Regulating Accounting in Foreign Invested Firms in China: From Mao to Deng

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REGULATING ACCOUNTING IN FOREIGN INVESTED FIRMS IN CHINA: FROM MAO TO DENG

by

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Dedicated to Houyi Xiao, and for the fond memories of Fatima El-Sherbini, Mahmoud Ezzamel Snr, and Juying Zhou.
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Abbreviations

AICPA: American Institute of Certified Public Accountants
ASBE: Accounting Standard for Business Enterprises
ASC: Accounting Society of China
BoD: Board of Directors
CETC: China Economy and Trade Committee
CF: conceptual framework
CICA: Canadian Institute of Chartered Accountants
CPC: Communist Party of China
CPA: Certified Public Accountants
EAS: Enterprise Accounting System
EPS: earnings per share
FDI: Foreign direct investment
FIF: Foreign invested firm
GAAP: Generally accepted accounting principles/practices
GDP: Gross domestic product
HK: Hong Kong
IAS: International Accounting Standards
IASB: International Accounting Standards Board
IASC: International Accounting Standards Committee
ICAEW: Institute of Chartered Accountants in England and Wales
ICAS: Institute of Chartered Accountants of Scotland
IFRS: International Financial Reporting Standards
IJV: International joint venture
JV: joint-venture
MoF: Ministry of Finance
MNC: Multinational corporation
PRC: People’s Republic of China
RMB: Renminbi (the Chinese currency)
SEZ: Special economic zone
SOE: State-owned enterprise
UAS: Unified Accounting System
WTO: World Trade Organisation
The rapid expansion in China’s economy and the move towards increasing globalisation of business increases the pressure for increased global harmonisation of accounting standards. Indeed, the risk and cost to industry of non-compatibility with global accounting standards can be high. However, the issue of cultural differences in the quest for global accounting harmonisation can not be ignored.

This report aims to address some of these issues arising in China by providing a better understanding of the extent to which political, economic and ideological changes and the development of foreign direct investment have impacted upon accounting regulation in China. These changes have resulted in China now being the largest destination worldwide for foreign direct investment.

The study recognises the importance of political ideology on the development of accounting and the demand which the rapid increase in foreign direct investment has had on the need for international accounting harmonisation. The interaction between accounting regulations for foreign invested firms, domestic firms and IFRS is also considered, highlighting the need to recognise the cultural peculiarities of China. The authors conclude with the following important and far reaching policy implications:

- the international community should show greater appreciation of China’s cultural characteristics and the state of its economic and market development, which render complete compliance with international accounting standards impractical;

- the Chinese regulators need to monitor economic developments and embrace international accounting standards more fully; and

- Chinese regulators should continue to phase out the preferential treatment offered to foreign invested firms.
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David Spence
Convener of Research Committee
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This study examines the development of foreign direct investments (FDIs) and accounting regulations for companies and other businesses in receipt of such investments (referred to as ‘foreign invested firms’ or FIFs) in the People’s Republic of China (PRC). The study covers the period beginning with the formation of the PRC in 1949 to the present time, thereby spanning two different political regimes under Mao and Deng. The Mao era (1949-1977) was characterised by an emphasis upon class-struggle, central-planning, public ownership, and self-reliance. In contrast, the Deng era (1978 - present) accords primacy to economic development, marketisation (the development of free markets that rely on the operation of free market mechanisms), mixed ownership, and an open-door policy. This report specifically addresses the following questions:

- How did the development of accounting for FIFs reflect and reinforce the political changes that occurred under both Mao and Deng?
- How were international accounting principles introduced into China for the purpose of accounting for FIFs and domestic companies?
- How does accounting for FIFs interact with accounting for domestic companies?
- What are the implications of the interactions between the political systems under Mao and Deng and the regulation of accounting for FIFs for foreign investors and international accounting regulators?
To address these questions, an extensive literature review was conducted of primary and secondary sources and over 30 interviews were held with Chinese regulators, Chinese academics and Chinese and foreign partners of FIFs in China during 2004 and 2005.

Historical and contemporary events, whether internal or external, were shaped by the environment and were reinforced by political ideas, such as those of Mao. These political and ideological interactions had three consequences during the Mao era. First, China had very limited international trade and only a few foreign direct investments (FDIs). Second, accounting was considered as a tool for class-struggle, and capitalist accounting theories and techniques were rejected because they were construed as a means for the exploitation of the working class by capitalists. China introduced a uniform accounting system, based on Soviet Union accounting, as this was considered compatible with Mao’s emphasis upon class-struggle, central-planning and public-ownership. Third, no accounting regulations existed for FIFs.

Deng’s ideas gradually replaced Mao’s ideas from the late 1970s onwards, and this transition was facilitated and reinforced by several economic reforms that occurred during the last 25 years. These reforms led to a sustained increase in international trade and FDIs so that China is now the third largest international trader and the largest recipient of FDIs. Accounting is now constituted as a neutral technology without national boundaries, and foreign accounting theories and practices, including those practiced in capitalist countries, are now widely adopted in China. Moreover, Chinese accounting regulations and standards, including those for FIFs, have become increasingly harmonised with international accounting conventions, particularly International Financial Reporting Standards (IFRSs).

The rise of FIFs in China promoted the need for international accounting harmonisation. As a result, an independent auditing profession was re-established and the first accounting regulations for FIFs were formulated in the early 1980s amid a heated debate on the
nature of accounting, accounting principles and accounting standards. These regulations incorporated many principles, concepts and techniques that were considered to prevail internationally including some limited application of conservatism in specific areas such as the adoption of accelerated depreciation methods subject to approval by the tax authorities. However, the scope of these regulations remained limited; conservatism was not widely adopted, as even provision for bad debts was forbidden, and many accounting requirements were determined by tax and fiscal regulations.

Because conservatism is one of the key concepts referred to frequently in this study, it is important to clarify its meaning in the context of accounting regulation in China. Two terms, ‘conservatism’ and ‘prudence’ are used interchangeably in Chinese accounting literature, by both academics and practitioners, and also by all those interviewed in conducting this study. In China, conservatism is an accounting principle which results in the understatement of assets and income and the overstatement of liabilities and losses (Ezzamel et al., 2007). It is a measure used to reduce optimism in financial reporting. Hence, conservatism in China has a meaning that is very similar to the meaning of conservatism in Western countries.

By the early 1990s, the ideological climate in China had changed greatly. Accounting was no longer viewed as a tool for the exploitation of the working classes, but rather as a neutral and a technical tool (Ezzamel et al., 2007). Also, FDIs and the open-door policy were considered to have achieved a high degree of success. The new accounting regulations for FIFs enhanced the scope for the application of conservatism and reduced the dependence of accounting on tax and fiscal regulations. However, conservatism was still not recognised as a general principle because the ideas of central-planning and public ownership were still influential. In 2000, when China became a preliminary market economy and was close to gaining accession to the World Trade Organisation (WTO), new regulations were promulgated in the Enterprise Accounting
System (EAS) for both domestic and foreign invested firms. In this new system, priority was accorded to substance compared to form. Moreover, conservatism was fully adopted in order to permit provisions for eight types of asset impairment. The system also delegated greater power to the firm to formulate accounting policy. Since the promulgation of the EAS, numerous accounting standards have been issued which are largely consistent with their equivalents under IFRS.

However, there are still discrepancies between Chinese GAAP and IFRS due to the special Chinese context which creates a different scope for standard-setting compared to Western countries. Thus, China has taken a firm stance in trying to control earnings management, which has led to the non-recognition of appreciation in asset revaluation, and the developing nature of the Chinese market restricts the scope for use of fair value. Further, leading Chinese regulators hold the view that harmonisation of Chinese accounting regulation with the IASB standards has to be seen as a process that permits difference and local innovation, rather than being seen in terms of ‘complete compliance’. This should inevitably lead international foreign capitalists and regulators to expect some variations to persist between Chinese accounting regulations and the IASB standards. Although China has made a great effort to harmonise its accounting regulations with IFRS, international investors and regulators need to be aware that the effectiveness of implementing accounting regulation in China will be partly dependent upon a host of local factors. These include understanding and enforcement of the regulations, the Chinese context (for example, the extent of capital market efficiency, scope for possible harmonisation of tax systems to remove tax advantages currently enjoyed by foreign investors, and concerns over national security caused by the large-scale inflow of FDIs to China), and the Chinese culture.

The exact nature and form of the ideological impact on FDIs and accounting regulation (including accounting regulation for FIFs) in the future is likely to be contingent upon various factors, in particular the
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level of state ownership in private companies. It is now recognised in China that there is a need to improve social fairness in future economic development which may result in greater emphasis upon strengthening the role of government in addressing growing inequality and in creating employment opportunities. Some of the interviewees noted that there is considerable tension between domestic firms and FIFs in terms of discriminating tax regulations in favour of the latter. Whether this tension will ultimately persuade the Chinese government to phase out these advantages, and the potential impact that this may have on the attractiveness of China as a location for foreign investment, is an issue that should be explored by future researchers. Finally, the interviews suggest that issues relating to national security arising from large-scale FDIs, especially in the form of wholly-foreign-owned large multinational corporations, compared to weaker and smaller domestic firms, have become a major concern. Any future changes that might impact on all, or some of these issues, may have important implications for accounting regulation and practice in China.
1 INTRODUCTION

Introduction

Under Chairman Mao Zedong (1949-1977), China had a largely self-reliant, state-owned and state-managed economy, closed to the outside world except for other communist countries. In contrast, the succession of Deng Xiaoping (1978-1997) heralded a new era in which the Chinese economy became increasingly open to the world, following the open-door policy stipulated in 1978, and the first international joint venture (IJV) was launched in 1980. As a consequence of the open-door policy, China has now become the largest recipient of foreign direct investments (FDIs) and the third largest international trading nation after the USA and Japan. By the end of 2004, 508,941 foreign invested firms had been established in China, with a pledged investment amounting to US $1,096.61 billion, and an actual investment of US $562.10 billion (Chong, 2005). Among the 500 Top World Companies, over 450 have invested in China. The Chinese Gross Domestic Product (GDP) grew from US$140 billion in 1979 to US$ 16,496 billion by the end of 2004 with an annual growth rate of over 9%. In 2005, China became the fourth largest economy in the world. This impressive economic growth has been facilitated by significant increases in FDIs (Bo, 2004). The significant economic developments have contributed to making China a particularly interesting transitional economy for the study of accounting regulation in general and the accounting regulations for foreign invested firms (FIFs) in particular.

This study explores the emergence of FIFs and the development of Chinese accounting regulations for FIFs. There are three principal forms of FDI in China, all of which are jointly referred to as FIFs in this study:
• A Sino-foreign equity joint venture involves two or more partners participating in the creation of a new corporate entity in which each partner owns a given share of the equity capital, or in the redistribution of the shares of an existing company between the partners (Tang, 1992). From a legal perspective, such an international equity joint venture is a limited liability company recognised as a local legal entity by the Chinese Law on Chinese-foreign Joint Ventures.

• A Sino-foreign contractual joint venture involves two or more partners jointly controlling an asset or operation from which the partners benefit under certain contractual arrangements. This does not mean that the partners need to form a new entity although the Chinese Law on Contractual Joint ventures allows such ventures to be registered as Chinese legal entities.

• A wholly-foreign-owned firm is an enterprise that is established in China whose capital is wholly contributed by a foreign firm. It can be registered as a Chinese legal entity and its investments, earned profits, and other legal rights are protected by the Chinese law. These wholly-foreign-owned firms are governed by the Chinese Law for Wholly-foreign-owned Firms.

Before 2000, Sino-foreign joint ventures were the main form of FDIs in China, but since then wholly-foreign-owned firms have become dominant. Further, investments from Hong Kong, Taiwan and Macau are also considered foreign investments in China, receiving privileges equal to those enjoyed by non-Chinese investors. Indeed, joint ventures involving these areas have been among the most important sources of FDI in China.
Objectives and theoretical perspective

The relationship between political ideology and accounting has rarely been examined by previous researchers. An understanding of the relationship between political ideology and accounting is not only crucial to comprehending the changing accounting landscape in China over the last six decades, but will also enhance knowledge of how China might harmonise its accounting principles with internationally accepted accounting principles. Emerging conclusions might also be of relevance to similar transitional economies.

This research project has a number of objectives. First, the changes in the political and ideological environment in China from 1949 to the present are examined. The choice of 1949 is not arbitrary; this was the year in which the People’s Republic of China (PRC) was formed, thereby marking a major historical change in the history of China. In general, this period covers two main regimes with markedly different political ideologies: The Mao era (1949-1976) and the Deng era (1978-1997). The political leaders who succeeded Deng continued to embrace his ideology. Second, these different historical episodes contextualise the analysis of the development of FIFs in China. Third, the changes in accounting regulation, especially the evolution of accounting for FIFs, are investigated, again, within these specific Chinese contexts. The ultimate aim is to gain a better understanding of the extent to which political changes and the development of FIFs have together impacted upon accounting regulation. These research objectives can be formulated more specifically into a number of research questions:

- How does the development of accounting for FIFs respond to changes in political ideology?
- How are international accounting principles introduced into Chinese accounting for FIFs and then into accounting for domestic companies?
• How does accounting for FIFs interact with accounting for domestic companies?

• What implications do the interactions between political ideology and the regulation of accounting for FIFs have for foreign investors and international accounting regulators?

**Importance of the study**

Given its current membership of the World Trade Organization (WTO), China’s market will be increasingly open to foreign companies and consulting firms. Indeed, China has become the destination attracting the greatest amount of foreign investments worldwide. Because of this, it is important for foreign regulators and investors to appreciate that China is still using a uniform accounting system while simultaneously developing accounting standards. To understand the full implications of this dual development, it is imperative that foreign firms and accounting professions are informed of China’s political and regulatory environment. Thus, this project is not only relevant to the harmonization of international accounting and securities regulations, but is also highly relevant to foreign investors.

The findings of this study are likely to be of interest to international accounting standard-setters by promoting a better appreciation of the role of ideology in the context of international accounting harmonisation. If compliance is more cosmetic than real, world organisations, Western businesses, accounting firms, and professional bodies will be concerned to unravel the motives of such behaviour by Chinese regulators and practitioners. This is likely to have major implications for Western interests in socialist economies, in general, and in the Chinese economy, in particular. To the extent that Chinese compliance is not rhetorical, then it would be of interest to these Western groups to gain an appreciation of the processes through which compliance with
IFRS occurs, and to identify the extent to which accounting principles converge across political divides or the extent to which they become mediated, even at the margin, by local socio-political, economic and cultural values. Central to this understanding would be a recognition of the problems of implementing specific accounting standards, the help that foreign interested parties can offer China to deal with these problems, and the extent to which foreign parties regard compliance with IFRS fundamental to their continued involvement in China.

By adopting a political ideology perspective, this study will contribute towards an informed understanding of accounting change in transitional economies. Such a perspective has the potential of addressing a range of questions. For example:

- Why did China retain the existing chart of accounts while developing new accounting standards (MoF, 2000)?
- Why is the government seen as the major user of accounting in these economies (MoF, 1992)?
- Why, and how, is accounting so heavily influenced by political, fiscal and tax policies (Chen, 1999)?; and
- Why is the difference between home GAAP-based earnings and IFRS-based earnings increasing despite the reported increase in accounting harmonisation (Chen, et al., 2002)?

Finally, the study has policy implications for accounting regulators and users of financial statements. For example, to effectively promulgate new accounting regulations in particular regimes, it is important to consider whether the intended change is ideologically acceptable and whether there will be resistance to the new regulations for ideological reasons. Thus, a political ideology perspective provides a potentially useful way to assess issues relating to the adoption of IFRS. For instance,
it is possible that some reported technical difficulties in adopting internationally accepted accounting conventions or practices may be ideologically-laden. Also, it would be of interest to Western policy makers to identify the possible difference between the declared support by transitional economies for compliance with IFRS and the actions taken by them.

**Structure of the study**

The remainder of this study is organised as follows. Chapter two is the literature review and chapter three the research method, chapter four traces and analyses the political and ideological changes from the Mao era to the Deng era. Chapter five documents and analyses the development of FIFs in China. This is followed by chapter six which examines the development of Chinese accounting regulations for FIFs. Chapter seven provides a summary and conclusion. A separate appendix compares Chinese accounting regulations and IFRS in order to provide some evidence on recent trends in Chinese accounting regulations.
2 LITERATURE REVIEW

Introduction

This chapter provides a review of the literature relating to this study. The chapter begins with an overview of the literature on studies of accounting change in general. This is followed by a discussion of the literature on accounting change in transitional economies, which is of immediate relevance to China. There follows a review of the literature on accounting for foreign invested firms (FIFs), including accounting for international joint ventures (IJVs), accounting for joint ventures (JVs), and other prior studies focused upon international joint venture accounting. The penultimate section introduces the concept ideology and the summary section concludes the chapter.

General studies of accounting change

Over the last few decades, researchers have begun to pay increasing attention to accounting change within specific social and political contexts. As a result, accounting has been viewed as a political process (Solomons, 1978) with economic consequences (Zeff, 1978). In contrast to the traditional view that accounting is a set of techniques that are neutral to politics, the new approach views accounting as a set of practices embedded in the organisational and social contexts in which they exist (Burchell et al., 1980). As the social and political dimensions of accounting are inherently ideological (Robson et al., 1994), researchers have recently begun to examine the relationship between accounting and ideology (e.g. Arnold and Hammond, 1994; Tinker, 1980).
First, some argue that accounting is inherently ideological. Burchell 
et al. (1980) have identified a number of characteristics of accounting 
change. In particular, they point out that to the extent that accounting 
can be said to mirror societies or organisations, accounting change can 
be viewed as being ideological (in the general, rather than only in the 
political, sense).

Second, some studies have examined the ideology of accounting and 
the accounting profession. Viewing accounting ideology as a pattern 
of thought and a way of looking at the world of the profession, Gilling 
(1976) notes the existence of conflicting ideologies of accounting which 
clash over important issues such as the utilitarian (technology) view versus 
the theory-oriented (policy making) view of accounting development. 
Robson et al. (1994) posit self-regulation, independence and serving the 
public interest as elements of an ideology of the accounting profession 
and argue that the discourses of these elements enable and constrain 
accounting practices and are renegotiated and invoked to defy external 
regulation and acquire new service markets for accountants. More 
recently, Baker (2005) has examined the ideology of the American public 
accounting profession and suggested that its self-economic interests 
constitute a public accounting ideology that conflate its values and 
activities with serving the public interests.

Third, some writers conceive and have investigated accounting as a 
tool that serves the interests of certain social or political groups (Arnold 
and Hammond, 1994; Lehman and Tinker, 1987; Tinker, 1980). Brown 
(2000) argues that there exist multiple ideologies based on varying sets of 
assumptions about society and organisations (e.g. unitarist, pluralist and 
radical assumptions) and that different ideologies serve different social 
interests and promote different versions of accounting professionalism 
and the accountability of the accounting profession.

Finally, some commentators have noted that ideology shapes and 
changes accounting (Robson, et al., 1994; Hopwood, 1987). However, 
this aspect of the relationship between ideology and accounting has
received considerably less attention from researchers. This report contributes to this sparsely researched area by paying attention to the influence of political ideology on accounting in the context of accounting regulation for FIFs in China, whilst not ignoring the role that accounting could play in serving certain interests.

**Research on accounting change in transitional economies**

Prior studies on accounting change in transitional economies detail the stages of development in accounting regulation, features of new regulations and differences between regulations. They have been particularly informative in providing timely updates of current developments in accounting regulations and their contexts. A number of studies have advanced useful proposals for reform. For example, Macve and Liu (1995) criticise the existing separation of the regulation of accounting firms and audit firms under the Ministry of Finance (MoF) and the State Audit Administration and propose bringing the two types of firms under a unified profession in China. This proposal was introduced in 1998 when the Chinese Institute of Certified Public Accountants and the Chinese Institute of Certified Public Auditors merged. However, most studies in this area have tended to focus on technical changes by describing the promulgation of new accounting and auditing laws and standards; uniform accounting systems; or charts of accounts in Eastern European economies, Russia and China (e.g. Bychkova, 1996; Dutia, 1995). With a few exceptions they have largely neglected non-technical changes in accounting, such as cultural, organisational, and ideological changes. For example, in examining changes in Chinese accounting techniques, Xiang (1998) and Tang (2000) do not explore the reasons why some techniques, such as conservatism accounting, were banned under Mao and promoted under Deng. Typically, accounting change
in transitional economies has been perceived as unproblematic, and ideological resistance to change has been frequently neglected.

While some studies provide information on economic and political reforms, typically this is not explored in detail. Further, this literature is weakly theorised. Seal et al. (1995) study organisational change in accounting in the Czech Republic. Describing an accounting organisation as consisting of intangible beliefs, organisation structure and tangible elements such as financial statements, they conclude that the Czech Republic experienced a second order change (change in beliefs). There are, however, limitations associated with this organisational perspective: the organisation is seen as an end in itself and changes are typically perceived as planned and deliberate. In addition, the ideological characteristics of change are not explicated. Chow et al. (1995) examine accounting reform from a cultural perspective. Based on an analysis of China’s culture of authority, they argue that: ‘While financial reporting will be governed by accounting standards, their development and enforcement will remain a governmental and legalistic function’ (ibid, p.29). Irrespective of the plausibility of this conclusion, no link is made between ideology and accounting regulation.

Krzywda et al. (1995) examine accounting development in Poland from a finance perspective. They contrast two approaches to accounting: the Germanic and the Anglo-Saxon. They argue that the two approaches have evolved to their present distinctive features largely because of the initial differences in the financing structure of their businesses. This explanation, however, does not explicitly address ideological change and its impact on accounting reforms.

In short, research on the relationship between ideology and accounting in transitional economies is at an embryonic stage. More research is needed to address many pressing issues and this report is a contribution to this end.
**Accounting for foreign invested firms**

Most prior research on FDIs has tended to focus upon foreign invested firms (FIFs); hence this section mainly reviews the literature on international joint ventures (IJVs). Zhai (2000) identifies several strands of research in the IJV literature including: motivations for forming IJVs; theories that underpin IJV strategies; institutional environments suitable for forming IJVs; IJV strategic decisions (such as ownership choice, partner selection and IJV control); cross-culture IJV management; IJV performance; and stability, survival and duration of IJVs.

Surprisingly, very little has been written on IJV accounting either in the Chinese literature or in the English literature. The few studies available cover a wide range of themes that can be grouped under financial accounting and management accounting and control. This section focuses on studies relating to financial accounting theory, regulation and practice, in particular studies undertaken on, or with implications for, China. There are two types of issues relating to joint venture accounting, accounting in joint ventures and accounting for joint ventures (Tang, 1992). The former relates to how IJVs account for their business transactions and operations. By contrast, the latter is concerned with how the parent company accounts for the investment in a joint venture in the consolidated financial statements of the parent company. This chapter reviews studies on these two themes before summarising the literature on management accounting and control in IJVs.

**Accounting for international joint ventures**

Tang (1992) identifies three general approaches to accounting for IJVs. First, in theory, the joint venture could follow the accounting standards and regulations of the foreign partner. This is problematic because of the complications of using foreign legal, tax and accounting practices when dealing with the Chinese legal or tax systems. Second,
the joint venture could adopt the accounting standards and regulations of the host country, an approach adopted by Russian and most East European joint ventures, but this ignores the accounting regulations of the country of the foreign venture capitalist. Third, the joint venture could follow a hybrid of accounting standards, and this is the approach adopted by many Chinese joint ventures.

Some studies compared differences in IJV accounting regulations between China and other countries. Lou (1986) argues that China's IJV accounting regulations issued in 1985 maximised harmonisation with international conventions whilst reflecting China's economic, legal, political and social environment. Ge et al. (1988) note that the main difference between China's accounting system for IJVs and the then International Accounting Standards (IASs) was that the application of conservatism in the former was very restricted. However, they argue that the reason for the use of conservatism is market uncertainty. As IJVs tended to use international capital, technology, and material supply and product sales markets, uncertainty was inevitable. Therefore, they argue, conservatism should be adopted in IJV accounting, especially in stock valuation, bad debts provision, foreign currency exchanges, and fixed asset depreciation.

Other studies have examined the regulation of accounting for FIFs in China. Yang (1986) emphasises three principles adopted by the Chinese government in formulating accounting regulations for IJVs:

- Chinese conformity, that is, China's IJV accounting systems must be consistent with Chinese laws and regulations;
- equality and mutual benefits as a result of reflecting the characteristics of FIFs; and
- maximum adoption of internationally accepted standards.
In particular, he suggests that accounting regulations relating to IJVs in China should not be the same as those used in State-Owned Enterprises (SOE), nor be an exact copy of Western accounting. According to Yang, joint ventures could develop their own principles wherever the government did not provide regulations. Ju (1986) analyses the differences between China’s Accounting System for Sino-Foreign JVs stipulated in 1985 and International Accounting Standards (IASs). He reported that the 1985 System was a set of administrative rules that must be complied with by all Sino-foreign JVs while IASs did not have any legal enforcement power in China. In addition, the scope of applying conservatism in the former was much smaller than in the latter. Xu (1985) identifies three reasons why the 1985 System did not allow provision for bad debts: cash sales were the main form of sale in China, whereas in Western countries credit sales prevail; bankruptcy was rare in China; and if the possibility of incurring a bad debt increased in exports and credit sales, such bad debts could be expensed when they occurred. This was an after-tax provision compared to the pre-tax provision approach adopted in Western countries.

Another group of studies focused on accounting practices in FIFs in China. Tang (1992) tests whether IJVs with different foreign partners differed in making accounting choices. His findings suggest that UK and US-related joint ventures were more likely to choose income-decreasing or conservative accounting methods compared to Japanese and HK-related JVs, while Asian-related JVs tended to adopt less conservative accounting measurements compared to American and European-related JVs. Tang (1992) also examines the perceptions of Chinese and UK accounting academics and practitioners concerning the extent to which Chinese accounting standards would produce true and fair financial statements. He reports that due to cultural differences few UK respondents to his survey considered that Chinese JV accounting would provide a true and fair view of the value of a joint venture’s assets and liabilities, although most Chinese respondents did. Tang (1994)
observes that there was great pressure from international investors to change the Chinese accounting standards which were so different from their home standards and could cause difficulties in accounting for assets, profitability and taxation. Meanwhile he notes a favourable change in the attitudes of Chinese regulators and practitioners towards international harmonisation. He also analyses the costs, benefits and economic consequences of China’s new accounting regulations for Sino-foreign JVs issued in 1985. A particular economic consequence for the Chinese government was that the new standards would lead to lower taxable income, but China would benefit from the influx of foreign investment with advanced technology and management skills. Tang reports evidence to suggest that accounting practices in Sino-foreign JVs were a mixture of Chinese and Western practices.

**Accounting for joint ventures**

There are three methods of accounting for JVs: cost; equity; and proportionate share. IAS 31 (IASB, 2004) prescribes proportionate consolidation as the preferred method of accounting for a venturer’s interest in a JV. The equity method is also permitted by IAS 31 as an alternative method. Under the proportionate consolidation method a venturer’s share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined line by line with similar items in the venturer’s financial statements or reported as separate line items in the venturer’s financial statements. By contrast, using the equity method, an interest in a jointly controlled entity is initially recorded at cost and adjusted thereafter for the post-acquisition change in the venturer’s share of net assets of the jointly controlled entity. The profit or loss of the venturer includes the venturer’s share of the profit or loss of the jointly controlled entity.

While accounting for JVs may be well-developed, its application is problematic. Hoyt and Maples (1980) examine the issues arising from
the adoption of the consolidation method by a Western firm engaging in a JV with an Eastern partner. The authors show that the differences in the two economic systems could make the process of valuation of an entire business entity for purposes of presentation in the US and Canadian financial statements a highly problematical exercise. The most significant problems were the absence of a market economy and lack of rules for valuing assets and enterprises in the East. As a consequence, it was impossible to obtain a fair presentation of the Western corporation’s interests in a series of values arbitrarily set by the foreign government as its share of a JV. By implication, these problems are also significant in China because of its highly centralised planning system that prevailed until the early 1990s.

Tang (1992) arrives at similar conclusions. He points out that although accounting differences might not seriously affect the initial investment decision, multinational corporations (MNCs) met with major difficulties in valuing the JVs and in determining the interest of MNCs in the JVs. He also identifies two approaches that UK MNCs adopted to alleviate these difficulties, namely: to establish a separate source of information; or to take advantage of the flexibility of local accounting regulations to design a desirable accounting system for JVs.

Other prior studies relating to international joint venture accounting

Apart from financial accounting, another topic that has attracted the interest of some researchers is the adoption of management accounting and control techniques in IJVs. Groot and Merchant (2000), through an examination of three IJVs, formulate a tentative contingency theory of IJV control system differences. This theory consists of three elements of a control system; control mechanism, control focus, and control tightness; and a group of factors that explained the differences in the three elements. These factors include: breadth of partners’ objectives for the IJV; fit between the IJV’s products and the rest of partner’s
businesses; partners’ level of trust in other partners; partners’ unique knowledge and capabilities; partners’ management style; and partners’ need for short-term performance. Drawing upon institutional theory and innovation diffusion theory, Firth (1996) compares the adoption of cost accounting and control methods among 456 Chinese-foreign JVs, 432 Chinese JV partners, and 370 SOEs during the period 1990-1993. He finds that Chinese SOE which formed a JV with a foreign partner were more likely to adopt western management accounting practices than non-JV participants.

Through a questionnaire survey of 242 Chinese-USA JVs, Chalos and O’Connor (2004) investigate factors that affected the use of control mechanisms: expatriate staffing; socialisation practices; general manager decision-making responsibility; frequency of communication with parent company; and managerial performance incentives. They report that differences in partner knowledge and specific investments influenced the objectives of using certain control mechanisms by Chinese and USA partners of Chinese-USA JVs.

Cheung and Qiang (1997) document a successful internal audit function at Guangdong Nuclear Power Joint venture Company Limited. They identify several elements contributing to the success of the internal audit function, including its independence, the extent to which its role was fully understood throughout the organisation, and whether or not it adopted a systems approach.

**Political ideology**

While the above literature has provided many valuable insights, the above review demonstrates that much more research needs to be undertaken to provide a more comprehensive understanding of the development of accounting for FIFs in China. Moreover, none of the previous studies has considered the impact of political ideology on accounting for FIFs in China, an important issue that forms the main focus of this study.
A political ideology perspective has been adopted as the theoretical framework that informs this study. Accounting change has been attributed by many researchers to various organisational and social factors. In addition to these factors, ideology is an important force as it can play a key role in promoting or inhibiting accounting change; and facilitate the emergence of ideology-specific configurations of accounting regulations. These may involve changes in accounting techniques, changes in the rhetoric and legitimisation of accounting, and/or changes in the organisation of the accounting profession.

There are alternative ways of conceptualising ideology (Thompson, 1984). The common sense uses of ideology usually have a negative meaning: a system of false, twisted, or misguided beliefs (van Dijik, 1998). In this sense, ideology is considered to be in opposition to truth, or something that ‘other people’ have with truth belonging to ‘us’. This understanding is usually attributed to Marx and Engels (1974) who defined ideology as the prevailing ideas of an age, normally associated with the ruling class. As the ruling class owns the means of production, it is held that it is capable of imposing its ideology on the ruled and using it to sustain its power and domination. However, the ruled classes also have their own ideologies (Ezzamel et al., 2007). Thus, in a capitalist society, there are working class ideologies as well as capitalist ideologies, although the latter are most likely to be dominant.

Acknowledging the existence of multiple approaches to the definition of ideology, an alternative, and critical, conception is that ideology is intertwined with the process of sustaining asymmetrical relations of power and domination (Torfing, 1999). Under this conception, different ideologies exist to stabilise society and groups by ‘virtue of the diversity of values and beliefs’ (Thompson, 1984, p.5).

More generally, ‘ideology’ has been used in neutral, descriptive terms, as a ‘system of thought’, ‘system of beliefs’, or a type of ‘symbolic practice’ which relates to social action or political projects. Ideology is thus seen as a ‘system of social beliefs’ shared, and subscribed to, by a social or political group (e.g. van Dijik, 1998; Baradat, 1991). An ideology may be used to legitimise or oppose power and dominance, or
symbolise social conflicts and problems. In this understanding, ideology is considered to be applicable to every political programme, irrespective of whether the programme is directed towards the preservation or transformation of social order (Thompson, 1984).

In this study, an ideology is defined as a system of ideas or beliefs associated with a social or political group. Different ideologies can become dominant at different times. One ideology emerges as dominant under certain social and economic conditions while others become less central, marginalised or even suppressed. Moreover, political ideology is a system of ideas intended to be about political values, processes and structures, and/or a set of beliefs that influence political behaviour, action, and socio-political and economic contexts. Maoism and Dengism are such political ideologies.

**Summary**

This study examines the relationship between political ideology and accounting in a Chinese context, in particular accounting regulations for FIFs. Over the last two and a half decades, China has experienced major changes not only in its economy, but also in its political ideologies. The main changes are manifest in the shift from a Maoist focus on class-struggle to a Dengist emphasis on economic development: from self-reliance to open-door policies; from central-planning to an economy where the market plays an important role (marketisation); and from state-ownership to mixed ownership.

The development of accounting in China has reflected these changes. For example, certain accounting principles and techniques (such as conservatism) were criticised or even banned under Maoism because they were construed as capitalist tools aimed at the exploitation of the working classes. In contrast, Dengism has encouraged the use of those same accounting principles and methods for the purpose of developing the Chinese socialist productive forces (see Ezzamel *et al.*, 2007).
The relationship between political ideology and accounting is examined using accounting for FIFs in China for several reasons. First, as mentioned above, FIFs have made a significant contribution to China’s economic development and are likely to continue to do so in the foreseeable future. Second, FIFs provide an ideal opportunity to examine how international bodies interact with political ideas and how these two jointly affect the development of accounting regulation. Third, a political ideology focus might allow a better perspective on how international accounting practices could be introduced in China (Firth, 1996).
To carry out this study a total of 31 interviews with 40 people were undertaken in 2004 and 2005, as shown in Table 3.1. These interviews were undertaken for two main purposes. First, to help identify the relevant literature as well as archival sources, memoirs, opinions and comments on regulatory change and to enhance an understanding of ideological changes over the period of study. Second, to solicit the views of the informants concerning changes in accounting regulations in China and their link to ideological changes in the Mao and Deng eras. While it was hoped that interviewing the regulators would provide insights from the perspectives of policy makers, the interviews with academics and practitioners were intended to offer alternative, but complementary, perceptions of accounting regulation during the period under investigation.

A list of open-ended questions was prepared beforehand and in some cases this was sent to the interviewees upon request. The questions served as a guide to the conduct of the interviews. The order of the questions in the list was not adhered to rigidly: the list was expanded and revised during the interviews to include new questions as a follow up to some of the themes that emerged in earlier interviews, in addition to ensuring that the questions asked were suited to the interviewees’ background/expertise.
Table 3.1 Information about interviewees

Panel A: Practitioner interviewees

<table>
<thead>
<tr>
<th>No.</th>
<th>Interviewee</th>
<th>Company</th>
<th>Experience</th>
<th>Nationality of Foreign Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Practitioners 2, 3, and 4</td>
<td>Chinese-Foreign Joint venture B (Beijing)</td>
<td>Currently Finance Director, Internal Auditor and Finance Manager respectively.</td>
<td>US</td>
</tr>
<tr>
<td>3.</td>
<td>Practitioner 5</td>
<td>Chinese-Foreign Joint venture C (Beijing)</td>
<td>A former state auditor. Currently Deputy Financial Controller.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>4.</td>
<td>Practitioner 6</td>
<td>Chinese-Foreign Joint venture D (Beijing)</td>
<td>Currently Financial Controller.</td>
<td>Germany</td>
</tr>
<tr>
<td>5.</td>
<td>Practitioners 7 and 8</td>
<td>Chinese-Foreign Joint venture E (Xiamen)</td>
<td>P7 is currently responsible for finance as Special Assistant to CEO. P8 is Head of the Finance Department.</td>
<td>US</td>
</tr>
</tbody>
</table>
Table 3.1  Information about interviewees (Continued)

<table>
<thead>
<tr>
<th>No.</th>
<th>Interviewee</th>
<th>Company</th>
<th>Experience</th>
<th>Nationality of Foreign Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.</td>
<td>Practitioners 9, 10, 11 and 12</td>
<td>Chinese-Foreign Joint venture F (Xiamen)</td>
<td>P9 is accounting and personnel officer for subsidiary 1. P10 is an accounting manager for Subsidiary 2. P11 is an accounting officer of the group. P12 is accounting manager for Subsidiary 3. The group is a private company. Each subsidiary is a Chinese-foreign joint-venture.</td>
<td>Taiwan, Canada</td>
</tr>
<tr>
<td>7.</td>
<td>Practitioner 13</td>
<td>Chinese-Foreign Joint venture G (Xiamen)</td>
<td>Currently Deputy CEO responsible for finance.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>8.</td>
<td>Practitioner 14</td>
<td>Chinese-Foreign Joint venture H (Shenzhen)</td>
<td>Former state auditor. Formerly finance director and currently Deputy CEO responsible for finance.</td>
<td>Netherlands</td>
</tr>
<tr>
<td>9.</td>
<td>Practitioner 15</td>
<td>Chinese-Foreign Joint venture I (Shenzhen)</td>
<td>Currently Head of Finance Director.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>10.</td>
<td>Practitioners 16 and 17</td>
<td>Chinese-Foreign Joint venture J (Shenzhen)</td>
<td>Previously an accounting regulator at Ministry A, P16 is currently Deputy CEO responsible for external relations and finance. P17 is Head of Finance Department.</td>
<td>South Korea</td>
</tr>
</tbody>
</table>
Table 3.1 Information about interviewees (Continued)

<table>
<thead>
<tr>
<th>No.</th>
<th>Interviewee</th>
<th>Company</th>
<th>Experience</th>
<th>Nationality of Foreign Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>11.</td>
<td>Practitioners 18 and 19</td>
<td>Chinese-Foreign Joint venture K (Shenzhen)</td>
<td>P18 is currently Head of Accounting Department. P19 is Accountant.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>12.</td>
<td>Practitioner 20</td>
<td>Chinese-Foreign Joint venture L (Shanghai)</td>
<td>Finance Director</td>
<td>UK</td>
</tr>
<tr>
<td>13.</td>
<td>Practitioner 21</td>
<td>Chinese-Foreign Joint venture M (Shanghai)</td>
<td>Finance Director and Deputy General Manager</td>
<td>UK</td>
</tr>
<tr>
<td>14.</td>
<td>Practitioner 22</td>
<td>Chinese-Foreign Joint venture N (Shenzhen)</td>
<td>CEO.</td>
<td>UK</td>
</tr>
<tr>
<td>15.</td>
<td>Practitioner 23</td>
<td>Chinese-Foreign Joint venture Foreign Partner A</td>
<td>Financial Controller.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>16.</td>
<td>Practitioner 24</td>
<td>Chinese-Foreign Joint venture Foreign Partner B</td>
<td>Financial Controller. Based in Hong Kong.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>17.</td>
<td>Practitioner 25</td>
<td>Wholly-Foreign-Owned Firm A (Shenzhen)</td>
<td>Owner and CEO.</td>
<td>Hong Kong</td>
</tr>
</tbody>
</table>
Table 3.1  Information about interviewees (Continued)

<table>
<thead>
<tr>
<th>No.</th>
<th>Interviewee</th>
<th>Company</th>
<th>Experience</th>
<th>Nationality of Foreign Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>18.</td>
<td>Practitioner 26</td>
<td>Wholly-Foreign-Owned Firm B (Beijing)</td>
<td>Owner and executive.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>19.</td>
<td>Practitioner 27</td>
<td>Wholly-Foreign-Owned Firm C (Dongguan)</td>
<td>Owner and executive.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>20.</td>
<td>Practitioner 28</td>
<td>Auditor of Joint ventures A</td>
<td>Partner of an auditing firm.</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>21.</td>
<td>Practitioners 29 and 30</td>
<td>Foreign Invested Firm A (Xiamen)</td>
<td>Currently Accounting Manager and Accountant respectively.</td>
<td>Hong Kong</td>
</tr>
</tbody>
</table>
**Table 3.1  Information about interviewees (Continued)**

Panel B: Other interviewees

<table>
<thead>
<tr>
<th>Interviewee</th>
<th>Company</th>
<th>Experience</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Regulator 1</td>
<td>Ministry A</td>
<td>Retired. Involved in accounting regulation from the 1960s to the early 1990s</td>
</tr>
<tr>
<td>2. Regulator 2</td>
<td>Ministry A</td>
<td>Retired. Involved in accounting regulation from the 1960s to the early 1990s</td>
</tr>
<tr>
<td>3. Regulator 3</td>
<td>Accounting Professional Body A</td>
<td>Involved in accounting regulation from the 1980s to present</td>
</tr>
<tr>
<td>4. Regulator 4</td>
<td>Government Agency A</td>
<td>Involved in accounting regulation from the 1980s to the late 1990s</td>
</tr>
<tr>
<td>5. Regulator 5</td>
<td>Accounting Professional Body B</td>
<td>Involved in accounting regulation from the 1980s to the early 1990s</td>
</tr>
<tr>
<td>6. Regulator 6</td>
<td>Ministry A</td>
<td>Involved in accounting regulation from the 1980s to present</td>
</tr>
<tr>
<td>8. Local Government Official 2</td>
<td>Large Municipal Government B</td>
<td>Involved in implementing accounting regulations and setting local accounting regulations since the early 1980s.</td>
</tr>
<tr>
<td>9. Academic 1</td>
<td>Research Institute at Ministry A</td>
<td>Research fellow</td>
</tr>
<tr>
<td>10. Academic 2</td>
<td>University A (Fujian)</td>
<td>Full professor, specialising in accounting for foreign joint ventures.</td>
</tr>
</tbody>
</table>
Each interview began by asking informants about their educational background and career, focusing on their current jobs. Thereafter, interviewees were asked to comment on their understanding of the political and socio-economic contexts under Mao (if relevant) and how these compared with those under Deng; how such contexts affected the environment for developing IJVs, and how they facilitated or inhibited the proper functioning of these IJV. Thereafter the interviews covered issues relating to accounting regulation in general under Mao and Deng, ultimately narrowing the focus to accounting for IJVs, how the accounting content in different regulations compared with each other and also with IFRS, and the scope and desirability for Chinese accounting standards to completely mirror IFRS.

Tape-recording was used and notes were taken for 24 of the interviews, and only notes were taken for six interviews because the interviewees refused to give permission for tape-recording. One interviewee provided a written response because of the difficulty of arranging a face-to-face interview. Nine interviews were conducted in English, two in a mixture of Chinese and English, and 20 in Chinese. The interviews were subsequently transcribed and those in Chinese translated into English.

In addition to the interviews, special visits were made to relevant government departments, mainly the Ministry of Finance in Beijing, the State Tax Bureau, and their branches in Xiamen, Shenzhen and Shanghai. The purpose was to collect primary, publicly available, data from original sources on changes in accounting and finance regulations, including: discussion papers; draft regulations; minutes and papers on government meetings; and conferences relating to accounting regulations. Key ideological works were collected, as well as published communist party and government policies and statements of an ideological nature and published accounting as well as finance regulations.

The next three chapters draw on these interviews and visits as well as the prior literature to analyse accounting in FIFs.


Introduction

This chapter reviews the political and economic changes in China from 1949 to the present time. It provides a background against which the development of FIFs and accounting for FIFs will be analysed in the next two chapters. The shift from class-struggle primacy to economic development primacy is examined as well as the related changes from those policies that favour self-reliance, state-ownership, and central-planning to those policies that encourage open-door, mixed ownership, and marketisation. This shows how social, political and economic environments create the conditions that inhibit or encourage the adoption of Western accounting practice.

From class-struggle to economic development

From the 1950s to the 1970s, class-struggle was the primary focus of the Communist Party of China (CPC) and the Chinese government. Marxist political economy, with its emphasis upon production relations (Engels and Marx, 1844; 1848; Marx, 1867), was adopted, class-struggle between the proletariat and the bourgeois was seen as the main contradiction in society, and socialism’s triumph over capitalism was believed to be an inevitable law of social progress (Yu, 1998, Mao, 1954).

The emphasis upon class-struggle was a response to China’s hostile internal and external environment. Internally, the CPC declared a military victory over the Nationalist Party in 1949 following a three-year civil war, and the PRC was founded. Immediately afterwards, private
properties were confiscated (CPC, 1981). From 1949 to 1980 China became isolated internationally, fought wars against capitalist countries in Korea and Vietnam and had a bitter relationship with the Soviet Union because of ideological differences and border disputes, in contrast to the rather harmonious relationship that existed earlier between these two socialist countries.

As a result of the promotion of the class-struggle policy under Mao, several actions were taken by the government. These included: the suppression of those considered to be ‘counter-revolutionaries’; confiscation of more private lands in 1950-1952; and the transfer of private enterprises into public ownership between 1953 and 1957 (CPC, 1981). Following the economic failures of the Great Leap Forward movement, designed to speed up economic development, a four-year mass Socialist Education movement was initiated in 1962 with the aim of restoring ideological purity within the party. Emphasis on class-struggle reached a peak during the Cultural Revolution (1966-1976) which sought to eliminate the remains of what were regarded as surviving capitalist tendencies. This political movement was guided by a Theory of Protracted Revolution under the Proletarian Leadership which maintained that class-struggle should be undertaken regularly at the level of the masses (CPC, 1966a & b).

The main effect of this class-struggle was the drawing of a distinction between socialist accounting and capitalist accounting, based on the argument that the former promoted a proletarian view and sought to develop a socialist economic system. Accounting was therefore deemed to be non-neutral, and had a class nature (Yu, 1964). As a result, Western accounting theories and techniques were regarded as part of the ideology of capitalism and were treated with suspicion by Chinese academics and practitioners (Bromwich and Wang, 1991).

Almost all other major social, political, and economic policies were espoused to support the emphasis upon class-struggle. Relevant to the purposes of this study were those policies that favoured state-ownership,
central-planning, and self-reliance (close door). The policies in general considered accounting to be of marginal importance and rejected the adoption of accounting techniques developed in capitalist countries (Ezzamel et al., 2007).

Under Deng, this class-struggle focus was considered to have had disastrous consequences (CPC, 1978), and, hence, emphasis shifted to economic development (productive forces) as stipulated at the Third Plenary Session of the CPC’s 11th National Congress in 1978. Economic development was considered the primary task of socialism and the main social contradiction was believed to have shifted from class contradictions to the tension between China’s increasing material and cultural demands and its relative under-developed productive forces (Zhao, 1987). Deng (1979a) argued that if socialism was indeed superior to capitalism, then socialism should have more advanced productive forces than capitalism, or should make socialist countries richer. Thus, the economic development focus was more commonly referred to as Deng’s productive forces criterion, i.e. political activities and economic reform should be judged according to whether or not they contributed to developing socialist productive forces. Thus, any means could be used to develop socialist productive forces: what might be considered as capitalist accounting could be used as long as it served a socialist end, so the end justified the means.

The adoption of Western accounting methods was justifiable under this new ideological view as they were considered to be helpful to the development of socialist productive forces. Thus, Western accounting theories and practices began to be discussed and applied in China from the 1980s onwards. However, the influence of the class view of accounting continued to be felt for a long time afterwards, and the suitability of Western accounting theories and techniques was debated because there were concerns over whether profit-maximising should be the goal of socialist firms (Ezzamel et al., 2007, Bromwich and Wang, 1991).
The shift from class-struggle to economic development also caused a shift from policies that favoured state-ownership, central-planning, and close-door towards policies that encouraged mixed-ownership, marketisation, and open-door. These policy changes and related political and economic reforms created demand for, and conditions suited to, the adoption of Western accounting.

**From isolation to open-door**

From the 1950s to the 1970s, the Chinese economy was, with few exceptions, closed to the outside world. This international isolation was manifest in three forms. First, economic exchange with foreign countries between 1949 and 1978 was very limited. In the early 1950s, China borrowed 1.27 billion New Roubles and imported 304 large projects from the former Soviet Union. In the 1960s, over 20 projects were undertaken by Western countries. In the mid 1970s, nearly 20 sets of projects involving new technology were imported from Japan and Germany. Second, imports and exports represented only 6.2% of total industrial and agricultural output in 1978. This was low even when compared with other developing countries (Cannon, 1983). Third, except for former socialist or developing countries, China did not have formal diplomatic relations with the vast majority of capitalist countries until the late 1970s.

There were two main reasons for this isolation. First, as suggested earlier, because of its socialist politics, China faced a hostile international environment during the Cold War period. However, ideological struggles and border disputes between China and the Soviet Union also marred the relationship between China and other socialist countries. Second, the emphasis on class-struggle widened the ideological gap between China and the West.

The combined effect of these two factors was that China adopted a self-reliance policy, which meant that China was opposed to becoming
too reliant on foreign technology. However, the self-reliance policy meant that things deemed to be of a capitalist nature could not be imported to China for fear that they might lead to exploitation and capitalist restoration (Cannon, 1983). Effectively, this policy put China in a position of ‘owing no domestic debt, nor foreign debt’ (Expert Group, 1995).

Because of the adoption of the self-reliance and class-struggle policies, China denounced capitalist accounting theories and techniques such as the conservatism principle. However, in the 1950s China imported Soviet accounting practices because they were considered to be politically compatible with China’s ideological position. These included a uniform accounting system for financial accounting, and internal management accounting and control techniques such as internal economic analysis and budgeting.

However, the Chinese government realised that China lagged behind capitalist economies and was short of capital, technology and know-how to an extent that was considered to be hampering the speed of socialist reform (Expert Group, 1995). Thus, an open-door policy was adopted at the 3rd Plenum of the 11th National Congress of the CPC in 1978. This policy led to the creation of Special Economic Zones (SEZ) in Shenzhen, Xiamen, Zhuhai, and Shantou in 1980; the Hainan Province SEZ in 1988; and the Shanghai Pudong New Economic and Technology Development Zone in 1990. The government also gradually opened up all portal, coastal, and major inland cities to foreign investors. The SEZs and opened-up areas were given special administrative powers and foreign investors in these areas were granted tax privileges (see chapter five).

China’s accession to the WTO in 2001 provided a further boost to China’s open-door policy, and this had three implications (Lardy, 2001). First, as the third largest trading nation, China’s compliance with the principles and rules of international trade is considered essential for the future effectiveness of the WTO. Second, while China’s reform-oriented leadership intends to use WTO membership commitments as a lever to
speed up its transition to a more market-oriented economy by exposing domestic firms to international competition in order to induce greater efficiency, this policy is not without both economic costs and political risks. Third, China’s commitment to opening-up its markets to increased investment in telecommunications, financial, and distribution services not only offers enormous potential for commercial opportunities to foreign firms, but is also likely to contribute to the further development of the domestic economy (Ezzamel et al., 2007).

The open-door policy has produced dramatic results. The ratio of imports and exports to GDP, which had risen to 36.21% in 1997, grew further to 69.36% in 2004, and China was ranked third internationally in terms of total imports and exports in 2004. Moreover the use of foreign capital rose dramatically from US $4.46 billion in 1985 to US $60.63 billion in 2004 (Websites of National Statistics Bureau of the PRC and the Ministry of Commerce of the PRC). In addition, the open-door policy has made up for the shortages in capital, imported advanced technology and management experience, created employment opportunities, contributed to China’s high economic growth rate, and supported the market-oriented economic reform (Expert Group, 1995).

As a response to foreign direct investments, China has issued a set of basic laws, corporate tax laws, and accounting regulations aimed at governing the operation of FIFs, as discussed in the following chapter. In particular, the accounting regulations represented the first Chinese attempt to harmonise its accounting practices with international accounting standards. In addition, FIFs in China were also the first to adopt foreign management accounting techniques (O’Connor et al., 2004, Firth, 1996).
From state-ownership to mixed-ownership

State-ownership under Mao was considered superior to collective ownership which in turn was deemed superior to private-ownership (Yu, 1998). The purpose of adopting public ownership was to eliminate exploitation and class differences with individuals enjoying equal rights. In the early 1950s private land was confiscated by the government before being let to individual peasants. By 1955, the remaining private-ownership was transformed into either state-ownership or collective-ownership. Even the land distributed to individual peasants was collectivised and 23,000 communes were created to replace family ownership, during the Great Leap Forward campaign (Liu, 1999). Similarly, State Owned Enterprises (SOEs) were seen as superior to collectively-owned firms in urban areas (Yu, 1998). In 1952, there were nearly nine million self-employed businessmen representing 35.5% of the total urban labour force; by 1978 this figure had dropped to only 1.6% (Expert Group, 1995).

One of the biggest problems of state-ownership was ‘the socialist iron bowl’ (life time employment and social welfare). A second problem was excessive egalitarianism. These are well-captured by two popular Chinese sayings: ‘Rou Lanzai Tangli’ (individuals’ interests depend on the wealth of the state) and ‘Chi Daguo Fan’ (everyone gets an equal share from the same bowl). Firms were evaluated by their outputs not by profitability, and firm profits accrued to the state which also retained provision for depreciation. Firms had no incentive to make profits, and, being supported by the state, could live beyond their means over the long run if necessary. Another problem was that excessive public-ownership gave rise to a condition known as ‘shanbufeng’, meaning no separation of responsibilities between the CPC and the government, or between the government and the firm, or between the government as the owner and the government as the administrator of the state. Therefore, property rights relations were unclear, and the concept of economic agency was
ill-defined at best, or even absent altogether, as lines of responsibilities were blurred (Ezzamel et al., 2007).

Under the conditions of the ‘socialist iron bowl’, ‘shanbufeng’, and government plan-based resource allocation, accounting was used mainly for the national economy but not for individual firms, except when the focus was on achieving planned output targets. Firms did not have to worry about over-spending and making losses because managers were not considered to be decision-makers, and losses and profits were channelled to the state. In this context, Chinese accounting was reduced in practice to mere bookkeeping (Yang, 1998).

Rather than seeing public-ownership as an end in itself, Dengism regards ownership as a means to an end and evaluates forms of ownership on the basis of the extent to which they contribute to productive forces (Jiang, 1997, Deng, 1992). Thus, many forms of non-state-ownership emerged such as: IJVs which grew considerably in the mid 1980s; township and village enterprises which contributed greatly to China’s economic growth in the late 1980s and early 1990s; and joint-stock companies which first emerged in the middle 1980s and took off in the mid to late 1990s (Expert Group, 1995). In 1988, private-ownership secured the protection of China’s Constitution for the first time. By the end of 1999, there were over 1.28 million private firms employing 17 million people and 31 million sole traders (Liu, 1999).

The change in ownership form created a need for a new conceptualisation of accounting whose aim is to serve emerging forms of organisation, such as IJVs and shareholding companies. Indeed, this change has prompted the Chinese regulators to develop accounting regulations and systems for these organisations. As will be shown later, many of these new accounting regulations and systems have gradually adopted accounting theories and techniques that had previously been viewed under Mao as tools for capitalist exploitation. For example, the experiments with the shareholding system and the introduction of IJVs that began in the 1980s raised a concern over maintaining shareholders’
capital, and subsequently the concept of ‘capital’ was accepted in accounting regulation and practice.

As a series of enterprise reforms were promulgated, the ‘socialist iron bowl’ became increasingly vulnerable even in SOEs. During the first stage (between 1978 and 1983), reforms were undertaken to make SOEs relatively independent economic entities. SOEs were given more autonomy and were allowed to retain a share of profit and depreciation funds. In addition, bank loans replaced the state as the source of working capital. One widely adopted reform was the ‘Economic Responsibility System’ that required the SOEs to submit a contracted amount or percentage of profit to the government, with over 80% of industrial companies adopting some version of this system (Wang, 1998).

During the second stage (1983-1986), profit submission from SOEs to the state was replaced by the imposition of a corporate tax. In the meantime, SOEs were given greater autonomy in 10 areas: planning; sales; pricing; procurement; fund use; production decisions; organisational arrangements; personnel and labour management; salaries and wages; and cooperation with other SOEs.

During the third stage (1987-1992), various forms of ‘Contracted Operational Responsibility Systems’ were adopted while small SOEs were sold or leased (Expert Group, 1995). This reform extended the ‘Economic Responsibility System’ adopted during the first stage by enlarging the scope of responsibilities which included not only profit, but also major input and output measures. In addition to regulating the fiscal relationship between the government and SOEs, this new reform also aimed at establishing an enterprise management system. The most popular form of ‘Contracted Operational Responsibility Systems’ was dubbed as ‘two assurances and one link’ (to assure tax and profit submission, to assure technological upgrading, and to link total salaries and wages to tax and profit submissions). Over 90% of industrial enterprises which were included for government budgeting purposes adopted some form of the contract system (Wang, 1998). While many
forms existed, they all shared some common characteristics. First, they all involved a contract-based relationship between the enterprises, usually represented by their directors, and their supervisory government agencies. Second, directors faced substantial risks and rewards as a result of participating in these schemes, because their performance was linked to the performance of their enterprises. Third, in these systems enterprise directors were selected openly. Finally, most of these systems had multi-year targets and incentives in order to reduce the tendency towards short-termism (Ezzamel et al., 2007).

The ‘Economic Responsibility System’ and ‘Contracted Operational Responsibility System’ were also transformed to become ‘Internal Economic Responsibility Systems’ which established targets for managers and departments, linking their salaries and those of other employees to how close actual results were to pre-determined targets.

The fourth phase spans the period from 1993 to the present. The main characteristic of its reforms was the focus on the establishment of a ‘modern enterprise system’. This system was conceptualised in the ‘Decisions on Issues Relating to the Establishment of Socialist Market Economy’ made at the 3rd Plenum of the 14th National Congress of the CPC. It was considered to have four characteristics: clear property rights; well-defined responsibilities and duties; separation of government and enterprise; and scientific management. Joint-stock corporations were considered the main form of a modern enterprise system. In addition, Corporate Law was enacted in 1994, stipulating the establishment of new internal corporate governance mechanisms including shareholder meetings, boards of directors and supervisory boards. In 2001, the China Securities Regulatory Commission (CSRC) issued ‘Guidance on the Establishment of an Independent Directors’ Monitoring Mechanism in Listed Companies’ which required that all domestic listed companies appointed independent directors. In 2002, the CSRC and the China Economic and Trade Commission (CETC) jointly issued ‘Standards of
Corporate Governance’ to regulate duties and obligations of boards of directors, senior managers, and supervisory board members.

These reforms have created a considerable scope for accounting to perform a contracting role in China and provided incentives for companies to pursue their own interests. The changes made it necessary for distributable profits to be determined more meaningfully than before because the profit figure was seen as a main performance measurement as well as the basis for wealth distribution between the state, the enterprises, and managers and employees. The reforms directly prompted the wide application of several major accounting techniques. For example, responsibility accounting was adopted in the implementation of the ‘Economic Responsibility System’ and the ‘Contracted Operational Responsibility System’ in the 1980s and 1990s. Further, the reforms created an environment that was more conducive to the adoption of IFRS. For example, the establishment of the modern enterprise system gave managers more autonomy and responsibility to pursue economic goals. This motivated, perhaps even forced, managers to adopt new accounting techniques in order to obtain needed information.

From central-planning to marketisation

From the 1950s to the 1980s, central-planning was considered a main element of socialism (Yu, 1998). In particular, Stalin’s ‘Law of the Socialist Economy’, which implied that the economy should develop in a planned and proportionate manner, was adopted (Yu, 1998, Stalin, 1972). Central government planning was assumed to balance demand for, and supply of, resources and to allocate resources better than the market mechanism. China’s first five-year national planning system was established during the 1953 to 1957 transition period and it cascaded from central government (who fixed prices) to local government. Hare (1983) argues that the Five Year national plans were never taken seriously and that the focus was on the annual plan. For most industrial firms,
the annual plan provided them with a range of targets, mainly volume of output, quality, product mix, consumption of raw materials and energy, cost of production, wages and salaries, profits and permitted amount of working capital. Both the supply of materials, finance and sale of products were taken care of by government departments. Because of this, the main targets were the quantity measures mentioned above, rather than financial measures (Ezzamel et al., 2007). Under such a system, business enterprises were considered to be merely units for implementing central plans with very little autonomy, and government and the CPC controlled the hiring and firing of managers who were viewed as government officials. Further, each enterprise typically operated in a narrowly defined industry sector. The main incentive was construed as moral and political rather than material as workers and managers were awarded such titles as model workers or excellent managers rather than given any financial reward (Expert Group, 1995).

It was held that capitalism needed accounting conservatism because of the inherent uncertainty attributed to the market (Gregory and Stuart, 1985). There was little scope for adopting the market mechanism in China because it was seen as an exclusive feature of capitalism, with its spontaneous nature that contradicted central-planning (Yu, 1998). The market was construed as a disruptive force and a means of exploitation, causing unemployment and inequality and this view inhibited the adoption of Western accounting principles and techniques. Because the development of socialist economies in a planned manner was seen as a natural economic law (Yu, 1998), uncertainty and risk were assumed absent and, thus, it was not considered necessary to adopt accounting conservatism.

Generally, accounting was seen as a tool for central-planning. According to Ge (1955), the main purpose of socialist accounting was to provide information on the implementation of plans by the SOEs, systematically reflecting progress in order to identify and mobilise potential resources, ensure that SOEs utilised internal resources properly,
and help national plans to reflect the requirements of the law of national economic development in a planned and proportionate manner.

To facilitate central-planning, the government enforced the adoption of the uniform accounting system on SOEs. This system typically consisted of a chart of accounts, explanations of how to apply the accounts specified, a set of prescribed financial statements, and detailed regulations concerning depreciation, costing and spending.

Von Mises (1969) has argued that, for a state to direct resources rationally towards the achievement of given ends (even if resource availability and ends were known), a knowledge of relative valuations (prices) would be essential. The absence of a market makes it impossible for such information to be obtained without significant distortions. In practice, it was not possible for the planning system to obtain all required information because of the complex and changing nature of many economic parameters (Expert Group, 1995). Between the 1950s and the 1970s, government set prices for 100% of production materials and for up to 97% of retailing products. Partly due to the central-planning system and the inability to obtain accurate information on product costs and demand-supply relations for numerous products, prices were extremely distorted. For example, prices for agricultural products and infrastructure products or services were too low. This created a false sense of price stability and led to the misallocation of resources (Expert Group, 1995). More generally, China’s economy was on the brink of collapse in the late 1950s and during the Cultural Revolution.

Deng (1992) argued that neither central-planning nor the market was exclusive to either socialism or capitalism and hence the market mechanism could be used to develop socialist productive forces. A planned economy, Deng stated, was not socialism, as capitalism also undertook planning, and a market economy was not equal to capitalism because socialism could also have a market. Deng’s remarks provided a major stimulus for the 14th CPC National Congress held in 1992
which sanctioned the development of a socialist market economy as the objective of economic reform.

In practice, the scope for state planning was gradually reduced during the Deng era. Even before 1985, the government gradually de-regulated small-value commodities and allowed the market to regulate their prices. Between 1985 and 1991, a formal dual pricing system existed of planned prices and market prices. From 1992 onwards, the market gradually replaced the dual pricing system (Expert Group, 1995), so that by 1998, the number of products whose prices were directly set by central government had dropped from 1336 in 1978 to only 58 (Liu, 1999).

**Chinese capital market**

In 1984, a small number of companies began to experiment with the shareholding system in which the state, institutions (whether state-owned or not) and private investors held firm shares (Expert Group, 1995). Following the establishment of the Shanghai and Shenzhen Stock Exchanges in 1991, more than 1,400 companies have become listed on these two stock exchanges or on overseas markets. By 2003, the market capitalisation on the Shanghai and Shenzhen markets amounted to RMB 4,245.8 billion Yuan, accounting for about 36.21% of China’s GDP. Listing has become an important way of transforming SOEs into shareholding companies, and hence the capital market is increasingly becoming an important disciplinary mechanism in the Chinese economy (Ezzamel et al., 2007).

However, the Chinese capital market is segregated in the sense that about 70% of shares are non-publicly tradable. This is considered to be a major factor that affects capital market functioning, distorts share prices, and misallocates resources. As a result, the CSRC (2005) has recently announced a scheme to experiment with converting these non-publicly tradable shares into tradable ones.
With the gradual shift of price-setting from the government to the market, companies began to face increasing competition, risk and uncertainty. Inflation also became a major concern during most of the 1980s and 1990s; at times reaching over 20% (Liu, 1999; Expert Group, 1995). Although the 1986 Bankruptcy Law was not effective, it at least provided a challenge to the traditional view that bankruptcy should not occur in socialist countries. The 1985 change from free-state allocation of basic construction funds to interest-laden bank loans further diminished firms’ reliance on the state which encouraged the development of the credit market (Xiang, 1999).

With a growing capital market and a market-based price-setting mechanism, most firms became exposed to market monitoring and competition. As a result, enterprises were forced to strengthen their internal management and to introduce effective accounting methods in order to survive in the face of fierce competition.

**Summary**

This chapter has provided an analysis of the political and ideological changes in China since the 1950s. In particular, it identifies four changes in political ideology: from an emphasis on class-struggle to concern with economic development; from central-planning to marketisation; from public-ownership to mixed-ownership; and from self-reliance to open-door policies. The chapter has also briefly discussed the impact of the political ideologies under Mao and Deng on accounting. More detailed analysis of this theme will be undertaken in the remaining chapters of this study.
**5 THE DEVELOPMENT AND REGULATION OF FOREIGN INVESTED FIRMS IN CHINA**

**Introduction**

This chapter traces the development of foreign invested firms (FIFs) in China, describes their current state, and analyses the main laws and regulations that govern the formation and management of FIFs. The purpose of doing this is to provide the relevant background needed for an informed analysis of accounting for FIFs in China in the following chapters.

**The development of foreign invested firms in China**

The interviews and literature review undertaken for the purposes of this project identified only two IJVs before 1978: Zhongchang Railway Co., operated jointly by the Soviet Union and China after the Second World War (CAAC Journal, 2005), and the China-Poland Lunchuan Co. Ltd established in 1951, which was still in operation at the time of writing. In one interview, Regulator 1 identified multiple reasons for the lack of foreign investment in China during that period. First, during the cold war period, capitalist countries sought to isolate ‘Red China’. Second, investment in China was regarded as risky, hence foreign investors were discouraged from entering China. Third, in China and other socialist countries, investment was considered to be a capitalist transaction and hence was forbidden. Thus, a country could lend money to another for a fee or for free, but should not invest in another country with the aim of making profit. Fourth, China had ideological disputes with the Soviet Union and Yugoslavia and border disputes with the Soviet Union. In general, relations between China and other socialist countries...
were highly strained. China considered the Soviet Union to be engaging in an ideologically unacceptable revisionism of Marxism and Leninism. Finally, China placed an emphasis on economic self-reliance, and hence was willing to borrow from foreign countries, but was not prepared to accept foreign direct investment as the latter was perceived to compromise its sovereignty.

The 3rd Plenum which stipulated the open-door policy was the turning point in promoting more interest in establishing IJVs. Thus, following the open-door policy the first IJV was registered in Beijing in April 1980. This was called Beijing Aviation Food Co. Ltd jointly set up by a Chinese SOE and a Hong Kong firm. Since then China has continued to receive foreign investment in various forms, mainly Sino-foreign equity and contractual joint ventures, and wholly foreign-owned firms as shown in Table 5.1. From 1982 to 2004, China experienced an average annual growth rate of 24%. The average annual growth rates for equity JVs, contractual JVs, wholly-foreign-owned firms, and joint explorations were 31.99%, 13.89%, 37.03%, and -2.18% respectively.
Table 5.1  Statistics on FDIs to China (1979-2004) (US $ Million)

<table>
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<tr>
<th>Year</th>
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<th>Contractual Joint Ventures</th>
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<td>1982</td>
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Average Growth Rate (%) | 24 | 32 | 14
Table 5.1  Statistics on FDIs to China (1979-2004) (US $ Million)  
(Continued)

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<th>Year</th>
<th>Total FDIs $ million</th>
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<th>Shareholding Companies with Foreign Investments</th>
<th>Joint Explorations</th>
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<tr>
<td></td>
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<tr>
<td>2004</td>
<td>60,630</td>
<td>40,220</td>
<td>66</td>
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<td></td>
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<td>110</td>
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<td></td>
</tr>
<tr>
<td>Average Growth Rate (%)</td>
<td>24</td>
<td>37</td>
<td>15</td>
<td>-2</td>
</tr>
</tbody>
</table>
The Development and Regulation of Foreign Invested Firms in China

Table notes:

1. The components for FDIs do not add up to the total in 1979-1983, 1982-1985 because the statistics for these years were produced on a different basis.
2. All raw statistics in this table are based on prices of relevant years.
3. The amounts of compensation trade are deducted from the amounts of FDIs from 1979 to 1995 because compensation trade has not been included in FDIs since 1986.
4. The average growth rate is the geometrical average growth rate.

Data sources:

1. Almanac of China Foreign Economic Trade (1983-2004);

The development of FIFs has evolved through three main stages (Li, 2005): stage one involved the launching of the FDIs experiment; stage two entailed the use of FDIs for developing a socialist market economy; and stage three related to the impact of China’s accession to WTO on FDIs. These three stages are discussed in detail below.

Stage one (1978 to 1991): the foreign direct investments (FDIs) experiment

During the period 1978-1991, Sino-foreign joint ventures were the dominant form of FDIs. Moreover, FDIs were mainly concentrated in the low-tech, low capital, and labour intensive sectors such as manufacturing and property development. There are several reasons for this:

- Foreign investors had little knowledge of the Chinese market and the levels of uncertainty and risk were generally high. JVs presented a suitable way of entering the market with lower risk and investment cost;
• Foreign investment in many sectors was restricted. JVs were a convenient way to access these market segments;
• Prices were distorted in many industries that failed to attract large foreign investment; and
• The capacity of consumption in the Chinese market was limited as China was still managed largely through a planned economic system.

During this period, a basic legal framework for governing FIFs in China was established, which included laws and implementation rules for the formation of, and income tax in, FIFs, and accounting regulations for FIFs. Although a legal system was established, the first few years of this period were experimental in nature with a very limited growth in FDIs in terms of both the number of firms established and the amount of pledged investment. By 1982 there were only 83 IJVs with a pledged investment of US $141 millions. However, this small number of IJVs had a strong symbolic significance, as it signalled China’s commitment to an open-door policy thereby posing a serious challenge to the self-reliance policy. During this period several concerns emerged, many of which were politically and ideologically driven. For example, high efficiency in IJVs was seen as a threat to domestic firms and IJVs were considered a means of spreading ‘spiritual pollution’ (capitalist life style). There were also many complaints from international investors about the restrictions on domestic sales by FIFs, shortage in, and inconvenience of, foreign exchange, poor infrastructure, corruption and bureaucracy in local governments, and inconsistencies in accounting regulations.

In response to investor complaints, the government sought to prevent local governments or other institutions from imposing charges on FIFs, and it set targets for government departments to respond to applications and requests from FIFs. To attract FDIs, substantial tax incentives were offered to foreign investors. Initially, the new IJVs were
exempted from corporate income tax in the first year when a profit was made and given a 50% tax reduction for the next two years. In 1983, these provisions were revised to provide foreign investors with even better privileges: from the year when they made a profit, these JVs would pay no corporate income tax in the first two years and enjoy a 50% reduction from the third to the fifth year. In addition, the government provided special privileges for FIFs that were export-oriented and used advanced technologies in terms of favourable utility rates, land use fees, working capital loans, further reductions in income tax, preferential import and export rights, favourable foreign currency exchanges, and more managerial autonomy (State Council, 1986). For FIFs in special economic zones and other cities that were approved by the government to be open to foreign investment, the rate of corporate income tax was reduced from 30% to 15% and from 1986 they also became exempt from paying the uniform industrial and commercial tax.

However, FDIs also generated several political and ideological debates. There was a debate on the nature of SEZs. Reformers intended that SEZs were used as a window for importing foreign capital and advanced technologies while conservatives were concerned that introducing foreign capital to SEZs would be contrary to the policy of public-ownership and would be an undesirable concession. As SEZs hosted numerous FIFs, it was feared that these concerns would erode investors' confidence in SEZs and therefore discourage investment in FIFs. Academic 2 stated in an interview that a number of critics, including some senior members of the CPC Central Committee, considered SEZs as a restoration of foreign colonies. He also recalled that in practice certain restrictions were imposed on FDIs. For example, the proportion of Chinese ownership must be 51% and wholly-foreign-owned firms were forbidden. Yet, the main politicians, in particular Deng, stressed that the decision to experiment with SEZs was correct and claimed that the experiment with SEZs that took place in 1987 was a success.
However, an ‘Anti-Spiritual Pollution’ campaign was waged between 1982 and 1985 against FIFs. One effect of adopting the open-door policy was that some ‘capitalist decaying ideas and behaviours’ that had long been banned were introduced into China with foreign investment, foreign technology and increased international exchange. Some of these changes were considered to adversely affect people’s confidence in socialism, the communist cause and CPC leadership. To protect the latter, the CPC organised a national campaign against these changes which were dubbed ‘spiritual pollution’. Li and Li (1999) have argued that this movement, directly or indirectly, dampened the enthusiasm of potential foreign investors to invest in China.

Meanwhile, the economic reforms produced unexpected effects. For example, the dual pricing system (where some prices were regulated by the market while others were set by the government) allowed some government officials and their relatives and friends to use the system to their benefit. This caused much resentment. The reforms also created a wealth gap, with those working for the SOEs earning much less than those employed by FIFs, and intellectuals earning much less than self-employed traders. Most important was the inconsistent pace of economic reform compared to political reform with the later being fairly stagnant. Calls were made for political liberalisation to go hand-in-hand with economic liberalisation and for introducing Western-style democracy. As a counter measure, in September 1986 the CPC issued a ‘Resolution on the Guiding Principle for Developing Socialist Spiritual Civilisation’. This Resolution stressed that economic development must be accompanied by socialist spiritual civilisation development. But this and other efforts produced little effect and indeed by the end of 1986, a large-scale university student movement erupted across many cities demanding more democracy and freedom. This forced the Secretary-general of the CPC to step down for his failure to stem rightist ideas. In addition, this event prompted the CPC in 1987 to launch a national campaign of Anti-Capitalist-Freedom-Thinking. In
the same year, the guiding principles for economic and political reforms were formulated based on economic development: to uphold the open-door and economic reform policies; and to uphold the Four Cardinal Principles of Chinese socialism: a commitment to Marxism, Leninism and Mao Zedong Thought; to socialism; to Proletarian Dictatorship; and to CPC Leadership.

However, although the campaign suppressed the dissenting voices temporarily, the underlying problems were not addressed. The death of Yaobang Hu, the disgraced Secretary-general of the Communist Party of China in April 1989, prompted students to take further action. This evolved into the Tiananmen Square tragedy on the 4th of June that shocked the world. Most foreign countries denounced the Chinese government’s approach to dealing with the event and closed the door on China economically and politically. It looked as if China had gone back to the pre-economic reform period as the open-door policy effectively came to a halt during the second half of 1989 and the first half of 1990. Some foreign investors reportedly moved their investment elsewhere.

Stage two (1990 to 2000): FDIs for developing a socialist market economy

To recover from the depression that followed the Tiananmen Square tragedy and the Economic Austerity Program that was initiated in 1988 for curbing economic disorder, a series of new measures were taken in the early 1990s, whose aim was to encourage foreign investment. First, in 1990 the government opened the Shanghai Pudong Development Zone and provided even more favourable terms for foreign investors than those applied to other SEZs. These entailed a broadening of the scope for foreign investment to include areas such as banking and financial services, real estate, retailing and consulting. Second, in 1992 major inland cities were opened for foreign investments. Third, more traditionally closed tertiary sectors were opened for foreign investment,
such as roads, telecommunications, and primary industries such as oil, coal, and minerals.

As the former Soviet Union and Eastern socialist countries disintegrated in the early 1990s, China began to realise that radical political reform could lead to instability and an economic crisis. This created pressure to speed up economic reform. Economic growth was not only seen as a measure of economic achievement, but also as a means of solving social and political problems. Thus, during his South China tour in early 1992, Deng urged the government to speed up the pace of economic reform. He encouraged the development of a market economy by stating that markets could be used to develop socialist productive forces. As a result, in 1992 the CPC announced the establishment of a socialist market economy.

Deng’s South China tour speeches are widely regarded as the catalyst for the intensive and speedy marketisation that took place in China in the early 1990s (Ezzamel et al., 2007). Deng’s speeches were critical because, at that time, there was still a debate on the nature and future of SEZs. In an interview, Practitioner 18, a Deputy CEO for a Sino-foreign JV, recalled that a dispute arose from the fact that SEZs had serious problems of corruption, opportunism in share trading, and prostitution. From the perspectives of many older CPC and government officials, these problems were inconsistent with both Chinese culture and socialism. Therefore, conservatives called for a restriction on the development of SEZs. Practitioner 16 argued that if SEZs were rejected merely because of these problems, then Chinese economic reforms would have suffered a serious reversal. Deng’s support for SEZs silenced the conservatives and hastened the development of SEZs and foreign investments. At the time of writing, there was very little controversy over the nature of SEZs and foreign investments. The open-door policy has spread throughout China, with some regions becoming even more favourable to foreign investors than the earlier SEZs.
Prompted by the new open-door measures and the inspiration provided by the emphasis on economic reform, China regained its place as a favourable destination for foreign investment. From 1989 to 1993, the number of FDIs projects increased from 5,779 to 83,437, the pledged amount of FDIs increased from US $5.6 billion to US $111 billion, and the amount of used FDIs, as shown in Table 5.1, rose from US $3.4 billion to US $27.5 billion.

In the meantime, the form of FDIs began to change significantly. While IJVs were still a major form of FDIs, wholly-foreign-owned firms increased in proportion and eventually dominated the former. Before 1997, wholly-foreign-owned firms accounted for about 36% of FDIs in 1997, but this rose to 47% in 2000 (Li, 2005). Of the new FDIs between 1992 and 1999, 50% were in the form of IJV, but this was reduced to 30% by 2000 before China entered the WTO (Li, 2005). Not only was there a change of form of FDIs, but increasingly foreign partners began to exercise more control over JVs through non-equity measures such as funds, sales networks, and research and development (R&D). There were several reasons for these changes. First, the Chinese economy was becoming markedly stronger and the standard of living was improving rapidly following a decade of healthy economic growth. Thus, foreign investors began to realise the real potential of the Chinese market. Second, the investment environment improved significantly. This included a more open market, an improved infrastructure and a more comprehensive legal system. Third, some major foreign investors gained sufficient experience of working in the Chinese market, while some large MNCs, such as Coca-Cola and Pepsi, made great inroads into this market. The combination of these factors meant that risk and uncertainty were reduced and the need for a Chinese partner to enter the market became less necessary. Gradually, more foreign companies established wholly owned enterprises in China. Meanwhile, many Sino-foreign JVs came to the end of their contracts.
Stage three (2001 to present): The impact of China’s accession to the WTO on FDIs

China’s accession to the WTO in 2001 provided even greater scope for the open market to function. In the three years following its re-entry to the WTO, China amended over 2,500 laws and regulations and abandoned over 800 laws and regulations that were inconsistent with the WTO entry requirements. Also, by the end of 2004, China had lowered its tariffs from an average level of over 40% to just 10.5%. Meanwhile, China continued to open more sectors to foreign investors such as banking, insurance, securities, retailing, logistics, accountancy, engineering and management consulting. These developments provided greater scope for encouraging FDIs.

Since China’s accession to the WTO, there has been a significant increase in FDIs in HiTech sectors such as equipment manufacturing, electronics and machinery, and more FIFs established R&D centres and regional headquarters in China (Chong, 2005). According to the Ministry of Commerce (2007), in 2006, 41,485 new FIFs were approved, and the amount of FDIs actually used reached US $69.47 billion. Judging from the actual levels of FDIs, the top ten providers in 2006 were (in descending order): Hong Kong (US $20 billion); Virgin Islands (US $12 billion); Japan (US $4.60 billion); South Korea (US $3.90 billion); the USA ($2.87 billion); Singapore (US $2.26 billion); Taiwan (US $2.14 billion); Cayman Islands (US $2.10 billion); Samoa (US $1.54 billion); and Germany (US $1.98 billion). In 2006, the actual FDIs used from these ten providers accounted for 83.86% of the total FDIs invested in China.

To illustrate the speed and scale of foreign investment in China since 2001, the following discussion draws on developments in the sectors of accountancy, securities, banking, and telecommunications.
Accountancy profession

In the accountancy sector, foreign auditing firms were not allowed to provide audit services in China before 1992, although they were permitted to establish representative offices that could provide consulting services to foreign companies. Since 1992, they have been allowed to form JVs with Chinese domestic accounting firms and to undertake accounting and auditing services. As a result they have established more than 10 JVs whose revenues rose from RMB 0.154 billion Yuan in 1992 to more than RMB 60 billion Yuan in 1998. China’s WTO entry concessions relating to the accountancy industry include:

- allowing foreign Certified Public Accountants (CPA) firms to form JVs;
- granting CPA qualifications to foreign individuals who have passed qualifying examinations;
- not restricting JV CPA firms to firms approved by the Chinese authorities; and
- allowing CPA firms to undertake tax and management consultancy.

These concessions, along with the concessions relating to other sectors, expanded the scope for CPA work. It also set higher professional standards for Chinese CPAs. The market structure is, thus, likely to change with the Big Four gaining market share at the expense of large domestic firms. So far, China has opened up the following areas of its accountancy market to foreign investment, by allowing (CICPA, 2002; CICPA 2006):
• The Chinese Institute of Certified Public Accountants (CICPA) to hold the first qualifying examination in Brussels on 28-28 January 2007.

• Foreign audit firms to establish representative offices. By the end of 2002 there were 18 such offices established by 11 international or foreign CPA firms.

• The formation of JV accounting firms. By the end of 2002, nine international accounting firms had established nine JVs with 11 branches.

• International CPA firms to develop member firms. By the end of 2002, 10 international CPA firms established 19 member firms. Since 2001, there have been two mergers between the Big Four and domestic Chinese firms: Ernst & Young merged with Shanghai Dahua to become Ernst Young Dahua in 2001 and Deloitte & Touche merged with Tianjian Beijing CPAs in 2005. According to CICPA’s data, the top four CPA firms by revenue are all Big Four member firms in China (CICPA, 2007).

• Foreign CPA firms to conduct temporary auditing services. By the end of 2002, more than 600 temporary licences had been granted.

• Foreign citizens to take the Chinese CPA qualifying examination and be permitted to apply for a Chinese CPA qualification after they have passed the examinations. Since 1994, over 10,000 overseas candidates have taken CICPA’s qualifying examinations and 347 have passed and became CICPA members.

• CICPA overseas members to apply to become practising Chinese CPAs. By the end of 2002, 18 had met the requirements and were given a licence to practise auditing in China.
Financial services

In the securities industry, China has opened a fund management market and a securities underwriting market, and allowed the transfer of state-ownership and legal person shares to foreign investors. By October 2006, 11 overseas institutions had acquired qualified foreign investment institutions (QFII). Since the first Chinese-foreign joint securities company was formed in Beijing in 2002, jointly owned by a Chinese company and a French company, at the time of writing, there are three Chinese-foreign securities companies and 13 JV funds. Foreign investors’ equity ownership was also allowed to increase from 33% to 49% after 2006. This may provide further incentives for more foreign securities firms to form JVs with Chinese counterparts.

In the banking industry, China fully opened its foreign currency market in 2001, and the scope of trading Chinese currency (RMB) by foreign banks was expanded in 2003 to include Chinese firms as clients. Moreover, more than 60 foreign banks from 20 countries opened 204 offices in China and 105 of these were approved to transact in the Chinese currency (RMB). Nine Chinese banks were given permission to use foreign capital, and four foreign car manufacturers were permitted to provide motor financing in China.

Telecommunication sector

In the telecommunications industry, before 2001, there was no FDIs because of the policy restrictions imposed by the Chinese government. However, by the end of 2001 Chinese telecommunications firms had obtained a total of US $20 billion of indirect foreign investment. China’s WTO entry concessions allowed FDIs to enter this sector in a gradual way with foreign equity ownership being capped at 25% initially and then increasing to 49%, although the level of openness varied between basic telecommunications and value-added services. In October 2006,
there was only one Chinese-foreign JV in this sector, established in 2000 in Shanghai by AT&T and two Shanghai-based companies. This JV provides Internet broadband and other value-added internet services. However, several other major JVs are currently being formed. In addition, e-Bay has acquired 33% of a Chinese Internet company Yiwang and Vodafone has bought 0.237 billion shares in China Mobile (HK).

Cross border mergers and acquisitions

China’s accession to the WTO is partly attributable to two FDI trends in China. The first is that many JVs have become wholly-foreign-owned firms. In 2002, Siemens bought out the equity in its JVs with Chinese companies and the JVs invested in by companies such as BP became independent. Another trend is the increasing number of cross-border mergers and acquisitions. For example, oil giant ExxonMobil bought 19% of China Petrochemical Co’s shares in its IPO, Anheuser-Busch Breweries bought 99.66% of Haerbin Breweries’ shares, and Yahoo bought 40% of the biggest Chinese on-line retailer Alibaba.com. This is because China’s membership of the WTO made the Chinese market more transparent, thereby encouraging foreign investment. Moreover, the visibility of potential target industries and firms increased owing to the WTO terms for China’s accession. Strategically, mergers and acquisitions shortened the time for moving into the Chinese market. While China’s accession to the WTO accelerated the flow of FDIs into China, it also accelerated Chinese companies’ cross-border mergers and acquisitions. For example, China’s IT giant Legend bought IBM’s PC arm. GCL, a Chinese electronic company, acquired a German company and a French company. Further, in 2005 China’s Nanjing Motor Group took over the UK’s MG Rover Group.
Foreign direct investment: From the UK to China

The United Kingdom was the first Western country to diplomatically recognise the People’s Republic of China on 6 January 1950. However, when China opened its doors to foreign investors in the late 1970s, FDIs from the UK in China and were modest. As can be seen from Table 5.2, in 1984 total capital and FDIs from the UK only amounted to US $132 million and US $98 million respectively. In 1994 there was a large increase, with the two figures increasing to US $1,086 million and US $689 million respectively. These figures peaked in 1997 with total capital and FDIs from the UK reaching US $2,020 million and US $1,858 million respectively. Overall, between 1984 and 2003 the average annual growth rates were 12.38% and 11.25% respectively. In 2004 the UK became the third largest investor in China and the third largest trading partner, among EU countries, with total trade amounting to US $20 billion. The UK has also invested in a total of 4,272 projects in China with an accumulated, utilised investment of US $12.2 billion (BBC, 2005; Xu, 2005).
Table 5.2  
FDIs to China from the UK (US $ Million) 

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Capital to China from the UK</th>
<th>Total FDIs to China from the UK</th>
<th>FDIs as % of Total Capital</th>
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<tbody>
<tr>
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<td>98</td>
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<td>1985</td>
<td>98</td>
<td>71</td>
<td>72.75</td>
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<tr>
<td>1986</td>
<td>53</td>
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<td>588</td>
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<td>5.81</td>
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<tr>
<td>1989</td>
<td>375</td>
<td>28</td>
<td>7.59</td>
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<tr>
<td>1990</td>
<td>520</td>
<td>13</td>
<td>2.57</td>
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<td>1991</td>
<td>227</td>
<td>35</td>
<td>15.57</td>
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<td>1992</td>
<td>216</td>
<td>38</td>
<td>17.78</td>
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<td>1993</td>
<td>571</td>
<td>221</td>
<td>38.64</td>
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<td>1994</td>
<td>1,086</td>
<td>689</td>
<td>63.44</td>
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<td>1996</td>
<td>1,400</td>
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<td>92.90</td>
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<td>1997</td>
<td>2,020</td>
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<td>1,516</td>
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<td>2002</td>
<td>1,142</td>
<td>896</td>
<td>78.44</td>
</tr>
<tr>
<td>2003</td>
<td>1,209</td>
<td>742</td>
<td>61.39</td>
</tr>
</tbody>
</table>

Average Growth Rate(%)  
12.38
11.25


Notes: 1. All raw statistics in this table are based on prices of relevant years.
2. The average growth rate is the geometrical average growth rate.
Regulation of foreign invested firms in China

As mentioned earlier, the basic legal framework for managing FDI was laid down in the first few years of the adoption of an open-door policy and improved in later periods. This framework consisted of three groups of laws and regulations for FIFs: basic laws and regulations on the three types of FIF; tax matters; and accounting. This section deals with the first two types and the next chapter will introduce and analyse accounting regulations.

Basic laws and regulations on foreign invested firms

The laws on FIFs consist of the Law on Sino-Foreign JVs (first passed in July 1979, revised in April 1990), the Law on Foreign Firms (April 1986), and the Law on Contractual JVs (April 1988). In addition, there are corresponding regulations dealing with the implementation of these laws. These basic laws and their implementation regulations stipulate various aspects of FIFs including:

• nature and scope;
• legal status and liability;
• formation and registration;
• organisation and registered capital;
• payment of capital;
• governance;
• land use;
• planning, purchases and sales;
• tax;
• foreign currency management;
• accounting and finance;
• employees and their welfare; and
• termination and disorganisation.
The three laws are similar in many ways. For example, they permit all three types of FIF to obtain a Chinese legal person status and to be protected by Chinese law. They also require that payments of capital into any FIF be verified by a Chinese CPA and that all FIFs must adopt Chinese accounting regulations and establish an employee council.

However, there are also significant differences between them. For example, unlike wholly-for-ign-owned firms and contractual JVs, Sino-foreign JVs have to establish three funds after paying corporate income tax: reserves; an employee incentives and welfare fund; and an enterprise development fund. Moreover, both Sino-foreign JVs and contractual JVs are required to set up a Board of Directors, but this is not a requirement for wholly-foreign-owned firms.

Over the years, there have been some significant changes to these laws. For example, the 1979 Law on Sino-Foreign JVs stipulated that the chairperson of the Board of Directors must be from the Chinese partner, but this was changed in 1990 so that the chairperson could be either Chinese or foreign. A revision to the laws in 2000 has meant that:

- contractual JVs and wholly-foreign-owned firms do not need to balance foreign currency inflows and outflows;
- Sino-foreign JVs and wholly-foreign-owned firms do not need to consider the Chinese market first when purchasing material and fuel;
- wholly foreign-owned firms do not need to sell all or most of their goods abroad; and
- Sino-foreign JVs and wholly-foreign-owned firms do not need to file their production and operation plans with supervising government departments.

All these changes were made to accommodate the changing economic environment and the WTO requirements.
Laws and regulations on tax matters in foreign invested firms

Currently, the taxes that FIFs are liable to pay include VAT, consumption tax, revenue tax, import and export tariffs, corporate income tax, individual income tax, resource tax, land VAT, vehicle purchase tax, urban property tax, vehicle registration tax, stamp duty, and agriculture tax.

China adopted a two-tier tax system with differential taxes for FIFs and domestic firms. The initial income tax laws and regulations for FIFs were stipulated between 1980 and 1982 and included:

- Law on Income Tax in Sino-Foreign JVs (September 1980);
- The Regulations for the Implementation of Law on Income Tax in Sino-Foreign JVs (December 1981);
- Law on Income Tax in Foreign Firms (December 1981);
- Regulations on the Implementation of the Law on Income Tax in Foreign Firms (February 1982).

These were established before income tax laws were promulgated for domestic SOEs, collective enterprises, private enterprises and sole traders between 1983 and 1989.

The most significant difference between FIFs and domestic firms is that domestic firms are subject to a corporate income tax rate of 33% compared to considerably lower rates for FIFs in SEZs and other government-recognised special economic and technology development zones, in addition to tax holidays (temporary reductions or elimination of a tax). For example, a typical special economic zone that is approved by central government offers the following tax privileges for FIFs:
• Corporate income tax rate of 15% for production firms, i.e. manufacturing firms and firms in such sectors as energy (excluding oil and gas), construction, geographic survey, and transport, 30% for non-manufacturing firms, and 10% for firms that export their products.

• Production firms enjoy tax exemption in the first two years following the year in which they first make a profit and a 50% reduction in the next three years;

• Firms that specialise in ports, docks and electricity generation are tax free for five years and enjoy a 50% reduction for the following five years;

• All FIFs are exempt from local corporate income tax which would otherwise be 3%; and

• FIFs also enjoy such tax concessions as VAT relief, consumption tax relief, reinvestment tax relief, income tax reduction for purchasing large domestic produced equipment, and tax relief on certain specified revenues.

According to Zhang (1999), the average corporate income tax rate for domestic firms is 28% while that for FIFs is about 8%. In addition, the average turnover tax rate for FIFs is only 63% of that for domestic firms. This discrimination against domestic firms has been keenly debated. The government signalled some time ago that a unified system would be developed, but so far no action has been taken.

Yan (1997) argued that the development of Chinese laws and regulations on foreign investment reflected a basic tension between encouraging foreign investment and maintaining state control over it. The above discussion provides strong support for this argument. On the one hand, to attract FDIs together with foreign management experiences and technologies, the government has been willing to provide many
privileges to foreign investors such as the tax advantages mentioned above. On the other hand, the government has tried to open up gradually certain areas for government intervention, such as the initial, but now abandoned, requirement that FIFs should file their production and operating plans with their supervising government departments.

**Accounting regulations**

A detailed introduction and analysis will be provided in the next chapter, but for the sake of completeness of this chapter, the development of accounting regulations for FIFs is briefly described here. The first regulation was issued in March 1985 by the MoF: the Accounting System for Sino-Foreign JVs. This set of regulations was also used for the two other types of FIF: contractual JVs and foreign firms. In 1991, this was amended to become Accounting System for Firms with Foreign Investment. In 2001, FIFs, together with domestic companies, began to adopt the Enterprise Accounting System (EAS) issued in 2000.

**The future of foreign direct investment in China**

The analysis by Zhuo (2005) shows a number of trends in FDIs in China. In terms of sources of FDIs, Hong Kong tops the league table, but its share is likely to be reduced in the future as FDIs from other countries or areas is expected to increase. Although the shares of FDIs held by Japan, Taiwan and South Korea have been reduced in recent years, these countries are anticipated to remain the main Asian investors. While there have been fluctuations, FDIs from North America and Europe have increased in recent years and are likely to continue to do so in the future. Moreover, FDIs in free trade zones have increased sharply and it is likely that this trend will continue. In terms of receiving areas, eastern China attracted over 85% of FDIs although its share has been decreasing. Central and western China, especially the old industry base in northeast
China, has been attracting increasing amounts of FDIs. Also, FDIs in manufacturing sectors are targeted towards heavy, hi-tech and new-tech industries, with enormous potential for FDIs in the agricultural sectors. Similarly, FDIs in the tertiary sector, a quarter of total FDIs in 2003, are set to increase in the next few years by 10% -15% per year.

Zhou (2005) also argues that there will be several barriers to FDIs growth in China in the future. First, Chinese SOEs and non-SOEs cannot match foreign firms in many aspects such as management systems, capital, technology, and market channels. Second, there will be a shortage of energy in some areas which is expected to slow down the growth of FDIs. Third, the system for state assets management is lagged, and this will reduce the motivation for mergers and acquisitions by foreign investors. These problems relate to the incomplete legal system, marketised property transferring mechanisms, and low quality intermediaries. Moreover, the level of economic open policy activities is low in some sectors such as telecommunications, biomedicines and IT industries. Furthermore, FDIs are likely to be adversely affected by some regulations and policies, for example, the elimination of tax privileges that have been enjoyed by foreign investors. Finally, competition for FDIs from other countries and regions, such as India, is anticipated to adversely impact the flow of FDIs to China.

**Summary**

The flow of FDIs to China has evolved through three stages. Although there were numerous barriers including ideological ones, China has now become the largest FDIs destination worldwide. The two main forms of FDIs in China, the equity JVs and wholly-foreign-owned firms, have been growing at a rapid pace with the latter becoming dominant and setting the trend for attracting foreign funds to China. The Chinese government has made a great effort to attract FDIs to China, including creating a favourable legal infrastructure and accounting regulations.
China’s accession to the WTO has provided a new incentive for further increases in the flow of FDI to China, but several barriers to this have been identified. These include an unbalanced industrial environment, a shortage of energy, poor state assets management, and the possible termination of tax advantages to foreign investors.
The Development of Accounting Regulation for Foreign Invested Firms in China

Introduction

The preceding two chapters provided an account of both the politico-economic context and the industrial background within which the development of Chinese accounting regulation and practice relating to FIFs can be analysed meaningfully. This chapter examines the three stages of development in accounting regulation and practice concerning FIFs from the early 1980s to the present time. During the first stage (1980-1991), the Accounting System for Sino-Foreign JVs was issued. At the second stage (1992-2000), the Accounting System for Firms Using Foreign Investment was promulgated. The third stage (from 2001 onwards) has been characterised by the development of the Enterprise Accounting System (EAS) and accounting standards.

Blake et al. (2000) have briefly traced the development of accounting regulations for Sino-foreign JVs up to 2000, and divided them into three-stages:

- A two-tiered system (transaction-based and industry-based) from 1981 to 1992, which witnessed a reduction from over 40 to 13 industry-based uniform accounting systems; and
However, it may be inappropriate to characterise the period since 1993 as having a single accounting system because apart from the accounting standards, there were 13 industry-based and ownership-based accounting systems (including the system for FIFs) in addition to the individual accounting standards, and the latter were often inconsistent. Indeed, the inconsistencies were a major motivation for further accounting reforms in 2000 when the MoF developed the EAS as a substitute for the 13 industry-based uniform accounting systems (Li, 2001). Even after 2000, a dual track system existed, evidenced by the co-existence of a uniform accounting system in the EAS and accounting standards (Xiao et al., 2004).

The remainder of this chapter is organised into six sections. The next section reviews accounting regulatory developments from 1949 to the present. Thereafter, in the following three sections, the regulations and practices for each of the above mentioned stages are analysed. Where possible, a comparison is made of these accounting regulations and practices and those of the SOEs. The final section provides a summary and some concluding remarks.

**Accounting developments in China: An overview**

Table 6.1 outlines the development of accounting in China from 1949 to the present time. The main developments are further described and analysed in the next two subsections that deal with the Mao era and the Deng era respectively.
### Table 6.1 Development of accounting for foreign invested and domestic firms in China (1949-2006)

<table>
<thead>
<tr>
<th>Year</th>
<th>Accounting for Foreign Invested Firms</th>
<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td></td>
<td></td>
<td>The MoF established an accounting regulations department</td>
<td>Founding of PRC</td>
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<tr>
<td>1950</td>
<td></td>
<td>Ten uniform accounting systems and several related regulations including those for SOE financial planning, profit submission and depreciation</td>
<td>State Council issued The Decision on Unifying Fiscal and Economic Work</td>
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<tr>
<td>1951</td>
<td></td>
<td></td>
<td>The MoF was empowered to develop accounting systems; State Council issued Regulations for Managing Certified Accountants</td>
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<tr>
<td>1952</td>
<td></td>
<td>MoF issued a series of uniform accounting systems and related regulations advised by Soviet experts</td>
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<tr>
<td>1953</td>
<td></td>
<td>MoF issued further uniform accounting systems and related regulations advised by Soviet experts</td>
<td></td>
<td>Start of 1st Five Year National Economic Plan</td>
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</tbody>
</table>
Table 6.1  Development of accounting for foreign invested and domestic firms in China (1949-2006) (Continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Accounting for Foreign Invested Firms</th>
<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
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<tbody>
<tr>
<td>1957</td>
<td></td>
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<td>Anti-rightists campaign</td>
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<td>1958</td>
<td></td>
<td>MoF issued Announcement on Methods for Developing Enterprise Accounting Systems, suspending many issued uniform accounting systems (UAS) and deregulating its powers to other ministries</td>
<td>Great Leap Forward mass movement</td>
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<tr>
<td>1959-1965</td>
<td>Accounting order restored by re-issuing new UASs</td>
<td>MoF regained power lost during the Great Leap Forward movement; State Council issued Regulations on Accounting Personnel’s Duties and Rights (1963)</td>
<td></td>
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<tr>
<td>1966-1976</td>
<td>Simplified UAS, political accounting</td>
<td>MoF abolished accounting regulations department</td>
<td>Cultural Revolution</td>
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</table>
Table 6.1  Development of accounting for foreign invested and domestic firms in China (1949-2006)  (Continued)

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<th>Year</th>
<th>Accounting for Foreign Invested Firms</th>
<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
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<tr>
<td>1978</td>
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<td>State Council</td>
<td>The Third Plenum of the</td>
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<td>issued revised</td>
<td>Communist Party of China</td>
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<td>Regulations on</td>
<td>(CPC): decided to shift</td>
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<td>Accounting</td>
<td>from class-struggle to</td>
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<td>Personnel’s Duties</td>
<td>economic development</td>
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<td>and Rights</td>
<td>primacy and to adopt</td>
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<td>economic reform and</td>
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<td>open-door</td>
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<td>1979</td>
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<td>MoF restored</td>
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<td>regulations</td>
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<td>department; Birth</td>
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<td>Society of China</td>
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<td>(ASC)</td>
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<td>1980</td>
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<td></td>
<td>Birth of</td>
<td>Special Economic</td>
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<td></td>
<td>MoF issued new</td>
<td>Accounting</td>
<td>Zones opened in Shenzhen,</td>
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<td></td>
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<td>UASs for SOEs</td>
<td>Research (ASC’s</td>
<td>Zhuhai, Shantao, and</td>
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<td>research journal);</td>
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<td>first Sino-foreign</td>
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<td>joint venture</td>
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<td>accounting firm</td>
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<td>Third Plenum</td>
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Table 6.1  Development of accounting for foreign invested and domestic firms in China (1949-2006) (Continued)

<table>
<thead>
<tr>
<th>Year</th>
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<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>MoF issued Accounting System for Sino-Foreign Joint ventures (trial draft)</td>
<td>MoF issued Regulations on Cost Control in SOEs</td>
<td></td>
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<tr>
<td>1984</td>
<td>MoF issued Accounting System for Sino-Foreign Joint ventures</td>
<td>MoF issued Regulations on Cost Control in SOEs</td>
<td>The CPC issued the Decision on Economic Structural Reform</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>MoF issued Accounting System for Sino-Foreign Joint ventures</td>
<td>MoF issued Regulations on Depreciation in SOEs</td>
<td>Promulgation of the Accounting Law</td>
<td></td>
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<tr>
<td>1986</td>
<td>MoF issued Regulations on Costing in SOEs</td>
<td>State Council issued CPA Regulations</td>
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<tr>
<td>1988</td>
<td></td>
<td>Formation of the Chinese Institute of Certified Public Accountants (CICPA), Research Groups on: (1) Foreign Accounting; and (2) Accounting Principles and Basic Accounting Theory established by the ASC</td>
<td>The State Council started a four year Economic Austerity Campaign</td>
<td></td>
</tr>
</tbody>
</table>
Table 6.1  Development of accounting for foreign invested and domestic firms in China (1949-2006)  (Continued)

<table>
<thead>
<tr>
<th>Year</th>
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<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
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<tbody>
<tr>
<td>1989</td>
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<td>Tiananmen Student Movement</td>
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<td>1990</td>
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<td></td>
<td>Shanghai Stock Exchange launched</td>
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<tr>
<td>1991</td>
<td></td>
<td></td>
<td></td>
<td>Shenzhen Stock Exchange launched</td>
</tr>
<tr>
<td>1992</td>
<td>MoF issued Accounting System for FIFs to replace Accounting System for Sino-Foreign Joint ventures</td>
<td>Shenzhen municipal government issued Shenzhen Special Economic Zone Enterprise Accounting Standards (January); MoF issued Accounting System for Firms Experimenting Shareholding Systems (May); MoF issued Accounting Standards for Business Enterprises (ASBE-Basic Standard) (effective from July 1993) and General Rules for Enterprise Financial Management</td>
<td></td>
<td>Deng Xiaoping South China tour and speeches</td>
</tr>
</tbody>
</table>
Table 6.1  Development of accounting for foreign invested and domestic firms in China (1949-2006)  (Continued)

<table>
<thead>
<tr>
<th>Year</th>
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<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>Accounting Standards for Business Enterprises (ASBE-Basic Standard) and General Rules for Enterprise Financial Management effective from July. Based on ASBE-Basic Standard. MoF subsequently issued 11 Industry-based UASs</td>
<td>Promulgation of CPA Law</td>
<td>CPC determined a socialist market economy as the goal of economic reform in China</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>MoF issued first Enterprise Accounting Standard (EAS): Disclosure of Related Parties and Their Transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>MoF issued Accounting System for Shareholding Companies and several Enterprise Accounting Standards</td>
<td>The MoF established the Chinese Accounting Standards Committee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>MoF issued EAS intended for both domestic and foreign firms</td>
<td>State Council issued Enterprise Financial Reporting Regulation; MoF issued EAS to replace industry-based and ownership-based UAS</td>
<td></td>
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</tr>
</tbody>
</table>
### Table 6.1 Development of accounting for foreign invested and domestic firms in China (1949-2006) (Continued)

<table>
<thead>
<tr>
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<th>Accounting for Domestic Enterprises</th>
<th>Accounting Event</th>
<th>Political and Economic Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Foreign invested firms began to adopt EAS</td>
<td>EAS applicable to all domestic firms except SMEs and financial firms which have separate UAS; MoF issued (or revised and reissued) 38 Accounting Standards for Business Enterprises (ASBEs) and a Basic Accounting Standard applicable initially to listed firms</td>
<td></td>
<td>China’s accession to the WTO</td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td>MoF issued 48 Independent Auditing Standards and a Basic Auditing Standard</td>
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</tbody>
</table>

### Accounting developments before 1978

In 1950, the central government issued ‘Decision on Unified Fiscal and Economic Work’ which stipulated a system of unified fiscal revenue and expenditure management, and unified material distribution and cash flow control. The first Uniform Accounting System (UAS) was produced for the Treasury in 1950 and this was followed by a series of uniform accounting systems for government budgetary units and industries in the same year. These systems consisted of eight chapters on general rules, financial statements, accounts, ledgers, documents, transaction processing procedures, accounting systems flowcharts, and
supplementary rules. The most striking feature of these systems was that they reflected the desire to unify the management of fiscal revenues and expenditures (Xiang, 1999). As a result, the systems prescribed accounting methods for profit allocation and depreciation provision and submissions to the government by enterprises according to the requirements of fiscal regulations.

There was a debate in 1950 on whether or not the western Debit-Credit bookkeeping method should be adopted. This led to a debate on the nature of accounting that began in 1951. Reflecting the class-struggle emphasis, the majority view was that accounting was of a class nature. Western accounting theories and methods were regarded as tools for exploiting the working classes for the interests of capital. Therefore, it was considered that a distinct socialist accounting system should be developed (Xin and Huang, 1951). A minority view that accounting was merely a neutral technique devoid of political interest was criticised heavily (Tao, 1951).

In 1951, the government empowered the MoF to develop a uniform accounting system. The MoF adopted the guiding principle that accounting regulations and practice should be developed to serve the needs of central-planning. In response to international pressures and the war with capitalist countries in Korea, China adopted a one-sided international policy - to take the side of socialist countries. Following a period of economic recovery in the early 1950s, China imported a central-planning system from the Soviet Union and entered its first five year planning period (1953-1958). Accordingly, the Soviet Union uniform accounting system was imported because it was judged to be suited to central-planning. This system consisted of uniform, industry-specific, and ownership-specific, financial statements and charts of accounts as well as regulations on cross-industry financial and accounting issues such as asset verification, accounting treatment of materials, costing procedures and methods. Also, in order to reflect the needs of central-planning, it distinguished basic transactions from infrastructure transactions.
During the ‘Great Leap Forward movement’ that occurred in 1958, accounting regulation, policy and practice was in disarray. A policy of ‘complete devolution and great simplification’ was adopted with the aim of reforming accounting. The powers previously accorded to the MoF to enable it to develop accounting and finance regulations were delegated to local governments and many industry-specific uniform accounting and finance regulations were suspended. By the end of the 1950s, a combination of the ‘Great Leap Forward movement’ and natural disasters precipitated an economic crisis. From 1961 to 1965, interest in accounting began to re-surface. In particular, it was realised that ‘economic development depends on accounting; the more advanced the economy, the more important is accounting’ (Xiang, 1999, p. 25).

In the first part of the 1960s, another debate emerged on the nature of accounting and whether the process involving the collection of accounting documents and the preparation of financial statements was the same in both capitalist and socialist accounting. However, the class-view of accounting remained dominant. For example, Yi (1963) argued that accounting must serve proletarian politics in China.

However, China was soon swept into the ten year period of the Cultural Revolution. During this period, accounting education was again abandoned, the department in the MoF responsible for developing and maintaining accounting regulations was suspended, and accounting regulations and uniform systems were criticised as being oppressive tools of capitalist exploitation. As a result, accounting became dressed-up as being politically driven. For example, in June 1967, Liberation Daily published an article attacking The Regulations on Accounting Work in State-Owned Industrial Enterprises (Draft) as being a means of overthrowing socialism and restoring capitalism (Xiang, 1999). However, in the early 1970s efforts were yet again made to resurrect interest in accounting, such as in 1973 when the MoF issued several new regulations on accounts, financial statements and costing methods, which were applicable to SOEs.
Accounting developments after 1978

In 1978, the Chinese Communist Party’s Third Plenum of the 11th National Congress replaced its emphasis on the class-struggle with that of economic development, economic reform and ‘open-door’ policies (CPC Central Committee, 1978). In light of the new political and ideological climate, a third debate on the nature of accounting began to emerge. The class-view of accounting remained strong initially, but lost ground gradually. By contrast, a dual-view and a technical-view of accounting began to dominate. The dual-view considered accounting as both class-laden and technical (Yang and Yan, 1980). But by the early 1990s, the technical-view of accounting prevailed as it was viewed to be consistent with Deng’s principle of developing socialist productive forces and its open-door policy.

The late 1970s onwards marked the beginning of many significant changes in Chinese accounting. In 1978, the State Council issued Regulations on Rights and Duties of Accounting Personnel which stipulated that enterprises should appoint a Chief Accountant (similar to a chief finance officer), equivalent to a deputy general manager. In 1979, the Accounting Society of China was established as a national academic organisation. At the inaugural session, an eminent practitioner and an eminent academic forcefully argued that accounting was a type of management activity (called accounting management) rather than just a management tool (Yang and Yan, 1980).

The MoF regained control of developing accounting regulation in 1979 when it not only restored, but also improved its uniform accounting system and issued: the Accounting System for Industrial Enterprises (The Chart of Accounts and Financial Statements); Regulations on Fixed Asset Depreciation in 1980; and Rules on Costing in State-Owned Industrial Enterprises in 1984. China restored the industry-based Unified Accounting Systems (UASs) of the earlier period because the UASs were regarded as extremely effective (Xiang, 1999). Because China
still operated a central-planning system, China’s approach to reform was one of gradual experimentation (Expert Group, 1995) and so restoration was an obvious choice.

In 1985, the Accounting Law was promulgated, granting accounting the highest possible legal recognition, and requiring medium-sized and large firms to appoint a chief accountant, and also promoted the formation of accounting firms. As new forms of business (such as Sino-foreign JVs and Joint-stock companies) emerged, further industry-specific or ownership-specific UASs were developed. The Chinese-foreign JVs created a need for international accounting harmonization (Xiang, 1998). This prompted the MoF to issue the Accounting System for Sino-Foreign Joint ventures in 1985 and led both the Accounting Society of China and the MoF to establish a project group to study accounting standards in 1988.

The Tiananmen Student Movement of 1989 reinforced the ongoing ideological debate over the direction of economic reform. The question was whether or not China should adopt a market economy; this was regarded by conservative factions as a capitalist development. Despite ideological resistance, China established the Shanghai and Shenzhen Stock Exchanges in 1991, driven by a desire to transform SOEs and the function of government. Deng (1992), regarded as the ‘Chief Architect’ of China’s economic reform, openly called for the development of a socialist market economy. As indicated in chapter four, his intervention concluded the ideological debate between those who called for reform and those conservatives who questioned the nature of reform (Ma and Ling, 1998). The development of a socialist market economy subsequently became the official objective of China’s economic reform. Hence, in 1992 the MoF issued the Accounting System for Companies Experimenting with a Shareholding System and the Accounting Standard for Business Enterprises (ASBE)-Basic Standard (MoF, 1992a, b). Beginning in 1993, the MoF completed a three-year standard-setting
project sponsored by the World Bank, resulting in exposure drafts of 32
detailed standards (Xiang, 1998).

In 1992, the MoF issued the ASBE-Basic Standard, which became
a framework for issuing specific accounting standards, and 13 industry-
based and ownership-based accounting systems as well as the Financial
Standard for Business Enterprises (FSBE) which was meant to guide
corporate financial management. The ASBE-Basic Standard provided a
set of standards but did not give sufficient guidance on the application
of permitted accounting methods. As the government needed more
time to promulgate all the detailed standards, separate industry-based
UASs were developed to implement the ASBE-Basic Standard. Although
listed companies have been required to adopt either the existing Chinese
accounting standards or IFRS, they have also been required to adopt
various UASs where accounting standards are lacking.

Although the first accounting firm was set up in 1980, the CICPA
was not established until 1988. In 1994 when the CPC declared that the
objective of China’s economic reform was to establish a socialist market
economy, the CPA Law was promulgated. In 1995, the MoF issued
a set of measures for SOE performance evaluation, including financial
measures as well as social contribution ratios. The latter were designed
to measure the contributions that an enterprise made to society; one
such measure was the profit and tax over sales ratio. In 1997, the MoF
issued the first of a series of 16 specific accounting standards entitled
‘The Disclosure of Related Parties and Their Transactions’. In 1998,
the MoF established the Chinese Accounting Standards Committee.
In 2000, the State Council issued Enterprise Financial Reporting
Regulations, redefining financial statement elements in accordance
with the conceptual framework of the IASB. In the same year, the MoF
issued an EAS to replace the existing 13 industry or ownership-based
accounting systems.

For several years following the launch of the open-door policy, there were no accounting regulations for Sino-foreign JVs. In an interview, Regulator 5 recalled that:

*At that time JVs adopted a dual accounting system: keeping one set of books following the regulations for SOEs for the Chinese partner, and another set based on foreign regulations for the foreign partner.*

To move beyond this situation, in 1983 the MoF issued the first ever accounting regulation for FIFs: the Accounting System for Sino-Foreign Joint ventures (Trial Draft). This was amended and formally issued in 1985 as the Accounting System for Sino-Foreign Joint Ventures. Below the system and its application are described and compared with the SOEs system.

An introduction to the accounting system for Sino-foreign Joint ventures

The new system consisted of 17 chapters and 88 articles. The first chapter described the legal basis of the system which was the Law on Sino-Foreign JVs and the Corporate Income Tax Law on Sino-Foreign JVs. Although it stipulated that the regulation was applicable to Sino-foreign JVs, the interviewees suggested that the system was also effectively applied to other types of FIFs.

The second chapter provided rules on accounting organisation and staff. It was required that a JV should establish an independent accounting department, and for large JVs, a chief accountant and an internal auditor should be appointed.
The third chapter listed general principles of accounting that JVs should comply with. It stipulated that the accounting period should run from 1st January to 31st December and that the Debit/Credit bookkeeping method should be adopted. The general requirements for accounting were to exhibit complete procedures, a comprehensive content, accurate calculations, and timely reporting. The language must be Chinese or Chinese plus a language that was agreed by the two parties. The currency for accounting and reporting should be Renminbi, although the two parties could agree to use a foreign currency. The principles of accruals, matching, historical cost, and consistency had to be applied and a distinction made between capital expenditure and revenue expenditure.

Chapter four provided rules on the basis and date of recording capital contributions from the partners. Chapter five dealt with accounting for cash, receivables and payables and required JVs to expense bad debts when they occurred rather than providing for bad debts. Chapter six regulated accounting for stock; it required that stock be valued at original cost using FIFO, moving average cost, weighted average cost, or batch cost. If the market price was lower than cost, the cost, net realisable value and potential loss should be reported. To change the stock valuation method, approval had to be obtained from the tax authorities.

Chapter seven was concerned with accounting for long-term assets and liabilities. Chapter eight dealt with fixed assets and stipulated that, in general, the straight line method of depreciation should be adopted, and that the estimation of residual value and economic useful life should be based on corporate income tax law. If a JV wished to adopt accelerated depreciation methods or to change its depreciation method, it should apply to the tax authorities for approval. The next chapter regulated accounting for intangibles and other assets. It required that intangible assets be amortised over the contract period or 10 years with no useful life being estimated. It also stipulated that opening expenses should be amortised at 20% per year. Chapter ten covered accounting for cost
and expenses. Chapter 11 dealt with sales and profits and losses based on the accruals principle.

Chapter 12 prescribed the principles for designing accounts and financial statements. Apart from providing a chart of accounts in an appendix and a list of financial statements to be prepared, it also permitted Sino-foreign JVs to add accounts and items in financial statements. It listed the following financial statements: the balance sheet, profit and loss account, statement of changes in financial conditions, and other supporting statements. It also required JVs to submit a report that explained the financial conditions together with the financial statements to the JV partners, the tax authorities, the supervising government departments, and the finance bureau.

Chapter 13 dealt with accounting documents and books, chapter 14 required Sino-foreign JVs to appoint CPAs approved by the Chinese government to undertake an independent audit and chapter 15 was concerned with accounting files. Chapter 16 dealt with disorganisation and liquidation and required that the related accounts must be audited by a CPA approved by the Chinese government. The final chapter stated that the MoF was responsible for amending and explaining the accounting system if necessary.

A comparison with accounting for SOEs

The Accounting System for Sino-Foreign Joint ventures and the Accounting System for State-Owned Industrial Enterprises (1980) had several similarities. Both systems were dependent on the tax regulations for guidance on issues such as depreciation and stock valuation, and neither system stipulated conservatism as a general principle. Both systems contained a chart of accounts, explanations of how to use them, a set of financial statements, and how to prepare them; thus both could be regarded as UASs, but neither system defined the elements of financial statements such as assets or liabilities.
However, there were a number of major differences. First, the JV accounting system adopted several IAS principles, such as the matching concept, while the SOE accounting system did not discuss these principles. Second, the JV accounting system adopted the accruals principle in revenue recognition, but the SOE accounting system only required that issued goods in transition be recorded as a special stock of the selling firm - stock in transition. Third, the JV system left many accounting issues to the Board of Directors. For example, profit distribution and the disposal of obsolete stock had to be approved by the Board of Directors, whereas for SOEs these had to be approved by the SOE’s supervising government department, which suggested that JVs enjoyed more autonomy compared to SOEs. Fourth, the JV accounting system required JVs to adopt the Debit-Credit Bookkeeping method while the SOE accounting system permitted SOEs a choice between the Debit-Credit Bookkeeping method, the Increase-Decr ease Bookkeeping method, and the Receipt-Payment Bookkeeping method (Chen, 1998). The increase-decrease bookkeeping method was widely adopted in China from the 1960s through to the 1980s and classifies accounts into fund applications and fund sources. It uses ‘increase’ and ‘decrease’ as bookkeeping labels, and records increases in any account on the left side and decreases on the right side of the account. It adopts the following recording rules: if a transaction involves two accounts of the same category, one account is increased and another is decreased; and if two accounts belong to different categories, both are either increased or decreased. An increase in fund application or a decrease in fund source is the same as a debit, whereas a decrease in fund application or an increase in fund source is a credit. This method was developed and used in the 1950s and the 1960s in some sectors such as banks. Chen (1998) describes the Receipt-Payment bookkeeping method as follows: “receipt’ and ‘payment’ are used as bookkeeping labels and accounts are classified into three categories: fund balance accounts; fund source accounts; and fund application accounts. Fund balance accounts are
assets, such as cash and equipment, where increases are recorded as receipts and decreases as payments. The same recording rules apply to fund source accounts (liabilities, equities, and revenues). However, fund application accounts (operating expenses and withdrawals by the owner) are processed differently with increases recorded as payments and decreases as receipts. Because of the difference in recording fund balance and application accounts, a set of complicated procedures had to be followed to keep accounts in balance. If a transaction increases the fund balance, receipts are recorded in a fund balance and a fund source account, while if a transaction decreases the fund balance, payments are recorded in a fund balance and a fund application account. For transactions not affecting the fund balance, a receipt is recorded in one account and a payment in the other. While not as apparent as in the case of the Increase-Decrease bookkeeping method, the Receipt-Payment method can also be effectively reconciled with the Debit-Credit method. A debit is equivalent to a receipt in a fund balance account or a payment in a fund source or application account, while a credit is the same as a payment in a fund balance account or a receipt in a fund source or application account. Consequently, the fundamental balance between total debits and credits still exists but in a less obvious way as follows - total receipts in fund balance accounts plus total payments in fund applications and sources accounts are equal to total payments in fund balance accounts plus total receipts in fund applications and sources accounts.

Moreover, the JV accounting system adopted the concept of capital as an element of the financial statements, but this concept was absent in the SOE accounting system. The JV accounting system adopted the prevailing accounting equation \[\text{assets} = \text{equity} + \text{liabilities}\] while the accounting system for SOEs adopted the equation of \[\text{sources of finance} = \text{applications of finance}\]. Finally, the SOE accounting system consisted of only a chart of accounts, explanations of how to use these, a list of financial statements and explanations of how to prepare them.
In contrast, in addition to these, the JV accounting system included the above mentioned 17 chapters and 58 articles. The JV accounting system was to become the model for devising future UASs for all entities.

**Analysis of the accounting system for Sino-foreign Joint ventures (1985)**

As discussed earlier, between the 1950s and 1980s, accounting was politically driven rather than being seen as a neutral set of techniques. In the early 1980s, China was coming to terms with the aftermath of the Cultural Revolution. The reformists had a strong desire to break away from the emphasis on the class-struggle principle and to focus instead on economic development, but the conservatives were still loyal to Maoist principles. Although Maoist class-struggle policies were denounced by the CPC’s Central Committee, the importance of his contribution was reaffirmed (CPC, 1981). In this shifting ideological climate there was a heated debate on whether introducing foreign capital to China would be consistent with socialist ideas. Conservatives argued that introducing capitalist investments would pollute Chinese firms and workers. In parallel, as suggested before, during the late 1970s and the late 1980s there was a third debate on the nature of accounting.

The Accounting System for Sino-Foreign JVs mirrored the dynamics of this ideological transition. On the one hand, it adopted international accounting principles of accruals, matching, historic cost, consistency and the distinction between capital expenditure and revenue expenditure. It also adopted the concept of ‘capital’ and the accounting equation of [assets = equities + liabilities] which had been rejected during the Mao period. Moreover, the lower of market value and cost became allowed. These changes partly reflected the ideological changes that had begun to occur during the Deng era, but they were also partly a consequence of the pressures exerted on China by foreign investors and other forces to adopt IFRS.
However, the provision for bad debts and accelerated depreciation were not allowed and prudence/conservatism was not adopted first because, as Regulator 4 stated in an interview, the class-struggle ideology was still influential, and central-planning was still dominant. A main concern of the central-planning system was the ability to centralise the receipt and distribution of resources. One interviewee, Academic 2, who was among the first to teach accounting for FIFs in the 1980s, recalled that the finance department at the MoF was against the adoption of conservatism. Economic reform required that the government could mobilise resources in order to implement reform. A general application of the conservatism principle would have possibly reduced state revenues and, thus, it was not permitted. Another interviewee, Regulator 1, stated that:

*For a long time, conservatism had been regarded as a tool for protecting capitalist interests, rather than a means of maintaining capital and competitive advantage.*

Further, some senior accounting regulators were cautious about the possible use of conservatism to manipulate profits and build secret reserves, this was noted by Academic 2 in an interview. Consequently, the Accounting System for Sino-Foreign JVs left many issues to be determined by the tax authority. Thus, if a JV wanted to change its stock valuation or depreciation methods, it had to obtain prior approval from the tax authority. One interviewee, Regulator 4, argued that the system was too dependent on tax and finance regulations.


In 1992, the MoF issued the Accounting System for Foreign Invested Firms to replace the Accounting System for Sino-Foreign JVs
(1985). This section introduces this new regulation and compares it with the 1985 regulation and the accounting system for SOEs at that time.

**An introduction to the Accounting System for Foreign Invested Firms**

The 1992 system consisted of 16 chapters. The first chapter dealt with the legal basis and scope of application. The second chapter prescribed accounting principles. The third chapter covered bookkeeping. The next four chapters detailed principles for accounting for current assets, long term assets, fixed assets and construction in progress, intangible assets and other assets. Chapter eight related to short-term and long-term liabilities while chapter nine dealt with equities. Chapter ten was concerned with costs and expenses while chapter eleven covered revenues, profits, and profit distribution. Chapter twelve discussed foreign currency transactions while chapter thirteen related to liquidation transactions. Chapter fourteen dealt with accounts and financial statements. Chapter fifteen prescribed rules for managing accounting documents and files. Chapter sixteen stated the date at which the system became effective and indicated that the MoF was charged with responsibility for interpreting and amending it.

**A comparison with the 1985 accounting regulation for foreign invested firms and accounting regulation for SOEs**

Compared with the 1985 Accounting System for Sino-Foreign Joint Ventures, the new system was expanded to include a chapter on long-term investment which stated that the cost method should be used to value the investment if the investment was 25% or less than the total capital of the investee, and the equity method should be used if the investment was above 25%. The new system also required the JVs to prepare consolidated financial statements if these companies investment in a third party accounted for over 50% of the total investee’s capital. The accounting period postulate was incorporated into the new system.
The general requirements for accounting were also amended to become accurate records, comprehensive contents, correct methods, complete procedures, and timely reporting. The most significant change was that the new system permitted a provision for bad debts at 5% of outstanding debtors, and allowed the adoption of LIFO (last-in, first-out) for stock valuation, and the unit of production or service method and reducing balance method for fixed assets depreciation with the residual value capped at 10%. It also allowed a provision for stock impairment, although this had to be approved by the government. In addition, the new system changed the revenue recognition criterion from ‘whether goods are delivered’ to ‘after goods are delivered’.

In 1992 when the new Accounting System for FIFs was introduced, a large-scale reform of SOE accounting was launched (The ASBE-Basic Standard). This was stipulated in November 1992 to be implemented from 1 July 1993 onwards. In many respects, the two regulations were similar although there were still some differences between them. Concerning similarities, the ASBE-Basic Standard adopted the same accounting equation [assets = liabilities + equities]. Also, consistent with the new Accounting System for FIFs, the ASBE-Basic Standard provided rules on accounting for the main elements of financial statements: assets; liabilities; capital; revenues; and expenses. The ASBE-Basic Standard embraced the following accounting principles that were adopted in the new Accounting System for FIFs: timeliness; consistency; historical cost; and distinction between capital and revenue expenditures. Moreover, the ASBE-Basic Standard prescribed the same set of financial statements as those for FIFs, and indicated that a report was required to explain financial conditions, although an enterprise could also prepare either a cash flow statement or a statement of changes in financial conditions. Furthermore, like the new Accounting System for FIFs, the ASBE-Basic Standard allowed the application of conservatism. Finally, as suggested by Xiao (1997), both regulations adopted an income statement-oriented approach to accounting as opposed to the balance sheet-oriented approach.
The ASBE-Basic Standard had several features that were absent from the new Accounting System for FIFs. In particular, the ASBE-Basic Standard had a more conceptual orientation as it provided definitions of the elements of financial statements. Moreover, the ASBE-Basic Standard emphasised three objectives for financial reporting: to meet the requirements for national macro economic management; to satisfy the needs of various parties in understanding the firm’s financial conditions and performance; and to meet the information needs of internal management. Furthermore, the ASBE-Basic Standard included more accounting principles in addition to those contained in the FIFs regulation: truthfulness; understandability; conservatism; and comprehensiveness. It is important to note that while both regulations permitted the application of conservatism in certain areas, it was the ASBE-Basic Standard that prescribed conservatism as a general principle.

**Analysis of the Accounting System for FIFs (1992)**

The need to update the 1985 regulations for FIFs was explained by one interviewee, Regulator 5, who suggested that:

*The MoF began to draft similar accounting systems for other types of FIFs but soon realised that the additional regulations would mostly be a repeat of the 1985 regulations for Sino-foreign JVs.*

So a unified regulation for all FIFs became possible. Another interviewee, Regulator 3, commented further that:

*Foreign investors, including the World Bank, had been complaining that China’s accounting practice was different from international conventions, and that China had now begun to experiment with the shareholding system and established the two domestic Stock Exchanges, which required accounting for equities as well as liabilities.*
To address these issues, the MoF set up an accounting standard project group whose deliberations culminated in the publication of the ASBE-Basic Standard (1992). According to Regulator 3, the earlier versions of the ASBE-Basic Standard became the basis for formulating the 1992 accounting system for FIFs although another interviewee, Regulator 4, suggested that the two were being developed in parallel.

Some of the changes made in the 1992 accounting regulations also reflected the new development of Sino-foreign JVs such as the increasing importance and complexity of foreign currency translation. Others indicated a politically more open attitude toward foreign principles and practice such as the application of conservatism in inventory valuation and fixed asset depreciation. By 1992, the emphasis on economic development, economic reform and open-door policies had been pursued for over a decade. The extent of economic reform was being increased significantly, for instance, from merely expanding enterprise autonomy to greatly reducing the number of commodities whose prices were set by the government, and from having a limited number of firms experimenting with shareholding systems to the establishment of two Stock Exchanges. The debate about the nature of accounting was seemingly drawing to a close, with the technical view becoming dominant (Yang, 1993). This more conducive environment allowed regulators to stipulate several applications of the conservatism principle in the new accounting regulation for FIFs. However, this raises two questions: why wasn’t conservatism adopted as a general principle? And why did it become a general principle in the ASBE-Basic Standard which was issued just a few months later?

Concerning the first question, Regulator 4 suggested in an interview that:

*There was still an ideological barrier to the full adoption of conservatism in accounting, and that the general application of conservatism could not be permitted because this would allow FIFs to underestimate profits.*
Regulator 4 suggested that:

Conservatism had been adopted in the ASBE-Basic Standard because it was considered desirable that accounting standards be stable while allowing accounting systems to change by providing supplementary rules.

It is possible that the regulators who developed the ASBE-Basic Standard had in mind the newly established Stock Exchanges, joint stock companies and listed companies, while the 1992 Accounting System was geared towards FIFs, as suggested by Regulator 3.

As mentioned above, Regulator 4 suggested that the 1985 accounting regulations for JVs were too dependent on tax and fiscal regulations. The 1992 regulations for FIFs may have become more independent because the items that required approval from government agencies were reduced, but the 1992 regulations for FIFs stipulated several hard and fast accounting rules (e.g. 5% of provision for bad debts and 10% of residual value of fixed assets).

The harmonised accounting system for foreign invested firms and domestic enterprises (2001 to present)

In 2000, the MoF issued a new uniform accounting system: the EAS, intended for all enterprises in China, whether domestic or foreign invested with the exceptions of small firms and financial enterprises. This section discusses the EAS, and compares it with the 1992 Accounting System for FIFs.

An introduction to the Enterprise Accounting System

The introduction of the EAS in 2000 was seen as a continued regulatory response to ‘an accounting information crisis’ (Li, 2001).
Extensive false reporting and earnings manipulation by companies had discredited accounting information and hampered the development of the capital market. To tackle this issue, the Accounting Law was amended in 1999 to emphasise the importance of ‘true and complete’ accounting information. In 2000, the State Council issued the Enterprise Financial Reporting Regulation. In order to reduce the scope for manipulation that could take place under the looser definitions provided in the ASBE-Basic Standard, the regulation redefined the elements of financial statements in line with the conceptual framework of the IASB and stipulated the responsibilities and liabilities for parties involved in accounting, auditing and reporting.

The EAS was designed to bring about the desired uniformity in accounting. Before it was promulgated, there had been 13 industry-specific or ownership-specific accounting systems. Although these systems were all based on the ASBE-Basic Standard, they were inconsistent in terms of account names and accounting methods. As firms, and their transactions, became increasingly complex, firms were often unsure as to which accounting system to adopt. The inconsistencies are demonstrated in the above comparison between the accounting system for FIFs and the ASBE-Basic Standard. Therefore, the EAS was intended for all industries and firms with different ownership structures and for both group and individual companies.

The EAS had three parts. Part one defined some basic concepts, elements of financial statements, recognition and measurement principles, permissible accounting methods, structures and content of the main financial statements. Part two prescribed a chart of accounts and financial statements. Part three clarified accounting treatments of the main elements of financial statements.

Part one had 14 chapters. They contained detailed accounting principles and methods. Chapter one prescribed a list of accounting principles, concepts and qualitative characteristics, including: the accounting entity; going concern; accounting period; substance over
form; consistency; the accrual basis; matching; historical cost; distinction between capital expenditure and revenue expenditure; prudence; timeliness; understandability; and materiality.

Chapters two to seven defined elements of financial statements: assets; liabilities; owners’ equity; revenues; costs and expenses; and profits, consistent with the IASB’s conceptual framework. There was further classification and definition of sub-elements, with rules on permissible accounting methods. A separate section in chapter two dealt with provision for impairment in short-term investments, loans, accounts receivable, stock, long term investments, fixed assets, intangible assets, and construction in progress, based on regular inspection and revaluation.

Chapters eight to 12 detailed accounting principles or methods for non-monetary transactions, foreign currency translation, adjustments, contingent items, and related party transactions.

Chapter 13 covered financial statements, requirements for their submission, and minimum disclosure in the footnotes. The balance sheet and the income statement should be prepared half-yearly and annually, with the cash flow statement being prepared at least annually. The balance sheet should be supplemented with a statement of provisions for asset impairment and a statement of changes in owners’ equity. The income statement should be supplemented with a statement of profit distribution and a segmental report either by line of business or by geographical area.

Part two provided the basis of a chart of accounts by prescribing 85 general ledger accounts, sub-accounts, and their application. It prescribed the layouts of the financial statements and guidance on the preparation of the financial statements and footnotes.

Part three is an appendix containing illustrative accounting entries and treatments for a range of transactions including current assets, long term investments, fixed assets, intangible assets and long term deferred
assets, deferred income or loss, accounts payables or receivables, owners’ equity, costs and expenses, revenues, profit and profit distribution.

A comparison of the Enterprise Accounting System with the ASBE-Basic Standard and the 1992 Accounting System for FIFs

The EAS exhibits several new features:

- an expanded application of the prudence principle, first prescribed in ASBE-Basic Standard, requiring provisions for impairments of eight types of asset;
- increased freedom in allowing companies to determine the rates of provision for asset impairment;
- a new accounting principle of substance over form;
- new requirements relating to segmental reporting; and
- reduced orientation towards the government that was no longer considered the most important user group (see below).

Analysis of the Enterprise Accounting System

Since Deng’s South China tour speeches in 1992, the stock market grew rapidly with over 1,400 listed firms by the end of 2006. The level of marketisation reached 73% of the economy according to a study that used international standards to measure marketisation (Institute for Economic and Resource Management, 2003). The capital market is thus playing an increasing role in regulating listed firms and in channelling and allocating resources. The function of government has changed from direct management and control of enterprises to mainly regulating the market, which in turn regulates firms, although the government still
controls some mega-sized enterprises in key industries. This is why the Chinese government is no longer seen as the most important user of accounting information.

More significantly, the debate on ownership, which is sensitive both politically and ideologically, concluded with the view that ownership is not an end of socialism, but could be used to enhance socialist productive forces (Jiang, 1997). State-ownership was previously regarded as the defining feature of socialism, but this is now considered as only one of several ownership forms that could be adopted in China. Other ownership forms such as the shareholding system and Sino-foreign JVs, can now be adopted as long as they are considered conducive to increasing socialist productive forces. Thus, non-state interests have become recognised and protected.

As a means of protecting the interests of all stakeholders, especially shareholders, and as a way of enhancing the reliability and transparency of the information provided by enterprises to the market, conservatism was finally adopted as a general principle for all business enterprises, as required by the EAS of 2000. Moreover, in one interview Practitioner 19 remarked that:

\[\text{As the 2000 EAS became more independent of tax and fiscal regulation, enterprises could be given more freedom to choose their own accounting policies.}\]

However, this increased freedom could be problematical. For example, one interviewee, Regulator 3, said that:

\[\text{The actual level of provision for bad debts could range from 0\% to 50\%... the MoF had identified many cases of mis-statement and had to issue particular guidelines on the proper estimation of bad debts.}\]
Summary

This chapter has traced the development of Chinese accounting regulation in general and accounting regulation for FIFs in particular. It has shown that ideology has been an important factor that has affected both types of accounting regulation. Under Mao, accounting was considered as a class-struggle tool and Western accounting theories and practices were construed as a means for exploiting the working classes. As a result, China adopted a uniform accounting system modelled on that of the Soviet Union which was regarded as ideologically compatible with China’s brand of socialism. From 1987 onwards, Maoism was gradually replaced by the Dengist ideological tenets of economic development, marketisation, mixed-ownership, and open-door policy. This resulted in sustained economic reforms, increasing international trade and FDIs, which in turn stimulated the development of accounting for FIFs. However, Maoist ideological ideas continued to exert influence throughout the 1980s and to a lesser extent the 1990s. Thus the accounting regulations for FIFs in the 1980s and 1990s still reflected some of the influence of Maoist ideology. Notably, conservatism was used on a very limited scale and accounting regulations were dominated by tax and fiscal regulations. This situation changed in 2000 when the EAS was stipulated for both domestic firms and FIFs, where the technical view of accounting as a neutral technology dominated and accounting conservatism was fully embraced and accorded the status of a general principle.

Endnote:

1. The standards adopted are: The role of the government, enterprises’ rights and behaviours, costs and prices of production factors, trade environment, and financial parameters. The report considered restructuring the administrative system of government; marketisation of Enterprises, labour, capital, land, domestic trade and foreign trade, intermediary organisations; and establishment of legal systems.
INTRODUCTION

This study investigates the extent to which political and ideological changes and the development of foreign invested firms (FIFs) have impacted upon accounting regulation in China. Specifically, it examines changes in the political and ideological environment in China from 1949 to the present, covering both the Mao and Deng eras. The study contextualises the development of FIFs, and investigates the changes in accounting regulation, especially the evolution of accounting for FIFs within the Chinese historical and ideological contexts. The objectives of this study were formulated into the following research questions:

• How did the development of accounting for FIFs reflect and respond to changes in political ideology?
• How were international accounting principles introduced into Chinese accounting for FIFs and then into accounting for domestic companies?
• How does accounting for FIFs interact with accounting for domestic companies?
• What implications do the interactions between political ideology and the regulation of accounting for Chinese-foreign JVs have for foreign investors and international accounting regulators?

The findings relating to these questions are summarised in the next sections before discussing the limitations of this study and suggesting some avenues for further research. This chapter then contains some concluding remarks.
Accounting for foreign invested firms and political ideology

The findings suggest that under Mao, accounting regulation was shaped by the emphasis upon the key elements of Maoist ideology: class-struggle; central-planning; public-ownership; and self-reliance; and the factors relating to China’s relations with the rest of the world. The political and ideological interactions that took place during the Mao era had three consequences. First, China engaged in very limited international trade and had only a few foreign direct investments. Second, accounting was considered a capitalist tool aimed at exploiting the working classes, and Western accounting theories and techniques were therefore denounced and rejected. In contrast, Soviet accounting was considered to be ideologically compatible with China’s brand of socialism, and China adopted a uniform accounting system based on the Soviet system, intended to serve the needs of the notions of class-struggle, central-planning and public-ownership. As self reliance militated against China welcoming foreign investments, particularly from capitalist countries, there was no accounting regulation for FIFs.

From the late 1970s onwards, the ideas of Deng gradually replaced those of Mao. The main tenets of Deng’s ideas included the emphasis upon economic development, marketisation, mixed-ownership and open-door policies. These new ideas have facilitated, and have been reinforced by, China’s successful economic reforms during the last 25 years. They have led to a sustained increase in international trade and a major inflow of FDIs so that China is now the third largest international trader and the largest recipient of FDIs. Under Deng, accounting was gradually made to shed its political image and became construed as a neutral technology without national boundaries. Hence, Western accounting theories and practices were gradually adopted. Further, Chinese accounting regulations and standards, including those for FIFs, were increasingly harmonised with IFRSs.
International accounting principles and Chinese accounting

IFIs provided a direct demand for international accounting harmonisation. As a result, an independent auditing profession was re-created and the first regulations concerning accounting for IFIs were promulgated in the early 1980s. The latter, formulated amid heated debates on the nature of accounting, accounting principles and accounting standards, incorporated many principles, concepts and techniques that were considered to prevail internationally. They also included some limited application of conservatism in specific areas. However, they still showed the hallmarks of the ideological transition period; conservatism was not included alongside other principles; even provision for bad debts was forbidden; and many accounting requirements were determined by tax and fiscal regulations.

By the early 1990s the ideological climate had changed greatly when the class view of accounting lost its favour to the technical view, implying that any technique, no matter where it came from, could be adopted in China as long as it contributed to the development of productive forces. By that time, FDIs, Special Economic Zones (SEZs) and the open-door policy had achieved a high degree of success. The new accounting system for IFIs enlarged the scope for the application of conservatism and reduced its dependence on tax and fiscal regulations, although conservatism was still not recognised as a general principle. By 2000, as China began to function as an embryonic market economy and was about to gain accession to the World Trade Organization (WTO), new regulations were promulgated in the EAS for both domestic and foreign invested firms. Conservatism was fully adopted and as a result provision for eight types of asset impairment was permitted. The system also delegated greater power to the firm to formulate accounting policies. Since the promulgation of the EAS, numerous accounting standards have been issued which are largely consistent with their counterparts in IFRSs.
Accounting for foreign invested firms and domestic firms

Accounting for FIFs was the arena where China experimented with international harmonisation in the 1980s. The 1985 Accounting System for Sino-Foreign JVs became an important source used in colleges, universities, and other training organisations, where special courses were launched on accounting for Sino-foreign JVs (interviewee, Academic 2). Moreover, the accounting regulations for FIFs provided an important reference for formulating domestic accounting regulations and standards (interviewee, Regulator 4). However, by the 1990s, the accounting regulations for FIFs lagged behind those for domestic firms in certain respects; notably conservatism was recognised as a general principle in the 1992 ASBE-Basic Standard, but not in the 1992 Accounting System for FIFs. Moreover, while the 1992 Accounting System for FIFs permitted provision for two types of asset impairments, the 1998 Accounting System for Shareholding Companies permitted provision for four types of asset impairment. These separate systems were replaced when the EAS was promulgated, it was first applied to shareholding companies (including listed companies) in 2000 and then to FIFs in 2001, finally bringing consistency of accounting treatment between different types of entity.

Political ideology and accounting

From the perspective of international investors, it is crucial that Chinese accounting regulations are in harmony with their home accounting standards or IFRSs so that they have confidence in the accounting information produced under Chinese accounting regulations. It can be seen from the analysis in Appendix one that China has made significant progress towards international harmonisation at the level of accounting regulation. Although closely related, accounting regulation and accounting practice must be treated separately. Prior studies show that while accounting standards can be greatly harmonised, the gap
between the earnings figures produced under the Chinese GAAP and IASB’s standards may be large (Chen, et al., 2002). This has much to do with perception, understanding and enforcement of accounting regulations which in turn relate to the Chinese culture, its special circumstances, and ways of doing things. For example, because of the strong government control, a relatively low level of marketisation, and greater familiarity with uniform accounting systems compared with accounting standards, Chinese regulators have not only issued accounting standards, but have also promulgated the EAS as a uniform accounting system (Xiao et al., 2004).

The interviewees for this study, particularly leading accounting regulators, have shown great enthusiasm for bringing Chinese accounting regulations closer to IFRSs. However, they welcome a greater appreciation and sympathetic understanding by international regulators of the specific context and culture of China (interviewee, Regulator 3). As a transitional economy, state-ownership still dominates key industries and thus the government has a strong interest in controlling accounting regulation. Although the Chinese capital market has grown rapidly, it is still much less efficient than its counterparts in advanced capitalist countries and thus there may be limited, or even no, scope for applying some of IASB’s standards, as suggested in Appendix one. A further consideration to be borne in mind is that while accounting education and training in China has improved greatly over the last two decades, there is still much to be desired in terms of the quality of accounting personnel, especially the quality of their professional judgement. The interviews with foreign partners of Chinese-foreign JVs considered this a major barrier to the implementation of international accounting standards (interviewee, Practitioner 25). In light of this, it would be useful if advanced capitalist countries and international professional bodies could provide some tangible help to China in the field of accounting education and training.
Chinese GAAP and IFRS

The comparison between Chinese GAAP and IFRS in Appendix one shows a clear trend: the Chinese regulations demonstrate a considerable measure of consistency with most comparable IFRSs. The issuing (and re-issuing) of 38 Chinese standards in 2006 is impressive. There are internal contradictions within the Chinese regulations, but these are mostly caused by pressure to make recent accounting standards more consistent with IAS/IFRS. However, such internal differences are expected to be only temporary.

Where there are still discrepancies between the IFRSs and the Chinese regulations, these arise mainly from the following factors. First, some special circumstances in China create a different scope for setting different standards and methods. For example, there are no defined benefit pension plans in China and thus this is not relevant to Chinese regulations, and the same applies to actuarial methods. Second, China has taken a firm stance in trying to control earnings management, leading to the prohibition of recognition of asset revaluation appreciation. As a result, unlike IFRSs, the revaluation model is not used in relation to various types of assets in China. In contrast, IFRSs often have additional disclosure requirements with respect to revaluation surplus and allow asset impairments to be expensed through revaluation surplus. Third, some standards are based on Chinese practices and special needs, for example the standard for oil and gas exploration and production, and those standards on non-monetary assets transactions and debt-reorganisation. Fourth, the use of fair value is more restricted in China because of the developing nature of the Chinese market.

The consideration of the above factors in setting accounting regulations in China suggests that China does not simply copy IFRSs, although Chinese regulators try to align accounting regulations to those of the IFRSs. Some of these factors also imply that discrepancies will exist as long as these factors are judged to have an impact on accounting regulation.
Limitations and avenues for further research

The above findings and implications must be viewed in light of the limitations of this study. First, the findings are based on a literature review and interviews with academics, regulators and practitioners. While the literature review is extensive and the interviews very informative, more research, using alternative theoretical perspectives, is needed to corroborate the findings reported here. Second, the focus has been upon the impact of political ideology on accounting regulation, not accounting practice. Future research could generate more insightful findings on the latter. A final issue that deserves the attention of future researchers is the question of the future impact of political ideology on FDIs and accounting regulations for FIFs in China. This issue is further elaborated in the next section.

Summary and postscript

China’s membership of the WTO is likely to greatly increase FDI inflows to China. This will create greater demands, opportunities and challenges for Chinese and international accounting regulators in their quest to harmonise Chinese accounting standards with international accounting standards, particularly those issued by the IASB.

Chinese regulators appear to be committed to international harmonisation. They have set principles and schedules for future harmonisation with the IASB’s standards. At a meeting in London, Mr Jun Wang (2005), China’s Assistant Minister of Finance [now vice Minister of Finance] who is in charge of China’s accounting affairs, stated that:

*China is adopting three principles for the convergence of its accounting regulations with the IASB’s standards: striving for harmonisation; permitting difference; and innovating positively.*
He also interpreted harmonisation as a trend, a direction, and a process, stressing that harmonisation does not mean being ‘completely equal’ and that it should be interactive, rather than one way. In July 2005, senior accounting regulators at the Ministry of Finance (MoF) announced that the immediate target of accounting regulation in China was to establish a comprehensive set of accounting and auditing standards by the end of 2005 or early 2006 that would suit the development of the Chinese economy whilst being harmonised with international accounting and auditing standards (Yin, 2005; Tao, 2005). In February 2006, China’s Ministry of Finance issued 38 accounting standards, in addition to the Basic Standard and numerous auditing standards. From these principles, plans and actions, the interviews with regulators, and the discussion in Appendix one, it can be seen that the overwhelming evidence at the regulatory level points to real rather than rhetorical efforts on the part of Chinese regulators to harmonise with IFRSs. Harmonisation between IFRS and Chinese standards has been progressed with the appointment of Liu Zhongli, President of the Chinese Institute of Certified Public Accountants, as a trustee of the International Accounting Standards Committee Foundation and the announcement by the Chinese Ministry and the IASB of a commitment to convergence. In fact, the convergence programme has resulted in the IASB revisiting IAS24 on Related Party Disclosures, with regard to state controlled entities.

The exact nature and form of the ideological impact on FDIs and accounting regulation (including accounting regulation for FIFs) in the future is likely to be contingent upon a number of factors (Zhou, 2005). At the regulatory level, state-ownership still has an important influence on the organisation and development of accounting standards (Xiang, 1999; Xiao, Weetman and Sun, 2004). Recently, the 5th Plenary Session of the 16th CPC National Congress held in October 2005 suggested that there was a need to improve social fairness in future economic development. This would not necessarily require a reversal of Deng’s idea that some people should be allowed to get rich first, but it would need to strengthen the role of government in addressing growing inequality in China and especially in creating employment opportunities. Of direct relevance to FDIs and
accounting for FIFs is the tension between domestic firms and FIFs in terms of discriminating tax regulations in favour of the latter, which is taken to suggest bias towards foreign firms. Whether this tension will ultimately persuade the Chinese government to phase out these advantages, and the potential impact that this may have on the attractiveness of China to foreign investment, is something that needs to be explored in future research (Yang, 1997; Zhang, 1999). Finally, issues relating to national security arising from large-scale FDIs, especially in the form of wholly-foreign-owned large MNCs compared to weaker and smaller domestic firms, have become a major concern. Any future changes that might impact on all, or some of these issues, may have implications for accounting regulation and practice in China, and is a topic for future researchers to address.

In summary, Chinese regulators have taken significant steps to reform Chinese GAAP in line with IFRS. However, due to China’s specific culture and context, including lack of well-developed markets for some assets, there are still some discrepancies between the Chinese GAAP and IFRS. Chinese regulators view harmonisation between Chinese GAAP and IFRS as a two-way process that should permit differences and local innovation. One important policy implication from the perspective of the international community, therefore, is to show willingness in its dealings with China to appreciate this view of a flexible harmonisation process. From the perspective of Chinese regulations, the international community would expect that Chinese regulators would take the necessary steps to reduce the discrepancies between the Chinese GAAP and IFRS in future years if changes in the Chinese context, for example developments of market conditions, may make it possible to embrace international accounting standards that were not suitable to China previously. As the preferential treatment offered to FIFs compared to domestic Chinese firms begins to be phased out, this will strengthen the hand of Chinese regulators in enhancing the extent of harmonisation further.
Thus, there are three policy implications, as follows:

- The international community should show greater appreciation of China’s cultural characteristics and the state of its economic and market development, which render complete compliance with international accounting standards impractical.

- Chinese regulators need to monitor economic developments and embrace international accounting standards more fully.

- Chinese regulators should continue to phase out the preferential treatment offered to FIFs to assist the harmonisation process further.
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Comparing Chinese Accounting Regulations and International Financial Reporting Standards

Introduction

This appendix compares Chinese accounting regulations with International Financial Reporting Standards (IFRSs). The objective of the comparison is to highlight the differences and similarities between the two systems and identify trends in Chinese accounting regulation. (See also Liu, 2007; Deloitte Touche Tohmatsu, 2006; The Ministry of Finance, China, 2006). The emerging findings will hopefully help academics, practitioners, investors, and regulators to discern the trend in Chinese accounting standard setting, make judgements on the degree of harmonisation between Chinese accounting and IFRS, and identify factors that cause any discrepancies to exist. The next section presents the two sets of accounting regulations. The following sections compare the two sets in terms of: conceptual basis; assets; liabilities; revenues; equities; presentation and reporting; and other elements and issues of financial accounting and reporting. The final section provides a summary and some concluding remarks.

The components of IFRSs and Chinese accounting regulations

The Chinese accounting regulations consist of EAS, accounting standards and other Chinese pronouncements. In contrast, the system of the International Accounting Standards Board consists of IFRSs, IASs and a conceptual framework. Table 1 lists both the Chinese regulations and the IASB’s standards and compares China’s 2006 ASBEs with IFRSs, and with EAS.
Table 1 Comparing IASB’s Standards and Chinese Accounting Regulations

<table>
<thead>
<tr>
<th>IASB’s Pronouncements</th>
<th>China’s Regulations</th>
<th>Degree of Convergence Between IASB and 2006 ASBEs</th>
<th>Difference Between IASB and China</th>
<th>Cause of difference</th>
<th>Differences between EAS and ASBE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. IAS 1 Presentation of Financial Statements</td>
<td>EAS-Ch13-Financial Reporting ASBE 30 - Presentation of Financial Statements (2006)</td>
<td>Almost consistent</td>
<td>Fair presentation not discussed in ASBE 30</td>
<td></td>
<td>Unlike EAS, ASBE 30 no longer covers an explanatory statement, nor does it distinguish main business revenues from other business revenues; it deletes the items of non-business revenue and expenditure</td>
</tr>
<tr>
<td></td>
<td>IAS 2 Inventories</td>
<td>EAS-Ch2-Sec1-Current Assets ASBE 1 - Inventories (2006)</td>
<td>Broadly consistent except IAS 2’s scope of application is narrower</td>
<td>LIFO allowed in EAS, but not in ASBE 1</td>
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<td>3.</td>
<td>IAS 7 Cash Flow Statements</td>
<td>EAS-Ch13-Financial Reporting ASBE 31 -Cash Flow Statements (2006)</td>
<td>Almost consistent</td>
<td>The direct method recommended in IAS v required in China; IAS also allows the indirect method while ASBE 31 requires it in a note</td>
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<tr>
<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
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<td>Differences between EAS and ASBE</td>
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<td>6. IAS 10 Events After the Balance Sheet Date</td>
<td>EAS-Ch10- Accounting Adjustments ASBE 29 - Events After the Balance Sheet Date (2006)</td>
<td>Consistent</td>
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<tr>
<td>7. IAS 11 Construction Contracts</td>
<td>EAS-Ch2-Sec1- Fixed Assets EAS-Ch5-Sec2 Revenue from Construction Contracts ASBE 15 - Construction Contracts (2006)</td>
<td>Almost consistent</td>
<td>ASBE 15 requires that the expenses relating to acquiring the contract be expensed in the current period while IAS 11 allows for these expenses to be recorded as part of the contract cost if certain conditions are met</td>
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<td>ASBE 15 allows financing expenses to be treated as part of contract cost in accordance with ASBE 17</td>
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<td>8.</td>
<td>IAS 14 Segment Reporting</td>
<td>ASBE 35 - Segment Reporting (2006)</td>
<td>Broadly consistent</td>
<td>ASBE 35 is applicable to all firms that operate across multiple businesses and multiple geographic regions while IAS 14 applies to entities whose equity or debt securities are publicly traded, including enterprises in the process of issuing equity or debt securities in a public securities market, but not to other economically significant entities.</td>
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<td></td>
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<td>EAS does not distinguish main v secondary reporting formats</td>
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<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
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<td>Cause of difference</td>
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<td>IAS 16 Property, Plant and Equipment</td>
<td>EAS-Ch3-Sec1-Fixed Assets ASBE 4 -Fixed Assets (2006)</td>
<td>Fairly consistent</td>
<td>ASBE 4 permits sum of digit, but it does not permit the revaluation model; IAS 16 requires separate depreciation of components under the cost model</td>
<td>ASBE 4 forbids revaluation appreciation to control earnings management in China</td>
<td>ASBE 4 considers disposal costs in determining fixed asset costs and requires at least an annual review of economic useful life, estimated residuals and depreciation method rather than regular review</td>
</tr>
<tr>
<td>IAS 17 Leases</td>
<td>EAS-Ch2-Sec1-Fixed Assets ASBE 21 -Leases (2006)</td>
<td>Almost consistent</td>
<td>In IAS 40 requires leased land to be classified as operating lease for the lessee unless it meets certain criteria and is accounted for at fair value as an investment property. ASBE 6 requires leased land to be treated as an intangible asset unless it meets certain requirements and is accounted for as investment property in accordance with ASBE 3</td>
<td>ASBE 21 requires the lessee to recognise assets and liabilities using the lower of the fair value and the present value of minimum lease payments, while EAS allows the adoption of the lower of book value and the present value of minimum lease payments. EAS, stipulates that if the leased assets amount to, or are greater than, 30% of the lessee’s total assets, the leased assets should be initially recognised at the minimum payment level</td>
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<td></td>
<td>IAS 18 Revenue</td>
<td>EAS-Ch5-Sec2 Revenue ASBE 14-Revenue (2006)</td>
<td>Consistent</td>
<td>ASBE 14 stresses that revenues are not related to owners’ investment; that revenues are determined on the basis of agreement or contract, unless such determined revenues are not fair; that sales and services in a contract or agreement that cannot be separated or separately measured should be treated as sales</td>
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<td>14.</td>
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<td>Special circumstances in China</td>
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<td></td>
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<td>New standard more sophisticated</td>
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<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
<td>Difference Between IASB and China</td>
<td>Cause of difference</td>
<td>Differences between EAS and ASBE</td>
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<td>IAS 21 The Effects of Changes in Foreign Exchange Rates</td>
<td>EAS-Ch9- Foreign Currency Transactions ASBE 19 - Foreign Currency Translation (2006)</td>
<td>Fairly consistent</td>
<td>IAS 21 permits the use of the exchange rate at the valuation date for translating non-monetary items carried at fair value; it provides several possibilities for arriving at the carrying amount; it prescribes rules for dealing with recognition of holding gains or losses relating to non-monetary assets and the components of such gains or losses; and it provides guidance on how to deal with change in functional currency</td>
<td></td>
<td>EAS permits the use of the transaction date exchange rate and the beginning exchange rate for initial recognition and the use of the closing date exchange rate to translate the balances of foreign currency accounts at the end of a period. EAS does not deal with the translation of financial statements in foreign currency</td>
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<td>16.</td>
<td>IAS 24 Related Party Disclosures</td>
<td>ASBE 36 - Disclosure of Related Party Relationship and Transactions (1997)</td>
<td>Consistent</td>
<td></td>
<td>ASBE requires disclosure of key personnel compensation, while EAS does not require that</td>
</tr>
<tr>
<td>17.</td>
<td>IAS 26 Accounting and Reporting according to Retirement Benefit Plans</td>
<td>EAS-Ch10-Equities ASBE 10-Pension Funds (2006)</td>
<td>Broadly consistent</td>
<td>Scope difference: no defined benefits plan in China; the Chinese standard also prescribes a set of financial statements</td>
<td>Special circumstances: no defined benefits plan in China</td>
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<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
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<td>19.</td>
<td>IAS 27 Consolidated and Separate Financial Statements</td>
<td>EAS-Ch13- Financial Reporting ASBE 33- Consolidated Financial Statements (2006)</td>
<td>Broadly consistent</td>
<td>IAS 27- requires the cost method to account for investments in subsidiaries, associates or joint ventures. ASBE 2 allows the cost method to account for subsidiaries and the equity method to account for jointly controlled entities as well as associates. ASBE 33 also requires the parent to adjust the investments in subsidiaries using the equity method before consolidation. There are also different requirements relating to the accounting periods for parent and subsidiary.</td>
<td>Proportional consolidation of joint ventures allowed in EAS, not in ASBE 33</td>
</tr>
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<td>20.</td>
<td>IAS 28 Investments in Associates</td>
<td>EAS-Ch2- Sec2-Long Term Investments ASBE 2 - Long Term Equity Investments (2006)</td>
<td>Broadly consistent</td>
<td>Both use the equity method</td>
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<td>22.</td>
<td>IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions</td>
<td>Accounting System for Financial Enterprises (2002)</td>
<td>Fairly consistent</td>
<td>Scope difference: IAS is only about banks disclosure while Chinese system is about accounting and reporting in banks and other financial institutions</td>
<td></td>
</tr>
<tr>
<td>23.</td>
<td>IAS 31 Interests in Joint ventures</td>
<td>EAS-Ch2-Sec2-Long Term Investments ASBE 2 - Long Term Equity Investments (2006)</td>
<td>Consistent</td>
<td>An investor in a joint venture that does not have joint control should account for that investment in accordance with IAS 39 or, if the investor has significant influence in the joint venture, in accordance with IAS 28. But in ASBE 2 the equity method is required to account for investments in jointly controlled entities while the cost method is required for investments in subsidiaries. ASBE 2 does not cover joint control of operations and assets</td>
<td>EAS requires the use of the cost method for accounting for investments if the investor does not have control, joint control or significant influence, or the equity method if the investor has control, joint control or significant influence</td>
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<td></td>
<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
<td>Difference Between IASB and China</td>
<td>Cause of difference</td>
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<td>24.</td>
<td>IAS 32 Financial Instruments: Disclosure and Presentation</td>
<td>EAS-Ch2-Sec2-Long Term Investments ASBE 37 - Presentation of Financial Instruments</td>
<td>Consistent</td>
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<tr>
<td>25.</td>
<td>IAS 33 Earnings per Share</td>
<td>ASBE 34 - Earnings per Share (2006)</td>
<td>Consistent</td>
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<td>26.</td>
<td>IAS 34 Interim Financial Reporting</td>
<td>EAS-Ch13-Financial Reporting ASBE 32 - Interim Financial Reporting (2002)</td>
<td>Broadly consistent</td>
<td>ASBE 32 does not require the preparation of a statement on changes in equity. IAS 34 also allows the firm to provide simplified finance statements</td>
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<td></td>
<td>IAS 36 Impairment of Assets.</td>
<td>EAS-Ch2-Sec5 Impairment of Assets ASBE 8 - Impairment of Assets (2006)</td>
<td>Fairly consistent</td>
<td>IAS 36 allows impairment loss to be recognised as a decrease in revaluation surplus for assets carried at re-valued amounts and the firm to reverse prior year asset impairment loss. ASBE 8 does not allow these. While IAS 36 uses the cash generating unit concept, ASBE 8 uses the concept of asset group.</td>
<td>Forbid revaluation appreciation to control earnings management in China.</td>
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<td>27.</td>
<td>IAS 37 Provisions, Contingent Liabilities and Contingent Assets.</td>
<td>EAS-Ch11-Contingencies ASBE 13 - Contingencies (2006).</td>
<td>Consistent.</td>
<td>IAS 37 defines provisions while ASBE 13 does not use this concept although it prescribes rules for recognising provisions.</td>
<td>EAS does not consider the effect of time value in estimating contingent liabilities, nor does it provide guidance on how to recognise and measure estimated liabilities in loss contracts and re-organisations.</td>
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<td></td>
<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence between IASB and 2006 ASBEs</td>
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<td>Cause of difference</td>
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<td>29.</td>
<td>IAS 38 Intangible Assets</td>
<td>EAS-Ch3-Sec1-Fixed Assets ASBE 6 - Intangible Assets (2001)</td>
<td>Broadly consistent.</td>
<td>The valuation model is allowed in IAS 38, not in ASBE 6.</td>
<td>ASBE 6 forbids revaluation appreciation to control earnings management in China.</td>
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<tr>
<td></td>
<td>IAS 40 Investment property.</td>
<td>ASBE 3 - Investment Property (2006).</td>
<td>Fairly consistent.</td>
<td>IAS 40 covers land ownership rights and land without specified purposes and requires the use of the same measurement model for all investment properties. This is not the case in ASBE 3. IAS 40 allows for the use rights of leased land to be classified as investment properties and that they must be accounted for at fair value, while ASBE 3 permits the use of the cost method or fair value model.</td>
<td>Special circumstances in China.</td>
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<td></td>
<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
<td>Difference Between IASB and China</td>
<td>Cause of difference</td>
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<td>32.</td>
<td>IAS 41 Agriculture.</td>
<td>ASBE 41 - Biological Products (2006).</td>
<td>Broadly consistent.</td>
<td>ASBE 41 permits the use of fair value only if it is evident that a fair value can be continuously obtained, while IAS 41 requires the use of fair value unless its use is clearly unreliable.</td>
<td>Special circumstances in China: No active bio-product market.</td>
</tr>
<tr>
<td>33.</td>
<td>IFRS 1 First-time Adoption of International Financial Reporting Standards.</td>
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<tr>
<td>34.</td>
<td>IFRS 2 Share-based Payment.</td>
<td>ASBE 11 - Share-based Payment.</td>
<td>Broadly consistent.</td>
<td>Scope: ASBE 11 does not cover share-based payment in either cash or equity.</td>
<td>Special circumstances: share-based payment in either cash or equity is rare in China.</td>
</tr>
<tr>
<td></td>
<td>IFRS 3 Business Combinations.</td>
<td>ASBE 20 -Business Combinations (2006).</td>
<td>Broadly consistent.</td>
<td>Scope: ASBE 20 covers combinations under common control.</td>
<td>Special circumstances: combinations under common control commonplace in China.</td>
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<td>36.</td>
<td>IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.</td>
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<td>37.</td>
<td>IFRS 6 Exploration for and Evaluation of Mineral Resources.</td>
<td>ASBE 27 - Oil and Gas Exploration and Production (2006).</td>
<td>Inconsistent.</td>
<td>Scope: IFRS for exploration of mineral resources while ASBE covers all stages from exploration up to production of oil and gas.</td>
<td>Based on Chinese practices.</td>
</tr>
<tr>
<td>IASB’s Pronouncements</td>
<td>China’s Regulations</td>
<td>Degree of Convergence Between IASB and 2006 ASBEs</td>
<td>Difference Between IASB and China</td>
<td>Cause of difference</td>
<td>Differences between EAS and ASBE</td>
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<td><strong>39.</strong> IFRS 7 Financial Instruments: Disclosure.</td>
<td>ASBE 37 - Presentation of Financial Instruments.</td>
<td>Consistent.</td>
<td></td>
<td></td>
<td>ASBE 37 additionally requires the identification of a financial instrument as either an equity or a liability when it is initially recognised; account for both separately if an instrument has both equity and liability; provision of more disclosure.</td>
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<tr>
<td><strong>40.</strong></td>
<td>ASBE 12 - Debt Re-organisation (2001).</td>
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<td><strong>41.</strong></td>
<td>ASBE 7 - Non-monetary Exchanges (2001)</td>
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<td>42.</td>
<td>EAS-Ch3-Sec1-Fixed Assets ASBE 26 - Reinsurance Contracts (2006)</td>
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<td>43.</td>
<td>Accounting System for Small and Medium-Sized Enterprises (2005)</td>
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</tbody>
</table>

**Endnotes**

1. ASBE 34 requires the disclosure of basic and diluted EPS while CSRC requires the disclosure of EPS according to its prescribed formula $\text{EPS} = \frac{\text{net profit}}{\text{year-end outstanding common shares}}$. If the shareholding structure changed over the reporting period, the denominator should be the average outstanding common shares weighted by numbers of year-end common shares, without considering dilution effects.

2. ASBE 20 defines goodwill arising from business acquisitions as the difference between the purchasing costs and proportion of the fair value of purchased firm's assets and liabilities. In contrast, EAS uses the concept of 'long term equity investment difference' which is the difference between the purchasing cost and the proportion of the book value of the investee's identifiable assets and liabilities. This difference should be amortised.
Conceptual basis

Just like the IASB’s conceptual framework (CF) which strikes a compromise between decision-usefulness and stewardship, the ASBE-Basic Standard (2006) states that the objectives of financial accounting are: to serve the needs of various parties (investors, creditors, government, and the public) in making economic decisions; and to reflect the accountability of management. This differs from the stated objectives in an ASBE-Basic Standard (1992) which defined the objectives as to serve the needs of: the state in managing a macro-economy; various parties in understanding the enterprise’s financial position and performance; and the enterprise in internal management. The ASBE-Basic Standard (1992) emphasised the state’s requirements and the characteristics of the central planning system. In subsequent pronouncements such as the EAS and the Enterprise Financial Reporting Regulation issued by the State Council in 2000, this emphasis is no longer discerned.

Both the IASB’s CF and China’s EAS and Basic Standard (2006) adopt a broadly similar set of financial accounting concepts. The common concepts adopted are: accruals basis; going concern; relevance; timeliness; materiality; reliability; faithful representation; completeness; prudence; substance over form; and comparability. However, the wording of some concepts adopted in EAS may not be directly translated to those adopted in IASB’s CF. For example, while ‘neutrality’ is used in the IASB’s CF, ‘objectivity’ is adopted in the EAS and Basic Standard (2006). In contrast, while the IASB’s CF explains the trade-offs between some qualitative principles and characteristics of accounting information and the balance between benefit and cost, these are absent in the EAS and Basic Standard (2006).

There are some important conceptual differences between the EAS and Basic Standard (2006). While the former requires a distinction to be made between revenue expenditure and capital expenditure, the latter does not have such an explicit requirement. In this respect, Basic
Standard (2006) is in line with the IASB’s CF. Both the Basic Standard (2006) and the IASB’s CF allow the use of various measurement bases. In particular, Basic Standard (2006) requires the use of historic cost in general, but also permits the adoption of replacement cost, realisable value, present value and fair value.

The IASB’s CF states that the application of qualitative characteristics and of appropriate accounting standards will lead to a true and fair presentation. By contrast, the EAS and the Basic Standard (2006) require financial statements to provide true, complete, and reliable accounting information.

The EAS and the Basic Standard (2006) classify six elements of financial statements: assets; liabilities; equities; revenues; cost and expenses; and profit. In contrast, the IASB’s CF defines four elements: assets, liabilities, income, and expenses. The definitions of assets, liabilities and equities are consistent in EAS, Basic Standard (2006) and the IASB’s CF. However, the IASB’s CF defines gains as a component of income whereas the EAS provides no definition of gains. Similarly, the IASB’s definition of expenses also includes losses while this is not followed in the EAS. In contrast, the Basic Standard (2006) defines gains and losses as components of profit. The IASB’s CF only treats conservatism as a qualitative characteristic, whereas the Basic Standard (2006) requires conservatism to be used in accounting recognition, measurement and reporting. Another difference lies in the fact that the IASB’s CF allows the adoption of performance measures other than profit, depending on the choice of the type of capital maintenance. In contrast, the EAS and Basic Standard (2006) do not adopt the concept of capital maintenance and thus only define profit as a performance indicator.

Assets

Assets impairment: Both IAS 36 and China’s EAS and ASBE 8 - Impairment of Assets (2006) - require a provision for the impairment
of assets. Both invoke the concepts of the recoverable amount of an asset and the value in use. The main difference lies in IAS 36 allows an impairment loss to be recognised through the income statement for assets carried at cost, or as a decrease in the revaluation surplus for assets carried at re-valued amount. In contrast, the EAS and ASBE 8 require that all impairment losses be recognised through the income statement. A second difference is that IAS 36 allows firms to reverse prior year asset impairment losses except those from intangible assets. However, China’s regulations contradict each other: the new ASBE - Impairment of Assets (2006) forbids reversals to control earnings management while EAS allows reversals. While IAS 36 uses the concept of an asset’s cash generating unit, ASBE 8 adopts the concept of ‘asset group’ and requires that assets incapable of generating cash alone to be grouped for the purpose of the impairment test. ASBE 8 improves upon the EAS in that it provides greater guidance on the impairment test.

For fixed assets, IAS 16 and China’s EAS and ASBE 4 - Fixed Assets (2006) require the use of purchasing costs for initial recognition. Both IAS 16 and the Chinese EAS and ASBE 4 allow the use of the cost model subsequent to acquisition, but IAS 16 also allows the use of the revaluation model. In addition, they allow the firm to determine economic useful age, residual value, and depreciation method. However, unlike IAS 16, China’s regulations permit the use of the sum of digit method as well as the straight line, unit of production, and reducing balance methods. IAS 16 requires separate depreciation for significant components of a fixed asset under the cost model while this is not required in the Chinese regulations. In addition, unlike the Chinese regulations, IAS 16 allows for the revaluation surplus of fixed assets and depreciation on the basis of re-valued fair value minus accumulated depreciation and impairment loss. Chinese regulations do not permit the existence of revaluation surpluses. EAS requires a review of the economic useful life, estimated residual value, and depreciation method regularly, whereas IAS and ASBE 4 require this to be done at least annually.
For inventories, both IAS 2 and ASBE 1 - Stock (2006) - require stock to be measured at the lower of cost and net realisable value. The EAS allows the use of LIFO, but ASBE 1 has followed IAS 2 which has eliminated this choice because it is considered to result in unfaithful representation of stock flows and stock showing in the balance sheet at amounts that bear little relationship to recent cost levels of stock. IAS 2 does not apply to the measurement of inventories of producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products to the extent they are measured at net realisable value in accordance with well established industry practices, and the measurement of inventories of commodity broker/traders to the extent that they are measured at fair value less costs to sell. ASBE 1 and the EAS do not offer similar exemptions.

For short-term investments, EAS adopts the lower of cost and net realisable value while IAS 39 allows fair value. IAS 32 additionally requires the disclosure of risk management policies and changes in fair value and their treatments.

For long-term equity investments in companies over which the investor does not have joint control or significant influence, EAS and ASBE 2 - Long Term Equity Investments - require the use of the cost method. ASBE 2 also requires the adoption of the cost method to account for equity investments in subsidiaries. In contrast, IAS 27 requires the parent company to account for investments in subsidiaries, associates or JVs at cost or as investments under IAS 39. In the case of accounting for investments in associates, the EAS, ASBE 2, and IAS 28 require the adoption of the equity method. For investment in jointly controlled ventures, both ASBE 2 and IAS 31 stipulate the adoption of the equity method, although the EAS and IAS 31 also permit the use of the proportionate consolidation method.

For long-term investments in bonds, EAS requires initial recognition at historical cost less interest receivables which are due but not yet received while ASBE 22 - Recognition and Measurement of Financial
Instruments (2006) - and IAS 39 stipulate the use of fair value at the date of acquisition or issuance which may be different from historic cost. In addition, while the EAS only allows the lower of cost and the net realisable value method with the difference between book value and recoverable value recorded as provision for long term investment impairment, ASBE 22 and IAS 39 distinguish four types of financial assets. These are:

- loans and receivables not held for trading;
- financial assets held to maturity;
- financial assets measured at fair value; and
- financial assets available for sale (other financial assets that do not fall into one of the above three categories).

Different methods are prescribed for subsequent measurement: amortised cost subject to an impairment test for the first two types; fair value in the balance sheet with value changes recorded in profit or loss for the third type; and fair value in the balance sheet with value changes recognised in equity subject to an impairment test for the fourth type.

For intangible assets, neither IAS 38 nor China’s EAS and ASBE 6 - Intangible Assets (2006) - allow the recognition of self-created goodwill as assets. The EAS allows research and development costs to be expensed when incurred, but the costs for obtaining patents (e.g. legal fees and registration fees) are to be capitalised. In contrast, ASBE 6 and IAS 38 require that research costs are expensed when incurred while development costs are capitalised when the technical and commercial feasibility of the resulting product or service has been established. Subsequent expenditure is expensed when incurred according to the EAS, but ASBE 6 and IAS 38 allow capitalisation of development costs that meet the requirements for capitalising research and development expenses. Both the Chinese
regulations and IAS 38 require amortisation of intangible assets, but
the EAS allows amortisation over the shorter of the period specified by
law and economic useful life, or 10 years. In contrast, ASBE and IAS
38 require finite intangible assets to be amortised over their useful lives
and infinite intangible assets not to be amortised. Finally, while IAS
38 permits the use of either the cost model or the revaluation model for
measurement after recognition, both the EAS and ASBE 6 only allow
the use of the cost model. Although the two Chinese regulations permit
provision for impairment, they do not allow recognition of appreciation
in asset revaluation.

For leases, both ASBE 21 -Leases (2006) - and IAS 17 require the
lessee to recognise the asset and liability using the lower of the fair value
and the present value of minimum lease payments, while EAS allows
the adoption of the lower of book value and the present value of minim
lease payments. EAS, however, also stipulates that if the leased assets
amount to or are greater than 30% of the lessee’s total assets, the leased
assets should be initially recognised at the minimum payment. In IAS 40
- Investment Properties, the leased land should be classified as operating
lease for the lessee unless it meets certain criteria and is accounted for at
fair value as an investment property. In contrast, in ASBE 6 - Intangible
Assets (2006) - leased land (the right to use the land) should be treated as
an intangible asset unless it meets certain requirements and is accounted
for as an investment property in accordance with ASBE 3 - Investment

The EAS does not deal with investment properties. ASBE 3 -
Investment Properties (2006) - differs from IAS 40 in several respects.
First, the Chinese standard includes land use rights rather than land
ownership as investment properties because all lands are owned by
the state in China. Second, IAS 40 includes land without specified
uses. This is not covered in ASBE 3. Third, IAS 40 stipulates that all
investment properties be accounted for using the same measurement
model except for certain special circumstances. This is not required by
ASBE 3. Finally, in IAS 40, the lessor can classify the leased land as an investment property using the fair value model. ASBE 3 allows the firm to use the cost model or the fair value model if the fair value of the land can be obtained continuously.

ASBE 5 - Biological Products (2006) - differs from IAS 41 - Agricultural Products - in that it prescribes that fair value should be used in subsequent measurement if there is firm evidence that the fair value of the asset can be obtained continuously. In contrast, IAS 41 requires the use of the fair value model unless the estimation of fair value is clearly unreliable. This topic is not covered by the EAS.

Liabilities, equities and revenues

Both IAS 23 and China’s EAS and ASBE 17 - Borrowing Costs (2006) - require that borrowing costs specifically incurred for building or acquiring a fixed asset be capitalised but the borrowing costs associated with the fixed asset after it is in a usable condition must be expensed when incurred. In all these standards or regulations, all other borrowing costs should be expensed when incurred.

ASBE 22 - Recognition and Measurement of Financial Instruments (2006) - and ASBE 37 - Presentation of Financial Instruments (2006) - are consistent with their counterparts IAS 32 - Financial Instruments: Recognition and Measurement - and IFRS 7 - Financial Instruments: Disclosure. ASBE 22 and ASBE 37 are applicable to all financial instruments. ASBE 22 requires the use of fair value to measure all financial instruments and their derivatives. ASBE 37 requires that an issuer should identify a financial instrument as either an equity or a liability when it is initially recognised; account for both separately if an instrument has both equity and liability; and provide more disclosure. By contrast, the EAS requires the firm to classify convertible bonds as a liability before being converted.
The EAS allows the firm to provide a legal accumulation fund at 10% of profit (capped at 50% of capital) to be used for covering losses, expansion or as capital; a welfare fund at 5-10% of profit to be used for employee welfare facilities, and a discretionary accumulation fund decided at the shareholders’ meeting. However, like IAS 19, ASBE 9 - Employee Benefits (2006) - requires the firm to recognise: a liability when an employee has provided services in exchange for employee benefits to be paid in the future; and an expense when the entity consumes the economic benefits arising from service provided by an employee in exchange for employee benefits. Unlike IAS 19, ASBE 9 does not classify post-employment benefits into defined contribution plans and defined benefit plans, nor does it discuss the actuarial valuation method to determine the present value of the firm’s defined obligations and the related current service cost and where applicable, past service cost. This is because there is no defined benefit plans in China.

ASBE 11 - Share-based Payment (2006) - is basically consistent with IFRS 2 although the scope of ASBE 11 is narrower than that of IFRS 2. First, ASBE only deals with transactions for services provided by employees or other parties, while IFRS 2 covers all transactions for goods or services rendered by employees or other parties. Second, ASBE does not cover share-based payment by a choice of either cash or equity because this type of payment is rare in China.

Similar to IAS 20, ASBE 16 - Government Grants (2006) - applies the income approach to both assets-related and income-related grants. One difference lies in the fact that IAS 20 allows the deduction of a grant from the carrying amount of the asset (i.e. systematically recognising income through reducing depreciation during the economic useful life).

The criteria for recognising revenues in both IAS 18 and IAS 11 and in China’s EAS, ASBE 14 -Revenue (2006), and ASBE 15 - Construction Contracts (2006) are generally consistent. However, ASBE 15 requires that the expenses relating to acquiring the contract be expensed in the
current period, while IAS 11 allows these expenses to be recorded as part of the contract cost if they can be individually identified and reliably measured, and if it is probable that the contract will be obtained. ASBE 15 allows indirect construction expenses (excluding administration, financing and sales expenses recognised in the current period) to be treated as part of contract cost in accordance with ASBE 17. This is not allowed in the EAS.

Presentation and reporting

ASBE 30 - Presentation of Financial Statements (2006) - is broadly similar to IAS 1, except that ASBE 30 does not discuss the principle of fair presentation and does not allow an entity to present an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant. However, ASBE 30 creates three major differences from prior Chinese regulations (e.g. EAS and Enterprise Financial Reporting Regulations). First, it does not purport to regulate the traditional explanatory statement of financial conditions because it is considered that it is difficult to regulate the statement and because this is not required in IFRS. Second, it no longer distinguishes main business revenues from other business revenues in the income statement because firms increasingly undertake multiple businesses. Third, it cancels the items of non-business revenues and non-business expenditures in the income statement, and instead requires the presentation of its main components separately in an effort to curtail earnings management.

ASBE 31 - Cash Flow Statement (2006) - requires the firm to adopt the direct method, but also provide a reconciliation of operating profit and cash flows from operating activities in a note, whereas IAS 7 allows both the direct method (recommended) and the indirect method for presenting cash flows from operating activities. In contrast, the EAS requires the firm to use the direct method only.
ASBE 28 - Changes in Accounting Policies and Estimates and Error Corrections (2006) are consistent with IAS 8. In contrast, the EAS does not define impracticability for exemption from changing comparative information.

ASBE 29 - Events after the Balance Sheet Date (2006) are consistent with IAS 10. However, EAS lists fewer non-post-balance sheet date adjusting items. ASBE 29 also replaced the concept of ‘material accounting errors relating to prior periods’ with ‘prior period accounting errors’ and adopts the retrospective re-statement of material prior period errors. This is not adopted in the EAS.

The EAS does not provide guidance on interim reporting, but ASBE 32 - Interim Reporting (2006) - is consistent with IAS 34 except that ASBE 32 does not require the preparation of a Statement of Changes in Equity which is required by IAS 34. In addition, IAS 34 also allows the firm to provide simplified financial statements.

IFRS 6 - Exploration for and Evaluation of Mineral Operations - only deals with the exploration stage of all types of mineral operations while ASBE 27 - Oil and Gas Exploration and Production (2006) - prescribes accounting and disclosure rules on stages up to the production of oil and gas only. IFRS 6 allows the use of either the cost model or the revaluation model while ASBE 27 only permits the use of the cost model. ASBE requires capitalisation of the expenses for obtaining the rights to explore, extract and produce oil and gas. It allows capitalisation of exploration costs if the exploration identifies and ascertains the economic extraction volume and the unit of production or straight line method for depreciation of field and other equipment. It also requires capitalisation of oil and gas extraction expenses according to their purposes.

ASBE 18 - Income Taxes (2006) - is consistent with IAS 12, but contradicts the EAS. On the one hand, the EAS allows the firm to choose between the tax payable method and the tax effect method and if the latter is chosen, it allows the firm to adopt either an income statement liability method or the deferral method. On the other hand, the ASBE and IAS 12 only permit a balance sheet liability method. Related to
this difference, while the EAS adopts the concept of time difference between taxable profit and accounting profit, the ASBE and IAS 12 use the notion of temporary differences between the tax base of an asset or liability and its carrying amount in the balance sheet.

The EAS and ASBE 35 - Segment Reporting (2006) - are consistent with IAS 14 except that EAS does not distinguish primary and secondary reporting formats. In addition, ASBE 35 and IAS 14 are applicable to different types of firms. The former is applicable to all firms that operate across multiple businesses and multiple geographic regions, while the latter applies to entities whose equity or debt securities are publicly traded, including enterprises in the process of issuing equity or debt securities in a public securities market, but not to other economically significant entities.

In the parent company’s separate financial statements, IAS 27- Consolidated and Separate Financial Statements - requires the use of the cost method or IAS 39 to account for subsidiaries, associates or JVs. In contrast, ASBE 2 - Long Term Equity Investments (2006) - allows the parent to account for investments in subsidiaries using the cost method and investments in associates and JVs using the equity method. ASBE 33 - Consolidated Financial Statements (2006) - allows only the equity method to account for jointly controlled entities as well as associates, whereas IAS 31 allows both the equity method and proportionate consolidation method for accounting for associates. ASBE 33 requires the parent and subsidiary to adopt the same accounting period. In contrast, when the accounting periods differ between the parent and the subsidiary, IAS 27 requires the subsidiary to adjust its financial statements, or prepare additional financial statements, in consistency with the accounting period of the parent.

ASBE 19 - Foreign Currency Translation (2006) - differs from both the EAS and IAS 21 - The Effects of Changes in Foreign Exchange Rates - in several respects. First, while IAS 21 permits the use of the exchange rate at the valuation date for translating non-monetary items carried at
fair value, this is not specified in ASBE 19. Second, IAS 21 provides several possibilities of arriving at the carrying amount, but ASBE does not provide the same. Third, IAS 21 also prescribes rules for dealing with recognition of holding gains or losses relating to non-monetary assets and the components of such gains or losses while ASBE does not do that. Finally, IAS 21 provides guidance on how to deal with change in functional currency, but ASBE 19 does not provide such guidance. In summary, the ASBE appears simpler than IAS 21. The EAS permits the use of the transaction date exchange rate and the beginning exchange rate for initial recognition, and the use of the closing date exchange rate to translate the balances of foreign currency accounts at the end of a period. The EAS does not deal with the translation of financial statements in foreign currency.

The EAS does not define earnings per share (EPS), nor does it require the disclosure of EPS in the income statement. Listed Companies Disclosure Standard No 9 stipulated by the CSRC defines basic EPS based on main business profit, operating profit and net profit, but it does not consider the impact of potential ordinary shares (e.g. convertible securities, share options, and warrants). This is attended to in ASBE 34 -EPS (2006). ASBE 34 is broadly consistent with IAS 33 except that the latter requires the firm to calculate both basic and diluted EPS on two bases: profit and loss; and profit and loss from continuing operations. In contrast, ASBE 34 does not require the calculation of EPS on the basis of profits and losses from continuing operations.

ASBE 13 -Contingencies (2006) - is consistent with IAS 37, except that IAS 37 defines provisions while the ASBE and other Chinese regulations do not use this concept although they prescribe rules for recognising what IAS 37 calls provisions (i.e. probable liabilities that are measurable). The EAS does not consider the effect of time value in estimating contingent liabilities, nor does it provide guidance on how to recognise and measure estimated liabilities under the circumstances of loss contracts and reorganisations.
Other elements

IAS 30 deals with disclosures in the financial statements of banks and similar institutions, while the MoF issued the Accounting System for Financial Enterprises (2002). The Chinese regulation is more inclusive than IAS 30 as it includes other types of financial institutions, such as insurance firms, and deals with not only disclosures but also with recognition and measurement.

ASBE 36 - Disclosure of Related Party Relationships and Transactions (2006) differs from IAS 24 in several respects. First, while IAS 24 considers state-controlled enterprises as related parties, ASBE 36 does not treat enterprises as related parties if they are merely controlled by the government without other related transactions. Second, ASBE 36 considers both parties that are under common control or material influence as related parties, while IAS 24 is not explicit in this regard. While ASBE 36 and IAS 24 require the disclosure of the key management compensation, this is not required by the EAS.

Unlike the EAS, ASBE 10 - Pension Funds (2006) - prescribes principles and methods for accounting and disclosing an enterprises pension fund as a separate entity. The pension funds in China are equivalent to the funds based on defined contribution plans. The Chinese standard is consistent with IAS 26 in principle with respect to defined contribution plans. To be more operational, however, the Chinese standard also prescribes a set of financial statements specific for pension funds.

Unlike IFRS 3 - Business Combinations - which deals with only combinations under no common control, ASBE 20 - Business Combinations (2006) - deals with combinations under common control as well as those not being under common control. This is because combinations under common control are commonplace in China. Compared with the EAS, ASBE 20 has a different definition of goodwill from business combination, it forbids amortisation of such goodwill, and
requires the adoption of the pool of interest method to accounting for mergers under common control. For combinations that are not under common control, both sets of standard adopt the purchase method.

ASBE 25 - Insurance Contracts (2006) - prescribes recognition and measurement rules relating to assets, liabilities, revenues and expenses arising from insurance contracts. In contrast, IFRS 4 does not provide specific guidance on these matters. ASBE 25 requires, if possible, the separation of the insurer's insurance risk from other risks. In contrast, IFRS 4 requires the separation of insurance risk from interest rate risk under certain circumstances. ASBE 25 also differs from China's prior insurance accounting regulations in relation to the identification of insurance contract. While the ASBE and IFRS 4 define insurance contracts on the basis of insurance risk, prior insurance accounting regulations do not define insurance contracts, and almost all contracts between the insurer and the insuree are treated as insurance contracts resulting in different criteria for recognising insurance premiums. There is no separate IFRS on reinsurance contracts. However, IFRS 4 requires an impairment test of the reinsured assets, whereas ASBE 26 - Reinsurance Contracts - does not require such a test. ASBE 26 basically follows accounting and disclosure practices in other countries such as the USA.

The Chinese standard setters have also stipulated several standards or systems that IFRSs do not currently cover. These include an Accounting System for Small Enterprises (2004), ASBE 7 - Non-monetary Exchanges (2006), ASBE 12 - Debt-reorganisation (2006), ASBE 26 - Reinsurance Contracts (2006), ASBE 23 - Financial Assets Transfer (2006), and ASBE 38 - First Time Adoption of ASBE (2006). In contrast, there are no Chinese equivalents to the IASB's IFRS 1 - First Time Adoption of ASBE, IFRS 5 - Non-current Assets held for Sale and Discontinued Operations, and IAS 29 - Financial Reporting in Hyperinflationary Economies.
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Regulating Accounting in Foreign Invested Firms in China: From Mao to Deng

The rapid expansion of China’s economy and the move towards globalisation of business increases the pressure for greater global harmonisation of accounting standards. Indeed, the risk and cost to industry of non-compatibility with global accounting standards can be high. However, the issue of cultural differences in the quest for global accounting harmonisation cannot be ignored.

This report aims to address some of these issues arising in China by providing a better understanding of the extent to which political, economic and ideological changes and the development of foreign direct investment have impacted upon accounting regulation in China. These changes have resulted in China now being the largest destination worldwide for foreign direct investment.

The study recognises the importance of political ideology on the development of accounting and the impact which the rapid increase in foreign direct investment has had on the need for international accounting harmonisation. The interaction between accounting regulations for foreign invested firms, domestic firms and IFRS is also considered, highlighting the need to recognise the cultural peculiarities of China. The authors conclude with important and far reaching policy implications.

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