China's Convergence to IFRS with Particular Respect to Its Banking Industry

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In this paper the author provides an overview of the process of China's convergence to International Financial Reporting Standards (IFRS) with particular respect to its banking industry.

I. INTRODUCTION

China's economy has grown rapidly for the past two decades and so has China's banking sector, which is a critical part of the economy. At present, banks in China remain the primary source for domestic savings and provider of funds for the real economy. With China's accession to the WTO in December 2001, business activities with and within China have been further expanding and the lifting of all geographical and customer restrictions on foreign banks will further promote China's integration with the rest of the world.

China fully understands that a sound financial reporting system plays a key role in the process of economic development. The Ministry of Finance (MOF), which has the responsibility for regulating accounting matters in China, has set itself the objectives of fostering investors' confidence in financial information, increasing transparency of financial reporting, and harmonizing Chinese national accounting standards with International Financial Reporting Standards (IFRS), so as to reduce the costs of raising capital by enterprises and alleviate the risks of financial crisis.

China has achieved a lot in the process of transforming itself from a centrally planned economy to a market oriented economy. In the past, the old accounting systems and regulations were designed to meet the needs of a planned economy, and therefore focused on whether the production goals of state-owned enterprises and their financial and cost plans were being met. Accordingly, the objectives of accounting and performance measurement some twenty years ago were significantly different from the financial reporting objectives in a market economy.

II. LAWS AND REGULATIONS

There are a number of laws and regulations covering accounting and financial reporting in China. The Accounting Law of the PRC, which was enacted by the

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National People's Congress in 1985 and was last revised as of 1 July 2000, is the highest authority on accounting in China. It sets out general principles of accounting for all enterprises, including a definition of the nature and role of accounting and basic principles. It empowers the MOF to administer accounting affairs and to establish uniform accounting regulations and systems. Such regulations and systems have the force of law. Developments since the enactment of the Accounting Law have shifted from traditional accounting practice, which, being comparatively more rule-oriented, was concerned with measuring progress by reference to the state plan and with monitoring the legitimacy of the application of state funds.

In 2000, the State Council issued Financial Accounting and Reporting Rules for Enterprises. It focuses on such financial accounting and reporting matters as bookkeeping, preparation of financial statements, and reporting practices. It applies to all enterprises other than very small ones that do not raise funds externally.

In the 1980s, the MOF issued the first set of accounting regulations, which was formulated by reference to international accounting practice, for joint ventures in China. In 1992, due to the rapid development of the Chinese securities markets, the Accounting System for Experimental Joint Stock Limited Enterprises, which was subsequently replaced by the Accounting System for Joint Stock Limited Enterprises (JSLE), was promulgated by the MOF in order to standardize accounting practice and disclosures by listed companies. In the same year, the MOF promulgated the Accounting System for Foreign Investment Enterprises and the Chart of Accounts and Accounting Statements for Foreign Investment Industrial Enterprises, which set outs a prescribed format for the financial statements of enterprises with foreign investment. These accounting systems were all subsequently replaced by the Accounting System for Business Enterprises.

In November 1992, the first accounting standard, the Accounting Standard for Business Enterprises (the 'Basic Standard'), which is regarded as the conceptual framework of China's accounting, was promulgated by the MOF and became operative from 1 July 1993. Financial Rules for Business Enterprises (the 'Basic Financial Rules'), which prescribe detailed accounting practice were promulgated in conjunction with the Basic Standard. Both are applicable to all enterprises established within China.

The issuance of these accounting pronouncements represented a milestone for Chinese accounting, because they introduced on a broader scope new accounting concepts and essential elements of financial statements that were in many respects based on international practice. However, these pronouncements were still found to have essential differences with international practice such as the restrictions on making provisions for doubtful debts and obsolete inventories, limited recognition of impairments of other assets, and, the limited disclosure of financial information for the users to understand the results and financial position of the reporting enterprise. Just to mention in passing, the Agriculture Bank of China continues to prepare its financial statements under these accounting rules. Also, many important issues for which international accounting standards existed simply were not addressed by Chinese standards. As a result, the MOF felt the need to embark on an even more focused effort for the development of China's new accounting requirements.

Apart from issuing new Chinese Accounting Standards (CAS), the MOF issued in December 2000 a new comprehensive Accounting System for Business Enterprises (the 'ASBE'). The MOF's plan is to ultimately require all medium-sized and large enterprises (other than financial enterprises) to adopt the new ASBE. When fully implemented, the ASBE will replace the numerous arcane and inconsistent industry accounting regulations that have been promulgated over the years, enabling the financial statements of different types of enterprises to become more comparable.

Although the scope of applicability of individual CAS differ (and only six are applicable to all enterprises), many of the issues addressed in individual CAS are also included in the ASBE, of which the scope of application is wider. The ASBE is consistent with those standards, though there is generally more detail in the individual standards and supporting guidance than there is in the ASBE.

Early in 2002, MOF adopted a new separate Accounting System for Financial Institutions (the 'ASFI'), which was required to be applied, starting 1 January 2002, by all listed banks, insurance companies, brokerages, leasing companies, and finance companies. Starting from 1 January 2004, unlisted brokerages have also been required to adopt the ASFI. Earlier adoption is encouraged. Unlisted financial institutions that are joint stock limited enterprises are also encouraged to follow the ASFI. ASFI is similar to the one for general business enterprises but, in addition, includes principles specific to financial institution.

Furthermore, the MOF issued 2 exposure drafts that are applicable to financial institutions in 2004 which covers the accounting treatment of derivative and hedge accounting, and the accounting treatment for transfer of financial assets. The general principles of the exposure draft on 'Derivative and Hedge Accounting for Financial Institutions' are:

Specifically, derivative instruments should be measured at fair value (at initial recognition and at the end of each period). Hedges are classified as fair value hedges, cash flow hedges, and hedges of the net investment in a foreign operation, and the accounting is similar to the IAS 39 requirements. Disclosure is required of risk management objectives and policies and, for hedge accounting, the hedging relationship, description of hedging instruments and their fair value, and nature of risk mitigated, with further disclosures for cash flow hedges.

The exposure draft on 'Provisional Regulations on Accounting Treatment for Transfer of Financial Assets of Financial Institutions' prescribes the accounting treatment for the transfer of financial assets by financial institutions. The accounting principles followed in the ED are generally consistent with the de-recognition provisions of IAS 39, including a continuing involvement approach to de-recognition if a financial institution has neither transferred nor retained substantially all the risks and rewards of the ownership of the financial assets.

The importance and acceptance of IFRS has increased significantly over the past few years. Convergence with this international benchmark is now seen as a high priority. However, given the specific circumstances and history of individual countries, differences currently exist between Chinese standards and IFRS.

There is no doubt that the MOF fully supports international accounting harmonization and has worked hard to achieve convergence of CAS with IFRS by giving sufficient consideration to IFRS in the process of drafting each CAS. The MOF generally looks to IFRS in its decision on the accounting principles that are included in the CAS, but sometimes modifications are required due to national laws and the practical issues associated with effective implementation by Chinese enterprises.

On 16 February 2006, the MOF announced that it has adopted a new basic standard and 38 new Chinese Accounting Standards that are substantially in line with international accounting standards. The basic standard is akin to a conceptual framework, and the 38 standards address nearly all over the issues covered in IFRS. The MOF has also adopted 48 new Chinese Auditing Standards that are similar to International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The new accounting and auditing standards will become effective for listed enterprises from 1 January 2007. Other enterprises are encouraged to adopt them.

III. NEW ACCOUNTING STANDARDS AND IFRS

The new accounting standards are substantially in line with IFRS, except for certain modifications that reflect China's unique circumstances and environment. In the light of China's evolving market economy and developing accounting profession and the practical circumstances of Chinese enterprises, the MOF has not adopted certain accounting conventions applied in the IFRS, notably the pervasive use of fair value as well as hyperinflation where the MOF has not developed a CAS because of limited application in China.

The new accounting standards change the primary basis of accounting in China. It is not simply an expansion of the disclosure requirements. These standards will have a significant effect on how an entity's financial position and performance are presented in the financial statements. For example:

- Share-based payment transactions for employee services are recognised as expenses in the income statement.
- Minority interest is presented within equity.
- All derivatives are recognised on the balance sheet, with changes in fair value taken to the income statement, unless they are designated and effective hedging instruments.
- Investment property may be measured at fair value with changes in fair value recognised in the income statement. The cost-depreciation-impairment model is also allowed.

- When an instrument that has both liability and equity components (such as a convertible bond) is issued, the debt and equity components are accounted for separately.

Clearly, establishing and improving a single set of high quality global accounting standards is the logical consequence of the trend of economic globalization. The MOF has stated on many occasions that convergence is one of the fundamental goals of its standard-setting programme. The MOF has affirmed its intention that an enterprise applying CAS should produce financial statements that are the same as those of an enterprise that applies IFRS. The response from IASB was quite favorable but it also noted that convergence to IFRS in China will take time, and how to converge with IFRS is a matter for China to determine.

Convergence to IFRS has also impacted significantly China's banking sector. Since 2000, Chinese banks listed in the local stock exchanges were required to prepare financial statements both in accordance with local accounting standards and international accounting standards. Local banks that are listed overseas have been able to convert financial statements prepared under local accounting standards into international accounting standards. However, the conversion exercise was not that straight forward and by no means easy. By way of example, one of our big banks, which was restructured and listed in Hong Kong recently, took 15 months to convert financial statements for 2002 to 2004 from local accounting standards to IFRS standards.

Specifically, in this exercise, the bank had to set up a new system for impairment measurement for loans and non-loans by way of using discount cash flows. In so doing it introduced a new set of rules and procedures for provisioning purposes, which differ from supervisory requirements. Second, all the bank's assets were re-categorized into receivables, held-for-trading assets, held-to-maturity assets, available-for-sale assets and financial assets at fair value though profit and loss. Of course, as a result, the bank introduced fair value accounting for derivatives whether for trading or hedging. Third, the bank put in place procedures for disclosure of financial information in line with the IFRS. Finally, the bank started to overhaul the existing management accounting system that is essential for adoption of IFRS.

As the next step, also in connection with the adoption of IFRS, our local banks are intended to better allocate their budget along business lines with some consideration for branches rather than branch by branch and region by region. In so doing, banks will gradually allocate budget more along business lines less on the basis of branch and region. By the same token, banks will gradually improve their performance review systems with more focus on business lines and less on the basis of branch and region. Such review will seek to incorporate economic value added and RAROC as well as economic capital.

As far as banking supervisors are concerned, we have closely followed the developments in the accounting profession closely. From a supervisory perspective, we have a strong interest in the quality of accounting standards and their implementation. Ideally, the adoption of IFRS should a basis for relevant and reliable measures of assets, liabilities, equity and income as well as capital adequacy and enhancing market discipline through transparent financial reporting. As a result, the adoption should help the banking supervisor in maintaining a safe and sound banking system. Overall, we are definitively highly supportive of the adoption of IFRS in China, particularly in China's banking industry.

As you may know, China's banking sector is generally divided into four categories. The first is the big four. These are the four state owned banks, three of which have been restructured with foreign minority interest and recently listed overseas. They play a major role in China's banking sector, accounting for 54 percent of market share in terms of assets. The second is other 12 national commercial banks, which represent 15.6 percent of the total assets. Five of them are listed in the local stock exchange and one in Hong Kong. The third is 115 city commercial banks, representing 5 percent of the total assets. Finally, there are three policy banks accounting for 8 percent of the total assets.

Following the MOF's announcement in February 2006 of the adoption of a new basic standard and 38 new Chinese Accounting Standards. In light of the importance of adopting IFRS for banks particularly in terms of promoting sound financial management, we consider that IFRS should be applied all listed banks as well as those that intend to list in the future. Specifically, we have asked all the listed banks at home and broad and those that plan to go public in 10 ten years' time to adopt IFRS. This will effectively cover almost all the banks in all the four categories of banks. In addition, even the rural commercial banks and rural cooperative banks are encouraged to get prepared for the adoption of IFRS as well.

Despite our support for IFRS, we note there are quite a few areas with respect to IFRS that attract supervisory concerns globally. The first is relevance of IFRS for banks. We all know that financial instruments comprise of future cash flows. Differences in the timing and risk in those cash flows are captured in a fair value measurement, based on updated market conditions. This is by the accounting profession seen as more relevant than a measure that is based on a historic value. Yet, some supervisors believe otherwise that cost is more useful in a banking book. The second is reliability of IFRS for banks. Clearly, for government bonds etc, there is in many countries an active and liquid market providing updated information about market values. However, for other instruments, in many countries, including China, this is not the case. As a result, the question remains why various types of calculations and models must be used to obtain a fair value. Furthermore, those methods may not enable the same degree of reliability and perhaps even open up for manipulation. The third is volatility. In contrast with a cost measurement, a fair value will change as conditions change. If in the accounts some items are fair value and others are measured at cost, there may be volatility in the financial reports that are purely caused by the accounting rules. Such volatility can have two causes in what can be referred to as 'real' and 'accounting driven'.

As accounting numbers remain the basis for the computation of prudential ratios, convergence to IFRS has a significant impact on capital adequacy. In recognition of the impact of IFRS on particularly on the magnitude, the quality and volatility of banks' available regulatory capital, at the moment, we continue to rely the existing system for capital regulation except one minor change. In July this year, we issued a notice on the treatment regulatory capital in the context of adoption of IFRS. We provide that only 50 percent of the unrealized gains for available-for-sale assets can be included in Tier II capital, while unrealized losses for such assets should be fully deducted from Tier II capital.

Going forward, we will continue to assess the impact of IFRS on banks and keep the options open to use some technical tools similar to the prudential filters developed by the CEBS, Committee of European Banking Supervisors, in order to avoid any unwanted change likely to be introduced by the new accounting rules.

IV. CONCLUSION

To conclude, in transition to a market economy, China has achieved significant progress in developing its accounting standards since the early 1990s. The development of new Chinese accounting standards is an important step for the development of the Chinese economy. While the adoption of new accounting standard represents a tremendous change for companies in China, in the words of Sir David Treedie, this can not be seen "as the end of the efforts to achieve convergence between Chinese accounting standards and IFRS."

The benefits of these accounting changes are clear as they will encourage investor confidence in China capital markets and financial reporting and reduce the costing of complying with accounting system in other countries where Chinese firms operate. However, convergence is a process and perhaps quite a long one. As envisaged by the banking supervisor, in about 10 years' time, the adoption of IFRS will effectively cover almost the entire banking sector, which is extremely encouraging and ambitious. We fully support this development, but at the same time we will continue to assess its impact on banks and will consider possible supervisory adjustments for the sake of sound and prudential regulation.

V. NOTES ON CONTRIBUTOR/ACKNOWLEDGMENTS

Mr. Luo, Director General of Training Department China Banking Regulatory Commission (CBRC), has a supervisory policy career serving both the People's Bank of China and the CBRC ever since its inception in 2003. As a member of the Basel Core Principles Liaison Group/International Liaison Group and regional supervisory groups, Mr. Luo has been actively involved in the development of international supervisory standards and policies. Mr Luo is the chief author for the Chinese capital standards issued in 2004 and is working energetically to promote the best practice for risk management as enshrined in Basel II and its early adoption in China. Mr. Luo received a Master degree in banking and finance from the University of North Wales and worked at two international financial institutions from 1998 to 2000 and 1993 to 1995.

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