

IFRS in China, or China in IFRS?

I was brought up on western business practices and financial reporting standards. Now I work in China and have begun to understand the differences between Chinese business and accounting culture and that of Western countries. I suggest that international standards such as IFRS may need adaptation to suit the Chinese environment, that China has a fresh perspective to bring to IFRS and that this will be not only for its own benefit but also for the benefit of all users of IFRS.

Business practices are a function of the society in which they are based and as Chinese society differs in several important ways from western society, so business practices also differ in some important ways. However, IFRS were developed in the context of western business practices and so do not always accommodate well business practices rooted in a different culture.

In general, Chinese people place more importance on personal relationships than on contract terms. This has been pointed out in numerous articles alerting westerners to the importance of ensuring that they have a real rapport and understanding with their business counterparts in China and of not assuming that a contract will always be followed to the letter. I do not contend that one way is better or worse than the other, just that they are different and that assuming that the western, contract-based model of doing business will work equally well in China can lead to misunderstanding, frustration and disappointment.

It is common to find that what happens in practice is out of line with what the contract says. Chinese management will often say that what they have agreed informally with their business partners is more important than what the contract says. In the west, the relationship provides the context but the contract determines what happens in practice. By contrast, in China, the contract provides the context but what happens in practice is determined by the relationship. While IFRS contain the notion of 'substance over form' (i.e. one should try to portray the economic substance of transactions, not just their legal form), in many details IFRS take a narrow view of legal and constructive obligations, and often cannot reflect the depth and sophistication of Chinese personal and business relationships.

A simple example would be the collection of receivables. While the contract may say that payment is due in 30 days, it is common to find amounts owing for a year or more. The debtor and creditor may well have a tacit understanding, not reflected in the contract, that payment will be made when the debtor has sufficient funds and that the creditor will not press for payment before that. IFRS require that receivables be recognised initially at fair value, which would be the discounted present value of the expected cash flows. Consequently, a debt that will only be received in a year's time is worth less than face value. Sales revenue would be the lower amount and the remaining income would be recognised as interest receivable during the following year. However, it is not usual to discount the receivable in a sales transaction, because the contract says that the debt is due in 30 days. Thus, the total amount of cash that will eventually be received is often recognised at the time of sale. The principles of IFRS (IAS 39 and IAS 18) in this case are appropriate but in practice IFRS are not easy to apply when the expected settlement date is open-ended.

Related parties are another area where IFRS do not recognise the sophistication of business relationships in China. The stated objective of IAS 24 is to:

'draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties'

In China, you would hardly consider doing business with somebody without some kind of relationship. However, these are personal relationships built on trust and a sense of honour, rather than on prescribed connections between the parties, such as share ownership, family relationships, etc. Very few of the many relationships that have a significant effect on the terms of business meet the definitions in IAS 24, so financial reporting does not draw attention to the possibility described in the objective, let alone tell you what the results might have been without that relationship.

IFRS also assume that companies enter into transactions (or series of linked transactions) so as to maximise their economic benefits from the transaction(s). The problem is that in China the advantage to a company from entering into a transaction will often come in an unspecified way at an unspecified future date. It is therefore impossible to link the costs and the benefits when accounting for a (series of) transaction(s).

For example, it is not uncommon for Chinese companies to guarantee other, 'unrelated' companies' bank borrowings, sometimes on a reciprocal basis, sometimes not. This results in the beneficiary of the guarantee being able to obtain bank financing at a lower interest rate than it otherwise could or even to obtain financing that it could not obtain without the guarantee. However, the giver of the guarantee may not be paid or receive any immediate or identifiably related benefit. Perhaps, for example, it is just that the other company will put in a good word for it when, in future, it seeks to obtain land use rights to build a new factory.

IAS 39 treats this as a financial guarantee contract, requiring the giver of the guarantee to account for the obligation at fair value. This can be a material figure and will vary over time depending on the credit-worthiness of the borrower, prevailing interest rates, etc. The giver of the guarantee will generally not be able to take account of the 'favour' it has built up for the future, because the nature of the benefit is generally so undefined that it would not meet the recognition criteria for an asset. The transaction thus has to be accounted for as a one-sided and disadvantageous one under IFRS, when in reality the company may have done itself a net favour by giving the guarantee. IFRS are not good at accounting for 'guānxi' (which literally translates as 'connections' or 'relationship' but commonly indicates a debt of honour). This can represent a huge difference between two otherwise similar companies.

China's new accounting standards, which are effective for years beginning on or after 1 January 2007, are based closely on IFRS. There are some differences, both at the detailed level and at the conceptual level. However, they import the fundamentals of IFRS largely intact.

In the past, a lot of inward investment into China was through foreign parent companies, who told their subsidiaries or joint ventures how to do financial reporting. Many Chinese companies just did what their foreign parents told them to do in terms of reporting and thus were not too concerned about what IFRS said. Now the trend is for Chinese companies to expand on their own, using foreign equity, so they are having to make their own decisions about accounting policies and methods. This gives them a much greater interest in financial reporting in general and IFRS in particular. Financial reporting matters more to them now.

Now that Chinese companies have a more direct interest in what IFRS say, I hope they will speak out when those standards make assumptions that do not hold in China or when IFRS fail to reflect the full sophistication of Chinese business practices. That way, IFRS will be improved not only for the benefit of Chinese preparers and users of financial statements but for other preparers and users worldwide.

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