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## 2004 Year-End Review


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2004 was a year of continued progress in accounting and financial reporting in China. The Ministry of Finance (the "MOF"), the China Securities Regulatory Commission (the "CSRC") and the Chinese Institute of Certified Public Accountants (the "CICPA") have continued to issue and publish new accounting and auditing regulations to improve the accounting and financial reporting environment in China as well as to improve corporate governance requirements of listed companies.

## MOF

During 2004, the MOF issued a set of Questions and Answers (the "Q & A 4") on the Accounting System for Business Enterprises (the "ASBE"). The MOF also issued, a number of accounting systems and accounting guidelines that are required to be followed by enterprises engaged in specific industries. The content of some of the major pronouncements are summarised in the following sections.

### Q & A 4 on the ASBE

The Q & A 4 was issued in May 2004 and includes a series of authoritative questions and answers covering implementation issues of the ASBE. This Q & A is applicable to all enterprises that adopt the ASBE. Financial institutions that adopt the Accounting System for Financial Institutions should also follow the requirements set out in this Q & A if the related transactions are covered in the Q & A 4. The key issues are:

**Share issue costs**: Share issue costs arising from the issue of new shares should be deducted from share premium. If the share premium is not sufficient to cover all share issue costs, the excess amount should be expensed immediately. The old rule required such an excess to be deferred and amortised as a long-term deferred expense. The new requirement should be accounted for prospectively. Existing deferred share issue costs should continue to be amortised.

**Equity investment difference (i.e. goodwill / negative goodwill)**: Specifies the accounting treatment of equity investment differences (i.e. being difference between the cost of acquisition and the investor's share of the shareholders' funds of the investee) arising in step acquisitions of subsidiaries, associates or jointly controlled entities. Under certain conditions, a debit equity investment difference and a credit equity investment difference arising from the increase in the same long-term investment can be offset. This requirement should be applied to increases in long-term investments made subsequent to the issuance of this Q & A.

**Impairment losses on equity investment differences**:

1. For a credit equity investment difference balance that was credited directly to capital reserves (i.e. accounting treatment for negative goodwill arising after 17 March 2003), an impairment loss should first be charged against that amount of capital reserves and, the excess should then be expensed in net profit and loss. A reversal of impairment losses should first reverse any impairment recognised in net profit and loss and then be recognised in capital reserves.

2. For an equity investment that includes an amount of unamortised goodwill arising on acquisition, an impairment loss should be charged directly to the income statement. However, for an equity investment with unamortised credit equity investment difference (i.e. accounting treatment for negative goodwill arising before 17 March 2003), an impairment loss should first be charged against the credit balance, and the excess should then be expensed in net profit and loss. Q & A 4 does not specifically address the accounting treatment where there is a subsequent reversal of impairment losses in an equity method investment.

**Reversal of impairment losses on fixed assets and intangibles**: Specifies the accounting treatment of reversals of impairment losses in respect of fixed assets and intangible assets.

<u>Fixed assets</u>:

1. Reversal of accumulated depreciation: The difference between (i) the amount of accumulated depreciation determined without considering the impact of the impairment and (ii) the amount of accumulated depreciation determined after considering the impact of the impairment should be recorded by debiting "Allowance for impairment losses in respect of fixed assets" and crediting "Accumulated depreciation";

2. Reversal of impairment losses: The difference between (i) the lower of the recoverable amount of the fixed asset and the carrying amount of the fixed asset determined without considering the impact of impairment losses and (ii) the carrying amount of the fixed asset before the reversal of impairment losses should be recorded by debiting "Allowance for impairment losses in respect of fixed assets" and crediting "Non-operating expenses".

<u>Intangibles</u>:

There is no requirement to set up a separate account, "accumulated amortisation," to account for amortisation of intangible assets. The reversal of impairment losses of an intangible asset should be accounted for in the following way:

The difference between (i) the lower of the recoverable amount and the carrying amount of the intangible asset without considering the impact of impairment losses and (ii) the carrying amount of the intangible asset before the reversal of impairment losses should be recorded by debiting "Provision for impairment losses in respect of intangible assets" and crediting "Non-operating expenses".

**Change in the depreciation method of fixed assets**: It should be accounted for as a change in accounting estimate. The old requirement was to treat it as a change in accounting policy. The new requirement (change of estimate) should be applied prospectively.

**Discounted bills with recourse**: Because the risks and rewards associated with the bills have not been transferred due to the recourse feature, the carrying amount of the bills receivable should not be derecognised; instead, a collateralised borrowing should be recognised. This accounting treatment should be applied retrospectively. Under the old treatment, such bills receivable were derecognised and the amounts were disclosed as contingent liabilities.

**Property developers that develop properties for rental purposes**: The properties developed for rental purposes should be accounted for as “other long-term assets”. In addition, the cost of these properties and the key terms of the lease agreements should be disclosed. Under the old requirement, these properties were presented as “inventories”.

## Accounting System for Financial Enterprises

The scope of the MOF’s Accounting System for Financial Enterprises, which was adopted in 2002 for listed financial institutions and unlisted foreign invested financial institutions, was extended to unlisted non-foreign invested brokerages from 1 January 2004.

## Accounting System for Small Enterprises

This Accounting System was issued in April 2004 and is effective from 1 January 2005 onwards. Qualified small enterprises are allowed to choose to adopt the Accounting System for Small Enterprises (ASSE) or the ASBE. If a parent adopts the ASBE, its subsidiaries must also adopt the ASBE even if they qualify as a small enterprise. If a small enterprise adopts the ASSE but its size subsequently changes so that it no longer qualifies as a small enterprise for three years that enterprise should change to adopt the ASBE. In October 2004, the MOF issued a pronouncement that provides the transitional arrangements for a small enterprise that chooses to adopt the ASSE.

A small enterprise is one:

- that does not raise funds from the public (that is, has not issued any shares or debt securities to the public);
- whose operations are relatively small as defined in a document jointly issued by four government bodies covering number of employees, sales volume, and total assets;
- that is not a sole proprietorship or a partnership; and
- that is not a financial institution.

Following are examples of the size test for a small enterprise:

| **Type of enterprises** | **Number of Employees** | **Turnover (in RMB)** | **Total Assets (in RMB)** |
|---|---|---|---|
| Industrial | < 300 | < 30,000,000 | < 40,000,000 |
| Construction | < 600 | < 30,000,000 | < 40,000,000 |
| Retail | < 100 | < 10,000,000 | Not applicable |

The ASSE provides a number of simplifications or exemptions from the requirements of the ASBE. The major differences from the ASBE are:

- Simplified disclosure requirements. A small enterprise does not need to comply with all the disclosure requirements of the ASBE or other accounting standards.
- Only an income statement and a balance sheet are required. If a cash flow statement is presented, only direct method is required to report cash flows from operating activities.
- Only three types of current assets (short-term investments, inventory and accounts receivable) need to be assessed for impairment losses. There is no requirement to conduct impairment tests on other assets.
- Long-term equity investments over which a small enterprise does not have control, joint control or significant influence should be accounted for using the cost method. Any dividend received (both pre-acquisition and post-acquisition) should be recognised as investment income.
- Long-term equity investments over which a small enterprise has control, joint control or significance influence should be accounted for using a simplified equity method.

- A fixed asset held under a finance lease should be recorded at the total amount of rental payments specified in the lease agreement and other direct costs.
- All specific borrowing costs incurred before the related fixed asset reaches the condition of its intended use can be capitalised as the cost of that fixed asset. Interest income earned on investing any funds from the specific borrowings should reduce the cost of the related fixed asset.
- Always use the tax payable method to account for income taxes (deferred tax assets and liabilities are not recognised).

## Accounting System for Private Not-for-profit Organisations

This accounting system should be applied by qualifying private not-for-profit organisations from 1 January 2005 onwards. The accounting system provides guidance on transactions that are specific to not-for-profit organisations, for example, donation income.

Not-for-profit organisations include different kinds of private not-for-profit organisations, for example, community societies and other private unincorporated organisations. A qualifying private not-for-profit organisation is one that meets all of the following criteria:

1. Its operating purposes are other than to earn profit;
2. Its resource providers do not have the ownership of the not-for-profit organisation. The operating result is not distributed to the resource providers; and
3. In the event of liquidation, the residual interests are used for other community charitable purposes.

## Accounting System for Co-operative Economic Organisations of Villages

The MOF issued an accounting system for the co-operative economic organisations set up by the local villagers. This System supersedes the Provisional Accounting System for Co-operative Economic Organisations of Villages issued in 1996 and is effective from 1 January 2005 onwards. It prescribes the fundamental accounting principles and the chart of accounts that such co-operative organisations should follow in preparing their accounting records.

## Accounting Guideline for Agricultural Enterprises

This Accounting Guideline prescribes the accounting treatment of biological assets and agricultural produce and should be adopted by agricultural enterprises in the PRC. It is effective on 1 January 2005. The Accounting Guideline requires the cost model to be used for the measurement of biological assets. A mature biological asset should be amortised over its estimated useful life, after considering the residual value. Agricultural produce should be carried at the lower of cost and net realisable value.

## Accounting Guideline for Enterprises Engaged in Publishing Business

This Guideline is applicable to those publishing enterprises (enterprises engaged in publishing books, newspapers, periodicals, printing, and audio and video products) that have adopted the Accounting System for Business Enterprises, starting from 1 January 2004.

The Guideline specifies the following general principles for recognising revenue and related costs for sales of goods:

- risks and rewards have passed to the buyer;
- no continuing managerial involvement and no control retained over the goods sold;
- the relevant economic benefits will flow to the enterprise; and
- revenue and cost can be measured reliably.

Those principles are the same as those set out in the MOF's standard on revenue.

In addition to the general principle, the guideline also sets out specific principles relating to credit sales, instalment sales, cash sales, sales where cash will be received by another party, consignment sales and sales when right of return exists.

## Accounting Guideline for Railway Transportation Enterprises

In July 2004, the MOF issued a new accounting guideline for Railway Transportation Enterprises. This new Guideline replaced the Accounting System for Transportation (Railway) Enterprises issued in 1993. It is effective from 1 January 2004 onwards and it applies to all railway transportation enterprises that adopt the ASBE.

## Accounting Guideline for Investment Enterprises

This Guideline, issued in October 2005, is effective from 1 January 2005 onwards and applies to all investment enterprises that adopt the ASBE. This Guideline introduces new accounts that are specific to investment enterprises, for example, designated borrowings, government designated investments, interest expenses and interest income, etc.

## Accounting Guideline for Insurance Brokers

The Guideline requires all insurance brokers that adopt the ASBE to follow the requirements of this Guideline from 1 January 2004 onwards. Insurance brokers refer to the registered professional insurance agencies in the PRC. The Guideline sets out the accounting treatment and the accounts that are specific to insurance brokers.

## Accounting Guideline for Enterprises of the Film Industry

The MOF issued this Accounting Guideline in December 2004. The Guideline applies to enterprises that adopt the ASBE and carry out film related activities, including the production, processing, import, export, distribution and the showing of commercial movies. This Guideline sets out the accounting treatment of items of income and expenditure whose nature is specific to the film industry. According to the Guideline, film rights owned or controlled by an enterprise (including copyrights and film use rights, etc.) should be classified as current assets and amortised over the effective period stipulated by law or contract. The Guideline also recommends TV production enterprises to establish their accounting policies by reference to the requirement of this Guideline.

## Accounting Guideline for Enterprises in the Shipping and Port Industry

This Guideline was issued in December 2004 and it applies to enterprises engaged in the following operations that adopt the ASBE:

- Shipping companies: transportation of passengers and goods by sea or river, and
- Port operators: Provision of port and terminal services

The Guideline was effective from 1 January 2005 onwards. It provides detailed guidance on the accounting treatment for different kinds of income (for example, freight charges for passengers and goods, container fees, storage fees and other port service fees) and expenses (for example, allocation of fixed costs of vessels, container fees, crew salaries, and tax expenses) incurred by shipping companies and port operators. It requires:

- The depreciation charge should be determined separately for each significant part of an item of property, plant and equipment, with specific requirements for depreciation of vessels.
- The percentage of completion method should normally be used for sea journeys covering more than one accounting period. (If the number of sea journeys and related income are consistent between different years, the completion method may be used.)

### Accounting Guideline for Trust Activities

The MOF issued this Guideline in January 2005. It is applicable to all parties engaged in trust activities (include the trustor, trustee and beneficiary) and the implementation of trust arrangements. The Guideline requires separate accounting records to be kept for different trust projects. The recognition and derecognition criteria of trust assets (in the accounting records of the trustor and trustee) depend on whether the risk and rewards of the related assets are transferred or not.

### Standards on Internal Control

Since 2001, the MOF has issued 7 provisional standards to prescribe the requirements in respect of internal controls. These provisional standards cover the basic principles, bank balances and cash, purchase and payment systems, sale and receipt systems, construction projects, provision of guarantee and investments. These internal control standards prescribe the fundamental principles, procedures and methods that an enterprise should follow in the formulation of its internal control systems.

Furthermore, the MOF issued an exposure draft in June 2004 on internal controls in respect of fixed assets, inventories and fund raising activities.

### Exposure Draft on Derivative and Hedge Accounting

In July 2004, the MOF issued an ED on Derivative and Hedge Accounting for Financial Institutions. The general principles are:

- Derivative instruments should be measured at fair value (at initial recognition and at the end of each period).
- Hedges are classified as fair value hedges, cash flow hedges, and hedges of the net investment in a foreign operation, and the accounting is similar to the IAS 39 requirements.
- Disclosure is required of risk management objectives and policies and, for hedge accounting, the hedging relationship, description of hedging instruments and their fair value, and nature of risk mitigated, with further disclosures for cash flow hedges.

### Exposure Draft on Provisional Regulations on Accounting Treatment for Transfer of Financial Assets of Financial Institutions

This ED, issued in September 2004, prescribes the accounting treatment for the transfer of financial assets by financial institutions. The accounting principles followed in the ED are generally consistent with the derecognition provisions of IAS 39, including a continuing involvement approach to derecognition if a financial institution has neither transferred nor retained substantially all the risks and rewards of the ownership of the financial assets.

## CSRC

In December 2004, the CSRC revised the Form and Content Standard No. 2 (revised 2003). The revisions do not have a material impact on financial reporting but they require additional disclosures on various corporate governance matters. The key revisions are set out below:

- Disclose the nature, amount, reason and financial impact resulting from correction of material accounting errors in the notes to the accounting statements.
- Where the major shareholders are related, the relationship between these parties should be disclosed. The listed company should also disclose the ownership as well as the controlling relationship with its controller(s) graphically.
- Disclose details of any investments invested jointly by the listed company and its related parties, including the name of the related parties, the operation of the investee, capital structure and significant projects of the investee.

- Disclose the policy in respect of cash dividends of the listed company and the details of any proposed capitalisation of capital reserves (if any). If the listed company has distributable profits but does not propose to pay cash dividends, the company needs to disclose the reason and its intended use of the undistributed profits in the future.
- Disclose how the independent directors have performed their duties, for example, the attendance of independent directors during board meetings. Where an independent director has made a recommendation or an objection in a meeting, the details of such a recommendation/objections and the name of that director should be disclosed.
- Disclose the details of significant events of its subsidiaries, for example, court cases and arbitrations.

## CICPA

To improve the self-regulating structure and practices of the accountancy profession in China, the CICPA established four special committees during 2004:

**Auditing Standards Committee** - To develop proposed independent auditing standards, including an exposure draft and comments prior to final adoption.

**Discipline Committee** - To discipline those CPA firms and CPAs who violate regulations.

**Appeal Committee** - To consider an appeal of a decision of punishment made by the Discipline Committee and to affirm or modify the decision.

**Right-protecting Committee** - To protect the rights of the accountancy profession and members of the profession.

### Technical Bulletin No. 8

The CICPA Technical Expert Team issued Technical Bulletin No. 8 on 19 February 2004. It addresses five issues:

- Four questions in connection with the application of a provisional regulation relating to Impairment Losses of Assets issued in 2003.
- How to account for “surplus reserves” (a special reserve under PRC law) when an investment no longer qualifies for consolidation because the investor no longer has a majority interest.
- How a parent should account for a dividend receivable by the minority interest in a subsidiary when the parent acquires the minority interest including the dividend receivable.
- Offsetting in the balance sheet of amounts receivable from and payable to the same party.
- Three questions relating to “the capital surplus” (a special reserve under PRC law).

### Independent Auditing Standards

The following auditing pronouncements were issued during 2004 for public comment:

- No. 1 Objective and General Principles Governing an Audit of Financial Statements
- No. 5 Audit Evidence
- No. 29 Understanding the Entity and its Risk Environment and Assessing the Risks of Material Misstatement
- No. 30 Procedures in Response to Assessed Risks of Material Misstatement

These auditing pronouncements are based on following International Standards of Auditing (ISA):

- ISA 200 Objective and General Principles Governing an Audit of Financial Statements
- ISA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
- ISA 330 The Auditor's Procedures in Response to Assessed Risks
- ISA 500 (Revised) Audit Evidence

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As early as 1917, we opened an office in Shanghai. Backed by our global network, we deliver a full range of audit, tax, consulting and financial advisory services to national, multinational and growth enterprise clients in China.

We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants. We also provide services to around one-third of all companies listed on the Stock Exchange of Hong Kong.

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