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Implementation of IFRS in a regulated market

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ABSTRACT

The year 2007 may well be remembered as a milestone in the development of accounting and financial reporting standards in China, as it was the year that the country's new, substantially IFRS-convergent, accounting standards became compulsory for selected companies. Having evolved from a closed regulatory culture inherited from the former Soviet Union, China's move toward IFRS provides an interesting example of how globalization is gaining support from regimes once regarded as the least likely to be interested. China's move also provides direct evidence on the question of whether IFRS can work properly in markets that are disciplined mainly by regulators rather than market mechanisms. This paper attempts to provide a descriptive analysis of Chinese accounting's "bumpy road leading to internationalization" [Tang, Y.W., 2000. Bumpy road leading to internationalization: a review of accounting development in China. *Accounting Horizons* 14-1, 93–102].

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1. Introduction

The year 2007 was a turning point in Chinese accounting regulation: the standard-setter adopted a new set of accounting standards, substantially convergent with IFRS, for selected companies. The standards were promulgated in February 2006 and announced in a high-profile ceremony held in China's National Congress Hall, at which the Minister of Finance proudly declared that China was entering a new era of globalization in its financial reporting practices. This step forward in the country's evolution from a tightly-regulated Soviet-type economy provides an interesting example of how interna-

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tional accounting harmonization is gaining support from regimes once regarded as the least likely to be interested. It may also provide direct evidence on the question of whether IFRS can work properly in markets disciplined mainly by regulators rather than market mechanisms. This paper aims to provide a review of the process of China's move towards IFRS and a comparison between Chinese GAAP and IFRS. The questions we try to answer in this paper are: to what extent are Chinese GAAP convergent with IFRS? Are Chinese companies ready for the changes brought about by the new standards? Are these new standards expected to produce better financial reports? If not, what are the obstacles?

2. Brief background history

China started its economic reform from a planned to a market-oriented economy in 1978. Since then, accounting regulation and practices have also undergone a significant change of purpose, from mainly serving macro-economic planning to providing information for decision-making by investors and creditors.

Before the economic reform that began in 1978, accounting and financial reporting in China was mainly designed to assist macro-economic planning. Accounting regulations were promulgated in the form of an "accounting rule", a centrally determined manual with detailed, rigid journal entry requirements and a prescribed reporting format. Accountants were obliged to comply strictly with accounting rule requirements.

After 1978, the reform transformed China's purely state-controlled economy into a mixed economy, with companies owned by foreign companies and local private investors. Its mixed nature created demand for an accounting system that would serve not only the state but also other shareholders, who wanted accounting information in line with internationally acceptable standards.

Serious attempts to align China's accounting system with international practices started in 1979 when a set of accounting regulations was prepared for joint ventures with foreign investments. These regulations, officially launched in 1985, incorporated concepts such as accruals, matching, distinction between capital expenditures and expenses, and conservatism as a financial reporting principle for the first time in China. The format of financial reports was also amended to make the statements at least look familiar to users outside of China.

Preparation of accounting standards, however, did not start until 1988 when the government-backed Accounting Society formed a research group to explore the possibility of China replacing its accounting rule with accounting standards.

The year 1992 was that China made historical progress in its reform of accounting: not only was the Accounting Standard for Business Entities (similar to a conceptual framework in other countries) issued, but the government also announced an ambitious plan to launch over 30 new accounting standards in the next few years. The exposure drafts of these standards were circulated among practitioners and academics for comments and suggestions, but the opinions collected were so divided that no standard could be promulgated. The development of the capital markets inevitably created transactions that were difficult to account for using the old accounting system. In response to market development, the first accounting standard, on disclosure of related party relationship and transactions, was promulgated in May 1997; this was followed by a further 15 standards by 2001. The major difference between these 16 Chinese accounting standards and the IAS lay in the degree of flexibility over the use of fair value. During the period 1997–2001, the newly promulgated standards were adopted by public companies only, while unlisted companies continued to follow the accounting system, which was amended several times to gradually incorporate practices from international standards.

The latest phase of internationalization in China's accounting standards was completed in 2006. Basic Accounting Principles (similar to a conceptual framework) and 38 accounting standards prescribing particular practices were launched on February 14, 2006. Some interpretations of standards were issued in 2007 and 2008.

This brief history shows that although the objective of accounting reform was defined and interpreted in different ways during the process, the general trend was for gradual convergence with IASs

(Tang, 2000). While the accounting standards were moving towards IAS, the actual effect of changes in accounting standards on financial reports was questioned by researchers due to weak enforcement (Chen et al., 2000, 2002).

3. Harmonization efforts and major remaining divergences

To address any concerns of other countries as to whether China's recently promulgated accounting standards were truly convergent with IFRS, the Ministry of Finance, the government body with responsibility for regulating accounting, set up a task force whose main job was to persuade the IASB to sign a memorandum to endorse China's move toward IFRS. That memorandum was signed by a representative of China and Sir David Tweedie of the IASB on November 8, 2005, supporting the view that China's new accounting standards were substantively convergent with IFRS except on three points: related party transactions and disclosure, reversal of impairment on depreciable assets, and government subsidies (this divergence was later eliminated as the revised standard realigned its requirement with IFRS).

The next major task facing the Chinese regulatory body is how to obtain recognition from foreign counterparts that Chinese standards are equally valid as IFRS. Recognition of equality would make financial reports prepared using Chinese accounting standards directly acceptable without restatement in countries that have adopted IFRS. The Hong Kong Institute of CPAs was the first professional body to fully recognize the equality of Chinese GAAP with IFRS. The EU is likely to follow suit in 2009 (Wang, 2007), and negotiations with Australia, Japan, Korea, Russia and other countries are also making reasonable progress.

Although the content of new accounting standards in China is now substantially convergent with IFRS (see Appendix 1 for the impact of new standards adoption in 2007), the way it is implemented is quite different. There are 156 accounts with illustrated journal entries, for example, are specified in a supplementary announcement, and companies are required to follow this bookkeeping guideline not only to preserve comparability but also to facilitate aggregation of financial statements for macro-economic purposes.

China's current accounting regulations continue to depart from IFRS on two major issues. First, the definition of related party entities excludes most state-owned enterprises (SOEs) in China, while IFRS consider all SOEs as related parties. Chinese SOEs are in fact independent legal entities, and their business activities are no different from other companies. Treating them as related parties would unnecessarily complicate accounting and financial reporting. Second, there is a difference concerning the reversal of impairment on depreciable assets. Regulators in China believe that impairments of tangible long-term assets are most likely to be permanent, and recovery is an exception rather than the rule. Given the prevailing poor corporate governance and widespread earnings management, it is easy to understand why reversal of impairment is not allowed in China.

Other differences between the two sets of standards arise from the difference in institutional arrangements. These differences are not regarded as departures from IFRS; they are more likely to take the form of supplements to IFRS on topics not commonly found in developed markets. Business combinations under common control, for example, are observed only in China and a few other countries. Under Chinese GAAP, business combinations between two entities controlled by the same shareholder must be recorded at historical cost, because transaction prices may not reflect market value (the pooling of interests method). Another example concerns the use of fair value (FV). While IFRS made significant progress in adopting FV, regulators in China are very reluctant to follow that lead. The new Chinese accounting standards adopted in 2006 emphasize that FV should be introduced carefully and gradually, because the prices applied in unsophisticated markets may not form a good basis for fair value. Consequently, in standards relating to investment property, biochemical products, and debt reorganization fair value is allowed only when an active market exists from which fair value can be reliably determined and verified. The IASB has agreed that China's prudence in adopting FV may be a good example for other emerging markets to follow. The IASB has also agreed with the Chinese authorities that transaction prices should not be automatically taken to reflect FV in markets where active trading is not always carried out on an arm's length basis (Wang, 2007).

4. Obstacles and problems

The internationalization of Chinese GAAP was motivated by China's economic development towards a market-based system, growing ties with multinational firms, and problems that were difficult to deal with under the old accounting regulatory framework.² However, this process, like other reforms in China, has had its share of obstacles and objections. Because of the excessive earnings manipulation found in many companies and the large number of accountants who had not received sufficient training in modern accounting and auditing, the Chinese regulators were unsure whether internationally acceptable accounting standards should also be accepted in China.

China's two stock exchanges were established in 1990 with the initial objective of raising capital for poorly-performing SOEs which were finding it difficult to survive in competition with foreign and private local companies. The newly-created capital markets unexpectedly induced a strong incentive for manipulating earnings, as reported earnings was the primary basis for deciding whether a company could be listed in the first place and, once listed, could raise more capital through rights issues or be de-listed. The required ROE (10% or above for rights issues, and above zero to avoid de-listing) was found to induce strong incentives for earnings manipulations (Chen et al., 2001). Most of these earnings manipulations were achieved through related party transactions, abusive use of accruals and illegal accounting "games" such as recording revenue from non-existent transactions. To curb excessive earnings manipulation, Chinese accounting regulations were revised between 2001 and 2006³ to make accounting practices more conservative and less subjective. As a result, during that period the reported profit was in general more conservative in China than under IAS.⁴ A survey of 122 companies that reported earnings using both Chinese GAAP and IAS found that on average, 2003 profit under Chinese GAAP was RMB38 million lower than under IAS (Li, 2007). Given that only a few years earlier profit reported under Chinese GAAP was significantly higher than profit reported under IAS (Chen et al., 1999), this turnaround was surprisingly impressive.

Another issue was that Chinese accountants, working in a country in transition from a centrally-controlled system to a market-based economy, had very little training in making professional judgments in a verifiable and ethical way. This was not a serious problem before the 1992 reform, when accountants were rarely called on to exercise judgment. The accounting rule manual was so prescriptive that virtually no judgment was needed. The useful lives and residual values of fixed assets, for example, were set out in the manual. Provisions for bad debt were fixed at 0.3–0.5% of the outstanding balance of accounts receivable.⁵ When these rigid quantitative requirements were gradually replaced by standards in which some judgment was allowed, many companies saw an easy way to meet their profit target. As a result, about 20% of listed companies received modified audit opinions, and many of those modified opinions were issued for accounting "games" aimed at meeting the profit target (Chen et al., 2001).

The accounting regulations promulgated after 1993 successfully reduced the scope for earnings manipulations, but this goal was not achieved without a significant cost. To avoid transactions being classified as related party transactions, for example, companies often went through a third, unrelated party so as to present the transaction as part of normal arm's length business. This meant the company

² The first accounting standard, disclosure on related party relationships and transactions, was promulgated in 1997 to address issues that came to light in the Qiong-Ming-Yuan scandal, in which the company manipulated earnings using inflated trading prices between related entities.

³ Profit from transactions with related parties, for example, must (since 1997) be recorded directly in a capital reserve account in Shareholders Equity. The more conservative nature of accounting regulations before the convergence to IFRS in 2006 was also reflected in other types of transactions, such as profits from debt reorganization and non-monetary transactions (recognized by IAS but not Chinese GAAP), government subsidies and public donations (included in current profit under IAS but recorded as a capital reserve under Chinese GAAP), and development expenses and long-term asset repairs (expensed under Chinese GAAP but capitalization allowed under IAS). In addition, amortization of intangible assets was limited to 20 years under IAS, but 10 years in China.

⁴ There were also items for which IAS was more conservative than Chinese GAAP. Housing subsidies and pensions were both recorded as current expenses under IAS, but directly deducted from equity in China. However, the impact of this small group of transactions was smaller than the differences caused by more conservative regulations.

⁵ Certain tax considerations also lay behind this fixed rate, since it prevented firms from overstating their provision and thereby minimizing their taxable income.

could now recognize the profit, but also led to recognition of unnecessary costs. There were no winners in this accounting game: companies increased their transaction costs, users were misled by inflated profits, and regulators found it difficult to differentiate between companies that were meeting profit targets by improving operations and those succeeding by means of manipulation.

Chinese accounting regulations have developed in a loop pattern, moving from tight regulation inducing practices that distort financial reports, to a flexible standard framework allowing a certain degree of subjective judgment. But once excessive earnings manipulation is discovered, the loop is closed in a return to tighter regulation. The convergence toward IFRS has no doubt increased the scope for judgment, thus renewing concerns about financial reporting quality. To avoid repetition of the same loop, the Chinese authorities have taken careful steps to ensure that the new standards are implemented in a reliable and controllable way.

In order to achieve the expected benefits from adoption of the new standards, enforcement may turn out to be more critical than the actual standard-setting, and corporate governance will definitely play a key role in this regard. The weak corporate governance found in Chinese companies (Clarke, 2003; Firth et al., 2006) is arguably a considerable challenge to the Chinese authorities' aim to convince foreign counterparts that Chinese financial reports are in line with international standards not just in form but also in substance.

Another concern is the ambiguity of the role played by the State in accounting regulation and practice. As discussed earlier, Chinese accounting regulation and enforcement is completely dominated by the State, and even after the country's thirty-year economic reform, the State is still the principal player in the Chinese economy: not only does it still have a controlling shareholding in almost all large listed companies, it also controls most resource allocation channels such as public listing and bank loans. This combined role as both "referee" and "player" could be a major source of conflicts of interests if companies find the new standards unfavorable.

Fortunately, China is one of the few countries to have gained significant experience in adjusting and bridging the gap between local GAAP and IAS. From 1993 onwards, about 125 companies issued B-shares to overseas investors, and were required to report their financial statements using both Chinese GAAP and IAS, until 2007 when the regulators concluded that the two sets of standards had converged to such an extent that the benefit of dual reporting no longer justified its cost. Between 1993 and 2007, details of the differences between the two sets of statements were clearly identified and explained by B-share listed companies. In 2001, the Chinese Securities Regulatory Commission (China's SEC) further stipulated that the two sets of statements must use the same estimations (e.g., the percentage of bad debt provision, useful life of fixed assets). This requirement enables users to clearly understand why earnings are different and whether the IAS produces a better set of statements for their decision-making. Given China's experience gained from regulating B-share companies, we have good reason to expect a smooth transition from an accounting profession that speaks Chinese to one that speaks a global language understandable to external parties.

Appendix 1. Impact of 2007 new standards adoption

To assess how the first adoption of the new standards would affect financial results, the Chinese Ministry of Finance (MOF), the government body assuming sole responsibility for accounting standard-setting and implementation, asked a renowned university to carry out a comprehensive study to understand the new standards' possible impact on financial reports.

Using actual and projected financial data, the task force tried to answer two questions: how would the beginning balance of net assets be affected by the first adoption adjustments? And how different would the actual reported earnings of 2005 be if adjusted to the new standards applicable in 2007?

The study was completed in 2006 and the task force, led by two professors, reported some interesting results in their report.⁶ First, they estimated that about 1000 companies would increase their beginning balances of net assets by an average of RMB31.54 million (or 9%), while 259 companies would

⁶ We are grateful to the Department of Accounting Affairs, Ministry of Finance, and Professor Yang Xiongsheng and Professor Chen Donghua, both are from Nan-Jing University, for granting us access to the report.

record an average decrease of RMB39.03 million (or 4%). As a result of the first adoption adjustment, 11 companies would see their negative net assets become positive; the highest increase was RMB2.2 billion (or 844%). The most influential items were (1) the write-off of long-term investment difference (an item similar to goodwill) by those business combinations now deemed to be under common control (646 companies affected, with a total adjustment of RMB15.4 billion), and (2) deferred income tax assets/liabilities (259 companies affected, with a total adjustment of 37.9 billion). In general, the reported profit of all companies for 2005 would be affected, with 775 increasing and 573 decreasing their reported net income. The median increase (decrease) in amount and percentage would be RMB31.92 (40.39) million and 10% (28%), respectively. On average, each company would have recorded a decrease of RMB50,000 in net income if it adopted the new standards in 2005, which was not a statistically significant difference. Ten (89) companies that originally reported net profit (loss) would have seen their results change to net loss (profit), respectively using the new standards. Long term investment, intangible assets, reversal of depreciable asset impairment, deferred income tax assets/liabilities, and government subsidies are the items that most affected the reported profit.

The projected results cited above show that in China as in many other countries, the implementation of new accounting standards convergent with IFRS should not substantially change corporate financial reports. The main reason for a smaller-than-expected difference could be due to the limited application of FV. In areas such as debt reorganization using non-monetary considerations, FV is not allowed, while in other areas such as investment properties, FV is an option, acceptable only when an active market is available. The issue of the suitability of FV for emerging markets where reliable market prices may not always be observable and verifiable may need more attention from the international accounting community.

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