

Strengthen Co-operation to promote International Convergence of Accounting Standards

Speech at the IASB National Standards Setters' Meeting

Madame Feng Shuping

Assistant Minister, Ministry of Finance, PRC

November 18, 2002, Hong Kong

Ladies and Gentlemen, Dear Friends,

Good morning! It is my pleasure to be here and discuss the issues concerning international convergence of accounting standards with delegates of accounting standards setting bodies from various countries. This forum offers an important opportunity for exchanging ideas among different national accounting standards setting bodies, and for improving the co-operation between these bodies and IASB to further enhance the convergence process.

With the globalization of the world economy and international capital flow, international convergence of accounting system is attracting growing attention in many countries. What are the benefits of the convergence? How should we go about it? What are the obstacles that will be encountered, and how can we overcome them? I'd like to take this opportunity to share with you some views on these questions from the perspective of China.

Financial reports are the most fundamental way in which a company communicates its operating results and financial conditions to outsiders. If an enterprise intends to invest in a foreign country or raise funds on the international capital market, it must provide a financial report that its business partners or

investors can understand. If the financial report is prepared or provided only in conformity with its national accounting standards, it may be difficult for investors to review and understand and compare with other investment opportunities they are considering. Communicating solely on the basis of national GAAP can, therefore, affect the capital raising activities of the enterprise. However, this problem can be avoided if an enterprise provides accounting information in accordance with a set of accounting standards that is accepted by most countries. After nearly 30 years of development and improvement, IAS to a great extent provides solution to this problem.

China has always referred to IAS in the process of formulating its own accounting standards. We have replaced the accounting model adopted under the planned economy by a set of standards that is more suitable for an evolving market economy, aiming at convergence with IAS. As early as 1993, with the technical assistance funds from the World Bank, China had engaged an international accounting firm as consultant on our accounting standards projects. Since then, more than 20 exposure drafts have been issued. These exposure drafts have been revised and amended, and most of them have subsequently been converted into final accounting standards. In 1999, China obtained accounting technical assistance from the World Bank to continue its program to formulate and improve the system of Chinese Accounting Standards. So far, China has issued an Accounting System for Business Enterprises, a similar System for Financial Institutions, and 16 specific accounting standards. Such specific standards include *Disclosure of Related Party Relationship and Transactions*, *Revenue*, *Investment*, *Changes in Accounting Policies and Accounting Estimates*, *Fixed Assets*, *Inventories*, *Leases*, *Contingencies*, *Non-monetary Transactions*, *Events occurring after the Balance Sheet Date*, and *Cash Flow Statements*. Through these reforms, we have made significant progress in the development of China Accounting Standards within a short period of time. In many aspects, Chinese Accounting Standards are consistent or converge with IAS. The major reforms are as follows:

- Define the objectives of accounting statements. The objective is to provide information that reflects the financial condition, operating results and cash flows of

an enterprise that are useful to investors, creditors, and other users of accounting information in making informed decisions. This accords with the goal set forth in the framework of IAS.

- Define the qualitative characteristics of accounting information. The qualitative characteristics of accounting information in China are relevance, reliability and comparability. These criteria are consistent with the qualitative characteristics set forth in the framework of IAS.

- Define the accounting elements. Accounting elements are assets, liabilities, owner's equity, revenue, expense and profit. For example, "asset" is defined as resources owned or controlled by an enterprise as a result of past events or transactions and from which future economic benefits are expected to flow to the enterprise. "Liability" is defined as the 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. "Revenue" is defined as the gross inflow of economic benefits arising in the course of daily activities of an enterprise such as sale of goods, supply of, services and transfer of asset-use rights. The above definitions of the elements accord with the definitions found in relevant IAS.

- Provide the recognition and measurement principles for assets, liabilities and revenues. For instance, an asset should be recognised when the following two basic criteria are satisfied: firstly, future economic benefit is likely to flow to the enterprise; secondly, the cost to obtain the asset can be reliably measured. Another example is revenue recognition. The major consideration is whether risks and rewards have been transferred to the purchaser, which is also consistent with the revenue recognition criteria prescribed in IAS 18.

- Establish a basis for presenting financial reports. A financial report consists of balance sheet, income statement, cash flow statement and relevant supplementary statements. A financial report prepared on this basis generally complies with the requirement of IAS I in terms of the format and content. For instance, the format and content of cash flow statement were designed with reference to IAS 7.

At present, if an enterprise issues B. shares in Mainland, China and H shares in Hong Kong, it is required to prepare a set of IAS reports. The number of adjustments required to convert the financial report prepared under Chinese Accounting Standards to an IAS report has reduced over the years. Also, Chinese laws and regulations require annual reports of listed commercial banks to be audited by both a domestic and a foreign accounting firm. Audits of such commercial banks show that the major reconciling items for these banks are related to accounting for derivative financial instruments and dividends proposed after the balance sheet date. As a result of the accounting reform over the recent years, China has made significant progress in harmonizing with international accounting standards.

It should be noted that there may be some inconsistencies in relation to the accounting policy of certain economic activities between CAS and IAS. For instance, the accounting policies of certain economic activities prescribed under CAS are designed to focus on truthfulness and prudence. The reason for such disparity is largely due to the fact that the current environment of market economy is not mature enough in China.

- In terms of market development, China is still in the process of economic transition. Different enterprises may have the same parent company. Related party transactions are common. These related party transactions may not be fairly priced. Secondly, the history of the capital market in China is short and the market itself is relatively small. Companies listed on the capital market have a distinctive capital structure comprising state-owned shares, legal-person shares and public shares. A large portion of capital is made up of state-owned shares and legal person shares. These shares, unlike public shares, cannot be traded publicly. Apart from the capital market, other commodities markets also continue to improve and develop. China has adopted a prudent approach in the consideration of using fair value as a basis for measurement due to the current market situation. For example, in 1999, we have referred to IAS 16 in the formulation of Accounting Standard for Non-monetary Transactions. This standard prescribes the respective accounting treatment of non-monetary transactions involving exchange of similar and dissimilar assets. However,

it is difficult to determine a fair value for non-monetary assets. These transactions are related party transactions in most cases. A few listed companies took this opportunity to polish their financial statements. The same problem also applies to other requirements, including the accounting treatment of debt restructuring.

- In terms of the provider of financial information, a few enterprises still have not established a proper management structure despite strong encouragement from the Chinese government. Even in enterprises with an established management structure, there still exist situations where the system is not effectively implemented. Unfortunately, lack of effective corporate governance will adversely affect the implementation of accounting standards.

- In terms of the users of financial information, the government is an important investor in China. Secondly, China does not have the range of experienced institutional investors as compared to countries with a developed market economy. We expect the institutional investors profession to grow in China over the next several years. Thirdly, China now suffers from a shortage of experienced financial analysts, and there is an urgent need to foster and develop such talents. Different users of financial information have different experience. They have different sensitivity to the market signals and different requirements for accounting information. This affects both the formulation of and the effective implementation of accounting standards.

- In terms of supervision of the quality of accounting information, we focus on regulating the past performance of an enterprise. In evaluating an enterprise, we focus on indicators of profitability. For example, an enterprise must have made profits for three consecutive years to be eligible for IPO. For a listed company to apply for additional floating, it must have a weighted average return on net assets of 10% or higher for the preceding 3 accounting years and the weighted average return on net assets for the latest accounting year should be no lower than 10%. If an enterprise has incurred losses for 3 consecutive years, its stock trading will be suspended. If the enterprise is unable to generate profit in the 1st half year subsequent to the suspension, the stock exchange would decide to delist the

enterprise immediately. If the enterprise becomes profitable, it could apply to resume the trading of its securities. Since profitability is critical in the evaluation of a listed enterprise, users and providers of financial information focus on indicators of profitability. Some enterprises with poor performance in an accounting year may use different techniques to manipulate profit illegally. Because of the importance of measures of profit for market regulation, the formulation of accounting standards in China focuses more on the income statement instead of balance sheet.

The above are the major obstacles faced by China in the process of convergence with IAS. I believe that these obstacles are not restricted to China. Other developing countries, especially those economies in transition, may face the same problems. Some of them may have appeared in developed countries at certain stage. Since IAS is formulated primarily in the context of developed market economies, it would be difficult to smoothly bring our standards in line with international financial reporting standards if these obstacles are not completely eliminated. 'To facilitate the convergence of accounting standards in developing countries and economies in transition with IAS, I hope IASB can fully take account of these countries' situations while formulating and revising IAS. For China, which is still in transition, the right approach would be to take account of its realities and draw on IAS as much as possible.

Moving into the 21st century, China will have even more significant developments in its market economy and market opening. China's accession to the WTO in 2001 represents the beginning of a new era of the opening of Chinese economy. China will increase its scope and extent of international cooperation. On the foundation of its reform to date, China will expedite its process of accounting reform, more actively participate in international projects,, and seek to make increased contributions to the international convergence of accounting standards.

We will continue to support and participate in the IAS projects. We will reflect special accounting issues in China and provide suggested solutions to IASB on a timely basis, so as to provide beneficial references for other developing countries. At the same time, we will hasten the progress of the accounting standards projects in order to accommodate the development of the market economy. We aim at

establishing a sound and comprehensive system of accounting standards in China in 3 years' time. During this process, we will continue to make reference to IAS. Unless there are clearly contradict with the existing law and regulations in China, or do not suit China's situations, we'll keep in line with the International financial reporting standards to the extent possible.

Our next step is to issue the following accounting standards: segment reporting, presentation of financial reports, translation of foreign currencies, earnings per share, government grants and assistance, discontinuing operations, business combinations, consolidated financial statements, agriculture, and oil and gas.

International convergence of accounting standards is inevitable as a result of globalization of the world economy and international capital markets. IAS is an important achievement of the convergence process. In order to promote this process, and to achieve convergence, the goal of IASB, I'd like to make a few recommendations:

First, IAS should consider the distinctive features of developing countries, especially where the market economies are evolving. So, these countries can easily refer to or adopt IAS.

Second, IAS should allow alternative treatments in special cases. For example, IAS should provide for another measurement basis, such as historical cost, when fair value is unable to be determined reliably. To prevent improper use of alternative treatments, the standard may require an enterprise to include a detailed disclosure in the notes to the financial statements.

Third, based on the current presentation of IAS, I suggest that IASB expand the explanatory notes, implementation guidance and background information of each standard. It will reduce the difficulties faced by standard setters and business enterprises while adopting IAS.

Fourth, I recommend that IASB publish IAS training materials to facilitate the education of the accounting profession and to improve their understanding and implementation of the standards.

And, finally, I would strongly encourage the IASB to strengthen its communications with different national accounting standards setting bodies. It should not restrict itself to the 7 existing major countries. By keeping other standard setting bodies informed about the latest developments of IAS, those organizations can provide specific problems and suggest solutions directly to IASB promptly, thereby preventing implementation problems from arising after an IAS is issued. Furthermore, it provides convenient forum by which the participating countries can understand the issues in other countries and the international convergence process.

Ladies and Gentlemen, China will always support the IASB. China is willing to work with IASB and other national accounting standards setting bodies and to promote the international convergence of accounting standards.