

# Accounting in China

With the founding of the PRC in 1949, all resources of production in the country came under State ownership, and basically the only form of economic entity was the state-owned enterprise (SOE). The accounting rules and regulations were known as “Fund Accounting”, and were characterized by their rigidity and uniformity. They were primarily used for establishing an information and reporting system for the implementation of national economic policies and resource allocation in the planned economy. In particular, they were used for the maintenance of administrative control over state-owned assets (SOAs) and to strengthen the financial discipline of the SOEs and thereby safeguard SOAs.

Following promulgation of the Joint Venture Law in 1979, a separate set of accounting rules and regulations were formulated to govern the preparation of financial statements by these JVs and other foreign invested enterprises. This was undoubtedly the first step away from the “Fund Accounting” concept. A third set of accounting rules and regulations, intended specifically for joint stock companies into which the SOEs were being restructured for public offering, were formulated in the early 1990s and revised in 1998.

In 2006 the government announced the issuance of the long awaited Accounting Standards for Business Enterprises (ASBEs). This new accounting and auditing standard, updated on February 15<sup>th</sup> 2006, is substantially in line with International Financial Reporting Standards (IFRSs), but includes minor modifications reflecting China’s unique circumstances and economic situation. The new rules, mandatory for all listed Chinese companies and gradually being phased in for all other enterprises, results in significant changes to China’s previous Generally Accepted Accounting Principles (PRC GAAP). Despite the apparent convergence with international standards, the practical application of China’s accounting principles is often a complex and opaque process.

## I. Legal Framework

---

The rapid growth and marketization of the economy, the influx of foreign investment, accession to the WTO, as well as the increasing maturity and importance of China’s securities market, have all highlighted the need for a sound, reliable, and transparent accounting system in China. To meet this need, a series of regulations have been issued over the past several years. They include:

- The Accounting Law (1999)
- The Standard Rules for Enterprise Accounting (2000)
- The Accounting Standards for Business Enterprises (2001)
- The Accounting Standards for Business Enterprises - updated (2006)

Chinese Accounting Standards (CAS), the collection of various standards and regulations issued since 1996, underwent a dramatic change with the issuance of the new ASBE in 2006. The previous system,

consisting of one Basic Standard and 16 Specific Standards, was overhauled and an additional 22 Specific Standards were issued. As mentioned earlier the 2006 ASBE is currently only mandatory for listed Chinese companies. The gradual nature of the new system's implementation means that the majority of enterprises are still subject to the old standards. Foreign investors operating in China should be mindful of the changing regulatory environment and its effect on their businesses.

## II. Relevant Authorities

Unlike in the West, the authority for formulating, promulgating and administering accounting standards is not the Accounting Society of China (ASC) or the Chinese Institute of Certified Public Accountants (CICPA), but the Ministry of Finance (MOF). ASC and CICPA are responsible for regulating, governing and monitoring the reform and development of the accounting profession in China. The CICPA also assumes administrative authority, delegated by the MOF, to serve as the bridge between the government and practicing accountants.

**Table 1 Government authorities in China's accounting system.**

Authority	Role
Ministry of Finance (MOF)	Formulating, promulgating and administering accounting standards. No direct involvement with enterprises.
State Administration for Taxation (SAT)	Tax collection, official invoice supplier, accounting audits. Most important authority related to tax & accounting.
State Administration of Industry and Commerce (SAIC)	Issue business licenses, reviews financial statements of enterprises on an annual basis.
External Audit Firm (CPA)	Conducts compulsory annual audit by third party.
Ministry of Commerce (MOC)	Approval of dividend distribution.

Source: InterChina Consulting

## Differences & Risks

As most enterprises in China still operate under the old accounting system (ASBE 2001), accounting practices and standards are often complex and difficult for FIE's to deal with. Qualitative and quantitative differences in implementation result in two main challenges. Firstly, understanding the Chinese accounts so as not to be misled, and secondly, consolidating the Chinese accounts with the parent company accounts. Some of the main differences and risks are outlined in Table 2.

**Table 2 Differences and risks related to China's accounting system.**

Issue	China Practice	International Practice	Main Risks
Accounting Standards	Specific procedures & practices. Integrated standards. Rigid framework.	Specific procedures & practices. Flexible choices and framework.	Methodology differences. → Conflict between FIE and HQ, as using the same format, but the content has different meaning.
Chart Of	Unified in different	Decided by enterprises	Qualitative differences.

Issue	China Practice	International Practice	Main Risks
Accounts	industries. Fixed templates & procedures.	based on their business and management style.	→ Incompatible charts and staff practices.
Accounting Reports	Standard forms. Detailed stipulation for filling and preparation. Must follow calendar year / quarter / month.	Decided by enterprises based on internal forms and following basic market structure.	Incompatible practices & principles, qualitative differences. → Conflict between FIE and HQ, both on format and content.
Bookkeeping Guidelines	Detailed stipulations for different kind of transactions.	Decided by enterprises, following basic Register Guidelines.	Methodology differences. → Conflict between FIE and HQ, as the content has a different meaning.
Tax Accounting	Detailed requirements. Sometimes different from ordinary accounting practices.	Decided by enterprises following basic government guidelines.	HQ has lack of understanding regarding tax burden and tax reports. → Possible source of misconduct.

The general accounting principles employed in China's accounting regulations include: accuracy, completeness, consistency, comparability, timeliness, materiality, accrual basis, matching, prudence, substance over form and going concern - mirroring those of IAS. Other major features of China's accounting regulations are as follows:

Enterprises are required to use the calendar year, from the 1<sup>st</sup> of January to the 31<sup>st</sup> of December, as their financial year. Financial statements should comprise a balance sheet, profit and loss statement, cash flow statement, notes to the accounts, and a loss appropriation account.

Due to the infancy of the new systems, certain footnote disclosures may not be as comprehensive as those elsewhere in the world. Yet, in certain areas, the Chinese standards are extremely stringent. This includes disclosing the corporate identity of related parties, commenting on the fairness of transactions conducted between related parties, and preparing the cash flow statements using both the direct and indirect methods.

The double-entry bookkeeping method should be adopted. Records in accounts and books have to be made in RMB (the lawful currency of the PRC). Transactions and balances denominated in foreign currencies have to be converted into RMB at the official rate, which may differ from the current market rate. All records and balances of transactions made in foreign currencies and the exchange rates used must be maintained for reference.

The historical cost convention is prescribed. Assets must be recorded at purchase cost (less any necessary impairment provision) and revaluations are strictly prohibited except when allowed by other State provisions. The concept of fair market value is not commonly used due to the limited existence of open markets.

### III. Internal Controlling

Operating and financing risks can be dramatically reduced by the use of controlling systems. The importance of these controlling systems only increases when companies expand overseas, especially European companies expanding to China, where time is needed before legal and business ethical practices can match the high economic growth, power struggles often occur between parent companies and FIEs, and linguistic and cultural barriers only exacerbate matters. In such circumstances, controlling FIEs is nothing but imperative.

For parent companies, formal financial reporting still remains the essential means of controlling FIEs. However, controllers from the parent companies should exert particular caution in dealing with these formal financial reports. Modern accounting, auditing, and taxation systems are relatively new to China; interpretation and enforcement of regulations and standards throughout the country tends to be quite poor; and a large proportion of the accountants who were trained under the planned economy seriously now undermine the quality of the accounting profession. Moreover, FIE General Managers may want to protect their own interests, and use accounting discretion to manipulate reported performance. As performance is used to evaluate managerial performance, it is a common practice for FIE General Managers to keep one set of accounts for the tax authorities, a second for the FIE management themselves, and a third for the parent company.

#### Controlling Risks

There are a number of areas in the formal financial reports to which parent companies should pay particular attention.

**High account receivables:** FIE General Managers may attempt to impress parent companies with high sales figures, not setting any credit limits to their customers in order to do so, and raising the risk of bad debts in the process. Indeed, many compensation schemes for FIE General Managers tend to reward higher sales without counter balancing that with penalization for higher account receivables. Although the payment default rate in China is very high, bad debt provisions or write-offs are not normally shown in an FIE's formal financial statements, and can easily deceive parent companies.

**Excessive inventory:** Due to long delivery lead times, poor logistic services, and currency restrictions, availability of supply is of particular importance in China. A common way to solve this is for FIEs to make advance purchases, holding large amounts of materials inventory in stock. Such a policy, which involves expensive financing, insurance and storage costs, also risks inventory obsolescence. Once again, these costs are not shown in FIE's formal financial statements, and can easily deceive parent companies.

With all of these potential risks, prevention is the safest approach. Firstly, InterChina recommends that parent companies ensure that their FIEs establish a second set of accounting books that are designed to translate the official Chinese accounting books into a format that is more recognizable and controllable by the parent company, reflecting the FIEs reality while meeting both minimum Chinese statutory requirements and those of the parent company. Secondly, InterChina recommends parent companies conduct internal audits every 6 months (even every 3 months in the first few years of establishment),

independent of the statutory annual audits that are nothing more than a simple document check, to properly ascertain the performance of the FIE. It is important for foreign investors to identify and analyze their operational risks in China on an ongoing process, and thereby anticipate and deal with problems before they occur.