IV. Accounting and Auditing Standards

This chapter describes the accounting and auditing standards that govern the preparation of external financial reports and the audit of those reports. The chapter comprises five sections, in two parts, as follows:

Part One: Accounting Standards

1 – Introduction

2 – New Uniform Accounting Systems (Financial Standard) – describes the new uniform accounting systems which coexist with accounting standards.

3 – Accounting Standards – discusses the development of accounting standards, describes the bodies that are involved in their development, and compares the standards against International Accounting Standards (IAS).

Part Two: Auditing Standards

4 – Independent Auditing Standards

5 – Government Audit Standards

Part One. Accounting Standards

1. Introduction

In the 1950s, the PRC adopted a highly centralized administrative system from the Soviet Union. Under the system (called the Financial System for Business Enterprises – also called the "old uniform accounting system"), the financial management of enterprises was strictly controlled by the central Government. Headed by the Ministry of Finance, the task was carried out by finance bureaus in various levels of local government.

The Financial System for Business Enterprises had three characteristics. First, there was specific and strict government control over financial matters relating to sourcing, production, and marketing activities. Second, there was a vague distinction between taxes and profits since the Government was the sole owner of enterprises. Third, accounting was regarded as an integral part of the control system and directions that are usually included in the accounting standards of other countries were incorporated into the financial system.

Different financial systems were designed for different ownership arrangements and for different economic sectors. These systems created the following problems:

(i) Different profit-allocation and taxation mechanisms created unfair competition among enterprises. For instance, large and medium-sized State enterprises were subject to a profits tax rate of 55 percent, collective and township enterprises were subject to an eight-scale profits tax rate, and foreign enterprises enjoyed tax exemptions and a tax rate of 33 percent. This system adversely affected production incentives and focused attention on beating the rules, not on improving efficiency.

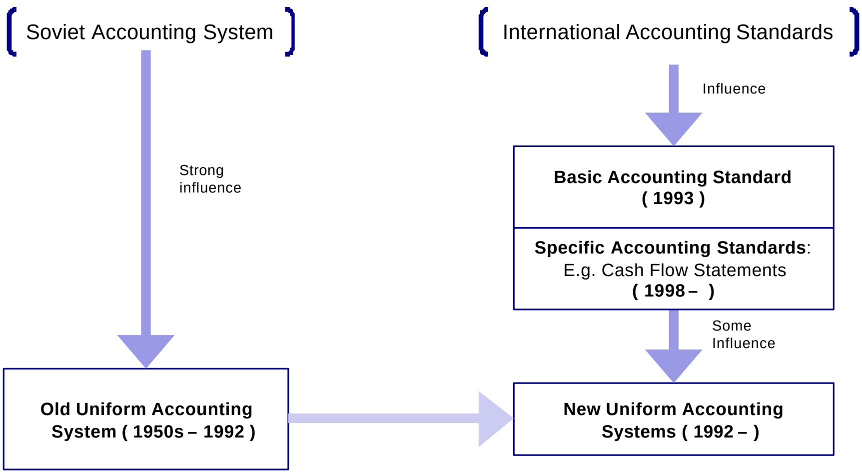
(ii) They inhibited enterprises' operating mechanisms. One financial statement was divided into three self-balancing funds: fixed assets, current assets, and special assets. Funds were nontransferable which reduced enterprise flexibility. For instance, it locked enterprises into a particular structure and production function.

(iii) They inhibited enterprise integrations. Under the centrally-planned economy, each enterprise was normally engaged in a single line of business. The economic reforms encouraged product-line diversification, and vertical and horizontal integrations. When these changes took place, the parent enterprise's specific financial system was required to be used by all acquired enterprises. It was unreasonable for a large group, engaged in various areas of business, including manufacturing, distribution, and financial servicing to follow only one specific financial system.

In the early 1990s, the PRC developed overall objectives for accounting-system reform. These objectives included the development of a series of basic and specific accounting standards that would be consistent with international accounting practices and that would cater to Chinese realities. A two-phase strategy was developed to achieve these objectives. First, the planned-economy accounting system would be transformed into a market-economy accounting system. The promulgation of the Basic Accounting Standard in 1992 was a key output of this phase. In addition, a new set of uniform accounting systems was published for the major economic sectors. Second, a full system of accounting standards for enterprises would be developed over time.[40] The new standards will apply to all Chinese enterprises and will bring the Chinese accounting system into line with international practice. Among the accounting characteristics specified in the standards are: the use of double-entry accounting (which was also used in the old system), accrual based accounting (which has always been used), and principles such as consistency and conservatism.

In 1992, the Ministry of Finance issued the first of the PRC's new IAS-based accounting standards – Accounting Standards for Business Enterprises No. 1 – Fundamental Accounting Standards. A further ten standards have been issued since and more are on the drawing board. With the release of the first new accounting standard, the Ministry of Finance published a series of new uniform accounting systems for the major economic sectors (e.g. Government Agencies, Public Institutions and Business Enterprises). Figure 3 illustrates these changes.

Figure 3: The Old and the New Accounting Systems



The Ministry of Finance (MOF) is responsible for developing accounting standards.[41] To exercise that function, the MOF has set up the Accounting Regulatory Department. In addition, and in line with the *CPA Law 1993*, the MOF supervises and guides the CPA profession, and approves all accounting standards. In October 1998, the China

40 Chen, Yugui. (March 2000). China Accounting and Finance Update, in *China Accounting and Finance Review*. Vol. 2(1). pp. 162–167.

41 Article 6 of the *Accounting Law 1985*.

Accounting Standards Committee (CASC) was established to provide advice on the setting of accounting standards.

2. New Uniform Accounting Systems (Financial Standard)

The new uniform accounting system (1992) standardized the financial activities of all business enterprises, public enterprises, and government agencies and addressed many of the issues associated with the old system. The key reform areas were as follows:

(i) It introduced the concept of owners' capital and upheld capital maintenance. For instance: profits and losses on fixed asset sales are no longer regarded as capital transactions; and special funds have been eliminated.

(ii) The reformed treatment of depreciation has helped technology improvements. The new Financial Standard allowed enterprises to choose their own depreciation policies. The subsequent adoption of accelerated-depreciation rates had favorable effects on technology improvements.

(iii) Reform of cost management systems. Most countries use the manufacturing costs method (which divides costs into manufacturing costs and period costs). Along with other changes, the new Financial Standard mandated the use of this method.

Box 2: Features of the New Uniform Accounting Systems[42]

The New Uniform Accounting Systems provide detailed accounting regulations for each sector. These regulations prescribe technical guidelines including: definitions of accounting terms, detailed descriptions of the items to be included in each account, rules for journal entries, a uniform chart of accounts, and rules of measurement and verification. Accounting practices must comply with these guidelines.

The old systems were criticized as extremely complicated and unnecessarily detailed. Moreover, they did not satisfy the information needs of investors, lenders, and other users. The implementation of the new financial reporting systems and the establishment of the new financial performance measurement system was seen as having two benefits. First, the old financial statements comprised of: the three-part

[42] Compiled from: Liu, Kin Cheung and Wei Guo Zhang. 1996. *Contemporary Accounting Issues in China: An Analytical Approach*. Prentice Hall: Singapore. p. 23.

self-balancing statement of financial position, the income statement, the cost statement, and other statistical reports. The new financial standard altered these to: the balance sheet, the income statement, the statement of changes in financial position[43], and related notes. These changes were intended to highlight an enterprise's assets, liabilities, and owner's equity, and to satisfy the needs of the various users of the financial statements. Second, there was previously no way of consistently evaluating the performance of an enterprise. The new Financial Statement adopted western methods of financial analysis (for instance, the current ratio, and the stock-turnover ratio).

3. Accounting Standards

Introduction

This section describes the PRC's new accounting standards. It begins by reviewing the history of their development then describes the operations and activities of the standard-setting bodies. A status update on accounting is provided and the section concludes with a discussion of differences between the accounting standards and International Accounting Standards (IAS).

A Recent History of Accounting Standard Setting

Since 1949, when the PRC adopted central planning, the Government strictly controlled all economic entities, including business enterprises. To meet the information needs of central planning, accounting practices were required to adhere to a uniform accounting system that was designed by the Accounting Regulatory Department of the MOF.

The appropriateness of the uniform accounting system was reconsidered with the introduction of the economic-reform program at the end of the 1970s. The systemization of accounting concepts, principles, and standards was considered an important issue. With the development of the market economy, the uniform accounting system was considered inadequate to cope with the complexity of accounting affairs in the PRC.

[43] Cash Flow Statements replaced this in 1998.

Box 3: Key Differences between the Uniform Accounting System and International Accounting[44]

The traditional Chinese accounting systems differed from western accounting conventions in the following key areas:

- They presented a high company net worth since provisions for future events were not included (e.g. provision for doubtful debts).
- The determination of asset values was difficult since land was not usually privately held, nor did secondary markets exist.
- Reporting formats were substantially different.

In its *1988 Program on Accounting Reform*, the MOF stated that the Accounting Regulatory Department should abandon the traditional approach of monitoring accounting affairs, and that accounting standards should replace the existing uniform accounting system.[45] In March 1988, the Panel on Accounting Standards (that was set up by the MOF and tasked with designing a blueprint for the accounting reforms) issued two documents: the Tentative Plan for the Establishment of Accounting Standards in the PRC, and a Discussion Memorandum on Major Issues Related to the Establishment of Accounting Standards in the PRC. The Plan recommended that a research group under the MOF should draft formal accounting standards. It also recommended that the Statement of Accounting Standards should be effective for financial reporting for the 1990 fiscal year.

In April 1989, the MOF circulated *An Outline of Accounting System Reform in the Near Future*. The outline specified four guidelines for this task including the need to maintain consistent with national economic policies, to take account of the PRC's socio-economic environment, and to harmonize the relationship between accounting standards and financial regulations. The Outline divided accounting standards into two levels: basic standards (conceptual framework), and specific standards (detailed rules and procedures).

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44 Compiled from: Liu, Kin Cheung and Wei Guo Zhang. 1996. *Contemporary Accounting Issues in China: An Analytical Approach*: Prentice Hall: Singapore. p. 23.

45 AAA. 1988. Program on Accounting Reform (Discussion Memorandum). References to Accounting Reform: Beijing, China. No. 2.

Box 4: Factors Influencing the Adoption of Accounting Standards[46]

The five critical factors that are credited with the move to accounting standards are as follows:

1. The Government's changing role in macro-economic management. The Government's role is changing from direct control of business enterprises, through central planning, to indirect control using fiscal and monetary policies. Central planning required uniform information.
2. The increasing complexity of business transactions. The uniform accounting system was not based upon a set of basic accounting theories (conceptual framework) and could not keep pace with the introduction of many new forms of business transactions. In equipment leasing, for example, accountants found it difficult to handle these transactions in the accounts.
3. The diversification of business ownership and operation. Under the old system, different government bodies divided by industry sector monitored business operations. With the diversification of ownership and operations, this was no longer possible or necessary.
4. The open-door economic policy led to an influx of foreign investment and the presence of foreign businesses. These businesses needed to comply with Chinese accounting regulations and accounting and financial reporting standards in their parent company.
5. The expansion of the securities market was probably the most influential factor in that it encouraged the adoption of internationally accepted accounting principles and standards.

In November 1991, the MOF issued a formal Exposure Draft on accounting standards called the *Accounting Standards for Business Enterprises No. 1: The Basic Accounting Standard*. The Standard was formally promulgated at the end of 1992 and it became effective from 1 July 1993.

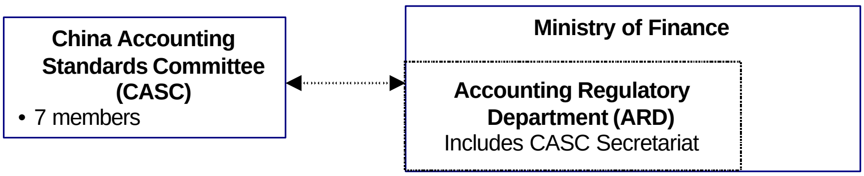
Standard-Setting Bodies and Processes

As described in the chapter introduction, the China Accounting Standards Committee (CASC) was established in October 1998 to provide advice to the MOF on accounting-standard setting. It has seven members including experienced public sector experts, academic experts and accounting professionals. The CASC has similar objectives to accounting standards-setting bodies operating in other countries. The accounting-standard-setting framework adopted closely parallels the

[46] Compiled from: Liu, Kin Cheung and Wei Guo Zhang. 1996. *Contemporary Accounting Issues in China: An Analytical Approach*: Prentice Hall: Singapore. pp. 9-12.

Japanese approach (the Japan Accounting Standards Deliberation Board is part of the government). This arrangement contrasts with arrangements in some other countries where accounting standards bodies are semi-professional associations.

Figure 4: The Relationship between the MOF and the CASC



Accounting standards are developed through a consultative process. The World Bank is supporting this process through the Accounting Reform and Development Project. A series of accounting standards have been identified for development (see below). Process timing varies according to the nature of each standard. The broad process steps are as follows:

- Research and Drafting: The CASC Secretariat is employing a consultative group of domestic and international consultants (Deloitte Touche Tohmatsu) to undertake research into particular issues associated with each standard.
- Exposure: The Accounting Regulatory Department releases Exposure Drafts (EDs) of each standard for general public comment. Each ED is published in the Government newspaper – the exposure period is usually two months. Six seminars will expose the draft accounting standards to experts before their publication (from 1999 to 2001).
- Promulgation and Dissemination: Four seminars will be held in key locations for about 350 high-level participants who are senior provincial accounting and finance policy makers (from 1999 to 2001). The seminars will cover the dissemination of, and training in, the new standards. In addition, master training manuals and videocassettes will be prepared for each standard. These materials will be published and distributed by publishing houses.[47]

[47] World Bank. 1999. Project Appraisal Document: Accounting Reform and Development Project. Annex 2, p. 23.

Status of Accounting Standards

The system of China Accounting Standards consists of a general standard titled *The Basic Accounting Standard*, and a series of specific standards. The basic standard, which was implemented in 1993, prescribes accounting assumptions and the general accounting principles, the accounting elements, and the general requirements for the preparation and presentation of financial statements. Specific standards are prepared in accordance with the basic standard. Since 1993, the Ministry of Finance has focused on the development of the specific standards.

The standards that have been issued so far provide a framework for basic accounting in shareholding companies. Different accounting policies are set out in the accounting system to cater to the differences between domestic and overseas listed companies. As at 30 June 2000, the following accounting standards had been developed and promulgated:

Accounting Standard (IAS Equivalent)	Applicability	Promulgated	Effective
Basic Standard			
The Basic Standard (IAS Framework)	All	November 1992	1 July 1993
Specific Standards			
Disclosure of Related Party Relationships and Transactions (IAS 24)	Listed	May 1997	1 January 1997
Cash Flow Statements (IAS 7)	All	March 1998	1 January 1998
Events Occurring After Balance Sheet Date (IAS 10)	Listed	May 1998	1 January 1998
Debt Restructuring (No Direct IAS Equivalent)	All	June 1998	1 January 1999
Revenues (IAS 18)	Listed	June 1998	1 January 1999
Investments (IAS 25 & 28)	Listed	June 1998	1 January 1999

Accounting Standard (IAS Equivalent)	Applicability	Promulgated	Effective
Construction Contracts (IAS 11)	Listed	June 1998	1 January 1999
Changes in Accounting Policies and Accounting Estimates, and Corrections of Accounting Errors (IAS 1 & 8)	Listed	June 1998	1 January 1999
Non-monetary Transactions (No Direct IAS Equivalent)	All	June 1999	1 January 2000
Contingencies (IAS 37)	All	April 2000	1 July 2000

The following accounting standards are being developed with World Bank support.

Draft / Intended Standard		IAS Equivalent	Timetable
1	Borrowing Costs	IAS 23	2000
2	Leases	IAS 17	2000
3	Basic Transactions of Banking Industry	IAS 30	2000
4	Intangible Assets	IAS Framework	2000
5	Fixed Assets	IAS Framework	2000
6	Inventories	IAS 2	2000
7	Interim Financial Reporting		2000
8	Presentation of Financial Statements		2001
9	Foreign Currency Translation	IAS 21	2001
10	Donation and Government Grants	IAS 20	2001
11	Income Taxes	IAS 12	2001
12	Segmental Reporting		2001
13	Accounting for Liquidation		2001
14	Business Combinations	IAS 22	2001
15	Consolidated Financial Statements	IAS 27	2001
16	Impairment of Assets		2002
17	Earnings per Share	IAS 33	T.B.D.[48]
18	Discontinuing Operations		T.B.D.

48 To Be Determined.

Draft / Intended Standard		IAS Equivalent	Timetable
19	Revaluation	IAS 29	T.B.D.
20	Insurance		T.B.D.
21	Discounting		T.B.D.
22	Retirement Benefit Costs		T.B.D.
23	Agriculture		T.B.D.
24	Oil & Gas		T.B.D.
25	Financial Instruments		T.B.D.
26	Extractive Industries other than Oil & Gas		T.B.D.
27	Owner's Equity		T.B.D.

Financial Reporting and Tax Compliance

The PRC's traditional accounting system was similar to that of some European countries in that financial accounting and reporting was directly linked to the tax return. Consequently, the information needs of taxation authorities dominated those of other users. For instance, business management had little freedom over accounting choices.

The economic reforms have diversified financial reporting objectives beyond tax compliance and macro-economic administration. Financial reporting must now meet the needs of other parties who are interested in the financial performance and financial position of enterprises.[49] The new accounting standards and systems allow enterprises to make the necessary adjustments to their financial statements when preparing their tax returns. At present, most listed enterprises adopt this practice. Moreover, the forthcoming development of the accounting standard on *Income Tax* (based on IAS 12) should reinforce this separation.[50]

Public Sector Accounting Standards

The uniform accounting system currently governs public sector accounting practices however, a research study into the feasibility of developing accounting standards for government organizations and not-for-profit organizations will be conducted as part of the *Accounting Reform Project.*

[49] Ministry of Finance. 1992. *Accounting Standard for Business Enterprises.*

[50] World Bank. 1999. Project Appraisal Document: Accounting Reform and Development Project. Annex 2, p. 23.

Consistency with International Accounting Standards

The MOF's objective is to bring accounting standards into line with IAS while taking account of the PRC's present laws and circumstances. The main difference between the Accounting Standards and IAS is that the PRC's accounting standards offer reduced accounting choices. Overall, while the new standards largely conform to international standards, certain PRC-specific features can be observed, e.g., there is a high degree of government control over accounting matters; the standards are less complex and less detailed than western standards, and result in many complex liability issues being omitted; and there is broad adherence to the historical cost principle, although this is gradually changing.[51]

Differences between IAS and the PRC's accounting standards are presented in Table 9 – the comparative analysis was undertaken by Deloitte Touche Tohmatsu in 1999. None of these differences are significant – with a major exception – which is the requirement to agree; divergences from regulations (to comply with relevant accounting standards), and provisions for damaged or obsolete inventories, with the relevant authorities.

Table 9: A Comparison with International Accounting Standards (IAS)[52]

Topic	Difference
IAS 1: Presentation of Financial Statements	
o Compliance with relevant accounting standards	No requirement to state compliance. Divergences from regulations are permitted only with the consent of the relevant authority.
IAS 2: Inventories	
o Measurement	Provisions for damaged or obsolete goods must be agreed with the relevant authority. However, this does not apply to shareholding companies.
IAS 21: Changes in Foreign Exchange Rates	
o Transactions	As for IAS, except that the exchange rate on the first day of the month may also be used.

51 Winkle, G. H., Huss, and Xi-Zhen Chen. 1994. Accounting Standards in the People's Republic of China: Responding to Economic Reforms. *Accounting Horizons*. Vol. 8(3). pp. 48-57.

52 Deloitte Touche Tohmatsu. 1999. *An International Accounting Comparison: Focus on Asia Pacific.* Volumes I and II.

Topic	Difference
IAS 24: Related Parties o Application of the Standard	Similar to IAS but only enterprises that are subject to control (not significant influence) from any of the specified individuals are regarded as related parties.

Table 10 illustrates the impact of differences between accounts prepared under the PRC statutory basis and International Accounting Standards.

Table 10: Impact of Differences between Statutory Reporting and IAS

Figures for the year ended 31 December 1999	Anhui Guijing Distillery Co. Ltd.	Shenzen Health Mineral Water Co. Ltd.
	Y '000s	Y'000s
I. Profit after Taxation and Minority Interests:		
As reported in the statutory accounts of the Group	149,082	20,585
Reversal of (increases in) provision for doubtful debts	3,156	(200)
(Increase) provisions for obsolete inventories	..	(999)
(Increase) provision for diminution in long-term investments	..	(3,064)
Unearned profits from related-party transactions	..	(13,483)
Reserve write offs	..	(906)
Depreciation adjustments	1,747	..
Others	144	108
As restated for the Group to IAS	154,129	2,041
II. Earnings per Share:	Y	Y
Using the Group's statutory accounts	0.63	0.13
After IAS Adjustments	0.66	0.01

Part Two. Auditing Standards

4. Independent Auditing Standards (Business Enterprises)

The CICPA is responsible for developing *Independent Auditing Standards* and these standards take effect once they have been approved by the MOF.[53] The development process began in 1991 when CICPA issued the *Rules on Audit Working Papers* and *Rules for CPAs on Capital Verification.* In 1994, CICPA began drafting the independent auditing standards and laying down the framework which includes the basic and specific standards of independent auditing, the practice announcements of independent auditing, and the ethical standards of the profession. The first and second sets of independent auditing standards were promulgated in December 1995 and December 1996, respectively. In 1999, the third batch of Independent Auditing Standards was formulated and issued. Auditors are required to adhere to the standards, which are broadly based upon International Standards on Auditing and include:

- The General Independent Auditing Standard
- Specific Independent Auditing Standards:

1 – Audit of Financial Statements
2 – Audit Engagement Letters
3 – Audit Planning
4 – Audit Sampling
5 – Audit Evidence
6 – Audit Working Papers
7 – Audit Report
8 – Error and Fraud
9 – Internal Controls and Audit Risk
10 – Audit Materiality
11 – Analytical Procedures
12 – Using the Work of an Expert
13 – Using the Work of other CPAs
14 – Opening Balances
15 – Subsequent Events
16 – Related Parties and Transactions with Related Parties
17 – Going Concern
18 – Non-compliance with Laws and Regulations
19 – Other Information Disclosed with Audited Financial Statements
20 – Auditing in a Computer Information Systems Environment
21 – Knowledge of the Entity's Business
22 – Considering the Work of Internal Auditing
23 – Management Representations
24 – Communication with Management

[53] Article 35. *CPA Law 1993.*

- Independent Auditing Practice Pronouncements:
  1 – Verification of Capital Contributions
  2 – Management Letters
  3 – Special Considerations for the Audit of Small Businesses
  4 – Examination of Profit Forecasts
  5 – Special Considerations for the Audit of Consolidated Financial Statements
  6 – Audit Report on Special Purpose Engagements

- Other General Standards:
  – Professional Ethics
  – Quality Control
  – Continuing Professional Education

5. Government Audit Standards

In 1995, the CNAO issued the Government Auditing Standards, which were effective from 1 January 1997. The 38 standards cover three categories: (i) basic and fieldwork standards on government audits, (ii) directions for government audits, and (iii) audit management.

CNAO encountered problems with the implementation of the standards. First, audit staff had difficulty applying the standards in their actual audit work. Second, the standards dealt mainly with the auditing compliance aspects. The *Audit Law 1994* also requires auditing of the authenticity and effectiveness of State revenues and expenditures. With the PRC's shift to a market economy, many state-owned enterprises were being converted to shareholding companies, which meant that the CNAO had to make subsequent changes to its audit approaches and procedures. With the changing audit environment in the PRC, some of the existing standards and the Provisional Regulation on Shareholding Enterprises Audit[54] were no longer relevant.

A preliminary assessment by the CNAO concluded that 27 of the 38 Government Auditing Standards needed to be reformulated and that the remaining 11 should not be retained. The assessment also concluded that an additional 23 standards needed to be prepared. This means that there will be a total of 50 auditing standards and procedures. ADB is

54 Jointly issued in 1992 by the CNAO and the State Council's Structural Reform Committee.

providing technical assistance to support this work, which includes a major training component.[55]

[55] TA No. 3103-PRC: *Strengthening the Government Audit System*, for $700,000 approved on 26 November 1998.