

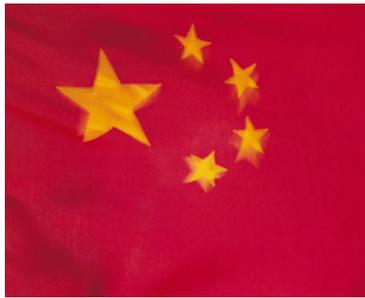


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Peeling the Onion

The Gap in GAAP: Bridging the Accountants Standards Gap in China



In China, there is a gap in GAAP. Given the differences that exist between Chinese GAAP and International Accounting Standards (IAS), at the end of every month accounting departments in China typically get busy preparing three sets of books: one in accordance with Chinese accounting standards, one for the taxman, and if a foreign company, one in accordance with the standards of its head-office's home country.

In an effort to increase the international comparability and the quality of accounting standards throughout the world, the generally accepted accounting principles (GAAP) are a widely accepted set of rules, standards, and procedures for reporting financial information. The ideal outcome of cooperative international accounting standard-setting efforts would be the worldwide use of a single set of high-quality accounting standards for both in-country and cross-border financial reporting.

China has however made considerable progress in the convergence of the two standards and the authorities fully understand that a transparent and sound financial reporting environment, and no rotten onions, are essential if the country is to continue to attract the record amounts of foreign investment witnessed over the past few years. This article will help foreign invested enterprises (FIEs) in China to understand the importance of bridging the gap between Chinese GAAP and IAS for management reporting purposes.



Compliance at Audit Time

All FIEs in China are required by law to be audited on an annual basis and all 2003 audited accounts, including balance sheets and income sheets, must be filed with the relevant authorities by the end of April this year. The Chinese authorities stipulate that all audited accounts must be prepared in accordance with Chinese GAAP. It's therefore important that FIEs pay particular attention to the differences that exist between Chinese GAAP and IAS in order to ensure compliance with the authorities in China and the requirements of foreign investors.

Chinese GAAP has been developed by a number of different government authorities including the Ministry of Finance (MoF), and, for listed companies disclosures, the China Securities Regulatory Commission. Most notably, the principles are based upon the Accounting Law, which sets out general principles of accounting for all enterprises, including a definition of the nature and role of accounting regulations. In accordance with its commitments under the Accounting Law, since the 1980s the MoF has issued various accounting regulations that apply to different categories of enterprises in China.

Although the accounting standards that the MoF unveiled in the early 1990s were broadly based on international practice, the regulations failed to make provisions for doubtful debts and obsolete inventories. The standards also provided for limited disclosure of financial information for the users to understand the results and financial position of the reporting enterprise. Therefore, since 1993, the MoF has been working to develop a body of Chinese Accounting Standards (CAS) that are broadly in line with IAS. Until now sixteen standards have been adopted and others are under active development and hope to be adopted within the next two years.



Gaining the Trust of International Investors

In January 2001 the MoF implemented a comprehensive Accounting System for Business Enterprises (ASBE), based on the existing individual CAS already issued. From that date all joint stock listed enterprises were required to follow the ASBE, but more importantly, as of January 2002 the MoF extended the applicability of the ASBE to all FIEs in China. It is

expected that eventually all medium-size and large enterprises, including state-owned enterprises (SOEs), will be required to adopt the ASBE. Early in 2002, the MoF also issued a new separate Accounting System for Financial Institutions, applicable to all listed and foreign investment banks, insurance companies and finance companies.

In order to gain the trust of more and more foreign investors, the MoF has set itself the goal of bringing Chinese GAAP fully in line with those standards used internationally. A senior official at the MoF declared little over a year ago that:

"Since financial reports are the most fundamental way in which a company communicates its operating results and financial conditions to outsiders, companies must provide reports that its business partners and investors can understand. If the financial report is prepared or provided only in conformity with its national accounting standards, it may be difficult for investors to understand. Communicating solely on the basis of national GAAP can, therefore, affect the capital raising activities of an enterprise."

Hence the need for a set of accounting standards accepted by most countries around the world. The International Accounting Standards Board (IASB) is responsible for the convergence of accounting standards on a worldwide scale. Founded in the 1970s as a result of an agreement between the accountancy bodies of nine different countries, including the USA, the UK, Germany and Japan, it has been decided that the IASB should have full and complete autonomy in the setting of international accounting standards, recently designated as International Financial Reporting Standards (IFRS), and in the issue of discussion documents on international accounting issues.



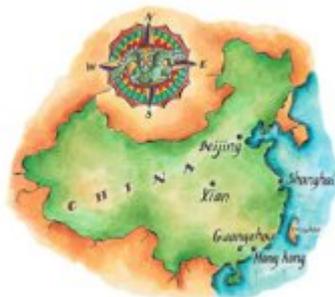
Chinese Accounting Standards

The sixteen specific accounting standards already issued by the MoF in China then are largely consistent with IFRS, though only seven are applicable to FIEs. Importantly, the new CAS have sought to define the objectives of accounting statements, establish a basis for presenting financial reports such as cash flow statements and define accounting fundamentals such as asset, revenue, expense and profit.

CAS assert that the objective of accounting statements is to provide information that reflects the financial condition, operating results and cash flows of an enterprise that are useful to investors, creditors and other users of accounting information in making informed decisions. This objective is in stark contrast to the standards typically prevalent in the old accounting system, when accounting statements were typically designed to service the needs of SOEs and local government for supervisory and management purposes.

Under both Chinese GAAP and IFRS, accounting statements reflect the characteristics of understanding, relevance, comparability and reliability and the presentation requirements of both standards include an income statement, a cash flow statement and notes to the financial

statements. The number of adjustments required to convert a financial report prepared under Chinese GAAP to a report prepared using IFRS have therefore reduced over recent years.



Shortcomings of Chinese GAAP

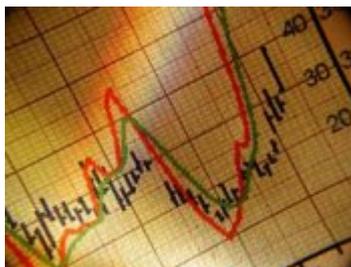
Inconsistencies still exist however in a few major areas and there are several reasons why international users consider the quality of financial statements prepared under Chinese GAAP to be insufficient for financial reporting purposes. CAS overlook the rule that inventories are valued at cost or at market price, whichever is lower, and the maximum amortisation period for intangible assets is ten years, whereas using IFRS it can be extended to a maximum of twenty years. Companies using international standards can choose whether to capitalise borrowing costs or not. In China however, borrowing costs on project-specific borrowings must be capitalised as part of the cost of acquiring or constructing a tangible fixed asset.

In some areas, such as mergers, amalgamation of accounting reports and hyperinflation, there are no specific standards. Furthermore there is no public requirement on the disclosure of some important issues such as the agreed value of financial means. There is also a difference in the classifications of assets in the balance sheet, since under IFRS assets are either not classified or are classified into current and non-current. Under Chinese GAAP however it is stipulated that assets must be classified into one of five different categories.

Before the implementation of the ASBE, the accounting regulations in China were closely aligned to tax laws and the taxation system. The new system however places greater emphasis on a conceptual framework and since unfortunately the tax system has not moved in the same direction, there currently exists a greater variance between accounting and tax requirements in China and the result is a larger number of deferred and current tax adjustments.

FIEs can now use a number of different accounting methods when making tax adjustments, none of which are comparable to the methods used in IAS. Under the 'tax payable' method the tax expense is equal to the provision for taxes payable in a particular period and deferred income tax is not recognised. Other methods do recognise deferred tax assets and liabilities, but when measuring the deferred taxes however, either the current tax rate or the expected tax rate may be used.

The tax implications of the new accounting system include a number of potential income tax adjustments such as the amortisation of intangible assets and pre-operating expenses (deferred until the entity begins operations, then charged to expenses), and timing and measurement differences on revenue recognition. It's essential therefore FIEs in China seek the appropriate advice in order getting tripped up by the potential pitfalls caused by the inconsistency between the accounting and tax requirements.



Need for Due Diligence

As a result of the differences that currently exist between Chinese GAAP and IFRS, financial reports in China do not always accurately reflect an enterprise's actual financial position and operating results. This can cause particular problems if a foreign investor needs to ascertain the true worth of a domestic Chinese company that it might be interested in acquiring. Many of the tax rules that are still applied by the majority of domestic Chinese companies were originally designed to suit the needs of SOEs, and are archaic in nature. Despite the rise in salaries in China in recent years, domestic companies are still only permitted to offset 960 RMB of a salary against revenue for tax as a deductible, meaning that employees are encouraged to offset the rest of the salary payment against expenses such as accommodation, transportation costs and meal allowances.

A clear analysis of a domestic Chinese company's strengths and weaknesses is therefore not an altogether straightforward process and extensive due diligence and repackaging services should therefore be mandatory in any M&A deal. If Chinese authorities can replace the current tax systems with one system for both domestic and foreign enterprises, and continue to reduce the difference between financial statements prepared under Chinese GAAP and those prepared in accordance with IFRS, then in the future foreign investors will be able assess the performance of investments more efficiently.



Steady Convergence with International Standards

Given the MoF's desire to establish a set of standards and procedures that reflect the specific economic conditions in China's evolution towards a market economy, certain important accounting principles applied in IFRS are not adopted under Chinese GAAP, such as the use of fair value. The approach of the MoF has been to establish a set of CAS suited to China's current business environment, while at the same time maintaining a steady convergence with IFRS.

The old accounting principles were designed to meet the needs of a planned economy, and therefore focused on whether the production goals and cost plans of the country's many SOEs were being met. Accordingly, the objectives of the accounting system at that time were starkly different from the financial reporting objectives necessary in a modern market

orientated economy. The principal aim of the new accounting system has been to replace this accounting model with a set of standards more suited to an evolving market economy.

A very significant portion of the Chinese economy is still dominated by SOEs however. Even after such enterprises have been restructured into joint stock enterprises, regional governments that remain stakeholders still exert considerable influence over the enterprises and their trading partners, and related party transactions are common. China has adopted a prudent approach in the consideration of using fair value as a basis for measurement due to the current market situation and it is therefore difficult to determine fair value for non-monetary assets. Similar problems apply in other areas, including the accounting treatment of debt re-structuring.

Since the IASB formulated the IRFS primarily in the context of developed market economies, the MoF has asserted that until the obstacles faced by an economy in transition, as is the case in China, are competently eliminated, it is impossible to bring Chinese GAAP completely in line with IFRS. In the meantime then, FIEs will have to continue to make numerous adjustments when they compile financial statements under international standards, as almost invariably will be required by their foreign investors. Such FIEs might therefore consider the benefits of having an outside professional firm review their financial reports, in particular those prepared for the annual audit in April, for GAAP adjustments.



Goals for the Future

As a result of its accession to the World Trade Organisation in 2001, China will increase its scope and extent of international cooperation. It is widely expected that the MoF will have issued a further nine accounting standards by the end of 2004 and has stated that the MoF's aim is to "hasten the progress of the accounting standards projects in order to accommodate the development of the market economy." The MoF has also stipulated that during this process they will continue to make reference to standards used internationally, declaring that, "unless they clearly contradict with the existing law and regulations in China, CAS will keep in line with the IFRS to the extent possible." The MoF will also embark on industry-specific standards that focus on sectors of the economy that are of great significance to China such as agriculture, banking, insurance, oil and gas.

Despite the above-mentioned efforts by the Chinese government authorities to bridge the gap in GAAP, it's important to note however that some users of Chinese GAAP have considered that such financial statements have proved insufficient for international users not because of the disparity that exists between the two standards. Rather, the main problem is a lack of transparency, auditor independence and reliable financial information, and a shortage of qualified accounting professionals.

The pressure for transparent, publicly disclosed accounting information is reduced by the continuing extensive share ownership by the state and institutional investors. The resulting close link between tax reporting and financial reporting creates demands such as ensuring a stable source of tax revenue for the state and avoiding reporting embarrassingly large profits

or losses. So long as the state remains a major stakeholder in the Chinese economy, there exists enhanced opportunities for income manipulation to hide losses. Off balance sheet liabilities of uncertain quantities further reduce the transparency of financial statements.

The real challenge facing the accounting environment in China then lies not only in adopting more internationally accepted standards but also in the reform of the financial and taxation systems, and in the development of auditor training and independence. Indeed, without an independent audit environment, even accounting statements prepared using IFRS might still prove to be unreliable. Bridging the gap in GAAP might seem like mission impossible, but with a clear understanding of the issue involved and the right assistance, all companies in China can ensure that their accounting statements satisfy all the necessary requirements, with no rotten onions!

Peeling the Onion is a series of newsletters designed to assist your company with the financial and accounting control of your China operations. We are interested in receiving your feedback on our articles and any suggestions as to future topics are more than welcome at [**newsletter@lehmanbrown.com**](mailto:newsletter@lehmanbrown.com)

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