THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

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

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First Published 2007
The Institute of Chartered Accountants of Scotland

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ISBN 978-1 904574-39-2
EAN 9781904574392

EXECUTIVE SUMMARY

Introduction

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 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.

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