uniformity, conservatism, and secrecy. See **Gray**, p. 8.

[141] *ibid*, p. 9.

[142] *ibid*, p. 8.

[143] See **Uzay**, S. et al., 'Financial Auditing in Turkey: Historical Context and Expectations', 12th World Congress of Accounting Historians, July 20-24, 2008.

[144] **Gray**, p. 11.

[145] *ibid*, p. 8.

[146] It was also found that managers with a tendency to be secretive would have less incentive to choose higher quality auditors because they would not want to share information with outsider investors. See **Hope**, O. K. et al., (2008) 'Culture and Auditor Choice: a test of the secrecy hypothesis' Journal of Accounting and Public Policy, 27, pp. 358-360.

[147] See **Uzay** et al. (2008).

[148] After the Imar Bank scandal, the BRSA took measures to strengthen Banking Law No. 5411, including measures on the audit of banks, internal audit, internal control, and transparency. CMB also issued specific regulations on the subject of corporate governance, independence of auditing, and ethical codes of accounting.

cade, there has been significant development on rules and regulations on auditing also since then auditing as a profession has developed with the adoption of international auditing standards.[149] Furthermore, the influence of national cultural factors is likely to be less relevant for the adoption of company and commercial law because they are linked to "*economic interests rather than national customs or sentiments*".[150] As Turkey keeps following an international route in audit regulation – including the adoption of international standards and EU law on auditing – and promoting the interaction between its capital markets and international markets, it is suggested that the influence of national cultural values on auditing is likely to decrease.

On the Table above, at level four, the degree of functional dissimilarities is high. At this level, the costs of harmonisation should be considered. With the enactment of new laws, the number of regulations on auditing has expanded gradually in Turkey. For the following reasons compliance costs are likely to be substantial: first, Turkey is not currently a member country of the EU. Its laws and rules may differ in certain areas. Moreover, currently, there is no cooperation with the European Council in terms of law making.[151] This may create a disadvantage for Turkey compared to the EU Member State countries, both in terms of law making and in the application processes. Second, an effective system of capital markets is necessary for the successful adoption of laws in the audit practice. Yet, the Turkish capital market is less developed and the economy is relatively fragile when compared with European countries. To reduce the negative effects of functional dissimilarities in convergence, it might be necessary to issue new laws in other areas as well. However, this is likely to increase compliance costs. Thus, functional dissimilarities can be seen to be a major impediment to convergence between EU and Turkish laws on auditing.

IV. CONCLUSION

Financial markets become more integrated every day. This integration has increased the number of cross-listed firms and international (and multinational) investments between countries. On the one hand, investors rely on auditing and assurance services for their investments to achieve the most return on their investments. In addition, companies use auditing services to provide a true picture of their financial situation. On the other hand, countries try to provide a secure and attractive investment environment for investors in their capital markets. An effective audit market can contribute to the stability and efficient operations of financial markets. As a result, the importance of external auditing has grown, not only for corporate governance in companies, but also in ensuring trust and confidence in financial markets.

The global need for auditing services has led to the creation of international professional standards in auditing. Ultimately, countries, such as Turkey, that aspire to benefit from a comparability advantage and to attract foreign investment have adopted this uniformity. As this paper has submitted, this kind of approximation is a kind of convergence through 'congruence'.[152] In addition to this natural convergence, there is also convergence of form through the adoption of EU laws on auditing that can be seen as convergence through 'pressure'.[153]

This paper has submitted that a current globalised world makes it difficult, if not impossible, to categorise systems into legal families. As worldwide globalisation and market integration increases, the trend will be for a convergence of laws on auditing between EU and Turkish laws. In Turkey, the effects of globalisation (i.e. adoption of ISAs) and EU membership process (i.e. harmonisation with EU law) have had a direct impact on the laws on audi-

[149] See also section III-A above.

[150] **Cabrelli**, D. & **Siems**, M. (2015) 'Convergence, Legal Origins, and Transplants in Comparative Corporate Law: A Case-Based and Quantitative Analysis' American Journal of Comparative Law, 63, p. 124.

[151] Throughout negotiations, the Commission monitors Turkey with regards its alignment with the EU *acquis*. However, the European Council only gives explanatory information regarding the law in context.

[152] The terms 'convergence through congruence' is borrowed from Siems. See **Siems** (2008) pp. 250-296.

[153] For 'convergence through pressure', see *ibid*, pp. 314-317.

ting and will continue to do so. However, the approximation of laws in this form does not necessarily result in actual convergence, suggesting that differences may still persist.

The main conclusions of this paper are as follows: If external auditing does not play a central and critical role in concentrated ownership structures, the enactment of audit reforms in Turkey can be read as the pressure of globalisation and worldwide integration of financial markets and the political and economic pressure of the EU membership process. This means that Turkey has succeeded in reforming its company and capital markets law in compliance with the EU Directive 2014/56/EU. Also, the positive effects of globalisation are likely to prompt the application of international auditing standards in businesses in Turkey. Nevertheless, despite harmonisation attempts, there are a number of impediments to the convergence of auditing between EU and Turkish laws. It is due to the institutional and legislative differences in the audit market in Turkey. As a result, actual convergence may not be easily achieved, although there seems to be convergence in form as a result of the adoption of EU *acquis*.

This paper noted the appearance of an ineffective institutional framework in the auditing industry in Turkey as an impediment to auditing convergence in practice. In particular, it proposed that the multi-headed structure of the audit oversight mechanism in Turkey should be terminated. In order to achieve this, the independence and institutional capacity of the POAT needs to be strengthened in the field of auditing both in terms of supervision and rulemaking. In addition, the cooperation and coordination with the other regulatory bodies operate in the auditing field need further enhancement.

Actual convergence cannot be achieved by approximation of laws alone, but requires institutional transformation as well. Institutional modification would make the adoption of imported law more successful.[154] There is a strong correlation between institutional structure in a country and the successful application of imported rules. In other words, the effectiveness of law is linked to the institutional set-up of economic institutions through, for example the enforcement force of these institutions. Without sufficient institutional set-up, the approximation of law alone is less likely to bring successful implementation. Institutions must operate efficiently for the law to make sense to the society. This should be understood as institutions work to familiarise the imported rules not only to the society (for the application of laws) but also to courts and other regulators (for the enforcement of laws). Unless these conditions are met it is unlikely that the imported law serve its purpose. If the society could not establish a familiarity with the imported law, there will be no implementation or the law will be implied in contradiction to its initial purpose. This is the case in the application of private litigation practice in Turkey. Institutional modification might be necessary to familiarize the private litigation system for investors in Turkey. In order to operate the system of paying compensation in Turkey, the capacity of courts must be improved to meet the demand for private litigation. To create such demand, it is necessary that the users understand the true meaning of the law. This could be achieved through increasing the public awareness on the legal remedies available within the judicial system in Turkey.

[154] **Berkowitz** et al. (2003b) pp. 180-181.

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