Fitch Ratings admitted in July that its ratings for Chinese companies included an inherent discount for, among other things, the low quality of information in their accounts.

This admission highlighted the broader implications of China’s progress towards the adoption of International Financial Reporting Standards. According to the rating agency, the use of Chinese accounting standards and a listing on the Shanghai Stock Exchange amounted to “key weakness indicators” in terms of credit worthiness.

Fitch’s portfolio of about 40 Chinese companies is rated BB or lower, with only state-owned or state-supported companies being assigned an investment grade. The report was coincidentally released after trading in several Chinese companies listed in the United States, Canada, Singapore and Hong Kong had been suspended amid claims of accounting irregularities.

For China, integrating IFRS into an economy that has, in accounting terms, done things in its own way for a very long time, is a huge chore. But rapid globalization has created pressure for China to adopt international standards that allow investors and others to compare accounts on an apple-to-apple basis.

With pain can potentially come gain. An IFRS-savvy China would mean that mainland accounting firms could bid for international audit work on increasingly equal terms with international firms – long thought to be a desire of the government.

Work in progress
While mainland accountants have been steadily shifting from Chinese standards in favour of IFRS, there’s still a divide between the two systems.

“Despite substantial convergence between [China Accounting Standards] and IFRS, practical implementation and interpretation differences remain,” says Stéphane Grand, president of S.J. Grand, a financial and tax advisory firm based in Hong Kong and in the mainland. One of the differences, he says, is that IFRS demands much more independent judgment than CAS.

Melanie Chen, the New York-based managing director of UHY Advisors, a global group of accounting and business consulting firms, shares a similar opinion.

“One of the more fundamental challenges,” she says, “will be to change the education and training methodology to put more focus on developing accounting professionals’ analytical skills and business judgment. Chinese accountants tend mechanically to follow specific rules and match numbers.
with supporting receipts. IFRS provides more general guidelines and requires accountants to use their professional judgment in applying principles.”

Grand points out areas where CAS is technically different from IFRS. Double-entry is done solely in yuan, while transactions in foreign currency are converted into local currency at the official, not the prevailing, rate. In private accounting firms, historical cost method prevails over fair value because accurate prices for the latter are hard to obtain. Tougher in some areas than others, CAS demands considerable extra information on such matters as the identity of business partners and fairness of transactions, neither of which are prominent requirements in IFRS.

CAS standards are less strongly enforced than IFRS, Grand claims, although he says this is changing.

One unfortunate result, Grand says, is that some large companies routinely keep three sets of conflicting accounts. One set, intended to impress the parent company and foreign investors, “often exaggerates sales and profits.” The second understates performance for the benefit of tax authorities, while the third and most accurate set is designed for internal management use only.

Other questionable accounting practices remain rife in China, Grand adds. Because defaults on payments are relatively common in China, many companies use the dangerous accounting tactic of boosting sales figures without making allowances for bad debt.

Sometimes managers pay themselves bonuses when they reach targets, without taking into account increases in receivables.

Inventories are often extraordinarily high by western standards for a variety of domestic reasons, including breakdown-prone logistics. In turn, this triggers high levels of working capital, financing insurance and related costs that are “too often not clearly depicted in the financial statements,” says Grand.

A change from within
CAS has been so embedded in China’s commercial culture that mainland accountants, as well as financial managers, have unsurprisingly been unable to throw off their old clothes immediately. Jean Jinghan Chen and Haitao Zhang of the University of Surrey pointed out in a 2010 paper that, with two competing standards, companies sometimes mix and match to suit their commercial needs.

“The convergence of accounting practices may be affected by not only the lack of insufficient understanding of IFRS by local accounting professionals, but also by the opportunistic behaviour of management during the application of different standards,” they said.

Interestingly, their research did not show that international audit firms were more effective at ensuring IFRS compliance than local firms. Therefore, they said, “the Chinese government should be cautious in promoting the participation of international audit firms in China for achieving IFRS.” Fitch argued the opposite, saying that using auditors from the Big Four firms should inspire investor confidence.
Arguably, overseas investors are now undertaking the job that China’s underdeveloped capital market has hitherto struggled to address: challenging Chinese management to adopt higher standards.”

In spite of the difficulties, Chinese companies listed overseas have been leading the way in compliance, according to John Haverty, a visiting professor at the Inter-University Institute of Macau. In his study of Chinese companies listed on the New York Stock Exchange, he found these companies uniquely prepared their accounts under IFRS, with a limited reconciliation to U.S. GAAP.

In July, the International Monetary Fund pointed out that China’s international banks had helped pioneer IFRS with the help of foreign investors. In its latest, largely optimistic, survey of the state of the Chinese economy, the IMF stated, “The main banks have been listed on foreign markets, helping to strengthen investor oversight and control, and to ensure compliance with international accounting standards.”

The general consensus among members of the International Accounting Standards Board, the IMF, western stock exchanges and investors is that China is on the right path in its sometimes tortuous progress towards the single international accounting language. Much of the impetus comes from foreign direct investment, especially in both outbound and inbound mergers and acquisitions. As Fitch pointed out in its report, “Arguably, overseas investors are now undertaking the job that China’s underdeveloped capital market has hitherto struggled to address: challenging Chinese management to adopt higher standards.”

Says Grand, “These developments have created an urgent need to reform the old accounting standards in favour of a modern system that takes into account a wider range of stakeholders.”

There are still sceptics of China’s ability to shift to IFRS, given the freedom of the semi-autonomous regions to interpret standards according to their often different circumstances. But there’s no doubt that the government, the China Securities Regulatory Commission and the Ministry of Finance – which is pushing IFRS in China – are committed to convergence. The CSRC has ordered accounting firms to toughen their selection criteria for staff and has doubled its on-the-spot inspections of firms.

Progress towards IFRS in China is likely to be much faster with the help of Hong Kong’s IFRS-familiar accountants. Chen of UHY Advisors says that her organization has achieved excellent results in this way, with both sides learning from each other.

“In practice, we have our western-trained Chinese associates working alongside China-trained ones on many engagements and we’ve noticed that China-trained associates tend to be strong in technical skills but weak in analyzing issues in a business context,” she says. “Using teams with mixed training has helped us to overcome these limitations.”

With pioneers and collaborators leading the way, China is slowly but surely making progress on the IFRS front. Whether complete convergence will ever happen remains up for debate, but at the moment, all signs seem to point that way.