

China Financial Reporting Update

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Significant Progress in Chinese Accounting

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Three important events in the development of accounting standards in the People's Republic of China occurred in January 2001. First, the Chinese Ministry of Finance (the "MOF") issued a new comprehensive Accounting System for Business Enterprises. Second, MOF issued three new long-awaited accounting standards on leases, intangible assets, and borrowing costs. Finally, MOF revised five existing accounting standards, though only the revisions to the standards on debt restructuring and non-monetary transactions are significant. All of these new and revised pronouncements became effective from 1 January 2001.

The new accounting system brings accounting practice in the PRC more closely into line with international best practice, including a requirement to recognise impairment losses on all assets. The system replaces all existing industry accounting regulations and accounting regulations applicable to joint stock limited enterprises and foreign investment enterprises. The intention is that the new system will apply to all medium and large sized enterprises, other than those in banking and insurance. However, as a transitional measure it will initially apply only to joint stock limited enterprises, as they have the resources needed to implement the new system. The MOF encourages other enterprises to early-adopt the new system with the provision that any State-owned enterprise seeking to early-adopt would be required to obtain approval from the relevant government authority. In addition, if a parent company adopts the new system, that parent should require its subsidiaries to adopt the new system at the same time.

We will discuss the implications of this accounting system in detail in a forthcoming China Financial Reporting Update. This issue of Update focuses on the new and revised standards.

Background of the Chinese Accounting Standards

In 1993, with funding from the World Bank, the MOF began a project to develop some 30 accounting standards appropriate to China's developing socialist market economy and aimed at bringing accounting and financial reporting practices in China more into line with those used internationally. Deloitte Touche Tohmatsu were engaged as consultants on the project. Exposure drafts on the 30 standards were published between 1994 and 1996. To date 13 have been issued as final standards. The others are being revised.

PRC Accounting Standards (1997-2001)

	Accounting Standard	Effective Date	Applicability
1	Disclosure of Related Party Relationships and Transactions	1 January 1997	Listed enterprises
2	Cash Flow Statements (revised 2001)*	1 January 2001	All enterprises
3	Events Occurring After the Balance Sheet Date	1 January 1998	Listed enterprises
4	Debt Restructuring (revised 2001)**	1 January 2001	All enterprises
5	Revenue	1 January 1999	Listed enterprises
6	Investments (revised 2001)*	1 January 2001	Joint Stock Limited Enterprises (prior to 1 January 2001 it was listed enterprises only)
7	Construction Contracts	1 January 1999	Listed enterprises
8	Changes in Accounting Policies and Estimates and Corrections of Accounting Errors (revised 2001)*	1 January 1999	All enterprises (prior to 1 January 2001 it was listed enterprises only)
9	Non-monetary Transactions (revised 2001)**	1 January 2001	All enterprises
10	Contingencies	1 July 2000	All enterprises
11	Intangible Assets	1 January 2001	Joint Stock Limited Enterprises
12	Borrowing Costs	1 January 2001	All enterprises
13	Leases	1 January 2001	All enterprises

* *With minor revision only.*

** *Revised significantly.*

In 2000, DTT was reappointed as consultants for the second phase of the project. The goal is to begin work on approximately 17 additional standards dealing with issues addressed by IASC since the original project as well as developing a number of industry-specific standards. The first exposure draft from the new project, interim reporting, has already been issued in June 2000.

Key Features of the New and Revised Accounting Standards

The following sets out a brief summary of the key features of the new and significantly revised Chinese accounting standards and compares them with their equivalent international standards. A more detailed analysis will be presented in forthcoming China Financial Reporting Updates.

The new standards

Intangible Assets – The new PRC standard is partly consistent with IAS 38, *Intangible Assets*. The standard sets out the following initial measurement rules for different circumstances:

Separately acquired – the intangible asset is recorded based on the actual purchase price.

Intangible asset developed by the enterprise – Costs to develop intangible assets are regarded as research and development costs, and all research and development costs must be charged to expense, which is the approach adopted by United States Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs*. In addition, all subsequent expenditure on an intangible asset should also be expensed as incurred. The only costs that are capitalised and amortised relating to a self-created intangible are registration fees and legal costs incurred to obtain a legal right to the asset, such as a patent.

Contributed by investors in exchange for shares in a first-time public offering – recorded at the carrying amount of the intangible asset on the books of the transferor. This is consistent with a Staff Accounting Bulletin issued by the United States Securities and Exchange Commission.

Other contribution by investors in exchange for capital – recorded based on the value agreed by all investors, which may or may not be the fair value.

Intangible asset donated by others with supporting evidence of original acquisition costs – recorded based on the amount shown on that supporting document.

Intangible asset donated by others without supporting evidence of original acquisition costs – (a) if an active market exists for this type of intangible asset, recorded based on the market price for the same class or a similar class of intangible assets; (b) if an active market does not exist for this type of intangible asset, recorded at the present value of expected future cash flows from that intangible asset.

If an intangible asset has no contractual or legal life, it should be amortised over a period not exceeding 10 years. This is stricter than IAS 38's requirement, which presumes a maximum of 20 years. Impairment of intangible assets must now be recognised and charged against earnings, a practice that was not allowed previously.

The new standard must be applied prospectively from 1 January 2001, except that impairment that occurred in prior years should be recognised retrospectively.

Borrowing Costs – This standard requires that borrowing costs on project-specific borrowings be capitalised as part of the cost of acquiring or constructing a tangible fixed asset. All other borrowing costs are expensed as incurred. The amount capitalised is determined by applying a capitalisation rate to the cumulative expenditures for the fixed assets during the construction period. This approach is similar to the United States Statement of Financial Accounting Standards No. 34, *Capitalisation of Interest Cost*. In contrast, IAS 23, *Borrowing Costs*, allows a choice of a capitalisation or expense policy, but if capitalisation is followed, IAS 23 (like US GAAP) requires capitalisation of interest on general borrowings as well as project-specific borrowings, and for a broader scope of assets – including inventories and intangible assets. In addition, under IAS 23, the amount of borrowing costs eligible for capitalisation on a qualifying asset is reduced by the amount of any investment income on the temporary investment of those borrowings. The new Chinese standard prohibits netting any temporary investment income against interest expense.

In the past, the PRC accounting regulations had said that interest costs incurred in connection with funds borrowed specifically for the purpose of obtaining a fixed asset should be capitalised. As a result, in practice, all interest costs incurred during the construction period for the specific borrowings were capitalised without regard to whether the amount of borrowing exceeded the amount of the actual construction expenditure. By restricting the asset capitalisation base to the amount of expenditure actually incurred, the new standard will reduce the amount of interest costs allowed to be capitalised.

This standard should be applied prospectively.

Leases – The new Chinese standard is generally consistent with IAS 17, *Leases*, though some measurement rules differ.

Under the new standard, a lease is classified as a finance lease if it transfers to the lessee substantially all of the risks and rewards incident to ownership of the underlying asset. All other leases are classified as operating leases. Finance leases should be recorded by a lessee as an asset at the lower of the carrying amount of the asset in the books of the lessor and the present value of the minimum lease payments. The lessee will recognise a liability at the gross minimum lease payments. The difference between the asset and the liability recorded should be recorded as unrecognised finance charges, which will be deducted

from the related liability. For a lessor, a finance lease should be recorded in the balance sheet as a receivable at an amount equal to the aggregate of the gross minimum lease payments and the unguaranteed residual value. The difference between the receivable recorded and the present value of that receivable should be recorded as unearned finance income, which will be deducted from the related receivable. IAS 17 is a bit different. Under IAS 17, a lessee recognises a finance lease as an asset and a liability at the lower of the fair value of the leased asset and the present value of the minimum lease payment.

If more than one instalment lease payment is delinquent for a finance lease, the lessor should cease to recognise finance income. Uncollected finance income that has previously been recognised should be reversed. In addition, the lessor should recognise impairment loss of the related receivable and charge against earnings. Only these two parts of the new standard must be adopted retrospectively.

In a sale and leaseback transaction, under the Chinese standard, any difference between the sales proceeds and the carrying amount of the leased asset should be deferred and amortised as an adjustment to depreciation, if the leaseback transaction results in a finance lease, or to rental expense, if the leaseback transaction results in an operating lease.

The revised standards

Debt Restructurings – MOF decided to revise the “debt restructuring” standard because a large number of loss-making listed enterprises appeared “profitable” solely because of restructuring gains reported as income. The MOF felt this could mislead investors. There are three major revisions in this standard. The first change extends the scope of the standard by broadening the term “debt restructuring”. The second change prohibits fair value measurement of assets or capital surrendered or received by the debtors or creditors in a debt restructuring. The third change disallows a debtor to credit any gain on debt restructuring to income, requiring instead a credit to a “capital surplus” account in equity.

Before the revision, a debt restructuring was defined as an event in which a debtor is in financial difficulty and a creditor grants a concession to the debtor in accordance with a mutual agreement or a judgment by a court. The revision removes the “financial difficulty” and “creditor concession” conditions and simply defines the term as an event in which the terms of a debt are modified by mutual agreement or court judgement. Accordingly, any change in the terms of a debt will fall within the scope of the revised standard.

Under the revised standard, a debtor must calculate the gain or loss on debt restructuring based on the carrying amount of the assets surrendered or the face value of the capital to be issued in settling a debt, instead of using the fair value as required previously. The creditor must record the assets or capital received from the debtor based on the carrying amount of the receivable to be restructured. Accordingly, the creditors will not record losses on debt restructuring but the assets received will be subject to impairment tests if the creditor is a joint stock limited enterprise. In addition, the revised standard requires any gain on debt restructuring (excess of the carrying amount of the debt over the revised total amount of cash or other assets it will pay, without discounting) to be credited by the debtor directly to equity rather than to income as in the past. Both IAS and US GAAP would report a restructuring gain (measured with discounting) in earnings. Under the Chinese standard as well as under IAS and US GAAP, a restructuring loss is recognised in the income statement.

This revised standard should be applied retrospectively. Financial statements covering periods ending on 31 December 2000 must adopt this standard.

Non-monetary Transactions – Prior to the January 2001 revisions, the standard divided non-monetary transactions into two types: exchanges of similar assets (gain or loss not recognised, except to the extent that minor amounts of monetary assets, known as “boot”, are received) and exchanges of dissimilar assets (gain or loss recognised). While IAS and US GAAP had made a similar distinction, the old

Chinese standard had classified more non-monetary transactions as exchanges of similar assets, resulting in a smaller group of exchanges that qualified for gain recognition as compared to IAS or US GAAP. The revised Chinese standard makes no distinction between exchanges of similar and dissimilar assets and prohibits all gain recognition on non-monetary transactions except to the extent that boot is received. If boot is received, the gain is calculated based on the following formula:

$$\begin{aligned} & \text{Gain to be recognised} \\ & = \text{Boot received} - [(\text{Boot received}/\text{Fair value of the asset surrendered}) \times \text{Carrying amount of the} \\ & \quad \text{asset surrendered}] \end{aligned}$$

The revised standard also simplifies the accounting for non-monetary transactions by specifying procedures for measuring the recorded amount of the non-monetary asset received, as follows:

No boot is involved:

$$\begin{aligned} & \text{Recorded amount of the asset received} \\ & = \text{Carrying amount of the asset surrendered} + \text{Related tax payment} \end{aligned}$$

Boot is paid:

$$\begin{aligned} & \text{Recorded amount of the asset received} \\ & = \text{Carrying amount of the asset surrendered} + \text{Boot paid} + \text{Related tax payment} \end{aligned}$$

Boot is received:

$$\begin{aligned} & \text{Recorded amount of the asset received} \\ & = \text{Carrying amount of the asset surrendered} - [(\text{Boot received}/\text{Fair value of asset surrendered}) \times \\ & \quad \text{Carrying amount of the asset surrendered}] + \text{Related tax payment} \end{aligned}$$

This revised standard should be applied retrospectively. Financial statements covering periods ending on 31 December 2000 must adopt this standard.

Prospects for the Near Future

In developing the new accounting system and standards, the MOF carefully considered existing international standards and practices. While the new system and standards are generally consistent with the international standards and practices, some differences remain. The most obvious difference is China's unwillingness to recognise unrealised increases in the fair values of assets, a procedure that is gaining increasing acceptance in IAS as well as in Australian, UK, and US GAAP. Chinese standards still use historical cost as the basis of measurement. However, the introduction of a broad asset impairment test is a great advancement of PRC accounting. In addition, the replacement of numerous arcane and inconsistent industry accounting regulations and accounting regulations applicable to joint stock limited enterprises and foreign investment enterprises by the new Accounting System for Business Enterprises will make the financial statements more comparable, although this new accounting system is initially applicable only to joint stock limited enterprises.

The MOF also has adopted a "need-based" philosophy of standards issuance rather than finalising all at once the various exposure drafts published earlier. The pending establishment of a secondary securities listing board – targeted toward hi-tech enterprises – was a driving force for the MOF to issue the "Intangible Assets" standard. The amendments of the "Debt Restructurings" and "Non-Monetary Transactions" standards were the result of a large number of listed enterprises entering into these kinds of transactions. Certainly, China's impending entry into the World Trade Organisation and its fast-growing stock market will put further pressure on MOF to speed up issuance of Chinese accounting

standards. We expect many of the matters in the outstanding exposure drafts to be finished within two years, as well as proposals on a good number of additional projects on subjects recently addressed by IASC. Some of these projects are likely to result in industry-specific standards that focus on sectors of the economy that are of great significance to China – agriculture, banking, insurance, mining, and oil and gas. It is clear that the People’s Republic of China is well on the way toward developing a comprehensive body of accounting standards to serve the needs of capital markets and resource providers for Chinese businesses.

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