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Chinese Accounting Standards Convergence with International Financial Reporting Standards

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Abstract: As the global economy becomes more integrated, Chinese Accounting Standards (CAS) are gradually moving towards convergence with International Financial Reporting Standards (IFRS). So far, CAS and IFRS do still have a number of variations including content, format and setup mechanisms. This paper analyzes three main differences in the content between CAS and IFRS regarding the financial instrument, biological asset, and lease measurement. These differences may cause problems for international practitioners and investors. In addition, the paper discusses the influences of the global convergence of CAS and the challenges faced by the technology industry, listed companies, and government. It is recommended that China need to consider the domestic economic situation and policies when adopting IFRS, and properly adjust the content of the standard accordingly, so as to better meet the domestic needs and development prospects. And industries should balance convergence and market challenges and work together to shape a practical and comprehensive China accounting system to enable China to develop globally further.

Keywords: CAS, IFRS, Convergence, Accounting.

1. Introduction

Accounting standards are closely related to a particular political and economic system and the legal or cultural environment. Chinese GAAP (Generally Accepted Accounting Principles), known as CAS, differ from International Financial Reporting Standards (IFRS), for example, in terms of their content, form, and formulation mechanism.

With the advancement of integration in the global economy and the accelerated development of China's society, the international convergence of accounting standards has become a global growth trend and aligning Chinese Accounting Standards (CAS) with International Financial Reporting Standards (IFRS) has become an inevitable trend. Following two significant modifications to the standard in 2014 and 2017, the general consensus is that there is little difference between IFRS and CAS. However, CAS and IFRS are still quite different in practice due to the concept, formulation process, and application context.

Consequently, further convergence will not only enhance the competitiveness of Chinese enterprises in the international market and help China to play a more significant role in global economic governance but is also an essential part of participating in global economic governance and promoting the development of international accounting standards.

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Extensive research has examined the trend of CAS' conversion with IFRS to explore its impacts on various accounting and business practices in China. CAS has evolved significantly since its inception. While CAS and IFRS share many similarities due to ongoing convergence efforts, notable differences remain that can impact financial reporting and compliance [1]. Hawksford briefly summarizes a few key differences between CAS and IFRS. Significant differences include fixed asset valuation, fiscal year and reporting requirements [1]. For example, CAS requires using the historical cost method for fixed asset valuation. At the same time, IFRS allows companies to select a method between historical cost and revaluation methods for certain assets which provides more flexibility in reflecting asset values.

According to Yang et al., practitioners acknowledge advantages such as enhanced transparency and comparability; however, they also encounter difficulties such as heightened complexity and further training requirements [2]. Hence, adequate assistance in implementing IFRS is imperative to ensure its effectiveness. The discovery emphasizes the tangible challenges that accounting professionals encounter, which affect the effectiveness of IFRS convergence. This aligns with a more comprehensive investigation conducted by Hao et al., which acknowledges the intricacies and regional disparities in implementing IFRS [3]. They analyzed the how IFRS convergence influence on accounting quality in China, especially focused on accrual aggressiveness and timely loss recognition. The analysis indicates that the convergence leads to higher arbitrary accruals and reduces the timely recognition of losses, particularly in regions with less advanced legal environments. It underscores the importance of increasing the quality of regional institutions to enhance accounting procedures.

Moreover, Tsai and Huang have proposed that the complexity and additional work required for IFRS compliance have led to higher audit fees for Chinese firms [4]. The increase in audit fees highlights a direct cost associated with IFRS convergence, pointing to the financial implications of IFRS convergence emphasizing the need for additional support and resources during the transition. Another study by Hou, Jin, Wang, and Zhang further support the opinion of IFRS's need for an extra cost and dependence on the region. This indicates that while IFRS adoption improves financial reporting quality, it also increases compliance complexity and costs, and the impact varies across regions and sectors and is influenced by the local institutional environment [5]. The study focuses on regional disparities, and the trade-off between improved reporting quality and increased costs echoes themes of institutional quality and financial burdens.

Nevertheless, Cheng, Lin, J. Zhang, and S. Zhang concluded the how the IFRS convergence influence the Chinese stock market, showing that the IFRS adoption has improved the informativeness of financial statements, which improved the stock price reactions to earnings announcements [6]. This indicates that investors consider IFRS-based financial statements more reliable and relevant, again emphasizing the importance of transparency and comparability. Therefore, IFRS adoption positively affects market dynamics. Similarly, another study also highlights the benefits of IFRS transparency. Sun, Zhao, He, and Zhang find that firms using IFRS better integrate with foreign companies and attract more international investors, leading to more successful mergers and acquisitions (M&A) [7]. The success in M&A activities demonstrates the strategic advantages of IFRS convergence for firms engaged in international operations, including enhanced transparency and comparability, facilitating cross-border transactions. Furthermore, Miah further examines IFRS convergence's influence on firm performance in China and concludes that IFRS adoption enhances financial reporting quality but introduces complexities requiring more outstanding professional expertise [8], similar to the requirement of additional audit support, as mentioned by Tsai and Huang [4]. Regulatory support is crucial for facilitating the transition and ensuring compliance.

As mentioned above, previous research has mainly focused on the fact that CAS and IFRS differ in their financial reporting policies. Further convergence with IFRS makes the financial reporting

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system more complete and helps Chinese companies improve transparency and comparability. Moreover, it also discusses the possible risks, such as increased audit fees. Therefore, this paper aims to critically analyze the differences between certain aspects of CAS and IFRS and analyze the impacts and challenges of convergence for domestic companies, industries, and governments.

2. Comparison between CAS and IFRS

2.1. Contents

2.1.1. Classification and Measurement of Financial Assets

IFRS 9 separates the measurement of financial assets into three main groups, they can be either measured at amortized cost, fair value through other comprehensive income, or fair value through profit or loss [9]. It uses an expected credit loss model to measure financial instruments, recognizing the credit losses based on not only historical and current information, but also the forecasting information. It can anticipate future losses and requires earlier recognition of impairment.

ASBE 22, broadly aligning with IFRS 9 in terms of classification, introduces specific criteria for classifying financial instruments. However, it diverges from IFRS 19 by primarily employing an incurred loss model for impairment, which trigger the recognition of impairment only when there is clear evidence of impairment, such as any events occurred after the initial asset recognition and indicates a significant reduction in the asset's recoverable amount [10]. Differ from IFRS 9 requirement which anticipates future losses, the incurred loss model focuses on losses that have already occurred, leading to later recognition of losses.

2.1.2. Biological Assets

Biological assets are those that are living plants or animals. Both CAS and IFRS provide guidelines for accounting for these assets, but their approaches differ significantly.

IAS 41 from IFRS requires firms to measure the biological assets at the value of fair value minus costs to sell and recognize changes in fair value in profit or loss, reflecting the current market conditions and the economic value [11]. Biological assets are not depreciated, but their fair value is reassessed at each reporting date. In contrast, ASBE 5 primarily uses the historical cost method for measuring, recording the biological assets at their acquired cost [10]. Applying the depreciation and recognizing the impairment losses when evidence shows that the carrying value of the assets is larger than the recoverable amount [10].

Under IAS 41, revenue is recognized at the point whenever the biological asset’s value changes. It requires to measure the government grants related to those assets at fair value and recognize the grants in profit or loss when they become receivable [10]. However, ASBE 5 requires firm to recognize the revenue when the significant risks of ownership are transferred to buyers [10], and confirm the government grants related to biological assets in income over periods matching with related costs.

2.1.3. Lease

Lease accounting under ASBE 21 and IFRS 16 involves significant differences that impact the recognition, measurement, and disclosure of lease transactions. These differences are evident in both lessee and lessor accounting aspects.

In recognition and measurement, IFRS 16 and CAS 21 requirements are consistent. In the lessee aspect, CAS 21, mostly converged with IFRS 21, does not differentiate operating leases from finance leases, and recognizes all leases on the balance sheet with asset depreciation and recognition of

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interest expense on the liability [12,13]. In the lesser aspect, CAS 21 and IFRS 16 separate leases into operating and finance leases. The lessor recognizes lease income on a linear basis over the whole period [12]. For finance leases, the lessor recognizes a receivable at an amount equal to the lease net investment and recognizes interest income [12].

In the disclosure of lease transactions, CAS 21 and IFRS 16 differ in the lessor aspect. CAS 21 emphasizes substance over form, providing guidance on lease classification and requiring disclosures about the net investment in leases and future lease payments [13]. IFRS 16 requires lessors to provide detailed information about lease income, future payments, and the nature of leasing arrangements [12].

2.2. Formats

IFRS provides clear provisions under IAS 1 “Presentation of Financial Statements”, which offers flexibility in the presentation format as long as the report includes necessary components and is presented fairly [14]. While CAS requires specific formats for the presentation of financial statements [10].

2.3. Standard-Setting Mechanisms

The Ministry of Finance (MoF) in China is responsible for developing and implementing CAS. The process is centralized, and the MoF issues detailed guidance and interpretations to ensure consistent application across China. CAS updates are reactive, with changes being implemented after thorough approval by the MoF [1].

The International Accounting Standards Board develops IFRS through a comprehensive process involving public consultation and global convergence efforts. IFRS standards are intended to be globally applicable and are subject to continuous improvement [15]. The standards are updated regularly through a transparent process. The IASB issues amendments and new standards after public meetings, ensuring that they reflect current best practices and address emerging issues in financial reporting [16].

3. Influence on CAS Convergence with IFRS

3.1. Influence on the Technology Industry

The technology industry, characterized by rapid innovation and significant investment in research and development, faces unique challenges in financial reporting. There is a significant impact from the conversion of CAS to IFRS on how technology companies report their financial performance and position.

Generally, tech companies, such as Tencent and Xiaomi, focus on innovation investment and, thus, always hold substantial financial instruments, including investments in other tech firms, start-ups, or marketable securities. This makes them more susceptible to market fluctuation under IFRS 9. As the economic environment drives, most tech companies have followed the IFRS requirement of using fair value to measure their financial assets. However, most of them, especially small tech companies, still use the incurred loss model under ASBE 22. Therefore, once CAS convergences with IFRS in the measurement of financial instruments by using fair value measurement, tech companies will reflect market conditions more accurately in their financial statements, and enhanced transparency in the valuation of financial instruments will boost investor confidence. This is crucial for those who rely heavily on outside investments. However, this may also potentially affect investors’ perceptions because the uncertainty of market volatility can expose smaller tech companies to market

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capitalization valleys, which may not represent their true capabilities but can significantly impact investor decisions.

Furthermore, the expected credit risk model under IFRS would encourage proactive risk management. Tech firms may have substantial receivables from various customers, and recognizing credit loss benefits them from earlier recognition of potential credit losses. This helps them maintain a healthier balance sheet and better prepare them for economic downturns.

Biological assets are not a primary concern for most tech firms. Only those involved in biotech or pharmaceuticals should consider this aspect of CAS convergence with IFRS. Real-time valuation of biological assets can lead to higher and lower asset values, better reflecting the company's growth potential. However, it would introduce volatility in financial statements, which can be challenging for investors who prefer stable earnings.

Technology companies often lease office space, data centers, and equipment. Recognizing these leases on the balance sheet increases assets and liabilities, which determines financial ratios like debt-to-equity and return on assets. The convergence requires companies to focus more on lease accounting disclosure, leading to an increasing expense in accounting and auditing.

3.2. Influence on Listed Company

The convergence of CAS with IFRS has profound impacts on listed companies in China. As an international standard, Convergence to IFRS means that the financial statements of Chinese-listed companies will be more comparable to those of global firms. This not only enhances the reliability and credibility of financial reports but also fosters greater investor confidence. As IFRS requires more comprehensive disclosures than CAS, the convergence would provide deeper insights into listed companies' financial health and risk exposures, promoting greater transparency.

The convergence also promotes regulatory compliance and enhanced listing requirements. Once convergence, listed companies will need to comply with more stringent financial reporting standards. And regulatory bodies such as stock exchanges will likely enforce stricter listing requirements, which can ensure that companies meet high standards of financial transparency and governance. In addition, the adoption of IFRS requires companies to strengthen internal controls and audit procedures, enhance board oversight, and improve overall corporate governance. Moreover, alignment with IFRS has helped domestic listed companies open up greater access to international capital markets and attracted global investors.

3.3. Influence on Government

The convergence of CAS with IFRS has several significant implications for the Chinese government. Firstly, financial statements' improved transparency and comparability help enhance investor confidence, which would contribute to greater foreign direct investment and capital inflows, which support economic growth and development. This further contributes to greater economic stability by reducing the likelihood of financial crises triggered by unrecognized risks. Secondly, convergence leads to harmonizing accounting standards, simplifying the regulatory environment. This facilitates easier compliance enforcement and government monitoring of corporate behavior and reduces the risk of fraud and accounting malpractice. Additionally, gradual convergence with IFRS will not only enhance the global reputation of Chinese firms and build trust among international investors and trading partners but will also allow China to play a more critical role in international accounting standard-setting bodies, thereby influencing the development of global accounting standards.

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4. Challenges of China's Convergence with IFRS

While the gradual development of CAS to emulate IFRS would bring benefits to China in many ways, it has also posed challenges in many areas. These challenges range from technical and operational adjustments to broader regulatory and cultural shifts. First, the technology industry in China may face a significant knowledge gap regarding IFRS, and converting systems to comply with IFRS requires substantial investment in new accounting software and systems as well as in staff training, which increases the implementation costs for firms. Also, IFRS has specific criteria for capitalizing research and development costs. Aligning their R&D accounting practices with new standards can be complex. Secondly, it is challenging for listed companies who are used to less stringent reporting requirements, as IFRS requires more detailed disclosures. Therefore, meeting the heightened expectations of international investors for transparency or comparability puts additional pressure on them. At the same time, this has a good inhibitory effect on companies with financial fraud. Also, with compliance with IFRS, the audit of listed companies is more stringent, so some audit firms that have not been exposed to IFRS may increase compliance costs. Moreover, aligning with IFRS requires extensive changes in laws and regulations, which can be complex and politically challenging for governments. They need to balance the need for transparency with the potential for increased economic fluctuations.

5. Conclusion

In conclusion, in the context of global economic harmonization, CAS has converged with IFRS in many respects but there are still some distinctions. The differences are not only in terms of form and standard-setting mechanisms but also about content, such as the measurement of financial instruments, biological assets, or leases. Although it is a trend of the times, CAS convergence is a long and arduous task, and companies, industries and governments are facing corresponding challenges. Therefore, all sectors need to balance convergence and social challenges. It is suggested that while converging CAS, enterprises and the government can keep track of international developments, strengthen training, actively participate in international exchanges, and formulate standards in the light of national conditions. It is believed that the international convergence of CAS will be able to achieve more significant results and provide powerful endorsement for the effective and healthy development of China's economy.

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