



Chinese accounting reform:

Towards a principles-based global regime

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Foreword

We are delighted to introduce this fascinating insight into China's adoption of IFRS-based standards. We welcome the work undertaken to embrace China in the important debate about the future of a global accounting language and principles-based standards and the opportunity for collaboration between The China Accounting Standards Committee (CASC) and The Institute of Chartered Accountants of Scotland (ICAS).

The report is instructive at a number of levels. On one level, China's implementation effort demonstrates just how much can be achieved by emerging markets and transitional economies if the right leadership and resources are committed. China, with the successful establishment of the Chinese Accounting Standards for Business Enterprises and its convergence with IFRS, is among the leading jurisdictions making efforts to move towards a single set of high quality, globally accepted standards. The experiences of China in this establishment, convergence and implementation process can also be used for reference by other countries. At another level, the reform highlights some important challenges for standard setters and regulators if the world is ultimately to move to the ICAS vision of principles-based accounting. We also hope that the report will be useful to other countries which are adopting IFRS.

CASC and ICAS are strongly committed both to IFRS-based accounting, as well as to the broader ideal of principles-based accounting. We commend this report for its insightful analysis of both.



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It should be noted that the members of the Working Group and the Critical Review Group were acting in their personal capacity and were not representing the organisations for which they work.

Executive summary

In 2006, The Institute of Chartered Accountants of Scotland (ICAS) published its seminal report “*Principles Not Rules: A Question of Judgement*”. That report set out the case for a single, global accounting regime based predominantly on high level principles rather than many detailed rules. The principles-rules debate is frequently and wrongly characterised as a transatlantic discussion about the relative merits of US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). But if we are truly to develop a single accounting language for the world, we must broaden the debate beyond simply Europe and the US.

ICAS is therefore keen to embrace China in the debate on the development of financial reporting standards. The objectives of this project are:

- To identify and highlight the achievements in the implementation of IFRS/principles-based standards in China;
- To identify and consider the issues to be addressed in the implementation of principles-based standards, based on the experience in China; and
- To assess the degree of support for principles-based standards in China, in order to influence the future development of IFRS.

In February 2006, the Chinese Ministry of Finance announced the introduction of an entirely new regime of Chinese Accounting Standards based explicitly on IFRS. Although many people would not define IFRS as a wholly principles-based accounting regime, IFRS is used in this study as a proxy for a principles-based system. The experience of implementation of IFRS in China is particularly interesting as China was moving from a “rules-based” to a more “principles-based” regime. Our objectives on this project have been to understand the issues and challenges associated with the implementation of these new standards, as well as to solicit views on principles-based accounting standards generally.

The report is based on a series of interviews held in

2009 with key stakeholders in financial reporting in China.

The introduction of the new Chinese Accounting Standards marked a watershed moment not only for China but also in the development of accounting standards more widely. For China, the new standards represented a radically different approach at a time of fast-moving reform in the economy. The magnitude of this step cannot be overstated. But the explicit recognition of IFRS by China also marks a significant step on the road towards a single, global accounting language. Based on the interviews, it is clear that global convergence of financial reporting is unlikely to be achieved without the simplification of IFRS and a move towards a more principles-based approach.

The most challenging aspect of operating in a principles-based environment is the need to apply professional judgement effectively, consistently and fairly. To support such an environment, accounting professionals have to be trained, ethics have to be upheld and additional guidance must be provided to make principles operational. Furthermore, all stakeholders need to recognise their responsibility for making and accepting judgements. As indicated in our recommendations, there remains work to be done – not least in terms of ensuring that all accountants, and especially those who are used only to applying rules under the old accounting system, develop the business experience associated with the workings of a market economy. However, we found that Chinese stakeholders recognise these issues and have sought to address them on a scale which is both impressive and difficult to comprehend. The implementation effort has been remarkable.

Our most striking finding is the strength of official support and commitment to principles-based accounting, led by the Ministry of Finance. It is unlikely that China will give up all accounting sovereignty in the near future. But China’s efforts in implementing an IFRS-based regime give cause to hope that the goal of a single accounting language is truly within reach.

Recommendations

The Working Group's recommendations are as follows:

For consideration by the Ministry of Finance as the Chinese accounting standards setter and other regulatory bodies:

- Chinese regulators should continue with their policy of openness and proportionate regulation. Enforcement actions should continue to be effectively communicated.
- Industry forums and professional forums should be established as information sharing mechanisms on accounting issues, interpretations and judgements.
- Reciprocal international exchanges should continue to be encouraged to support the international process of convergence and understanding.
- More emphasis needs to be placed on disclosing explanations for the key judgements made by preparers of financial statements, in accordance with IAS 1. This is critical to effective communication in financial reporting.
- Regulators should consider how they can achieve their regulatory objective without providing inappropriate incentives for profit manipulation. This is particularly the case for the rule whereby if a loss is made for three consecutive years a company is delisted.
- Consideration should be given to whether China is obtaining the benefits of compliance with a single set of global financial reporting standards as a result of not being able to claim full adoption of IFRS.

For consideration by the Chinese Institute of Certified Public Accountants (CICPA) and the Ministry of Finance as the professional accountants' regulator:

- Professional accountants need more experience of business practices in a market economy to be able to make appropriate judgements and apply principles-based standards. The CICPA and the Ministry of Finance need to ensure that

new practising members have not only passed their examinations but that they also have a minimum level of practical experience in a workplace environment.

For consideration by the International Accounting Standards Board (IASB):

- The IASB should now take steps to move to a more principles-based regime. In particular:
 - The IASB should establish a clearer hierarchy of overarching concepts, principles which reflect the overarching concepts, and the minimum additional guidance necessary to make the standards operational.
 - The concept of substance over form should be included in the IASB conceptual framework at a prominent and authoritative level.
 - The IASB needs to radically simplify IFRS in terms of length, usage of language and structure in order to provide a basis for equivalence, convergence or adoption.

For consideration by the profession internationally:

- Chinese companies, and other companies worldwide, should adopt a Global Standard of ethical norms and principles, such as that proposed by the Group of Eight Finance Ministers. This standard should encapsulate an ethical "tone at the top" and in particular an ethical approach to financial reporting judgements.
- A professional judgement framework should be developed, providing guidance to companies for adopting procedures and processes which enable employees to work within a principles-based environment.

China's new accounting regime

In February 2006, the Ministry of Finance announced the introduction of 39 new Chinese Accounting Standards. In this report we use the term “new Chinese Accounting Standards” to refer to the Basic Standard and the 38 specific Accounting Standards for Business Enterprises (ASBEs) issued by the Chinese Ministry of Finance. Although not complying fully with International Financial Reporting Standards (IFRS), the new Chinese Accounting Standards nonetheless adopt the principles contained in IFRS and are therefore considered to be substantially converged with IFRS. Furthermore, in December 2008, the European Commission decided to permit Chinese issuers to use Chinese Accounting Standards in the European Community for a transitional period of up to three years. A final decision on the equivalence of Chinese Accounting Standards to IFRS will be taken at a later date.

The new Chinese Accounting Standards were adopted by all listed companies from 1 January 2007 and are being phased in over time for other companies and enterprises. Chinese Accounting Standards will continue to be updated in line with IFRS developments.

The introduction of these new accounting standards represents a remarkable achievement. In part, the transition was challenging because of the materially different nature of the former accounting standards. These former standards had been highly prescriptive and rules-based. Furthermore, the previous standards were industry-specific and as each set of industry-based standards was so different in nature, from a technical point of view, it would have been difficult for diversified groups of companies to produce meaningful consolidated accounts.

The transition to new Chinese Accounting Standards was also challenging because it had taken place during China's fast-moving reform from a planned to a market economy. As is well known, the Chinese economy is dominated by State-Owned Enterprises and indeed, prior to 1999, many

accounting firms were themselves government-owned. Such firms were staffed in many cases by an older generation of accountants schooled in prescriptive methods of cost accounting. Several interviewees noted that the culture was one in which accountants were strongly averse to making judgements of the kind that were needed to support a more principles-based accounting regime. When combined with a relative lack of education and experience of IFRS accounting, the significant challenges of implementing the new Chinese Accounting Standards become clear.

Although some interviewees regarded the economic environment in China as fairly straightforward and uncomplicated, with little use of derivative instruments, others noted the complexity of certain transactions and that this had led to complicated accounting.

The implementation of the new Chinese Accounting Standards has been driven by the Ministry of Finance, which has sole authority for the setting of accounting standards. With effect from July 2006, the Ministry of Finance initiated a mass education program on the new accounting standards and hundreds of thousands of trainees have been involved. This training has been directed at listed companies, accounting firms, regulators and the academic community. Ongoing training efforts are supported by the three National Accounting Institutes (NAIs), in Beijing, Shanghai and Xiamen as well as by The Chinese Institute of Certified Public Accountants (CICPA) and The China Securities Regulatory Commission (CSRC). The Ministry of Finance and the CICPA has been particularly involved in developing and enhancing the examination system for accountants. In addition to these training efforts, the Ministry of Finance has also implemented a considerable supporting infrastructure with the assistance of the CSRC and CICPA. This includes feedback mechanisms for tracking the implementation of the new standards, as well as parallel initiatives in the areas of auditing, control and governance.

The degree of support within China, and the determination across all stakeholders to make the new IFRS-based Chinese Accounting Standards work, is very impressive. Where problems or issues have been encountered, these appear to have been resolved quickly and diligently. The guidance issued by the Ministry of Finance has been welcomed as helpful and less prescriptive and shorter than under the previous accounting regime.

In the following section, we explore in more detail the development of, and attitudes to, the principles-based approach embodied in the new Chinese Accounting Standards. We then explore issues surrounding the accounting profession in China and the role of responsible enforcement before looking to the future of financial reporting in China.

Perspectives on a principles-based approach in China

The ICAS definition of a principle and principles-based accounting

A principle is a general statement, with widespread support, which is intended to support truth and fairness and acts as a guide to action.

Principles-based accounting standards are based on a conceptual framework, consist of a clear hierarchy of over-riding principles and contain no “bright-line” or anti-abuse provisions. Such an approach requires the use of judgement by preparers, auditors and regulators.

(ICAS, 2006, p. 1-2)

Recent scandals over the last decade have made people realise that a rules-based financial reporting regime is not sufficiently robust for stakeholder needs. The adoption by the Chinese government of IFRS as the foundation for its new principles-based regime was thus welcomed by a number of parties.

It was clear from our discussions that the majority of stakeholders in financial reporting in China were familiar with the concept of principles-based accounting. Whilst there was a strong degree of overall support for principles-based standards, there was a variety of perspectives on the merits of such an approach, and a range of different, and sometimes conflicting, views were expressed on what other parties might think of principles-based standards.

Strong support throughout Government circles, led by the Ministry of Finance, was expressed for principles-based standards based on IFRS, but it was thought unlikely that China would simply give up its sovereignty in this area by adopting IFRS in their entirety in the near future.

In the light of the relative newness of the principles-based regime, and the consequent lack of accumulated experience and past education as a basis for making judgements, it is clearly a challenge for many to exercise judgement in a principles-based environment. Further, the previous cultural background was not one which

allowed or encouraged judgement and this has shaped people’s current perspectives. Preparers of accounts tend to be risk averse and to favour reliance on a definitive source as justification for a particular accounting treatment. “Written rules are safe” noted one interviewee.

“A principles-based regime places additional requirements on accountants.”

Various comments were expressed to us on investors’ attitudes to the new accounting standards. Some thought that investors had no preference regarding a principles-based or rules-driven regime. One interviewee told us that investors were only concerned with the profit figure while another suggested that, as investors had little knowledge of accounting standards anyway, they had no real preference between either approach. Other views were expressed, with little unanimity: a number of interviewees thought that a rules-driven approach would make it easier for investors to make comparisons between companies whereas another view was that under principles-based standards users would better understand the “language of accounting”.

Academics supported principles-based standards, but thought that the accounting profession was not generally in favour due to the associated difficulties of understanding how to treat detailed transactions.

However, auditor and preparer interviewees indicated that they were fairly comfortable working with principles-based standards, whilst recognising the additional challenges for individuals in relation to exercising judgement and developing higher level professional skills and ethics.

One auditor noted that: “principles-based accounting presumes that all people are benign and act in the best interest [of stakeholders]; rules-based accounting presumes that people are bad and will get around the rules and find loopholes”. Thus it was hard for this interviewee to conclude that one approach was better than another. Because there were always preparers who look for loopholes, there would always be a need for some rules, but this interviewee and others also noted that principles were needed to deal with new and complex situations. The majority of auditors, however, supported principles-based standards even though it was recognised that rules were easier to work with, notwithstanding their volume.

The CSRC, the enforcer of compliance with the new standards for listed entities, might be expected to favour a rules-driven approach, as this may generate more comparable figures which help the regulator be accountable to the Government. Interviewees believed that regulators needed to be tough, and therefore wanted to have detailed requirements as a basis for enforcement. However, it was also noted that regulators might favour principles-based standards as they allowed the principles to be applied to a wide range of transactions without the need for detailed rules to be developed for every new situation.

“As soon as you have a rule, a new thing will arise, you will always need to catch up and anticipate the issue.”

A number of commentators noted that standards of business conduct and ethics varied widely across organisations, such that the Government was unwilling to move to full principles-based standards in areas where judgements were difficult to verify, such as fair values.

Perspectives on the introduction of principles-based standards

The interviews showed that the majority of stakeholders in financial reporting in China had thought through the implications of a principles-based approach to accounting.

Principles-based accounting was thought to give the most “authentic presentation” of financial information and represent economic reality. A number of interviewees equated principles-based standards with a focus on economic substance over legal form.

“It [principles-based standards] will improve the quality of financial reporting.”

However, very simple principles alone would not work and additional guidance would be required to make those principles operational. Indeed one commentator observed that “one person’s rules are another person’s principles”, confirming the more general view that the principles/rules debate is not one of focusing on either principles or rules, but one which considers the right balance between principles and rules.

However, a significant degree of support was evident for principles-based standards. Clearly, though, the uniqueness and complexity of the Chinese economy had required principles-based standards to be supplemented with guidance (or “rules”). The Ministry of Finance had issued guidance to help users implement the new standards, and the CSRC had also issued disclosure guidance from the regulator’s point of view – for example on share option valuation.

“The guidelines make principles easier for users and auditors to follow and interpret.”

Four additional reasons why extra guidance was needed were given by the interviewees:

- to settle disputes regarding the appropriate accounting treatment;

- to assist accountants in reaching decisions quickly;
- to help preparers learn what to do; and
- to interpret translated standards (IFRS principles) which could otherwise be misleading in a Chinese business environment.

Interviews generally welcomed the overall reduction in levels of prescription from the previous accounting regime and the guidance issued by the Ministry of Finance.

A number of other perspectives emerged on principles-based standards. Such a regime was only thought to be truly workable for those who had benefited from a good education. Concern was also expressed that principles-based standards necessitated a reliance on management intention and management judgement, providing significant scope for manipulation of earnings.

The reliance of a principles-based system on professional judgement was understood but it was recognised that this also carried the risk of inconsistency between companies and from year to year, and a consequent impact on the perceived quality of accounts.

Lastly, it was recognised that a principles-based financial reporting regime needed a minimum level of infrastructure to support proper implementation. Within companies, there needed to be a process for making and approving judgements; an independent audit profession was needed to provide the necessary challenges to management and provide assurance to investors; and there needed to be an appropriate regulator to enforce compliance and communicate enforcement

decisions. One interviewee noted that “there is a tendency in China for investors, regulators and companies to see accounting judgements as the domain and responsibility of the auditor, rather than the company management”. Companies need to take responsibility for such judgements and be accountable for them.

“Accountants should have the basic understanding that they are entrusted by the public to work for the public good.”

A significant awareness of what a rules-driven regime would entail was also evident, characterised by mention of bright lines¹, anti-abuse provisions, exceptions and detailed requirements. It was recognised that rules could also be manipulated and avoided and bright lines could be misused and result in misleading information. Although rules were recognised as hard to learn, it was accepted that they were easier to apply. However, with rules, there was always an ongoing need to update the requirements as new issues and transactions arose.

The considerations identified above underlie the key points and discussions in the following sections and the recommendations arising from these.

The ICAS definition of a rule

A rule is a means of establishing an unambiguous decision-making method. There can be no doubt about when and how it is to be applied.

(ICAS, 2006, p. 4)

¹ Bright lines are fixed thresholds or percentages within standards which are used as a surrogate for a broader assessment of an issue, thereby taking away any element of judgement.

The accounting profession

As highlighted in the previous section of this report a principles-based system raises concerns about whether the accounting profession has the ability and integrity to make judgements and apply principles. This is particularly the case for cultures such as that in China, where accountants have been used to operating under rules both professionally and in their daily lives; indeed one interviewee stated that “Accountants in China might not have the experience, education and cultural background to understand how to exercise judgement”. It was suggested to us that the Chinese culture resulted in some reluctance to make judgements as people tended to be risk averse, with a preference to follow rules – a “rules mindset”. Much of this seemed to relate to concerns about regulatory challenge to the judgements made.

The success of a new accounting regime relies on the interplay between individual professional accountants, their professional accounting bodies, regulators and employers, and requires an appropriate mix of training and education, experience and individual integrity. In China this involves the Ministry of Finance, the CSRC, the CICPA, the National Accounting Institutes and higher educational bodies.

The quality of accountants working in China was generally thought to be of a high standard, with individuals having a thirst for knowledge and a commitment to self improvement and lifelong learning. There was some criticism of the older generation of accountants who were viewed more as “bookkeepers”, familiar only with applying the rules under the old accounting system and precluded by that system from exercising any form of judgement. However, it was noted that around 80% of accountants in China were less than 40 years old and, having been through more principles-based education processes, were more adept at applying principles-based standards.

The mass accounting education system undertaken by the Ministry of Finance and the CICPA was regarded as very impressive by our interviewees,

but there was still a general consensus that further education and training was essential as, in practice, levels of understanding are different and, as one interviewee noted “it takes time to introduce a new regime”.

For a principles-based system to work effectively the interviewees believed that education and training programmes needed to encompass the technical knowledge of the standards and an understanding of the concepts behind each standard, as well as how to apply professional judgement in an ethical manner and document appropriate supporting evidence.

“After several years’ education and training on principles, judgement will be improved.”

Interviewees believed that the most important skill of an accountant was the ability to understand the business and its strategy and to be able to understand the economic substance of a transaction; these are essential for the ability to exercise professional judgement. It was suggested to us that for accountants to understand the business properly there is a need for company management to be open with both internal company accountants and the auditors about the business strategy and the economic substance of transactions. The ability to exercise judgement under a principles-based system is a new skill in China and takes time to develop as people begin to gain both experience and confidence.

“To work in a principles-based regime you need a deeper understanding of the principles, the business and the transaction.”

Interviewees thought that the best way to develop these skills was through on-the-job experience with additional training on practical aspects of

applying judgement, possibly though the use of case studies. Many firms were already undertaking this type of internal case study training. However, it should be recognised that even with training and the appropriate technical skills, not everyone can develop these “judgemental” skills and recruiting the right individual was considered essential, with integrity outweighing the more technical skills needed by an accountant. Ethical training was currently largely undertaken through case studies and by experience of working in an ethical environment.

“Ethics are the cornerstone of making good judgements.”

We heard from many that the need for high ethical standards for accountants was vital, particularly when making judgements under a principles-based system. For example one interviewee stated that “ethics are the cornerstone of making good judgements” and another that “when making significant judgements there are higher ethical standards”. Although some interviewees referred to varying standards of business conduct, there was a strong view that most Chinese accountants had the right attitude of mind and were open to being challenged. The need to ensure the correct tone at the top and culture both within audit firms and companies was emphasised as vital in creating the right environment for staff to behave ethically under a principles-based system. Audit firm interviewees noted that it was important to remind staff of ethical perspectives and that accountants should work in the public interest. Some CPAs pointed out that the sanction of losing one’s (hard to obtain) CICPA qualification meant that accountants would not “sell their ethics lightly”. The CICPA has a code of ethics based on the International Federation of Accountants (IFAC) code for its members. However, as in many other countries, there is currently no generally accepted corporate code of ethics for companies in China. An opportunity might arise for such a code to be established through the proposals by the Group of Eight Finance Ministers to adopt a Global Standard of ethical norms and principles.

“If the culture of the whole organisation is ethical, the pressure and influence is there to behave ethically.”

Not only do accountants in China need to deal with a new more principles-based regime, they also need to deal with new, unique, situations as the economy and business develops. Our discussions identified that international experience had helped the development of the profession in China, with accountants and regulators often having benefited from overseas experience or links with other international bodies. The Ministry of Finance currently meets with the IASB twice per year and there is a Chinese member on the board of the IASB. There is a need for economically significant countries, such as China, to be in a position to influence the IASB and bring their experiences to the fore. The Ministry of Finance has been encouraging companies and accounting firms to comment to the IASB on IFRS exposure drafts and discussion papers and become more heavily involved in debate regarding IFRS. This international exchange of experience was thought to be vital for international convergence and this should not be a one way process.

The main professional body for accountants in China is the CICPA, although other international accounting bodies also have a presence within China. The CICPA is responsible for organising examinations for accountants. It also provides services to its members, monitors the service quality and professional ethics of its members and is a self-disciplinary body. The National Accounting Institutes are responsible for continuous professional development programmes. The Ministry of Finance has sole responsibility for issuing accounting standards. One interviewee suggested that the CICPA’s remit should be widened to include a more active role in commenting on accounting standards and creating debate on accounting issues.

“The Institute should set up a formal organisation to comment on and create debate on accounting standards.”

There are a number of routes for qualification as a Chinese CPA. Students must be graduates but do not necessarily need to have undertaken an accountancy degree. The examinations are set and administered by the CICPA but the training for these exams is undertaken within firms, by external training providers or by self study and not by the CICPA. We were informed that training courses were also available through the National Accounting Institutes for CPA students, although these were considered expensive and therefore used primarily for qualified staff rather than students. An interviewee also discussed the CICPA orientated degree courses offered at nineteen universities where students can pass their CPA exams at university before joining a firm. They are, however, still required to undertake two years work experience before becoming a practising member of the CICPA. One audit partner interviewed noted that, although recruiting such students saved time and money, he believed that experience within a firm was the main criterion for good performance and that “students taking this [university] route may be less able to apply principles-based standards”. However, this view appeared contrary to that of academics who emphasised that the “principles” were taught at the universities.

“The long term goal of upgrading professional levels of Chinese accountants can only be achieved through more training and experience.”

In terms of examinations set by the CICPA, an interviewee noted that there should be a move away from multiple choice questions, as it was

doubtful whether multiple choice exam questions fully assessed the ability of students to think and apply judgement. It was suggested to us that there should be more emphasis within the CICPA examinations on understanding business, applying accounting and auditing judgements and gathering appropriate audit evidence. Some interviewees thought that ethics was already at the core of the CPA exams, while others thought that more was required in this area. Training may be easier for larger firms, such as the Big 4, compared to smaller local firms, due to their international and technical resources. However, the local firms’ partners that were interviewed had all established internal and external training programmes.

“Ethics is at the core of CICPA courses but maybe there is not enough emphasis on how to exercise professional judgement and gather sufficient audit evidence.”

We were informed that currently, members of the CICPA are required to undertake eighty hours of continuous professional development every two years. Only a minority of accountants working in industry in China are CPA qualified; most of these accountants follow a different entry and training route operated by the Ministry of Finance. The Ministry of Finance has an Examination Office that administers examinations and qualifications for these accountants and there are also compulsory training requirements in place. Given the pace of accounting and economic change in China and the need to have sufficient up to date knowledge to make judgements, it is vital that accountants in practice and in business undertake sufficient continuous professional development.

Our recommendations

- Professional accountants need more experience of business practices in a market economy to be able to make appropriate judgements and apply principles-based standards. The CICPA and the Ministry of Finance need to ensure that new practising members have not only passed their examinations but that they also have a minimum level of practical experience in a workplace environment.
- Chinese companies, and other companies worldwide, should adopt a Global Standard of ethical norms and principles, such as that proposed by the Group of Eight Finance Ministers. This standard should encapsulate an ethical “tone at the top” and in particular an ethical approach to financial reporting judgements.
- Reciprocal international exchanges should continue to be encouraged to support the international process of convergence and understanding.

Responsible enforcement

A concern with any accounting system is enforcement, especially for a principles-based system that requires judgements to be made which can result in different interpretations and treatments. How can a newly established principles-based system be enforced and can other countries going through a similar process learn from the regulatory process in China?

The IASB approach, as stated by its Chairman Sir David Tweedie, is:

...an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle. This is not a soft option. Our approach requires both companies and their auditors to exercise professional judgement in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without those commitments. There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules. (2002 statement by Sir David Tweedie to a committee of the US Senate)

The first question to be asked is what does enforcement mean in the context of principles-based standards? As noted, a principles-based system may result in different interpretations and treatments. However in order to maintain the credibility of the accounting framework and provide a basis for comparability for investors and other users, accounting treatments need to have a reasonable degree of consistency. Accordingly the role of enforcement is to ensure a reasonable degree of consistency of treatment of similar items, to facilitate comparability from year to year and between companies. Companies may sometimes come to different conclusions and regulators should accept this provided that the companies and their auditors have properly exercised judgement in the public interest.

“For principles to be applied you need a process.”

The foundation for responsible enforcement lies initially with the preparers and auditors. As discussed in the previous section preparers and auditors need experience, training and guidance to enable them to make good judgements. Within companies and audit firms we believe there needs to be a professional judgement framework enabling companies to adopt procedures and processes so that employees can work within a principles-based environment.

A professional judgement framework would set out a process by which preparers and auditors with an appropriate level of knowledge, experience, and objectivity could form an opinion on an accounting matter based on the relevant facts and circumstances within the context provided by applicable accounting standards. This would include details of the authoritative and other information sources which could be used in making the judgement, similar to the manner in which paragraphs 10 to 12 of IAS 8 set out alternative sources, and a requirement to document the evaluation and the evidence to support the judgement made. IAS 1 already goes some way towards this latter point with a requirement to disclose:

...the judgements, apart from those involving estimates, that management has made in the process of applying the entity’s accounting policies and that have the most significant effect on the amounts recognised in the financial statements. (IAS 1, para 122)

The framework would be used in considering the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. The professional judgement framework would need to be accepted and recognised within the legal and regulatory processes relating to financial reporting.

A view was expressed to us that increased management judgement increased the risk of inconsistent financial information and therefore reduced comparability. It was stated that such increased risk required remedies such as strong audit functions and strong governance structures to approve key judgements, for example, the selection of accounting policies, and fair value measurements should probably be vetted by companies' audit committees. The importance of documenting the evidence for judgements was noted and this applies to both companies and audit firms - to support internal reporting of decisions by companies and maintaining audit evidence in audit files.

In order to engage in meaningful conversation about judgements, interviewees noted that companies needed more disclosure on key judgements and on how these judgements were made. Concerns were expressed to us about the quality of disclosure in accounts in China, and whether this may result in a consequent lack of visibility on the accounting treatment of different items.

"We need to pay more attention to disclosure."

Audit firms are part of the enforcement process and were identified in our discussions with preparers as very important in helping clients understand the new standards and reach key judgements. Some interviewees expressed the view that there was a difference between the audit rigour and level of expertise between the Big 4 and other audit firms. This was not borne out in comments by the non-Big 4 firms.

There was general support for how Chinese regulators were dealing with the new principles-based environment. The openness of the Ministry of Finance and CSRC was welcomed by interviewees, in particular the consultation with academics, companies and auditors when drafting guidance. The fact that the Ministry of Finance encouraged constructive feedback and discussions about technical issues arising in firms and companies was welcomed. One non-Big 4 audit firm interviewee

used this consultation process to involve junior staff in the debate on accounting issues to encourage them to think and make judgements.

"The Ministry of Finance encourage people from enterprises and accounting firms to come to them with issues."

A principles-based system may result in different judgements and treatments by different companies, reflecting management's judgement of the most appropriate way of applying the principles when accounting for a transaction in the company's specific circumstances. Under a principles-based framework we believe that regulators must be willing to accept that, in a limited number of circumstances, different companies may reach different conclusions about how the principles fit a transaction. The consensus expressed to us was that Chinese regulators would accept different treatments if they were appropriately justified and disclosed, although this would only be acceptable if the resulting differences were not too wide, the impact on earnings was not too significant, and the motives were not ill-intended. However, it is worth noting that in some instances a judgement, such as deciding whether to expense or capitalise an item, may result in a significant impact on earnings. Although the size of such an impact may act as a warning signal to regulators the judgement itself may not be inappropriate. By following the detailed guidance issued by the Ministry of Finance, regulators would be unlikely to challenge the judgements made by accountants and auditors.

"Under principles-based standards, compared to rules-based standards, there can be an explanation for different judgements – so any conflict can be addressed."

It was highlighted to us that, if a listed company made a loss for three consecutive years, it would be delisted, and that this provided a strong incentive for profit manipulation especially in the third year following two years of losses. In a principles-based environment, where there is a significant degree of judgement, such an incentive may distort decisions about accounting. It may be appropriate

for regulators to consider how they can achieve their regulatory objective without providing such an incentive.

If preparers and auditors could not justify their judgement on an accounting matter, we heard that the regulator would impose penalties on those companies and firms and sometimes require the restatement of the financial statements. Litigation was generally not seen as an issue, as redress in the courts was considered limited in China. However, tough regulators were generally favoured by interviewees and a view was expressed that the opportunity cost and punishments for not acting in an ethical manner should be increased. We support the view that tough but proportionate enforcement is required and that appropriate penalties are imposed where judgements are clearly inappropriate or cannot be justified.

“Cases of non-compliance can be used to train others.”

We heard from many that an important element to the success of enforcement is the communication of enforcement decisions. Regulators should continue to communicate enforcement actions to companies and firms as part of the development process. Our discussions identified that such cases could be effectively used in training organised internally by firms or regulators. An extension of this is the use of industry forums for people to communicate views and learn from each other.

Our recommendations

- A professional judgement framework should be developed, providing guidance to companies for adopting procedures and processes which enables employees to work within a principles-based environment.
- More emphasis needs to be placed on disclosing explanations for the key judgements made by preparers of financial statements, in accordance with IAS 1. This is critical to effective communication in financial reporting.
- Regulators should consider how they can achieve their regulatory objective without providing inappropriate incentives for profit manipulation. This is particularly the case for the rule whereby if a loss is made for three consecutive years a company is delisted.
- Chinese regulators should continue with their policy of openness and proportionate regulation. Enforcement actions should continue to be effectively communicated.
- Industry forums and professional forums should be established as information sharing mechanisms on accounting issues, interpretations and judgements.

The future of Chinese accounting standards and IFRS

The vast achievements of the profession in China in adopting IFRS-equivalent principles-based standards cannot be underestimated. But what does the future hold for the profession and accounting standards in China?

We support the view, expressed to us, of the importance of the concept of substance over form (i.e. accounting which reflects the economic substance rather than the legal form) when making judgements under a principles-based framework, in order to truthfully reflect economic reality. Our discussions identified that further guidance was necessary to help accountants apply this concept in practice. The concept of substance over form was closely related to the true and fair concept by interviewees. It was suggested that the IASB should draft implementation guidance or a standard on substance over form to aid the successful adoption of principles-based standards, which could then be adopted by the Chinese Ministry of Finance.

“You need to understand the true nature of a deal rather than its form – but there are no specific interpretations on this. The IASB should conduct a study on how you can define the true nature of a deal.”

Substance over form is currently included as a qualitative characteristic of financial statements in the current IASB “Framework for the Preparation and Presentation of Financial Statements”. However in the recent exposure draft for “An Improved Conceptual Framework for Financial Reporting” this has been replaced with lower level references to economic substance – which could be regarded as a narrower concept relating to individual components of a transaction rather than the whole transaction. In addition, the exposed conceptual framework states that the framework will not override individual standards. This is contrary to our view of principles-based accounting which as part of a hierarchy should have clear overarching concepts from which the principles-based standards follow. We believe that the IASB should establish a clearer hierarchy of overarching concepts, principles which reflect the overarching concepts, and the minimum additional guidance necessary to make the standards operational.

As has already been indicated, the new Chinese Accounting Standards are currently considered to have “converged” with IFRS. There were a few differences between the Chinese Accounting Standards and IFRS when the new Chinese accounting system was first established in 2005, in the areas of: reversal of impairment losses; disclosure of related party relationships and transactions; and accounting for certain government grants. The Ministry of Finance and the IASB revised their respective standards afterwards and resolved the differences in related party disclosure and government grants. The IASB also identified a number of accounting issues for which China, because of its unique circumstances and environment, could be particularly helpful to the IASB in finding high quality solutions for IFRSs. These include fair value measurements and business combinations of entities under common control.

Is full adoption of IFRS required in the future or is convergence with IFRS sufficient? Some interviewees believed that, to preserve Chinese sovereignty over accounting standards, a word-by-word adoption is unlikely to happen and that instead China will continue to adopt IFRS principles but apply them in a manner suitable to the Chinese economy and business environment. We believe that China should monitor whether it will obtain the full benefits of IFRS if it does not simply adopt IFRS in full. Some interviewees wondered, if Chinese standards are only “converged” with IFRS, whether this will be sufficient to continue to encourage investor confidence in financial reporting in China and hence stimulate inward investment. Other interviewees expressed concerns about threats to further convergence if the IASB issues more rules-driven “US-style IFRS” or poor quality complex standards in the future, especially if this could lead to “US GAAP through the back door”.

In drafting and amending standards we believe that the IASB needs to understand better the different cultures and economies of countries such as China. Complex standards result in problems of understandability and, as a result of this, the

Ministry of Finance issued additional guidance to help people apply the new standards. Views varied as to whether the amount of this guidance would reduce over time. China is a transitional economy and the pace of change is dramatic, but in some cases IFRS remain ahead of practice in China. We heard that when standards are to be used by non-English speakers and require translation, language becomes a major issue. We question whether some of the more complex IFRS can be translated in a way which preserves the original intention. For example, it was pointed out to us that the translation of the word “probable” could mean many different things in different countries. It was also suggested that there was not enough time between IFRS being issued and coming into effect to allow for full and rigorous translation into other languages.

“Language is a problem – what does a non-native English speaker make of some of the IASB material?”

The problems of fair value, which is a new concept in China where markets are not fully developed or active, was a consistent concern amongst interviewees, especially given the current financial crisis. Concerns were expressed regarding the problems of identifying a fair value in such a market. Another specific issue identified to us was the lack of a property market which resulted in no market values for assets which in some cases had no original cost. Standards need to be fully accessible to all countries. The IASB needs to show awareness of countries with different economic backgrounds and stages of development and consider whether standards are capable of application in emerging and developing economies. This is an important issue to enable global convergence of financial

reporting which we believe will not be achieved without simplification of IFRS in terms of length, usage of language and fewer rules. In summary, accounting standards should be shorter, simpler and more easily translatable to encourage global convergence of financial reporting.

China and Hong Kong currently operate a “one country – two systems” approach. The Hong Kong Institute of Certified Public Accountants (HKICPA) is a professional body which sets Hong Kong Financial Reporting Standards (HKFRS) which are fully converged with IFRS, with standards being translated word for word. However, the China Accounting Standards Committee and the HKICPA have an ongoing agreement to maintain their commitment to converge Chinese Accounting Standards and HKFRS on an ongoing basis. In addition, The Hong Kong Stock Exchange issued a consultation paper in August 2009 on whether the Exchange should accept mainland China accounting and auditing standards for listed companies that are incorporated in the mainland and to allow mainland audit firms to service these companies.

As has been highlighted in other sections of the report Chinese Accounting Standards have dramatically changed over a relatively short period of time. Major achievements have been made in implementing this new regime but as expressed to us in many of our interviews, this process will take time as accountants, regulators and users develop the necessary experience and skills.

“As we become more experienced the troubles will decrease and the understanding of users will increase.”

Our recommendations

- The IASB should now take steps to move to a more principles-based regime. In particular:
 - The IASB should establish a clearer hierarchy of overarching concepts, principles which reflect the overarching concepts, and the minimum additional guidance necessary to make the standards operational.
 - The concept of substance over form should be included in the IASB conceptual framework at a prominent and authoritative level.
 - The IASB needs to radically simplify IFRS in terms of length, usage of language and structure in order to provide a basis for equivalence, convergence or adoption.
- Consideration should be given to whether China is obtaining the benefits of compliance with a single set of global financial reporting standards as a result of not being able to claim full adoption of IFRS.

Conclusions

The main objectives of this research project were:

- To identify and highlight the achievements in the implementation of IFRS/principles-based standards in China;
- To identify and consider the issues to be addressed in the implementation of principles-based standards, based on the experience in China; and
- To assess the degree of support for principles-based standards in China, in order to influence the future development of IFRS

The major achievements in the implementation of principles-based standards will be clear from the report. The scale and time taken to implement IFRS/principles-based standards has been very impressive. The organisation by the national regulatory bodies and the motivation and keenness of individuals was inspiring. A very much “can-do” attitude appears to have been adopted, although there are still areas for improvement as accountants gain the experience of working with principles-based standards. The scale of the training programme rolled out by a number of government bodies in China is very impressive. The commitment shown to the “change” has definitely contributed to the success of the implementation.

China’s experience of adopting a new accounting regime based on principles-based standards provides a useful example for other countries, although it is recognised that the starting point for each country is likely to be different.

The key factors in the successful implementation of principles-based standards would appear to have been:

- the commitment and enthusiasm from the Ministry of Finance, regulators such as the CSRC and the profession;
- the shared efforts of all stakeholders in financial reporting to making this work;
- major educational and training programmes;
- the issue of comprehensive guidance to assist in the application of the accounting principles;
- sensible and proportionate enforcement by regulators;
- the development of a culture of ethics to underpin accounting judgements;
- the increasing accumulation of technical knowledge and practical experience; and
- the assistance and challenge received by companies from their auditors.

The degree of official support for principles-based standards is strong in China. Our interviewees showed a strong degree of overall support for principles-based standards although a variety of perspectives were provided and often conflicting views were expressed about what other parties might think. Some concerns were expressed to us about the risk of IFRS moving to a more rules-based approach and the resultant impact on global convergence.

Appendix 1

List of interviewees

Interviewee	Position at time of interview
Ge Xu	Partner, Pan-China CPAs, Hangzhou
Zhu Haiwu	Partner, Zhongrui Yuehua CPAs, Beijing
Professor Lu Zhengfei	Professor of Accounting, Associate Dean, Guanghua School of Management, Peking University, Beijing
Dr Yang Zhiguo	Deputy Secretary General, Chinese Institute of Certified Public Accountants, Beijing
Zhuo Chengwen	Deputy General Manager, Finance Department Bank of China Limited, Beijing
Dr Liu Yuting	Director General of Accounting Regulatory Department, Ministry of Finance, Beijing
Professor Zhou Zhonghui	Chief Accountant, China Securities Regulatory Commission, Beijing
Claire Sandford	Director, PricewaterhouseCoopers LLP, London (seconded to PricewaterhouseCoopers, Beijing)
Winnie CW Cheung	Chief Executive, Hong Kong Institute of Certified Public Accountants
Paul Pacter	Director, Global IFRS Office, Deloitte Touche Tohmatsu, Hong Kong
Martin Wardle and Catherine Morley	Partners, KPMG, Hong Kong
Dr Zhang Wei-Guo	Board Member, IASB
Sarah Legg and James Fawls	Chief Accounting Officer and Head of Accounting Policy Asia Pacific, HSBC, Hong Kong
Professor Xie Rong	Vice President, Shanghai National Accounting Institute, Shanghai
Dai Dingyi	Senior Partner, BDO China Shu Lun Pan CPAs, Shanghai
Professor Chen Xinyuan	Dean, School of Accounting, Shanghai University of Finance and Economics, Shanghai
Dr Lin Yongfeng	Vice Director, Listed Company Department, Shanghai Stock Exchange, Shanghai
Hua Qiang and Gou Xingyu	Partners, Zhong He Zheng Xin CPAs (PKF), Beijing
Zhang Xianyun	Chief Accountant, Zhongzheng Tiantong CPAs, Beijing
Jing Zhou	Deputy Director, PetroChina Company Limited, Beijing

All interview notes remain confidential to the members of the Working Group.

Appendix 2

Interview themes

Principles versus rules

- Is there a distinction recognised in China between principles-based and rules-based accounting standard setting?
- What do you believe is the difference between principles-based and rules-based accounting standard setting?
- Is one approach superior to the other and, if so, why?
- Is it a worthwhile effort to distinguish between principles-based accounting and rules-based accounting?
- Is there some other alternative that you prefer? Please describe.
- What are the key reasons underlying the need for more detailed standards and detailed accounting guidance? Which bodies provide guidance and other advice?
- How do you see financial reporting standards in China developing over time?

The profession

- What are the issues for preparers of accounts in China in an environment of principles-based accounting standards?
- What are the issues for auditors in China in an environment of principles-based accounting standards?
- What changes are required to assist in the implementation of a principles-based system?
- How are users of financial statements served by principles-based accounting?
- How would tax authorities and regulators regard principles-based accounts?
- What would happen if two companies took a different view on an accounting treatment? How would regulators react? Why? How would tax authorities react? Why?
- How can auditors deal with being “second guessed” after making their best judgements based on the available information?

Education and professional judgement

- How are students and accounting professionals educated so as to enable them to exercise judgement?
- How does this differ between firms and between training organisations?
- What does the Chinese profession regard as being the key skills and experience that qualified accountants need?
- What additional skills and experience are needed to exercise professional judgement and work in a principles-based regime?
- What are regarded as the correct attitudes and values for a qualified accountant?
- How do accountants learn to use professional judgement?
- How do accountants learn to act in an ethical manner?

Appendix 3

Summary of recommendations from the ICAS 2006 report

Reproduced from the April 2006 report 'Principles Not Rules: A Question of Judgement'

The report defined a principle as:

... a general statement, with widespread support, which is intended to support truth and fairness and acts as a guide to action.

The report went on to say:

Principles-based accounting standards are based on a conceptual framework, consist of a clear hierarchy of overriding principles and contain no 'bright-line' or anti-abuse provisions. Such an approach requires the use of judgement by preparers, auditors and regulators.

The report defined a rule as:

A rule is a means of establishing an unambiguous decision-making method. There can be no doubt about when and how it is to be applied.

The 2006 Working Group's recommendations were as follows:

1. We support the consensus that only principles-based accounting standards can fully serve both the needs of business and the public interest.
2. It is necessary to recognise that complete comparability is never possible in accounting. More emphasis needs to be placed on explaining the key judgements made by preparers of financial statements. This is critical to effective communication in financial reporting.
3. Principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance. The additional guidance should be restricted to brief explanation built into the standards themselves, as well as a small number of interpretations on major issues.
4. Rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a 'true and fair view' or a 'fair presentation'.
5. Principles-based accounting provides a comprehensive basis for the preparation of financial statements that has the flexibility to deal with new and different situations as they arise and leaves far less scope for people to convince themselves that an 'inappropriate' interpretation is acceptable.
6. Our vision of principles-based standard setting will require a change in the global profession, with both preparers and auditors assuming more responsibility for their judgements and seeking less in the way of detailed guidance.
7. In order to implement these changes the training of both current and future professionals will need to be addressed to ensure that accountants have the expertise, and the courage, to make sound and ethical judgements in the overriding interest of a true and fair view. To support this approach, the judgements need to be documented and disclosed.
8. Responsible enforcement of accounting standards requires regulators to be willing to accept a range of judgement-based outcomes. Regulators need to be able to trust preparers and auditors, who in turn must be capable of exercising judgement. One corollary is that anti-abuse provisions and 'bright lines' should not be included in accounting standards.
9. A single interpretative body should focus on significant issues rather than detailed matters. Detailed matters should be left to the judgement of preparers and auditors with clear disclosure of how that judgement has been exercised.
10. Convergence cannot be achieved if the basis for convergence is a detailed rules-driven approach as this will be difficult to roll out across the different jurisdictions and cultures around the world.

