

China Financial Reporting Update

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Chinese Accounting Standards – the Process of International Harmonization

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China's rapid economic growth in the past two decades has amazed the rest of the world. With China's accession to the WTO, business activities with and within China will further expand. Many economists and economic organizations predict that China's influence on the world's economy will continue to increase.

China fully understands that a sound financial reporting system plays a key role in the process of economic development. The Chinese Ministry of Finance (MOF), who has the responsibility for regulating accounting matters in China, has set itself the objectives of fostering investors' confidence in financial information, increase transparency of financial reporting, and harmonize with International Financial Reporting Standards (IFRS), so as to reduce the costs of raising capital by enterprises and alleviate the risks of financial crisis.

China has hitherto made significant progress in harmonizing Chinese accounting standards with IFRS. In this process, Deloitte Touche Tohmatsu has been engaged as consultants to the MOF to develop a body of Chinese Accounting Standards in line with accounting and financial reporting practice used internationally. With significant involvement in the project, the authors review in this article the progress of international harmonization to-date and the future outlook.

History of Development

In the process of transforming itself from a centrally planned economy to a market oriented economy, China has long realized the importance of a sound financial infrastructure. The old accounting systems and regulations were designed to meet the needs of a planned economy, and therefore focused on whether the production goals of state-owned enterprises and their financial and cost plans were being met. Accordingly, the objectives of accounting and performance measurement some twenty years ago were significantly different from the financial reporting objectives in a modern market oriented economy.

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Since China opened its door to foreign investments in 1979, the rapid growth of its economy, international trade and securities markets has shaped new objectives for financial reporting. State-owned enterprises now look a lot like profit-oriented businesses, and managers and other users need reliable and relevant financial information on which to base decisions about the efficient allocation of capital. At the same time, China has reached out to the international community to form joint ventures and gain greater access to the latest technologies and the world's capital markets. This growing economy increasingly demanded a framework of accounting standards to meet the needs of investors and creditors as well as management and government. As a result, significant accounting reforms were undertaken in the past two decades.

In the 1980s, the MOF issued the first set of accounting regulation, which was formulated by reference to international accounting practice, for joint ventures in China. In 1992, due to the rapid development of the Chinese securities market, the Accounting System for Experimental Joint Stock Limited Enterprises, which was subsequently replaced by the Accounting System for Joint Stock Limited Enterprises (JSLE), was promulgated by the MOF in order to standardize accounting practice and disclosures by listed companies. In the same year, the MOF promulgated the Accounting Regulations for Foreign Investment Enterprises (FIE), as well as the Basic Accounting Standard for Business Enterprises, the conceptual framework of China accounting. The issuance of these accounting pronouncements represented a milestone for China accounting, because they introduced on a broader scope new accounting concepts and essential elements of financial statements that were in many respects based on international practice. However, these pronouncements were still found to have essential differences with international practice such as the restrictions in making provision for doubtful debts and obsolete inventories and, the limited disclosure of financial information for the users to understand the results and financial position of the reporting enterprise.

The New Accounting Standards and Accounting System

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In 1993, with funding from the World Bank, the MOF engaged Deloitte Touche Tohmatsu as consultants to develop a body of Chinese Accounting Standards (CAS) broadly in line with accounting and financial reporting practice used internationally. Exposure Drafts on about 30 standards have since been published. 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. To date, 16 standards have been adopted, and a number of other standards are under active development to be issued shortly.

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China accounting has achieved remarkable progress in unifying its accounting practices since Year 2001. Apart from issuing three new CASs, the MOF issued in 2001 a new comprehensive Accounting System for Business Enterprises (the "System"). The new System replaced the Accounting System for JSLE from January 1, 2001 and Accounting Regulations for FIE from January 1, 2002. In other words, all JSLE (including all listed enterprises) and FIE are now required to follow one unified new System. The MOF plans to ultimately require all medium-size and large enterprises (other than financial enterprises) to adopt the new

System, and announced its expectation that state-owned enterprises will adopt the new System over time. When fully implemented, the new System will replace the numerous arcane and inconsistent industry accounting regulations, enabling the financial statements of different types of enterprises to become more comparable.

As well, by introducing a broad asset impairment test and by adopting updated definitions of accounting elements similar to that of IFRS, the System moves Chinese accounting practice further in the direction of international standards.

Impact of the New System on FIE

After the adoption of the new System, the differences between FIE's financial statements under PRC GAAP and those prepared in accordance with international accounting practice will reduce further, thereby enabling the foreign investors to assess the performance of their investments more efficiently.

As FIE's financial statements prepared in accordance with the Accounting Regulation for FIE could not properly reflect the enterprise's actual financial position and operating results, the enterprise had to make numerous adjustments when they compile financial statements under overseas accounting standards, such as IAS and US GAAP, as almost invariably required by the foreign investors. The process was time-consuming and imposed additional cost of investment to the foreign investors. After the adoption of the new System, the differences between FIE's financial statements under PRC GAAP and those prepared in accordance with international accounting practice will reduce further, thereby enabling the foreign investors to assess the performance of their investments more efficiently. Furthermore, since the new System has added additional disclosure requirements, the transparency of the financial information has improved.

China's strive for convergence with IFRS and challenges

The importance and acceptance of IFRS has increased significantly over the past few years. Convergence with this international benchmark is now seen as a high priority. However, given the specific circumstances and history of individual countries, differences currently exist between national standards and IFRS. For instance, our Firm's recently-published comparison of IAS and US GAAP identified over 80 differences.

The MOF clearly supports international accounting harmonisation and is working to achieve convergence of CAS with IFRS by giving due consideration to IFRS in the process of drafting each CAS. The MOF follows IFRS, while having due regard to national laws, and the practical issues associated with effective implementation by Chinese enterprises.

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While actively pursuing convergence with IFRS, the MOF necessarily has to ensure that accounting standards appropriately address the national circumstances that exist during this transitional period in the economy. Specific circumstances that currently exist include:

- A very significant portion of the economy is dominated by state-owned enterprises. Even after enterprises are restructured into joint stock enterprises and branched out from the government structure, functional or regional government that remain stakeholders still exert significant influences over the enterprises and their trading partners and their transactions. Related party transactions are pervasive. Many transfers of assets are government driven rather than motivated by pure business

objectives.

- Free markets are not sufficiently developed in many areas.
- Financial statements are multi-functional, serving not only the needs of the investors but also other interested parties including the State for supervisory and management purposes.
- Enterprises and professional intermediaries such as auditors and valuers are at a developing stage. During this transitional period, accounting standards must be realistically implementable by the preparers and auditors of financial statements.

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Circumstances where differences currently arise between CAS and IFRS include:

- Areas where IFRS allow choices but CAS do not. For instance, property, plant, and equipment may be stated at cost or at revalued amounts under IFRS whereas CAS generally require cost basis.
- Areas such as hyperinflation where the MOF has not developed a CAS because of limited application in China.
- Areas where the MOF is currently developing new standards. The MOF has an ongoing programme to issue standards that deal with areas specifically addressed by IFRS.
- In the light of China's evolving market economy and developing accounting profession and the practical circumstances of Chinese enterprises, the MOF has not adopted certain accounting conventions applied in the IFRS, notably the pervasive use of fair value.

As already noted above, the MOF's approach is to establish a set of CAS suitable to China's circumstances, while striving toward convergence with IFRS in an orderly manner.

Looking Ahead

The MOF has accelerated the development of CAS since 2001. Another six accounting standards, namely "Presentation of Financial Statements", "Segment Reporting", "Accounting for Government Grants", "Foreign Currency Translation", "Earnings Per Share", and "Discontinuing Operations" are expected to be issued shortly. We expect many of the other matters where exposure drafts have previously been issued would be finalized in the near future. The MOF will also embark on 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. At the same time the MOF is also in the process of studying the appropriateness of a comprehensive accounting system for small enterprises to further improve the comparability of financial statements of Chinese enterprises.

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Conclusion

As the consultants of CAS development projects, our Firm has been working closely with the MOF and has witnessed the great achievements made in China accounting internationalization. China has an ambitious economic plan. Transparency and reliable financial information remain crucial to the investors and other interested parties. It is clear that China is well on the way toward developing and further improving its accounting standards to serve the needs of the capital markets and users of financial information of Chinese enterprises.

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