

INTERNATIONAL BUSINESS NEEDS AND CHINA'S CONVERGENCE TO IFRS

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ABSTRACT

The purpose of this paper is to discuss the state and reason of China's ability to adopt the IFRSs, with an in-depth review of the literature based on historical and future direction of the Chinese accounting fraternity. The Chinese government used the challenges faced by the country to strengthen its core fundamentals to ensure a smooth gradual transition to embrace the international business community with the adoption of IFRS. This paper provides a better understanding on how the Chinese resilience was built over time and the differing approach to IFRS adoption. The formation of the six factors of China's past has assisted the Chinese leaders to shape its future and the six steps process is a manifestation of the solid gradual growth of the Chinese Accounting Standards toward full adoption of IFRS. The paper also discusses the historical reasons behind the current emerging and advance state of the Chinese accounting standards.

Keywords Chinese Accounting Standards, IFRS, Dual Track Pricing System (DTP), Chinese Accounting Standards Committee's (CASC), Convergence

Introduction

Deng Xiao Peng in 1992 postulated that the ultimate objective of socialism is to achieve prosperity for all and at the same time withstanding the liberation and development of productive forces and the elimination of exploitation and polarization. There are multiple overlaps between planned economy and market economy (Zhang, et al., 2007) and one such overlap of ideology, whether be it in politics or economy, have blurred the distinction between socialism and capitalism. Hence, such gray areas brought forward new thoughts and China leveraged both extremes to manifest itself as the possible setter of the new world order. An obvious reason to transform from a planned economy to a market economy is to improve the social standings of the Chinese people, and this was achieved through the immense inflow of foreign direct investment (FDI). China manages to attract huge amount of FDI, being one of the highest in the world and this success story is partially indebted to the efforts of the Chinese officials to implement dual track pricing (DTP) to attract FDI, hence elevate the Chinese economy. The volatile global economy is inevitable, therefore like any other globalized economy, China needs to make sure that they remain competitive and fully converging with International Financial Reporting Standards (IFRS) and being agile to the needs of current and future changes in the accounting fraternity makes China a force to be reckoned with. The IFRS foundation and the Ministry of Finance of China have paved the way to use the IFRSs in China for Chinese companies with an international outlook. The motivation of this paper is paved along the reasons of the resilience of the Chinese economy and the need by IASB to see that China eventually converges its accounting standards to IFRSs. The main issue of the convergence process is the cultural differences in China which is also embedded in its political views and economic dimensions.

2. A Century of Tribulations

China has weathered many years of internal and external challenges and the one hundred years of tribulations molded the current thinking of China's leaders. The issues that China faced since 1839 till the end of World War 2 paved the creation, popularity and establishment of the communist party. It seems like there was more of a need rather than an option to have the establishment of the communist party in China to consolidate the huge land mass and diverge Chinese ethnicity after 100 years of tribulations.

These challenges that were faced by China started with the intrusion by the western powers in 1839, followed by the surrender of Hong Kong and Macau and Japan's occupation until the end of World War II. After suffering the intervention and imperialism of the western powers and the Japanese, the Chinese nationalism rose and demanded sovereignty and integrity of Chinese territories. All these issues paved the establishment of Mao Zedong's People's Republic of China in 1949, depicting the rule of the Chinese Communist Party and the end of the century of humiliation.

Chinese Community Party has ruled China since 1949 and lead China to have a command economy. Economic and social transformation in both rural areas and urban areas were embarked by the party as most prices were set by the government to have greater control on the capacity and resources. Deng Xiao Ping who took over the leadership in 1978, introduced economic reformation in China. One of the economic policies was dual track approach to facilitate market liberalization. The element

under the dual track approach is dual track price system, which was advocated by Zhang Weiyong in 1984 and his theories had far reaching influence on the academic, governmental and industrial circles (Leonard, 2008).

3. Dual Track Pricing System (DTP)

Dual track pricing system was recognized as the most important aspects of Chinese reform in overcoming political constraints and contributed to economic boom in 1980s (Che and Facchini, 2007). Since China was lacking of legal and governance structure, there was a need for dual track system as a support to private ownership to protect the right of privatization (Resphasy, 2010). The purpose of dual track price system is to keep the existing planned economy while gradually building a free market system to move forward to a market-oriented system. Initially, dual track pricing was introduced to most industrial goods and under the dual track pricing, two prices which are planned price and market price are set on one item. Eventually the equilibrium of supply and demand will decide on the market price while the government will decide the price for the rest of the items with fixed planned price. Accurate information on the scarcity and availability of inputs and outputs was shown through market price and thus increased the efficiency (Resphasy, 2010).

One of the advantages of dual track pricing is increased employment rate. Consumers are allowed to purchase goods from both free and planned market, therefore the rise in supply and demand for products and services increases the demand for labour. Dual track pricing has setbacks like corruptions as producers and consumers view it as an opportunity to bribe the official government who is in control on which supplier to get the goods and the amount of goods allocated. However, it is undeniable that dual track pricing has helped China gradually come out from command economic to market liberalization (Resphasy, 2010).

China applied the dual track model with presence of both rules based accounting and principles based accounting. The old accounting system is based on rules based accounting and the new Chinese Accounting Standards (CAS) is based on principles based accounting. In order to converge to IFRS, China needs to go through the dual track system to prepare itself to embrace the inevitable change.

4. Chinese Accounting Standards Committee's (CASC) Kaizen: Continuous Convergence to IFRS

Kaizen was first introduced in Japan after the Second World War and became an important management philosophy. Kaizen is all about continuously implementing improvements in corporations. Therefore it can be viewed that Kaizen promotes small, but continuous improvements, so that the improvement becomes part of a routine process and blends into the day to day normal operations.

Leonard (2008) mentioned the metaphor that Zhang Weiyong used to explain the gradual introduction of zebras to replace horses in a village. This metaphor explains how to continuously converge local accounting standard to IFRS. Zhang Weiyong's 1984 'dual-track pricing' theory would allow the government to introduce market prices and at the same time maintain its commitment to socialism. This parallel pricing mechanism or shadow pricing system allowed the Chinese officials to work around obstacles and also to allow the end users to familiarize and accept the changes with maintaining the old fundamentals, which are also the fundamentals of Dual Track Pricing (DTP).

Parker (2011) posited that the Chinese government, mainly the China Securities Regulatory Commission and the Ministry of Finance are pushing for the implementation of IFRS in China very seriously to materialize the IFRS convergence in China. The metaphor of zebras and horses has led to the approach taken by the Chinese to implement a kaizen approach to IFRS convergence. China, even though is not fully converged to IFRS, but are making serious progress towards IFRS convergence. The current IASB chairman, Hans Hoogervorst, mentioned that the Chinese Ministry of Finance promulgated the new Chinese standards in 2006, which was developed through a process that China calls as a 'continuous convergence' with IFRSs and IASB.

5. No Big Bang = DTP = 'Condorsement' Approach

The big-bang approach, which is synonymous with the accounting reforms in Japan have proved that a drastic and abrupt change in the field of accounting will result in adverse effects, such as an increase in errors in managerial forecast in earnings and further derail the efforts to converge national accounting standards with IFRSs (Duangploy & Gray, 2007).

Former centrally planned economies in Eastern Europe and the former Soviet Union, implemented accounting reform using the 'big-bang' approach. These countries used the economic theories from the west that were not necessarily result in bringing positive changes. Even Japan's 'big bang' approach to adopt IAS proved to increase earnings management by Japanese firms to meet managerial earnings forecast, which in turn, showcased managerial earnings forecast errors (Duangploy and Gray, 2007). Blanchard, et al. (1991); McMillan and Naughton (1992) also argued that China's economic reforms were gradual, step by step approach, without any specific goal and timeline for the transition to the market economy that allowed the Chinese officials to realign and intervene as and when necessary.

The Chinese method and methodology in transforming their economy to market economy was also different compared to the route that was taken by the Russians. Blank (2011) stated that Russia decided to adopt the economic reforms similar to Poland's 'shock therapy' by abruptly changing policies and privatising Russia's state owned enterprises. These moves caused chaos in the Russian economy and politics and eventually the negative impact was felt by the Russian public. A gradual approach would have been better for the Russians to adopt, adapt and align to the new market economy. The method of a wholesome and sustainable

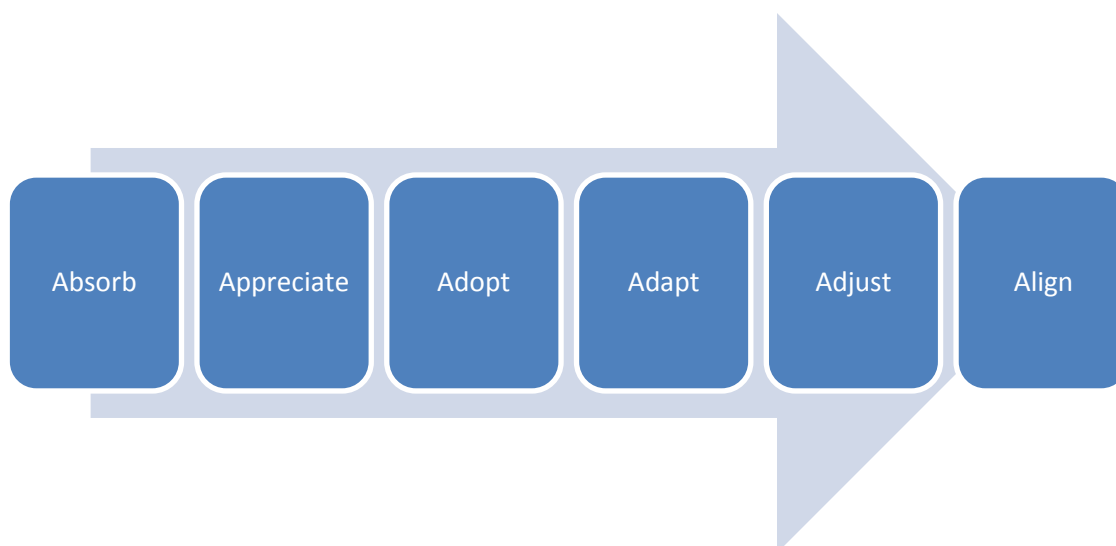
convergence to IFRS is shown in *Figure 1*, which is reflected by the successful progression of the adoption of IFRS by the Chinese regulators.

The current success obtained by China in its efforts to converge to IFRS is due to the adoption of the ‘convergence approach’. The ‘convergence approach’ is recommended by the United States Securities and Exchange Commission (SEC) and is to be applied by FASB, as opposed to the ‘endorsement approach’ used by many European Union (EU) countries. The Chinese officials are moving its standards closer to IFRS without fully incorporating IFRS into its national financial reporting framework, by eliminating the existing differences between its Accounting Standards for Business Enterprises (ASBEs) and IFRS. On the contrary, the EU incorporates individual IFRSs into their local body of standards and translates IFRS into their local language, but translated versions of IFRS may be misunderstood and applied differently from IFRS (SEC, 2011).

By applying the DTP, China has averted the trap of ‘uncertainty’ and ‘shock therapy’. The new ‘condorsement’ approach recommended by the SEC to incorporate IFRS into the US financial reporting system is in essence to incorporate IFRS principles into US GAAP over a defined period of time. This gradual implementation is expected to avoid the costs associated with the ‘big bang’ incorporation of accounting standards and allows a harmonised approach that presents the opportunity to develop a more comprehensive educational process (Pizzileo, 2011).

Therefore, the CASC’s slow and steady convergence approach, have influenced the FASB to aligned its accounting standards with IASB, but the FASB-IASB process involves movement by both standard setters toward a new, mutually-acceptable high-quality standard, hence known as the ‘condorsement approach’ (SEC, 2011).

Figure 1: The Approach to Converge



6. China’s Accounting Standards Development

Prior to 1978, the Chinese accounting system was different from the western accounting system but from 1978 onwards, China paved its transformation from planned to market economy that promotes foreign trade and economic investment. Since the open door policy was introduced, China has been implementing significant reforms to its economy and accounting practices by adapting from internationally accepted accounting standards.

China’s accounting standards continue to develop in the subsequence years, especially when China joined the World Trade Organization in 2001 as China had to participate actively at the international level and developing its own accounting standards (Wei, 2007). Chinese Accounting Standards Committee and the International Accounting Standard Board (IASB), signed a joint statement in 2005 in respect with the status of substantial convergence between Chinese Accounting Standards (CAS) and IFRS (Hsiao and Yen, 2009). In 2006, the Chinese Ministry of Finance formally announced the convergence of Chinese Accounting Standards with IFRS via issuance of the Accounting Standards for Business Enterprises which consists new basic standard and 38 specific accounting standards that are substantially in line with IFRS and this new set of CAS became mandatory for all listed companies in China from 1 January 2007 (Wei, 2007). Companies offering shares to international investors, known as B-shares were required to report using both the new CAS and IFRS, and those companies that offer shares to domestic investors, known as A-shares were needed to report using the new CAS, while unlisted companies are also encouraged to implement the new standards (Qu, et. al, 2012) and eventually the Ministry of Finance mandated the implementation of the new standards for all state-owned enterprises by the end of 2008, while financial institutions were required to apply the new CAS from 2009 onwards. According to China’s Convergence Roadmap 2010, the full convergence process was expected to be completed by 2011, but China deferred the full convergence to a later date. Nevertheless, since 2011, the Chinese MOF has been communicating with United Kingdom, Japan and Korea and sending experts to these countries for accounting standard discussions an effort in

promoting convergence towards IFRS, but Chinese standard setter had yet to announce any adoption or convergence plans to IFRS for small and medium enterprises (Solas & Ayhan, 2007; Gao and Yan, 2012).

7. Hong Kong's Role

Hong Kong has been under the rule of British since 1841 until it was handed over to China in 1997 and governed as a special administrative region. Under the principle of 'one country, two systems', Hong Kong is administered quite differently compared to China and this can be viewed from two perspectives. The first is that Hong Kong is applying accounting standards that are different from China, which means, that dual accounting systems are possible to be applied in one country. The other perspective is by using Hong Kong as a successful example, China will be convinced of the ability and applicability of IFRS adoption in China. The progress of convergence to IFRS should be faster in China with IFRS 'savvy' accountants and auditors in Hong Kong that are able to assist the convergence process in mainland China.

Despite some political setback, one country, two system approach in China and Hong Kong can institute a clear and doable roadmap for the seamless integration of IFRS in China. As Zhang Weiying advocated in 1984, the dual track pricing system (DTP) can be resonated as dual accounting system, but keeping in view, that the ultimate result should be one accounting standard, that is IFRS.

8. Principles-Based, Rules-Based and Needs-Based Accounting Standards

Principles-based accounting standards is the most prevalent accounting standards in the world, being the choice of standards for IASB which is followed by many countries as opposed to the rules-based accounting standards predominantly used in the United States of America. Principles-based accounting standards promotes the passing of judgement in interpreting issues compared to too much of rules driven regulation as in the rules-based accounting standards. Contrary to the principles-based and rules-based, the needs-based philosophy of standards issuance is practiced in China, where a standard will only be issued as and when it is required and the old standard will be re-alignment to the new.

This needs-based accounting standards development is a product of the well planned and executed transformation of the Chinese economic, political and social stances. The metaphor of zebras and horses, as explained by Zhang Weiying (Leonard, 2008) and with the introduction of DTP, implementation of the Kaizen of accounting standard development and the condorsement approach has led to the birth of needs-based accounting standards.

There is a need for China to converge to IFRS and this is evident in the gradual move of the Chinese accounting standards towards IFRS convergence. The concept of DTP has led to the increase of foreign direct investment in China. China has positioned itself as a leader in low cost production provider and coupled with the efforts to converge to IFRS has made China attractive to foreign direct investment. According to a publication by S.J. Grand, Financial and Tax Advisory in 2011, China's transformation from a planned economy to a market economy has increase the inflow of FDI, and the development of Shanghai Stock Exchange and Shenzhen Stock Exchange. The uniqueness of Special Administrative Regions, especially Hong Kong, demonstrated the enthusiasm of Chinese officials to bring China into the centre stage of world economy, which also increased unprecedented merger and acquisition activities within and outside of China.

These developments in China have pressed the need for the CAS to converge into IFRS, so that China can remain competitive and sustain itself in attracting foreign direct investment. China is at the forefront of many international accounting standard forums and **Hans Hoogervorst (2011), IASB Chairman, mentioned that IASB respects any decision that China takes with regards to IFRS and** further claimed that, IASB and China should work together, as there is a need for China to converge to IFRS, more so as the remaining differences between the Chinese GAAP and IFRSs are small. **Hans Hoogervorst** also mentioned that as China has invested substantially in high quality financial reporting and should decide the steps it want to take to further its interests in accounting standard-setting.

Figure 2: The Factors of China's Convergence to IFRS



9. The accounting profession in China

According to International Federation of Accountant's (IFAC) CEO, Fayezeul Choudhury (2013), China is becoming the impeller of the world's accounting development. Starting off to serve the planned economy after the formation of PRC in 1949, this mostly dormant accountancy profession leaped into importance to serve foreign funded operation in China and is currently the underlying institutional framework in China's market economy.

Chen Yugui, the vice president and secretary general of CICPA, aspires to increase the role and prestige of China's CPAs (Bruno, 2013). CICPA have three strategies to develop the accounting profession, the first being international standards convergence strategy, local accounting firms' development strategy and accounting talent strategy. The accounting profession development in China has been incorporated into the 12th five-year plan and the national programme for medium and long term talent development and staff training to ensure the mobility of local accounting professionals across the globe. This phase by phase development plan for the Chinese accounting profession, which ends in 2015, will propel the profession to greater and more visible heights (Barnes, 2012).

The need to converge to IFRS has benefited the Chinese economy by enhancing the 'understandability' of the reported earnings of the companies listed on the Shanghai and Shenzhen stock exchanges. Domestic and international investors are more confident to invest in Chinese companies as reported earnings are more informative. This paradigm shift is also credited to the accountancy profession reforms in China as the Chinese policymakers are serious in achieving a sustainable growth in a market economy (Schizas, 2013).

However, as promulgated by Hofstede & Hofstede (2005), the collectivism cultural dimension, with the nature of 'Quanxi' in Chinese culture had a negative impression on the international community and the last couple of years was an upset in the progress of the Chinese accounting convergence, where the transparency and integrity issues hampered the convergence process (Drawbaugh, 2012; Aubin & White and D'Aveni, 2013).

In May 2012, the Ministry of Finance announced that the big four auditing firms, namely Ernst & Young, KPMG, Deloitte Touche Tohmatsu and PricewaterhouseCoopers would have to give 60% control of their Chinese operations to Chinese accountants by the end of year 2012. Addition to that, by end of 2015, the head of country of the Big Four in China must be a Chinese. Addition to that, by 2017, the big four auditing firms can only hire 20% foreign certified accountants and senior partners too must be Chinese citizens with domestic qualification as well as having at least eight years work experience with Chinese accounting firms (Ziwu, 2012), and also it is virtually impossible for foreigners to pass the CPA exams in China. These hurdles have only strengthened the nationalisation of the profession.

To make the matter worse, in 2012, the Securities and Exchange Commission of the United States of America (SEC) investigated nine China-based companies for accounting fraud and required audit work papers from China's five biggest accounting firms. But these accounting firms refused to cooperate with the SEC, causing revulsion between the SEC and the Ministry of Finance of China, resulting in SEC imposing sanctions that will affect the listing of US-listed Chinese companies as

Public Company Accounting Oversight Board (PCAOB) might deregister companies that they are unable to inspect and further discourage new Chinese companies to have an IPO in the United States (Bruno, 2013).

10. Conclusion

China practices the theory of dual track pricing in accelerating their convergence process to IFRS, with presence of both rule based in old accounting system and principle based in new Chinese Accounting Standards (CAS). Dual track system is a process that China must go through to reach convergence and that is exactly what China did. Dual track approach was clearly seen when the Chinese government, the China Securities Regulatory Commission and Ministry of Finance, collectively fostered an alliance in achieving convergence of IFRS in China (Parker, 2011).

Since 2006, China have gradually improved and modified their CAS to be generally consistent with IFRS. Fundamentally, CAS is consistent with IFRS therefore it will not become a burden for organizations to adopt IFRS when full convergence is implemented in China in the future. From 2007, two sets of accounting standards were available to be adopted, which are the new CAS and IFRS. The mandatory requirement of industries to comply with the new CAS is a stepping stone to full convergence and the gradual increase of industries using new CAS will accelerate the process of convergence towards IFRS.

China is slowly but surely making progress on the IFRS front with the government leading the way (Parker, 2011), and it feels like there was a divine intervention in guiding the Chinese in converging to IFRS and China is doing it so seamlessly and can be rated as one of the most successful transformation from the socialist rules-based accounting system and standards to the capitalist principles-based accounting system and standards (S.J. Grand, 2011). From the accounting perspective, perhaps the three decades of socialist ideology paved a concrete path of perseverance and conviction towards a dynamic and forward looking China.

According to Leonard (2008), Deng Xiaoping and his allies had never set a date-line target of achieving a full market economy, but implemented step by step changes, without thinking too much of the destination. Likewise, in accounting convergence, the Chinese have adopted similar approach, by making sure that the convergence to IFRS is done very mindfully and without losing control of the benefits and without the need to mitigate the disadvantages that it might bring to the Chinese economy and society.

With the slowing down of the Chinese economy in 2014 and looking gloomy forward, coupled with the worlds' dependency on it, it is only right that the Chinese accounting fraternity embraces IFRS and converge seamlessly. This critical need to converge is vital to maintain China's position as the leader of the pact of the BRICS countries and to rival the United States of America, the emergence of MIKT (Mexico, Indonesia, South Korea and Turkey) and the ASEAN Economic Community (AEC).

While the progression to converge is long overdue, new current and future regulatory and market driven pressures are already out of the pipeline. While the first version of the framework for Integrated Reporting was launched in December 2013, the need to jump on the bandwagon is crucial to be attractive to foreign investors. The entire ecosystem of convergence to IFRS, integrated reporting and also the multiple bottom line reporting, that includes economic, governance, social ethics and environmental (EGSEE) dimensions of sustainability performance and accountability reporting will act as complementary to the IFRS compliance. These dimensions are related to the financial and non-financial key areas and are very crucial for the long term business sustainability of a firm at a micro level and an economy at the macro level, which are the building blocks of healthy international and borderless businesses, which is critical for the Chinese in order to be the largest, resilient and sustainable economy in the world in the near future. Finally, the success of the of the IFRS foundation and the Ministry of Finance in China to set up the joint working group in 2015 to find ways to make China fully converge with IFRSs within China and also be at the forefront of accounting standard development in the future is based on the sentiments, wisdom and vision of China's past and present political, economic and business leadership.

The limitation of this conceptual paper is that no primary data was collected either using qualitative or quantitative approach. This study is predominantly a review of literature on the different journeys of convergence to IFRS by a few countries, with China in focus. More rigours and causal and relationship or even comparative study can be done in the future to compliment this paper. This paper will be able to set an expectation on different reasons and needs of a country to converge to any regulatory requirement, be it IFRS or even Integrated Reporting.

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