

China Financial Reporting Update

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Chinese Accounting Pressing Ahead - 3 New Standards Effective 2002

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China accounting has achieved remarkable progress in Year 2001. At the beginning of the year, the Chinese Ministry of Finance (the “MOF”) issued a new comprehensive Accounting System for Business Enterprises (the “System”) and also three new accounting standards on leases, intangible assets, and borrowing costs. MOF also revised five existing accounting standards, though only the revisions to the standards on debt restructuring and non-monetary transactions are significant. We have already discussed and reviewed these pronouncements in our China Financial Reporting Updates in early 2001 (Issue numbers 01/2001 and 02/2001).

In November 2001, the MOF issued three further new accounting standards, namely interim financial reporting, fixed assets and inventories, all becoming effective from 1 January 2002. As a result, there are 16 final standards issued to-date. As well, the MOF announced in this month that with effect from 1 January 2002 foreign investments enterprises should adopt the System (which was only initially applicable to Joint Stock Limited Enterprises), thereupon replacing the existing Accounting System for Foreign Investment Enterprises. Further, the MOF also announced that a new Accounting System for Financial Institutions will apply to listed financial institutions (i.e. banks, insurance companies, brokerages) with effect from 1 January 2002.

EXHIBIT 1 Pronouncements effective 1 January 2002

Pronouncement	Applicable to
Accounting Standards:	
Inventories	Joint Stock Limited Enterprises (“JSLE”)
Fixed Assets	JSLE
Interim Financial Reporting	Listed Enterprises
Accounting System for Business Enterprises	Foreign Investment Enterprises (JSLE adopted this System from January 2001)
New Accounting System for Financial Institutions	Listed Financial Institutions

In this month, the MOF held an international symposium discussing four proposed standards, namely foreign currency translations, business combinations, impairment of assets and the newly issued exposure draft on segment reporting. It is expected that some of these will be issued as final standard in 2002.

This issue of Update focuses on the three new standards becoming effective 1 January 2002. We will discuss the implications of the System to foreign investment enterprises in detail in a forthcoming China Financial Reporting Update.

Changes from Existing Practice and Implications for Listed Companies and other JSLE

The requirements of the new standards on Inventories and Fixed Assets are highly consistent with the System, and accordingly there will be no substantial changes from existing accounting practices by listed companies and other JSLE.

The new standard on Interim Financial Reporting will bring about more notable changes for listed companies as follows:

- The China Securities Regulatory Commission (the “CSRC”) will require all listed companies to issue quarterly reports with effect from 2002 (now mainly some special treatment companies are required to do so, others just issue half-yearly reports). This will place China as one of the few major countries that require quarterly reporting, same as the USA. The new standard provides guidance on disclosures, recognition and measurement principles in line with international practice and will help to improve quality of interim financial reporting.
- The new standard requires the same level of disclosures in quarterly reports and half-yearly reports, this will ensure all interim reports issued by the same enterprise are subject to the same disclosures and hence more comparable.
- The new standard provides guidance on how to prepare interim reports, for instance recognition and measurement principles on seasonal revenue and uneven costs. This will increase comparability of interim reports of different enterprises.

As noted above, the CSRC requires all listed companies to provide quarterly reports from 2002 onwards. In particular, note that both the 2001 annual report and the 2002 first quarter report must be issued before 30 April 2002, because of the four months and one month reporting deadlines for annual and quarterly report respectively (in the listing rules). Listed companies should make sure their accounting system and personnel are prepared to cope with these requirements. In this regard, the transitional provision of the new standard in exempting companies from providing comparative figures (unless previously announced) for the first interim reports will help.

Key Features of the New Accounting Standards

The three new standards are generally consistent with the equivalent IAS, and are not expected to give rise to major differences for most routine transactions. The following paragraphs review the key features of the new standards, including the more notable differences with IAS.

Inventories

This standard requires inventories to be measured at the lower of cost and net realisable value. The comparison of cost with net realisable value should, in principle, be carried out on an item-by-item basis but, if this is impracticable, groups of similar items may be considered together. It is unacceptable to compare the total net realisable value of all inventories with their total purchase price or production cost.

The standard specifies that the cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bring the inventories to their present location and condition. The costs of purchase of inventories comprise, in general, the purchase price, import duties and other taxes, and transport, loading and unloading, insurance and other costs directly attributable to the acquisition of inventories. However, the costs of purchase for commodities distribution enterprises [商品流通企業] (such as supermarkets, department stores) only comprise the purchase price, import duties and other taxes. The cost components applicable to inventories of this type of enterprises exclude some cost components incidental to the acquisition of the inventories which would qualify as cost of inventories under IAS 2, *Inventories*. In addition, the Chinese standard on Borrowing Costs prohibits capitalising borrowing costs as part of the cost of inventories, except for property developers who develop properties for sales. IAS 23, *Borrowing Costs*, allows a choice of a capitalisation or expense policy, but if capitalisation is followed, IAS 23 requires capitalisation of interest on general borrowings as well as project-specific borrowings, and for a broader scope of assets – including inventories.

The standard sets out the initial measurement rules for different circumstances. Initial measurement rule on normal purchases is based on the actual purchase price but discounting is not allowed. There are also specific initial measurement rules for inventories acquired other than by normal purchases such as by donation, non-monetary contribution or obtained in debt restructuring, which are similar to those described in the System. (For details, please refer to the last issue of China Financial Reporting Update issued in April 2001)

The underlying concept of this standard is consistent with the System but a more detail guidance on the application of the concept is provided. The new standard must be applied prospectively from 1 January 2002, except that impairment that occurred in prior years should be recognised retrospectively.

Fixed Assets

The new standard specifies the appropriate accounting treatment for fixed assets which it defines as tangible assets that:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes;
- are expected to be used during more than one period; and
- have a relatively high unit price

This definition is similar to IAS 16, *Property, Plant and Equipment*, with the exception that the unit value requirement is not found in IAS 16. In practice, different enterprises may have different judgement on what is a relatively high unit price, and an item may be deemed by a subsidiary as having a high unit price but may be considered in the group level as having a relatively low unit price. Accordingly, this standard, quite rightly, allows judgement by enterprises in determining what are the most appropriate monetary limits, instead of setting a universal fixed amount that requires capitalisation.

The initial measurement rules for fixed assets are also highly consistent with those described in the new System.

In certain circumstances, it is appropriate to allocate the total expenditure on an asset to its component parts and to account for each component separately. This is the case when the component assets have different useful lives or provide benefits to the enterprise in a different pattern, thus necessitating the use of different depreciation rates and methods. The acquisition of fixed assets for safety or environmental reasons, while not directly increasing the future economic benefits of any particular existing item of fixed asset, may be necessary in order for the enterprise to obtain the future economic benefits from its other assets. Such acquisitions qualify for recognition as assets, in that they enable future economic benefits to be derived from related assets in excess of what could otherwise have been derived. However,

such assets are only recognised to the extent that the resulting carrying amount of the new asset and the related assets does not exceed the total recoverable amount of the combined assets.

Subsequent to the initial measurement, a fixed asset must be carried at cost less any accumulated depreciation, subject to the requirement to write the asset down to its recoverable amount. Depreciation of all fixed assets begins when the asset is ready for its intended 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 or under major repair are not depreciated, though we believe impairment may therefore 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. However, a change in the depreciation method is regarded as a change in accounting policy rather than as a change in accounting estimate specified in IAS 16. Revaluation, an alternative method for subsequent measurement under IAS 16, is in general not permitted.

Being consistent with the System, this standard introduces detail impairment rules for fixed assets. The rules are consistent with those in IAS 36, *Impairment of Assets* – impairment occurs when the carrying amount of an asset exceeds its recoverable amount (i.e. higher of net selling price and the value in use). An enterprise should reverse, wholly or partly, an impairment loss recognised in prior years only if the indicators of impairment no longer exist.

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. However, the new standard, same as the System, allows periodic major inspection and overhaul costs either to be deferred when incurred and amortised over the inspection intervals or to be accrued during the inspection intervals, a method not allowed by IAS.

Same as the Chinese standard on Inventories, this new standard must be applied prospectively from 1 January 2002, except that impairment that occurred in prior years should be recognised retrospectively.

Interim Financial Reporting

This new Chinese standard defines the minimum content of an interim financial report, including disclosures, and identifies the accounting recognition and measurement principles that should be applied in an interim financial report. While the CSRC already has rules governing the form and content of interim reports (i.e. half-yearly and quarterly) issued by PRC listed enterprises, the new standard requires some additional disclosures, and also addresses the principles for recognition and measurement in an interim financial report.

Accounting statements

The minimum components specified for inclusion are a balance sheet, income statement, cash flow statement and also selected explanatory notes. The requirement is slightly stricter than IAS 34, *Interim Financial Reporting*, which only requires condensed accounting statements, together with selected explanatory notes. When the line items in the accounting statements are reclassified, comparative amounts should also be reclassified, unless it is impracticable to do so, to ensure comparability with the current period, and the details of, and reasons for, any reclassification should be disclosed. When it is impracticable to reclassify comparative amounts, an enterprise should disclose the reason for not reclassifying.

Under the new standard, interim accounting statements are required for the periods listed at Exhibit 2 below:

EXHIBIT 2 Periods to be presented under the new interim reporting standard

Accounting Statement	Current	Comparative
Income statement	Current interim period and year-to-date	Corresponding interim period and year-to-date of immediately preceding financial year
Balance sheet	End of current interim period	End of immediately preceding financial year
Cash flow statement	Year-to-date	Corresponding year-to-date of immediately preceding financial year

Accordingly, on the basis of the requirements of the new standard, the following table illustrates the periods required to be presented when an enterprise with a 31 December 2002 year end reports its third – quarter result on the assumption that the enterprise can not take advantages of the transitional relief as discussed in the latter section:

Accounting Statement	Current	Comparative
Income statement	3 months ended 30 September 2002 9 months ended 30 September 2002	3 months ended 30 September 2001 9 months ended 30 September 2001
Balance sheet	30 September 2002	31 December 2001
Cash flow statement	9 months ended 30 September 2002	9 months ended 30 September 2001

Disclosure

The disclosure requirements of the new standard are based on the assumption that anyone reading the interim report will have access to the annual financial statements. Therefore, not all of the supplementary notes in the annual financial statements are required for interim reporting purposes, since this could result in repetition or the reporting of relatively insignificant changes. The explanatory notes required to be included with the interim financial information are intended to provide an explanation of events and transactions that are significant to an understanding of the changes in the financial position, performance, and cash flows of the enterprise since the last annual reporting date.

The new standard requires, as a minimum, that the information listed in Exhibit 3 be disclosed in the notes to the interim accounting statements which are generally consistent with IAS 34. For comparison, Exhibit 3 also includes CSRC's disclosure requirements set out in The Standard Form and Content of Information for Disclosure by Companies with Shares Issued to the Public No. 3 - Form and Content of the Interim Report ("Rule No. 3"), a rule governing the half-yearly report, and The Presentation and Disclosure of Information by Companies with Securities Issued to the Public No. 13 - Special Requirements for the Form and Content of the Quarterly Report ("Rule No. 13"), a rule governing reports of the first and third quarters. The new standard standardises the interim reporting requirements and, accordingly, facilitates comparison between different interim periods. For listed enterprises, both the new accounting standard and the CSRC rules should be followed.

Information in Exhibit 3 is only required to be reported on a year-to-date basis (comparatives not required), except for information in respect of related party transactions, and segment revenue and segment profit (loss), for which both year-to-date and current interim period information (with comparatives) should be reported.

EXHIBIT 3 Information to be disclosed in the notes to the interim accounting statements

Disclosure	New standard	Rule No. 3	Rule No. 13
1. Information about accounting policy changes (or a statement that the same accounting policies are followed in the interim accounting statements as compared with the immediately preceding year's annual accounting statements).	✓	✓	✓
2. Information about any accounting estimate changes.	✓	✓	✓
3. Details of any significant accounting errors and the amount of correction.	✓		
4. Explanatory comments about the seasonality or cyclicity of the enterprise's operations.	✓	✓	
5. Details of any changes in a control relationship with a related party and, information about related party transactions.	✓	✓ [Note 1]	
6. Details of any changes in the scope of consolidation.	✓	✓	✓
7. Explanatory comment about accounting statement items that are unusual because of their nature or size.	✓		
8. Issuances, repurchases, and repayments of debt and equity securities.	✓	[Note 3]	
9. Details of any distribution of profits to the enterprise's owners (including profits distributed and profits declared or approved but unpaid in the interim period), including the total amount of distribution to the enterprise's owners and dividend per share.	✓	[Note 3]	
10. Segment revenue and segment profit (loss) for business and geographic segments.	✓	[Note 3]	
11. Material non-adjusting events occurring subsequent to the balance sheet date.	✓		
12. Details of any changes to contingent liabilities and contingent assets after the immediate preceding year's balance sheet date.	✓	✓ [Note 1]	[Note 3]
13. A description of any changes in the composition of the enterprise such as business combination, reorganisation, acquisition or disposal of long-term investments over which the enterprise can exercise significant influence, has joint control or has control, or operations which are discontinued.	✓	[Note 3]	[Note 3]
14. Details of non-monetary transactions		✓ [Note 1]	
15. Earnings per shares.		✓ [Note 2]	
16. Breakdown of specified items such as current investments, account receivables, other receivables, bad debt provision, prepaid expenses, inventories, long-term investments, construction in progress, finance expenses, investment income, income/expenses from non-operating activities.		✓	
17. Any other significant transactions or events such as transfer and disposal of significant assets, significant expenditure on fixed assets, significant research and development costs incurred, significant non-monetary transactions, significant debt restructurings and, significant assets impairment losses and reversal of impairment losses	✓		

Note 1: Rule No. 3 requires full disclosure of related party transactions, non-monetary transactions and contingencies in accordance with respective China Accounting Standards.

Note 2: The methodology for the calculation of earnings per shares is different from IAS 33, *Earnings Per Shares*.

Note 3: Rules No. 3 and 13 require these information to be disclosed, to a different extent, in elsewhere of the interim report. Both rules also require the disclosure of some other information outside the notes to the interim accounting statements.

The new standard requires the disclosure of revenue and result analyses by both industry and geographical segments, while IAS 34 only requires analyses by either industry or geographical segment, whichever is the primary segment. Such requirements of the new standard are also more extensive than Rule No. 3, which requires discussion in MD & A of business segments which contribute to 10% or more of operating revenue. Since the standard contains no further guidance on the basis of segmentation, we believe for interim reporting purpose an enterprise may follow the guidance notes to the System and also the exposure draft on “segment reporting”, which is consistent with IAS 14, as best practice.

If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the accounting year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that accounting year.

Recognition and Measurement

As regards measurement rules, the new standard requires that the same accounting policies should be applied for interim reporting as are applied in the enterprise’s annual financial statements, except for policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. Measurements for interim reporting purposes should be made on a year-to-date basis, so that the frequency of the enterprise’s reporting does not affect the measurement of its annual results.

The new standard acknowledges that the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports. Following are examples from IAS 34 of the use of estimates in interim periods, as set out in Exhibit 4.

EXHIBIT 4 Examples of the use of estimates for interim reporting purposes

Inventories: Full stock-taking and valuation procedures may not be required for inventories at interim dates, although it may be done at financial year end. It may be sufficient to make estimates at interim dates based on sales margins.

Classifications of current and non-current assets and liabilities: Enterprises may do a more thorough investigation for classifying assets and liabilities as current or non-current at annual reporting dates than at interim dates.

Contingencies: The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.

Intercompany reconciliations: Some intercompany balances that are reconciled on a detailed level in preparing consolidated financial statements at financial year end might be reconciled at a less detailed level in preparing consolidated financial statements at an interim date.

Specialised industries: Because of complexity, costliness and time, interim period measurements in specialised industries might be less precise than at financial year end. An example would be the calculation of insurance reserves by insurance companies.

Seasonal, cyclical or occasional revenues

Revenues that are received seasonally, cyclically or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the financial year. Thus, an enterprise engaged in retailing does not use forecasted revenue for the full year to arrive at its half-year revenue figures. Instead, it reports its actual results for the six-month period. If the retailer wishes to demonstrate the cyclicity of its revenues, it may include, as additional information, revenue for the 12 months ending on the interim reporting date and comparative information for the prior 12-month period.

Uneven costs

The rule on revenues also applies to costs. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year. For example, as periodic major inspection and overhaul costs are allowed either to be deferred when incurred and amortised over the inspection intervals or to be accrued during the inspection intervals, a method not allowed by IAS, these costs are allowed to be deferred or accrued for interim reporting purposes.

Frequency of reporting

The new standard does not mandate how frequently or how soon reports should be issued after the end of an interim period. Such matters are decided by the CSRC. According to rules issued by the CSRC, half-yearly report and quarterly report (i.e. the first and the third quarters) should be reported to the public not later than 2 months and 30 days respectively after the end of the interim period.

Transitional arrangement

The standard becomes operative as from 1 January 2002 and, accordingly, all PRC listed enterprises should report their first quarter interim financial report prepared in accordance with this standard before the end of April 2002. However, all listed enterprises should also report their December 2001 annual report before the end of April 2002. Accordingly, the management should consider whether the resources of the finance function within the enterprise are sufficient to enable the preparation of the interim report on a timely basis. Moreover, they should also consider whether the accounting system is capable of providing comprehensive information at the interim reporting date and, in particular, sufficient information to enable appropriate estimates and judgements to be made. In view of the potential practical difficulty, the new standard does not require comparatives to be presented if an enterprise prepares its first interim financial report in accordance with this Standard and comparative information has not been reported in the past. If comparative accounting statements have already been reported in the past, the listed enterprise should provide comparative information.

Conclusion

The new accounting standards, together with the extension of the scope of application of the System to all foreign investment enterprises, bring accounting practice in the PRC more closely into line with international best practice. However, such movement will not automatically lead to better accounting if standards are not properly applied and enforced. Recently, the auditor-general of the State Auditing Bureau reported that "more than two-thirds of 1,290 largest state companies covered in official audits last year falsified their accounts, involving illegal money in excess of 100 billion Yuan and the problems of misinformation and fake accounting remain extremely serious". Accordingly, effective enforcement, quality audits and proficient training (i.e. technical and ethical training) of PRC accounting professionals will be the next important steps for the internationalisation of PRC accounting practice.

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