

China Financial Reporting Update

Issue 02/2001

April 2001

New Comprehensive Accounting System Adopted in China

*By Paul Pacter, Technical Director
and Joseph Yuen, Senior Manager*

As part of its programme for improving financial reporting by business enterprises in China, in January 2001 the Ministry of Finance (MOF) of the People's Republic of China adopted a comprehensive *Accounting System for Business Enterprises* (the System). The System is based, in part, on the experience of MOF in implementing the Accounting System for Joint Stock Limited Enterprises and, in part, on the existing individual Chinese accounting standards issued in the past few years, and the disclosure rules promulgated by the China Securities and Regulatory Commission (CSRC).

MOF intends the new System eventually to apply to all large and medium sized enterprises in China, eliminating the accounting distinctions based on industries or on the form of business enterprises that have existed in the past. Initially, the new System must be followed by all joint stock limited enterprises other than those in banking, insurance, and other specialised financial industries. The new system became effective for financial reports for periods beginning on or after 1 January 2001, except that the new provisions relating to asset impairments, debt restructurings, and non-monetary transactions that occurred in prior years should be applied retrospectively. The Accounting System for Joint Stock Limited Enterprises was abolished at the same time. Enterprises other than joint stock limited enterprises are encouraged to follow the new System as well, with the proviso that State-owned enterprises require prior approval from the relevant government authority. In addition, if a parent company adopts the new System, the parent should require that its subsidiaries adopt the new System as well.

The System is much more in line with international practice than were the prior accounting regulations.

Overview

The new System is not just a group of accounting standards. It is more like a comprehensive financial reporting framework that covers concepts, definitions, standards, presentation, and record-keeping. Among many other things, the new System:

- defines certain fundamental principles that must be applied in preparing financial statements, including going concern, accounting period, substance over form (this concept has not before been spelled out in Chinese accounting standards or regulations), consistency, timeliness, understandability, accrual basis, matching, impairment recognition, prudence, materiality, and measurement currency vs. presentation currency;

- defines the basic elements of financial statements: assets, liabilities, owners' equity, revenues, expenses, and profits;
- specifies classifications within the asset, liability, and equity elements;
- specifies recognition and measurement principles for receivables, prepaid expenses, inventories, current and long-term investments, fixed assets, construction in progress, intangible assets, and other assets;
- specifies recognition and measurement principles for current liabilities, long-term liabilities, lease obligations, and government grants and loans,
- specifies principles of revenue recognition for goods, services, royalties, and interest;
- specifies expense recognition principles for bad debts, cost of good sold, depreciation, major overhauls, and impairment of assets;
- requires that expenses be classified into operating, administrative, and financing and that profit be classified between operating profit, investment income, subsidy income, and several other non-operating income categories;
- specifies accounting principles for non-monetary transactions, assets contributed by investors, income taxes, foreign currency transactions, changes in accounting policies, changes in estimates, corrections of errors, post-balance sheet events, contingencies, and related party relationships and transactions;
- defines the content of a financial and accounting report (which financial statements are presented annually, half-yearly, quarterly, and monthly), minimum notes to the financial statements, and how soon after period-end the reports should be published;
- specifies principles for consolidated financial statements and accounting for investments in associates and joint ventures;
- requires a management discussion along the lines of the Management Discussion and Analysis (MD&A) in the United States and the Operating and Financial Review (OFR) in the United Kingdom (though not as detailed); and
- even gets into basic bookkeeping requirements such as the double entry system of debts and credits, keeping records in the Chinese language, maintenance of bank ledgers, monthly bank reconciliations, and the fixed assets register, as well as basic control procedures such as annual inventory-taking and physical counting of fixed assets.

Many of the issues addressed in the new System are already addressed in individual Chinese accounting standards. The new System is consistent with those standards, though there is generally more detail in the individual standards and supporting guidance than there is in the System document.

Assets

The definition of assets in the System is the same as that in the IASC Framework. It is also the definition that was adopted last year in the Chinese accounting standard on contingencies: "An asset is a resource owned or controlled by an enterprise as a result of a past transaction or event and from which future economic benefits are expected to flow to the enterprise." Even though matching of revenues and expenses is one of the fundamental principles in the new System, the asset definition places a boundary on the matching concept by excluding from the asset category deferred costs whose sole purpose is income smoothing.

The System classifies assets into current assets, long-term investments, fixed assets, intangible assets, and other assets. It specifies recognition and measurement principles for a wide variety of assets and liabilities. Selected recognition and measurement principles for tangible and financial assets are set out in Figure 1.

Figure 1 Recognition and measurement of selected tangible and financial assets under the new System	
Short-term investments	Carry at lower of cost or market. A portfolio basis may be used except that an investment that is 10 percent or more of the short-term investment portfolio must be assessed individually.
Receivables	A bad debt provision on an accrual basis is required.
Inventories	The new System takes a U.S. GAAP approach to inventories - FIFO, weighted average, moving average, specific identification, and LIFO are all acceptable for determining cost. If a standard costing system is used, a variance must be apportioned back to inventory. Inventories must be carried at the lower of cost and net realisable value (estimated selling price in the ordinary course of business less estimated completion and disposal costs).
Long-term investments	Debt investments are carried at amortised cost, with interest recognised using either the effective interest or straight-line method, and subject to an impairment test. Equity investments are carried at cost, subject to an impairment test, except use the equity method if the investor has significant influence or joint control. The investor stops using the equity method when it intends to dispose of the investment in the near future, which is different from the International Accounting Standard. Also, under the Chinese standard, the goodwill implicit in an equity method investment (termed the “equity investment difference” in China) is the excess of cost over the carrying amounts (book values) of the investee’s assets, rather than the excess over fair values.
Self-constructed assets	Cost includes direct materials (including transportation and insurance costs), direct labour, machinery rentals, and subcontractor costs. Costs incurred during a trial run are included. Construction costs are reduced by any income from the sale of products produced during the trial run. Losses due to normal damage or waste during construction are included in construction cost, but abnormal damage or destruction are recognised as non-operating losses.
Borrowing costs	Borrowing costs on project-specific borrowings must be capitalised. All other borrowing costs are expensed as incurred. The amount capitalised is determined by applying a capitalisation rate to the weighted average cumulative expenditures for the fixed assets during the construction period
Fixed assets and depreciation	Under the System, fixed assets include property, buildings, machinery, and vehicles, as well as smaller tools and equipment use in production whose life exceeds one year, and other operating assets not used in production whose cost exceeds RMB 2,000 and whose life exceeds two years. Original cost includes not only the invoice price but also costs of transportation, installation, and taxes. Self-constructed assets are measured at the cost necessary to get them to their expected usable condition. Depreciation of all fixed assets begins when the asset is put into use. Depreciation continues if an asset is under major repair or is not being used due to seasonal factors. Assets that are not being used for other than seasonal reasons are not depreciated, though impairment may be indicated. The method of calculating depreciation should reflect the pattern of consumption of benefits and can include straight-line, accelerated, and units-of-production depreciation. General repair and maintenance costs are charged to expense when incurred. Expenditures that improve a fixed asset – that is, increase its future benefits to the enterprise – are capitalised and depreciated. The System allows periodic major inspection and overhaul costs either to be capitalised when incurred and depreciated over the inspection intervals or to be accrued during the inspection intervals, a method not allowed by IAS.

Intangible Assets. The new System reinforces the requirements of the new standard on Intangible Assets. Initial recognition and measurement principles are set out in Figure 2. If an intangible asset has no contractual or legal life, it should be amortised over a period not exceeding 10 years. If the life is fixed by contract or law, the amortisation period should not exceed the period fixed by contract or law. Impairment of intangible assets must now be recognised and charged against earnings, a practice that was not allowed previously.

Figure 2 Recognition and measurement of intangible assets	
Intangible asset is separately acquired	Asset is recorded based on the actual purchase price.
Intangible asset is 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, <i>Accounting for Research and Development Costs</i> . 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.
Pre-operating, pre-opening, and start-up costs	These are not intangible assets under Chinese GAAP. Under the new System, these costs are deferred until operations begin, at which time they are charged to expense in full. IAS 38, <i>Intangible Assets</i> , requires immediate expensing of these costs when incurred.

Assets Acquired by Means Other Than a Normal Purchase Transaction. The new System includes guidance for measuring the cost of assets acquired other than by normal purchases. This guidance (Figure 3) applies to acquisition of inventories, fixed assets, and intangibles.

Figure 3 Measuring assets acquired by means other than a normal purchase transaction		
How asset is acquired	If this is true...	...then measure asset at:
By donation	Supporting evidence of donor's original cost	Donor's original cost, adjusted for depreciation, as appropriate
	No evidence of donor's cost but active market exists for this asset	Market price, adjusted for depreciation, as appropriate
	No evidence of donor's cost and no active market exists for this asset	Present value of expected future cash flows
By administrative transfer	State-owned enterprise receives an asset as grant or transfer from a government agency	Carrying amount on the transferor's books plus transportation and installation charges
In a debt restructuring	Acquirer gave up a receivable	Recorded amount of the receivable given up less any deductible input VAT, plus any tax paid on the exchange, less any boot received, and plus any boot paid

Figure 3 (continued) Measuring assets acquired by means other than a normal purchase transaction		
How asset is acquired	If this is true...	...then measure asset at:
In a nonmonetary transaction	No boot	Carrying amount of the asset surrendered plus any related tax payment
	Boot is paid	Carrying amount of the asset surrendered plus any related tax payment plus the boot paid
	Boot is received	Carrying amount of the asset surrendered plus any related tax payment minus a “boot adjustment” which is: (boot received/fair value of asset surrendered) x carrying amount of the asset surrendered
Contributed by investors	Represents investors’ statutory capital contribution	Amount agreed by the investors, which may not necessarily be fair value on the date of acquisition
	An intangible contributed as part of an IPO	Carrying amount of the asset on the contributor’s books

Impairment of Assets. The new impairment rules will be a dramatic change from current accounting practice, particularly when the new System is applied to non-joint stock limited enterprises over the next several years. Figure 4 summarises the rules for different categories of assets. In all cases, an enterprise should reverse, wholly or partly, an impairment loss recognised in prior years only if the indicators of impairment no longer exist. The reversed amount cannot exceed the amount of impairment provision made. Material over- or under-provisioning for impairment will be regarded as a significant accounting error requiring retrospective restatement.

Figure 4 Impairment rules under the new System	
Receivables	Accrue an allowance for bad debts. Special guidance is provided for certain kinds of receivables to avoid “over-provisioning”.
Inventories	Write down to net realisable value either on an item-by-item basis or, if that is not practicable, by product line.
Current investments	Carry at lower of cost and market.
Designated loans receivable	Write down to recoverable amount if that is below carrying amount.
Fixed assets and intangible assets	Write down to recoverable amount if that is below carrying amount. Recoverable amount is the higher of net selling price (market price less disposal costs) and the present value of the estimated future cash flows expected to arise from continuing use of the asset and from disposing of it at the end of its useful life. This definition is essentially the same as the one in IAS 36, <i>Impairment of Assets</i> .
Construction in progress	Impairment must be recognised if construction is suspended and resumption of work is not expected within three years.
Long-term investments	An impairment test applies to all such investments, including debt investments, equity investments, and joint ventures in which the investor has significant influence (accounted for by the equity method), and other equity investments.

Liabilities

The definition of liabilities in the new System is the same as that in the IASC Framework and the same as the definition used in the Chinese accounting standard on contingencies: An liability is a present obligation arising from past transactions or events, the settlement of which is expected to result in an outflow of economic benefits from the enterprise. The definition does not allow either income-smoothing revenue deferrals or accruals of provisions for which no obligation currently exists (such as “prudent” provisions for possible future losses).

The System classifies liabilities into current liabilities and long-term liabilities. Guidance (Figure 5) is provided for recognising and measuring various categories of liabilities.

Figure 5 Recognition and measurement of liabilities	
General	At the actual amount incurred (without discounting).
Bonds payable	Premium or discount must be amortised by either the straight-line method or the effective interest method.
Convertible bonds	There is no “split accounting” for the equity component (conversion feature). When bonds are actually converted, the carrying amount of the bonds, including any unamortised premium or discount, is credited to share capital (legally stated amount) and capital surplus (excess).
Finance lease obligations	Measurement of a finance lease obligation follows the guidelines in the new Chinese leasing standard, which are summarised in the System. However, the System includes guidance that finance lease obligations may be measured at the undiscounted amount of minimum lease payments, rather than at present value, if that undiscounted amount is not more than 30 percent of total assets.
Project-related government loans/grants	In some cases, enterprises finance construction projects with loans from the Chinese government. If the project is completed according to specified terms, a portion of the loan becomes a grant that is not repaid. Under the System, the entire loan is recognised as a liability until the project is completed. On completion, any amount relating to physical assets that is not repayable is credited to capital surplus.

Revenue

The new System summarises the principles of revenue recognition and measurement that are set out in the existing PRC standard on revenue. Other than the measurement of revenue based on the amount stipulated on the contract or agreement, both sets of provisions are substantially the same as those in IAS 18, *Revenue*. Under the new System, operating and non-operating income must be reported separately.

The new System also sets out principles of revenue recognition for construction contracts. These are similar to the principles in the existing Chinese standard on accounting for construction contracts. Both require that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs should be recognised as revenue and expenses by the percentage of completion method. If the outcome cannot be estimated reliably, then (a) if it is probable that costs will at least be recovered, use cost recovery accounting, and (b) if it is not probable that costs will be recovered, recognise a loss immediately.

In addition, the new System specifies that revenue from instalment sales, under which revenue is recognised as instalments are received in accordance with the terms of the sale contract rather at the present value of the total consideration received as required by IAS 18, should be separately disclosed.

Operating income, in general, is revenue from the sale of goods and services in the ordinary course of business.

Non-operating income includes investment income (for a non-financial enterprise), subsidy income, and gain or loss on disposal of fixed assets and intangible assets.

The new System highlights one revenue recognition issue that is not in the revenue standard. A property developer that develops properties for sale may use the construction accounting principles (percentage of completion and so on) if there is a non-cancellable construction contract.

Costs and Expenses

The System provides guidance on allocating costs to periods and to products or services sold. Expenses must be classified, for income statement presentation purposes, into these categories: (a) operating expenses; (b) administrative expense; (c) finance expenses; and (d) non-operating expenses (these include penalties, loss on debt restructuring, and provisions for impairment losses on fixed assets, intangible assets, and assets under construction).

The income statement will show income from operations, which is operating revenue minus items (a), (b), and (c) above. Impairment losses are considered operating items under IAS and US GAAP.

Income Tax

The system allows three methods of accounting for income tax (see Figure 6). None is comparable to IAS 12 or FASB Statement 109, both of which require recognition of more deferred taxes than any of the three methods. In any event, deferred tax assets may not be recognised if realisation is not probable within three years.

Figure 6 Permitted methods of accounting for income taxes	
Tax payable method (sometimes called the “flow through” method)	Tax expense for the current period is equal to the provision for taxes paid or payable for the period. Under this method, deferred income taxes are not recognised.
Tax effect accounting—deferral method	Deferred taxes are provided when an item enters into the determination of net profit or loss in a different period than it enters into the determination of taxable income. Deferred taxes are calculated using the tax rates prevailing when such differences arise. If there are any subsequent changes in the tax rates no adjustments need to be made.
Tax effect accounting—liability method	When an item enters into the determination of net profit or loss in a different period than it enters into the determination of taxable income, deferred taxes are calculated using the tax rate that is expected to be applicable when the timing differences reverse. Where there are changes in the rates, the deferred tax provision has to be revised to reflect these changes.

Foreign Currency Translation

The RMB is always the presentation currency for Chinese companies under the new comprehensive accounting System. The RMB is also the measurement currency for transactions denominated in RMB. For transactions denominated in other currencies, that currency may be used as the measurement currency. Those foreign currency transactions must be translated into RMB using either (a) the exchange rate at the date of the transaction or (b) the exchange rate at the beginning of the period. Guidance is provided on which rate to use if there is no exchange rate quoted by the People's Bank of China.

Foreign currency balances should be translated into the RMB using the closing rate at the end of the period. Any resulting exchange differences should be charged to the income statement unless the exchange differences (a) arise during the pre-operating period (in which case they are capitalised as part of pre-operating costs until operations commence, at which time they are charged to expense) or (b) relate to specific borrowings for the construction of fixed assets (in which case they are capitalised as part of the costs of the related fixed assets).

Accounting Adjustments

The new System summarises the requirements in the existing Chinese accounting standards on changes in accounting policies and accounting estimates and corrections of accounting errors and on post-balance-sheet events. None of those requirements is changed. The System regards as significant any accounting error that represents 10 percent or more of the total transaction amounts of a similar type of transactions. In addition, the new System takes a hard line on one related issue – inappropriate use of the concept of prudence to justify “secret reserves” for possible future impairment losses. The new System clearly states that accrual of such secret reserves is disallowed and will be regarded as a significant accounting error. Correction of such an error would require retroactive restatement.

Contingencies

The new accounting System summarises the requirements in the new standard on contingencies that was issued last year.

Related Party Relationships and Transactions

The new accounting System summarises the requirements in the standard on related party relationships and transactions. The System further requires explanation about the fairness of any related party transaction in which the transaction price is higher or lower than the normal transaction price.

Financial and Accounting Report

Under the new accounting System, a financial and accounting report includes three components: accounting statements (see Figure 7), notes to accounting statements (see Figure 8), and a financial condition explanation memorandum (see Figure 9). A published financial and accounting report should also include the name of the enterprise, the nature of its operations, its address, the date the report is issued, and the names of responsible individuals including the chief accounting officer and those with legal authority to approve the report.

Figure 7 Which accounting statements are required in an accounting report?
Balance sheet
Income statement
Cash flow statement
Statement of provision for impairment of assets, which is a reconciliation from opening to closing balances, with separate disclosure of impairment provisions, reversals, and write-offs, for: <ul style="list-style-type: none"> • bad debts (distinguishing between trade debt and other debt) • current investments (distinguishing between equity investments and debt investments) • inventories (distinguishing between raw materials and finished goods) • long-term investments (distinguishing between equity investments and debt investments) • fixed assets (distinguishing between properties, buildings, machinery, and equipment) • intangible assets (distinguishing between patents and copyrights) • assets under construction • designated loans
Profits appropriation statement
Statement of changes in owners' equity
Segment reporting statement, which must include the following information for both business segments and geographical segments: <ul style="list-style-type: none"> • turnover (external and internal shown separately) • cost of sales (external and internal reported separately) • expenses • operating profit • total assets • total liabilities <p>As in IAS 14, the System requires a business segment or geographical segment to be identified as a reportable segment if its revenue, results, or assets are 10 percent or more of the total revenue, combined results, or total assets of all segments. If total external revenue attributable to reportable segments constitutes less than 75 percent of the total consolidated revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 percent threshold as described above. The number of reportable segments is limited to 10.</p>
VAT payable movement table.

Figure 8 What is required to be included in notes to financial statements?	
Explanation of any non-compliance with any accounting concepts or standards	
Details of significant accounting policies and estimates	
Explanation on changes in significant accounting policies and estimates	
Details of contingencies and post-balance sheet events	
Disclosure of related party relationship and transactions	
Details of transfers or disposals of assets	
Details of business combinations and demergers	
Details of significant items in the accounting statements	
Other disclosures that can help the reader understand the accounting statements	

Figure 9 Content of the financial condition explanation memorandum	
This is a management discussion something similar to the Management Discussion and Analysis (MD&A) in the United States and the Operating and Financial Review (OFR) in the United Kingdom. Analytical discussion is required about:	the operations of the enterprise
	results and distributions
	cash flows
	other items that can affect the financial position, operating results, and cash flows of the enterprise

Preparation Period

The new System does not specify how frequently enterprises must publish accounting reports or accounting statements, but it does provide guidelines on timeliness of published reports (Figure 10).

Figure 10 How soon after period end must a report be published under the new System?	
Monthly report	6 days
Quarterly report	15 days
Half-yearly report	60 days
Annual report	4 months

Consolidation

The new System specifies that consolidated financial statements must be prepared when the enterprise holds more than 50 percent of the total registered capital of another enterprise or in other ways has the power to control. Proportionate consolidation must be used to incorporate the results of joint ventures.

Interim Reports

The MOF is working on a separate standard on interim reporting. Meanwhile, there is some guidance (Figure 11) in the new System and in the Financial Accounting and Reporting Rules for Enterprises (FARR) adopted by the State Council in 2000.

Figure 11 Interim reporting requirements under the System and FARR		
	Half-Yearly Report	Quarterly Report
Balance sheet	✓	✓
Income statement	✓	✓
Cash flow statement	✓	No
Notes	✓	✓
Comparative data	✓	No
Financial condition explanation memorandum	✓	No

Conclusion

The new accounting System is a significant advancement of Chinese accounting. While there are a number of accounting matters that remain to be addressed, such as business combinations, consolidation procedures, discontinued operations, revaluation, earnings per share, reorganisation, liquidation, and employee benefits, the new System constitutes an important building block in the continuing development of the PRC socialist market economy to meet international expectations. The inclusion of CSRC's disclosures in the System also significantly improves the transparency of joint stock limited enterprises and is in line with actions taken by many other countries to promote greater financial disclosure. However, it will take some time for all Chinese enterprises to adopt such an advanced accounting System, as it is necessary to train a large number of accounting professionals to ensure that the System is applied effectively. In addition, the change from the former rule-oriented accounting regulations to the new System, which requires more professional judgements, will increase the work of the accounting personnel significantly. That is why, as a transition measure, the MOF encourages, but does not require, non-joint stock limited enterprises to follow the new System. However, the MOF's clear mission is to harmonise the existing various accounting regulations so that the financial statements of all enterprises become more comparable. And even when fully applicable as planned, the new System will not apply to small enterprises. A separate accounting system will have to be developed for them.

Deloitte Touche Tohmatsu is one of the world's leading professional services firms, delivering world-class assurance and advisory, tax and consulting services. More than 92,000 people in over 130 countries serve almost one-fifth of the world's largest companies as well as large national enterprises, public institutions, and successful fast-growing companies. Our internationally experienced professionals deliver seamless, consistent services wherever our clients operate. Our mission is to help our clients and our people excel.

About This Update

This update has been written in general terms and is intended for general reference only. The application of its contents to specific situations will depend on the particular circumstances involved. Accordingly, we recommend that readers seek appropriate professional advice regarding any particular problem they encounter. This update should not be relied on as a substitute for such advice. The partners and managers of Deloitte Touche Tohmatsu will be pleased to advise on any such problems.

While all reasonable care has been taken in the preparation of this update, neither Deloitte Touche Tohmatsu nor any of its offices accept responsibility for any errors it might contain, or for any loss, howsoever caused, that happens to any person by their reliance on it. For further information, please contact your audit partner or manager. Please contact Canny Ma (canma@deloitte.com.hk) for copies.