

An 'Accounting Revolution' is Brewing in China

By Paul Pacter

It's hard to think of many national political leaders who have had profound effects on their country's accounting. Perhaps that could be said of Franklin Delano Roosevelt, who, in the early 1930s, spearheaded the creation of the U.S. Securities and Exchange Commission (SEC), which, in turn, caused the American Institute of Certified Public Accountants (AICPA) to form an accounting standards committee. That committee has evolved into the Financial Accounting Standards Board (FASB).

The same could also be said of Deng Xiaoping, who, as head of China's Communist Party, led the Chinese government from 1978 until 1989. Deng undertook major economic reforms that opened the country to international

dominate the economy, now look a lot like profit-oriented businesses, with outside shareholders, managers and others demanding relevant and reliable financial information with which to make capital allocation decisions.

China's Capital Markets Today

China's economy is big — to match its size. It has 1.3 billion people (20 percent of the world's population), a land area of 9.3 million square kilometers (virtually identical to the U.S.) and a gross domestic product of US\$2.6 trillion (fourth in the world behind the U.S., Japan and Germany). GDP growth in 2006 was 11 percent, and is expected to be slightly higher in 2007.

China's capital markets include two securities exchanges — one in Shanghai and one in Shenzhen. In 1992, there were 50 listed companies. Today there are nearly 1,500, with a market cap of around US\$3 trillion (larger than Deutsche Börse and just a little smaller than Nasdaq, Euronext and Tokyo).

For most of those companies, only a minority of shares actually trade publicly. The majority is still held by the state. Levels of institutional investment are low relative to Western securities markets. Only a small minority of the listed companies are audited by international auditing firms.

Financial Reporting in China

By law, all companies must prepare financial statements using Chinese generally accepted accounting principles (GAAP). The principal sources of Chinese GAAP are:

The Accounting Law — adopted by the National People's Congress.

Chinese Accounting Standards and Systems — developed by the Ministry of

Finance (MOF) pursuant to authority granted by the Accounting Law. The same law gives MOF authority to set auditing standards. MOF standards have the force of law.

Additional requirements for listed companies — imposed by the China Securities Regulatory Commission (Chinese equivalent of the U.S. SEC).

From 1997 to 2001, the MOF issued 30 Exposure Drafts and 16 final Chinese Accounting Standards (CAS), plus supporting guidance. No new standards were issued after 2001. However, starting in 2001, MOF began publishing several comprehensive "accounting systems" that specified accounting and reporting requirements for classes of entities, including large business enterprises, financial Institutions, small business enterprises and others.

In February 2006, MOF issued an entirely new set of CAS, comprising a Basic Standard (a conceptual framework) and 38 specific CAS (see sidebar on page 15). The new CAS became effective for listed companies on Jan. 1, 2007, replacing the earlier standards. All other Chinese enterprises are encouraged to adopt them in 2007.

The new CAS will become mandatory for all state-owned enterprises controlled by the Chinese central government starting in 2008, and phased in for all large and medium-sized unlisted enterprises starting in 2009.

A completely new set of CAS is required for listed companies in 2007 and is being phased in for others starting in 2008. These new standards cover most of the topics of International Financial Reporting Standards (IFRS). The requirements are much closer to

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trade and foreign direct investment, privatized agricultural activity and created such market institutions as a banking system and stock exchanges.

Before the reforms began in 1979, accounting in China reported on whether production goals and cost plans were being met. Today, accounting systems focus on providing information to investors and creditors. Even state-owned enterprises, which continue to

IFRS than previous CAS, but there are still some differences.

Big improvements for the investor include an investor/creditor focus, more relevance (including more recognition of current values), international comparability, fewer off-balance-sheet items, more disclosures and consolidated financial statements. The main uncertainties are implementation and enforcement.

The new standards cover nearly all topics in the current IFRS. With a few exceptions, the standards are substantially in line with IFRS. This means much more measurement at fair value than in the old CAS, and much more of an investor-creditor reporting focus — that is, a focus on providing information for capital markets.

What Did the New CAS Change?

Some examples:

- *Share-based payments*: Fair value is an expense. Previously: not recognized.
- *Business combinations*: Purchase method. Previously: no standard; where purchase accounting was used, the acquired assets and liabilities were often measured at the acquiree's book values, not at fair values.
- *Goodwill and indefinite life intangible assets*: Test at least annually for impairment, no amortization. Previously: amortized over 10 years.
- *Negative goodwill*: Credit to profit immediately. Previously: amortized over 10 years if it arose before 2003; 2003 and later credit to capital surplus.
- *Minority interests*: Presented within equity. Previously: "mezzanine."
- *Development costs*: Capitalized if certain criteria are met. Previously: expensed.
- *Borrowing costs incurred for general borrowings*: Must be capitalized. Previously: only project-specific borrowings.
- *LIFO*: Prohibited. Previously: permitted.
- Investments in subs in the parent's separate financial statements: Carried at cost. Previously: equity method.
- *Equity method for associates and joint ventures*: Requires the same accounting policies as the investor. Previously: not required.
- *Amortization of intangibles*: Match with benefits. Previously: straight line.
- *Functional currency approach to*

translation: Previously: RMB always was the measurement currency.

- *Investment property*: May be at fair value through profit or loss. Previously: only cost-depreciation model.

- *Non-monetary asset exchanges*: Measure at fair value. Previously: at carrying amount

- *Gains on debt restructuring*: Recognized in profit or loss. Previously: credit equity.

- *Finance-lease assets*: Measure at lower of fair value and the present value of minimum lease payments. Previously: at lower of the lessor's carrying amount and present value of minimum payments, and no discounting at all if leased assets were less than 30 percent of lessee's total assets.

- *Income taxes*: Temporary difference approach for all deferred taxes. Previously: no standard, and most companies did not recognize any deferred taxes.

- *Convertible bonds and other compound instruments*: Account for liability and equity components separately. Previously: 100 percent liability.

- *Employee benefits, including pensions*: Accrue as the employee works. Previously: only cash and short-term benefits were accrued.

- *Revenue*: Measure at present value if payment is deferred. Previously: no discounting.

- *Government grants*: Accrual basis. Previously: cash basis.

- *Financial instruments*: Essentially full IAS 39 is adopted. Previously: only debt and equity investments were covered, with short-term investments at lower of cost and market and others at amortized cost.

- *Derivatives*: All on balance sheet, with changes in fair value recognized in profit or loss unless hedging

China's New Accounting Standards, Effective 2007

Basic Standard

- 1 Inventories
- 2 Long-term Equity Investments
- 3 Investment Property
- 4 Fixed Assets
- 5 Biological Assets
- 6 Intangible Assets
- 7 Exchange of Non-Monetary Assets
- 8 Impairment of Assets
- 9 Employee Benefits
- 10 Enterprise Annuity Fund
- 11 Share-based Payment
- 12 Debt Restructuring
- 13 Contingencies
- 14 Revenue
- 15 Construction Contracts
- 16 Government Grants
- 17 Borrowing Costs
- 18 Income Taxes
- 19 Foreign Currency Translation
- 20 Business Combinations
- 21 Leases
- 22 Recognition and Measurement of Financial Instruments
- 23 Transfer of Financial Assets
- 24 Hedging
- 25 Direct Insurance Contracts
- 26 Reinsurance Contracts
- 27 Extraction of Petroleum and Natural Gas
- 28 Accounting Policies, Changes in Accounting Estimates and Correction of Errors
- 29 Events after the Balance Sheet Date
- 30 Presentation of Financial Statements
- 31 Cash Flow Statements
- 32 Interim Financial Reporting
- 33 Consolidated Financial Statements
- 34 Earnings per Share
- 35 Segment Reporting
- 36 Related Party Disclosures
- 37 Presentation of Financial Instruments
- 38 First-time Adoption of Chinese Accounting Standards

instruments. Previously not addressed.

- *Hedge accounting*: As under IAS 39. Previously: no requirements.

- *Derecognition of financial assets*: Use the IAS 39 "continuing involvement" approach. Previously: some rules for securitizations only.

- *Consolidated financial statements*: Required. Previously: optional except in a few limited circumstances.

Remaining CAS Differences with IFRS

Here are some examples:

- *Revaluation model for PP&E and intangibles*: CAS do not permit. IAS 16 and IAS 38 allow revaluation.
- *Land use rights*: Classify either as intangible assets or as investment property without requiring use of the fair value through P&L model, which IAS 40 requires.
- *Reversal of impairment losses*: CAS prohibit all reversals. IAS 36 prohibits reversal only for goodwill.
- *Related parties*: State-controlled entities are regarded as related in far fewer circumstances than IAS 24. However, the International Accounting Standards Board (IASB) has proposed to amend IAS 24 in this regard.
- *Defined-benefit pensions*: CAS do not address beyond an accrual principle, whereas they are covered in detail by IAS 19.
- *Agricultural assets*: Under CAS, default is the cost model, with fair value only if there is clear evidence of measurement reliability. Under IAS 41, the default is the fair value model, with reliability presumed.
- *Combinations of entities under common control*: CAS require use of previous carrying amounts (i.e., pooling). IFRS 3 excludes this entirely.
- *Presenting operating cash flows in cash flow statement*: CAS require the direct method, whereas IAS 7 also allows the indirect method.

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ACCOUNTING EXEC: 'IMPROVE CHINESE ACCOUNTING RANKS'

By Stephen Chipman

Since Henry Paulson became U.S. Treasury Secretary last year, he has taken an admirably constructive approach to the economic relationship between the U.S. and China. In a speech earlier this year, Paulson eloquently made the case for China to accelerate the reform of its capital and

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financial markets.

But Paulson overlooked a fundamental issue that, if not addressed, threatens to undermine every recommendation in his presentation. Although he pointed out the importance of "sound accounting standards" and "independent financial information" as significant attributes of successful financial and capital markets, he made mention of these matters only in passing, as opposed to setting them as the cornerstone of his formal recommendations.

Without appropriate accounting and auditing standards, and the ability of corporations to consistently apply them, and without an independent auditing profession to examine their application, further reform of China's financial and capital markets may stall or indeed never get started.

Chinese government officials must be credited with having worked diligently on the development of new accounting standards. According to the Chairman of the International Accounting Standards Board (IASB) Sir David Tweedie, the issuance in January 2007 of China's new "Accounting Standards for Business Enterprises" achieved "substantial convergence" with International Financial Reporting Standards (IFRS).

The point goes beyond the appropriateness of the accounting standards. What use are progressive standards without sufficient qualified and experienced accountants to apply them and trained auditors to examine their application?

From 1949 until the late 1990s, China's accounting profession was effectively disbanded. Chinese accounting firms in the 1990s had professional staffs who were either in their 70s or in their early 20s. The shortage of qualified accountants in China is acute and has been estimated at 300,000, a figure almost certain to be conservative.

Credit must be given to the Chinese Institute of CPAs in striving to develop and implement training and to encourage the recruitment of talented students into the profession. The talent and resource gap, however, is enormous and threatens to undermine many of the strides that China has made in the development of its capital markets.

For China to implement many of Paulson's recommendations, it must rapidly accelerate the development of its accounting profession. Paulson would be well advised to encourage the decision-makers in Beijing to direct additional focus and resources to this fundamental challenge and to accelerate their reform of certain restrictive regulations surrounding development of the practice.

Specifically, Paulson should have an agenda item on the next U.S.-China Strategic Economic Summit that is focused on the accounting profession in China. Within this agenda item, attention should be given to how the U.S. profession could help and how the Chinese profession should be more receptive to help in the following areas:

- Convergence of auditing standards and their application;
- Acceleration in the development and training of accounting talent;
- Development of a code of ethics for the Chinese profession;
- Development of a Practice Review System and Quality Assurance Review process for Chinese CPA firms;
- Assistance for the development of practice management and internal governance matters within Chinese CPA firms; and
- Development of clear and enforceable independence guidelines and policies.

As one who believes the accounting profession serves as the cornerstone of the financial and capital markets — by virtue of confidence provided to investors — I encourage Paulson to dedicate time and resources to this key issue at future U.S./China sessions.

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