

A COMPARISON OF CHINESE ACCOUNTING STANDARDS AND
INTERNATIONAL FINANCIAL REPORTING STANDARDS

by

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Submitted in partial fulfillment of the
requirements for Departmental Honors in
the Department of Accounting
Texas Christian University

Fort Worth, Texas

December 14, 2015

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INTERNATIONAL FINANCIAL REPORTING STANDARDS

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ABSTRACT

Twenty-five years ago, the Chinese accounting system was not like it is today. Globally recognized international accounting standards did not exist and, understanding there were problems with financial reporting in China, the Chinese government started issuing the first Chinese accounting standard since the 1970s. This standard was based on International Accounting Standards, the predecessor standards to International Financial Reporting Standards (IFRS). In 2005, China announced plans to converge its accounting standards with IFRS and expected all companies in China to adopt IFRS by 2011. On November 24, 2015, the Chinese Ministry of Finance and the IFRS Foundation announced the establishment of a working group to explore further the use of IFRS in China.

Keywords

Accounting Standards, Adoption of IFRS, China, Culture, Convergence, Investor, Business, Guanxi,

ACKNOWLEDGEMENTS

First, I would like to express my sincere gratitude to my advisor Dr. Walters for the continuous support of my thesis research and related research and for her patience and knowledge. Her guidance helped me with all of my research and also the writing of this thesis. I could not imagine having a better advisor and mentor for my thesis study.

Besides my advisor, I would like to thank Dr. Williams and Dr. Grau, for their insightful comments and encouragement over the course of my work on this thesis:

Finally, I want to thank you, my parents, for your support and confidence in me:

非常感谢我的父母亲对我学业上的支持。因为你们我才有机会在 TCU 完成我的本科和研究生学习，并在美国接受教育期间遇到非常好的教授和朋友。在完成这篇毕业论文的时刻，我想要再次感谢父母亲支持我出国留学的决定。

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INTRODUCTION

Accounting is called the language of business. Company accountants are responsible for preparing corporate financial statements to comply with a recognized set of “generally accepted” accounting standards (GAAP), so that these statements communicate the companies’ financial performance and position over a specific period of time. Other accountants are responsible for auditing those financial statements to ensure they comply with the relevant GAAP.

Why do we have such sets of accounting standards labelled “GAAP”? Such standards exist so that a company’s financial statements provide information that are useful to investors and creditors and other external users of the statements in making economic decisions about the company. . When cross-border investing and lending became more prevalent, accountants and others believed it was necessary to develop a single set of globally-accepted accounting standards to facilitate cross-border investment and credit decisions. Thus, over the last decade, one of the most important accounting developments was the development International Financial Reporting Standards (IFRS) (IFRS, 2011). Adoption of IFRS in 140 countries for some subset of companies in those countries, is a testament to the need for and acceptance of IFRS as the “global GAAP,” by preparers, auditors, shareholders, regulators and other investors and creditors.

One of the continuing goals of the International Accounting Standards Board (IASB) in formulating IFRS is to create a single set of high quality accounting standards that “take into account the financial reporting needs of emerging economies” (IFRS, 2011). Thus, from 2001 to 2010, countries varied in the degree and timing of their

commitment to adopt IFRS (Ramanna, 2012). Among those countries, China is the one taking a dramatic move and achieving convergence a relatively short period of time.

China is now the second largest economy in the world and increasingly plays an influential role in the global economy (World Bank, 2015). More and more foreign investors want to invest in China. At the same time, local Chinese firms look to expand their businesses both inside China and abroad. Thus, it is valuable for both preparers, auditors, investors and creditors to understand Chinese Accounting Standard (CAS). Both foreign investors and Chinese local firms need to understand CAS to gain a better understanding of their businesses. This paper focusses on CAS, during the convergence process with IFRS over the past 25 years.

On November 8, 2005, the China Accounting Standards Committee (CASC) and the IASB signed a joint statement on the convergence of CAS and IFRS (World Bank, 2015). Since that time, the CASC has worked to implement IFRS in China. However, Chinese regulators insisted that China has “unique circumstances” that preclude direct adoption of IFRS. Therefore, despite the 2005 agreement and subsequent convergence efforts, differences between CAS and IFRS remain.. This paper seeks to answer the overall question: did China really complete the convergence process with IFRS? This paper also compares the two sets of accounting standards and addresses whether the convergence process enhanced accounting quality in China, which was the primary goal of the convergence process.

“Convergence” is a dynamic process to ensure consistency of CAS with IFRS in both the letter and substance of accounting principles. Convergence is neither a “direct adoption” of IFRS nor a word-for-word translation of IFRS (Moussa, 2010). However,

convergence of accounting standards does not necessarily mean that accounting practices, application of the standards, in China have also converged with application of IFRS in other jurisdictions. Therefore, China may need additional time to achieve actual convergence with IFRS.

Previous research summarized specific differences between CAS and IFRS. However, there has been little research on whether China has fully completed the convergence process. Therefore, this paper fills this gap by testing the factors that impact accounting in China. In addition, this paper discusses the development of new standards and focuses on the impact of the new Chinese Accounting Standards by examining the different requirements in both Chinese and English.

BACKGROUND: THE PEOPLE'S REPUBLIC OF CHINA

In 1949, Chinese accounting practices were originally developed to meet the needs of the country's non-market, planned economy. These practices relied largely on practices borrowed from the Soviet Union (Ramanna, 2013). In the late 1970s, the process called "reform and opening up" led foreign investors to China. The demands of foreign investors required "a more advanced accounting system that better suited a market-based economy" (Ramanna, 2013). Subsequently, in an effort to improve financial reporting quality and to attract more foreign investment, Chinese government implemented several accounting standards reforms in 1992, 1998, 2001, and 2006 (Chen & Zhang, 2009). These reforms culminated in China mandating adoption of IFRS by all publicly-traded companies in 2007 (MOF, 2006). Chinese regulators claim that use of

IFRS reduces information acquisition costs and, therefore, increase the willingness of foreign investors to invest across borders (Tweedie, 2008).

It is not easy to reform an accounting system in a short period of time. Therefore, these rapid reforms created many issues. For example, in 1997, China implemented a guideline on debt restructuring, which required a company to recognize gains from restructured debts in net income. Thus, many companies saw the debt restructuring guideline as a way to inflate profits (Ramanna, 2013).

In addition, the skills of Chinese accountants did not keep pace with the change in the accounting system. By 2009, most accountants in large Chinese companies met the high professional standards of accountants in developed countries. However, accountants in small and medium-sized companies were less skilled (Ramanna, 2013). I discuss later in the paper how lack of understanding of IFRS among Chinese accountants is a major factor directly affecting accounting quality in China.

Although companies faced many difficulties during reform of Chinese accounting standards, China moved forward and adopted IFRS in 2005. By 2008, many of the companies listed on the major Chinese stock exchanges had begun using the new standards. It is expected that all Chinese companies would have adopted the new standards by 2011 (Ramanna, 2013).

RESEARCH QUESTIONS

This paper seeks to answer the following questions:

1. Did the convergence process with IFRS enhance the quality of accounting and financial reporting in China?
2. Has China completed the convergence process with IFRS?
3. What can we expect the future development or trend in Chinese Accounting Standards to be over the next ten (10) years?

This thesis attempts to answer these questions by first reviewing the existing literature related to this study. This paper also discusses the unique factors in China, which are the consequence of China's "relationship culture," fair value accounting, and insufficient understanding of IFRS by local Chinese accounting firms. The paper concludes with a discussion of the findings of my research and the possible answers to the research questions above.

REVIEW OF LITERATURE

China completed its accounting standards convergence process with IFRS in a very short period of time. This rapid convergence was widely viewed as a means by which the Chinese government could enhance the country's international position. In addition, this change would ensure continued economic growth. The major reason that the Chinese government supports the convergence process is that, by enhancing accounting quality, China is likely attract more foreign investors. However, convergence of accounting standards does not mean the practice of accounting in China has also converged with international practices. Factors like Chinese traditional culture, fair value measurement, and lack of professional competence means that standards convergence did not enhance the quality of financial reporting. Therefore, convergence did not lead to increased foreign investment. In fact, the amount of foreign investment has declined during the last several years.

Proposition 1: Traditional Chinese “relationship culture” hinders the convergence process, and compromises accounting quality.

The China's 5,000-year history means that the country has its own distinct culture. *Guanxi*, is a word that refers to the informal relationships that affect how business is conducted in China. Both local business people and foreign investors are aware that *Guanxi* is the key factor that affects business operations. In addition, *Guanxi* also had and continues to have a huge impact on the accounting standards convergence

process in China. Many sceptics consider national culture to be the major obstacle facing businesses seeking to enhance accounting quality (Forsberg & Ojala, 2014, p24).

Importance of *Guanxi*

People doing business in China must understand *Guanxi* to understand how to do business in China. Over thousands of years, top-down control of organizations plus the *guanxi* relationship has produced major culture shock for most foreigners. The concept of the *guanxi* relationship is an extension and derived from the close family member circle. Historically, people who lived in the same area had the same family name and shared loyalty with others who shared blood ties. To expand their influence and control, people extended this kind of relationship beyond family members.

“People who share a *Guanxi* relationship are committed to one another by an unspoken code of reciprocity and equity. Disregarding this commitment link can seriously damage one’s social reputation (Luo & Chen, 1997, p2).” Therefore, in society today, when a Chinese person considers doing business or making important decisions, he or she will first look for a *Guanxi* relationship. *Guanxi* penetrates Chinese people’s daily life and, normally, developing a *Guanxi* relationship takes lot of time, effort, and resources. The time commitment a person must make to build *Guanxi* is significantly more than that associated with “networking” in Western culture. The process of developing a strong *Guanxi* relationship is an investment. The more time and resources people put into the relationship, the more return they can receive in the future. Unfortunately, “a consequence of *Guanxi* is that personal connections and loyalties are

often more important than organizational affiliations or legal standards.” (Luo & Chen, 1997, p2) Consequently, such relationships may be more important than preparing financial statements in compliance with either CAS or IFRS and auditing those statements in accordance with internationally accepted audit standards and practices.

How is business conducted in China?

Normally, the Chinese prefer to do business with someone they know very well. Although this may not seem different from doing business in Western countries, the way the Chinese rely heavily on *Guanxi* means that, from the start of a business venture in China, foreign investors who are not part of a *Guanxi* relationship always start at a disadvantage. Because the *Guanxi* relationship exists not only between companies but also between individuals, it can take two to three years to build a *Guanxi* relationship before a foreign investor can conduct any business at all. Furthermore, the process of building and nurturing a *Guanxi* relationship does not stop when a product is sold or a service completed. It is an ongoing process which lasts forever if people want to remain in the same industry and continue to conduct business.

There are many ways that people can build *Guanxi* relationship, For example, it is common for an individuals from an organization to bring gifts to people from another organization. The key strategy for building a strong *Guanxi* relationship is to visit people frequently and show trustworthiness.

In addition, companies in China cannot succeed without the support of the Chinese government. Therefore, companies must maintain relationships with government

officials which require frequent visits to strengthen the *Guanxi* relationship. The better people know each other; the better the *Guanxi* relationship.

Showing trustworthiness is another key strategy to gain *Guanxi* relationships. If the person or company promised to do something within a certain time, they must deliver on that promise on time, if not earlier than promised.. . In reality, *Guanxi* relationship is a kind of friendship, which normally lasts a lifetime.

***Guanxi* relationships enhance companies' performance**

As described previously, *Guanxi* is a powerful and important business tool in China. Luo and Chen's research demonstrates that *Guanxi* does enhance firm performance and concludes that *Guanxi-based* business positively relates to a firm's accounting and performance. Strong *Guanxi* relationships benefit companies in many ways. For example, a company cannot pay a debt obligation when due to another company. Both companies are part of a strong *Guanxi* Network, which serves as a credit system, which is popular in Western countries. In this case, since the two companies have a strong relationship, the debtor company can extend its due date and have extra time to repay the money, therefore, the debtor company can grow as usual without worrying about the debt. Similarly, when companies try to borrowing money in China, those that have a strong *Guanxi* network can borrow money easily compared with companies without such a *Guanxi* relationship. According to Luo and Chen, *Guanxi* affects almost all aspects of business, including marketing, pricing, and advertising. "Business determinants that were highly involved with *guanxi*" will enhance companies' performance (Luo & Chen, 1997).

How does *Guanxi* inhibits convergence of CAS and IFRS?

Guanxi is a double-edged sword. Although *Guanxi* enhances a company's performance, it slows down convergence of CAS and IFRS. According to Cieslewicz's research, as long as the influence of national culture remains strong, accounting standards will not become uniform.

Proposition 2: Difficulties with fair value measurement in China.

IFRS were initially created for use in the developed countries. . Much of the literature discusses whether companies in developing countries can apply IFRS effectively. In addition to the unique aspects of Chinese culture affecting business already addressed, another factor that leads to incompleteness in the accounting standards convergence process is the increasing use of fair value measurements in IFRS.

What is Fair Value Measurement?

In 2006, China introduced the new accounting standards which highlight fair value accounting (Wang & Hu, 2007). Fair Value measurement means asset and liabilities are valued in accordance with the price to be received or paid in the market on the measurement date (Deloitte, 2013). IFRS requires fair value measurements because the historical cost measurement does not effectively reflect financial position or performance of a company. Thus, use of fair value helps ensure that corporations' consolidated financial statements reflect "real" values.

According to Yang (2013), within the New PRC GAAP, twenty-five out of thirty-eight of the standards “require or allow the direct or indirect use of fair value.” In addition, within those twenty-five standards, seventeen require the use of fair value in the initial measurement of assets and liabilities, eight requires its use in subsequent measurement of assets and liabilities, eleven require it in asset impairment testing, and seventeen require it in other uses such as disclosure of fair value in accounting measurements and financial reporting, and allocation of lump-sum cost based on the fair values of acquired assets” (Yang, 2013). The New Chinese Accounting Standards highlight the adoption of the IFRS fair value method.

Why fair value is one of the obstacles to convergence of CAS and IFRS?

One of the major issues in implementation of the fair value method in China is that “IFRS’s principles-based standards and greater use of fair value accounting provide opportunities for Chinese managers to misreport under IFRS” (He et al, 2012 [usc]).

Willison states that:

The fair value method consists of a three level hierarchy into where assets can be put, and choice of level depends on whether there is an observable price in the market for the asset in question. Those assets that have this are measured in level 1. If assets do not have a quoted price, level 2 applies, which means their valuation can be based on similar market can be found (level 3) the management’s own assumptions and expectations is used for valuation The third level gives the corporations’ management team a chance to manipulation the rise with fair value.

The second obstacles in application to the fair value in accounting standards and accounting system is an insufficient understanding of fair value methods. Table 1 lists the articles that have been published in Chinese journals on this issue.

YEAR	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total	Percentage Increase
All Journals	2	6	9	12	23	33	44	38	51	218	49.91%
Core Journals	1	5	5	7	12	15	19	17	18	99	43.52%
CSSCI Source*	1	1	2	2	2	2	6	5	7	28	27.54%
Major Journals	1	0	2	2	0	0	1	2	2	10	9.05%

*CSSCI is the major library catalog system in China

Source of Table 1: <http://www.cqvip.com/read/read.aspx?id=23137944>

Since 1998, the number of published articles about fair value measurement increased dramatically. This indicates that fair value measurement has become one of the hot topics in accounting in China. However, the number of articles decreases when the quality of the journal increases. The maximum number of published articles in Major Journals is two, with no articles published in 2001 and 2002, showing that China did insufficient research of adoption of IFRS's fair value measurement requirement. Consequently, Chinese accountants understanding of the fair value method was not sufficient and fair value measurement is a major problem for IFRS implementation in China.

The third drawback mentioned by Wallison (2008) is that fair value measurement will create "financial instability and asset bubbles and puts ... [fair value measurement] as one of the core parts of the latest financial crisis in 2008." In addition, according to Ramanna (2012), a large number of Chinese regulators believe that, because fair values "played only a minimal role," China avoided serious losses during the financial crisis in

2008. Wallison (2008) explains how use of fair value measurement can result in the valuation of assets below their real values: “Many of these assets generated cash flows, which were not taken into account by fair value measurements whilst the falling market prices made them lose value to an unreasonable low point” (Wallison, 2008). Thus, Wallison concludes that implementation of fair value measurements underestimate the assets’ value, which do not reflect discounted cash flows.

The final issue is application of fair value measurement requirements. The unique circumstances in China actually reduce the benefits of implementing these requirements. One of the major issues is the evaluation of fair value measurements by a third party, especially for assets in illiquid markets (Pamanna, 2013, p7). The local Chinese accounting firms do not have the knowledge or ability to prepare these evaluation reports, and the *Guanxi* relationship mentioned above impacts implementation of fair value measurements. Peng and Bewley (2010) point out that the Fair Value measurement requirements should be implemented in a well-functioning capital market and financial reporting environment. Therefore, because the *Guanxi* relationship is more important than rules or standards, the resulting complexity of the Chinese economic and political system may lead to a failure to appropriately implement IFRS fair value measurement requirements.

Some skeptics also argue about whether IFRS should completely eliminate historical cost measurements. Although fair value measurements enhance the relevance and quality of the financial statements, Penman (2013) claims that the historical cost data is provides important information that investors should consider. In addition, fair value

measurements enhance the quality of the balance sheet by providing information that reflects the company's financial position.

Proposition 3: Insufficient qualified accounting professionals.

China is one of the largest countries in the world, to grow its economy, China needs well-qualified accountants According to Wild (2005), "China has been aware of its need to train more accountants for almost a decade. A strategy was put in place by former president Jiang Zemin with the baton taken up by his former premier Zhu Rongji, who opened the China National Accounting Institute in 2001." The premier identified a need for 300,000 accountants, but progress toward the goal has been very slow (Wild, 2005).

Why does China need so many accountants?

The Chinese realize that if they want the economy to continue to grow, China needs not only globally-acceptable accounting standards, IFRS, but also a world-class accountancy profession. . Otherwise, audit failures and fraudulent financial data will damage its reputation with investors.

Countries who have adopted IFRS either adopt IFRS in its entirety or modify their own standards by convergence with IFRS. Countries like Australia, New Zealand, Hong Kong-China choose to directly adopt IFRS in its entirety, without modification. China did not want to follow the lead of any particular country because of China's unique economic and cultural circumstances. At the same time, China did not have an existing set of accounting standards. In fact, the Chinese government only issued its first accounting standard in 1997.

According to Wild (2005), the Chinese government required all “listed companies that sell shares to foreign investors...to prepare accounts in accordance with Chinese GAAP and international standards [and all] financial institutions to publish IFRS compliant accounts as well.” According to Deloitte, the establishment of new accounting standards is not something that can be done overnight. However, many companies used the initial public offering (IPO) process to make a quick change to meet the new accounting standards. Since an IPO requires a lot of work to improve companies’ accounting standards, companies also need more professional accountants to do the work. Wild (2005) estimated that China has a “shortfall is 300,000 accountants – widen that to finance departments in general and some say the number is nearer to three million.”

Another problem is that Chinese accounting professionals are not fluent in the English language. An Ernst & Young partner in Beijing (2005) noted that his firm uses secondments to offer its Chinese accountants overseas experience with the hope that they return to China with better language and accounting skills. However, speaking both English and Mandarin effectively became a prerequisite for acceptance into these training programs, which is one reason the supply of qualified accounting professionals is still low. The skills gap also exists in both financial services and tax as well as audit. Although both the Chinese government and the companies themselves care about catching up with the global accounting system and international financial reporting standards, it will take a long time and a lot of training for China to develop a sufficient supply of well-qualified accounting professionals.

Insufficient supply due to the higher education system

In order to find the reason why the supply of accountants is much lower than the demand of it, many researchers point out that the main problem is related to the Chinese university system.

Table 2 below identifies the problems of accounting education in China:

Issue	Percentage
Rigid Education	41.20%
Low Practical Skills	16.47%
Irresponsibility	15.74%
Weak Research Ability	13.46%
Insufficient Knowledgeability	13.11%

Source of Table 2: <http://www.cqvip.com/read/read.aspx?id=23137944>

Educators have little experience working as professional accountants

Many accounting professors and instructors in China do not have real working experience and start teaching immediately after they graduate from university. These professors and instructors are familiar with the accounting theories in the textbook; but they cannot provide students with the practical instruction. Table 2 above shows the survey results from the top ranking universities in China. Within the student sample, almost 50% of students are extremely dissatisfied with the rigid education style of their professor and instructors.

Like many of their professors and instructors in business school, most students do not receive internships or other opportunities to practice their accounting skills before they enter the workplace. Due to the unique culture and economic environment in China, many of the corporations are not willing to offer internship opportunities to graduated

students. The table below is a summary of the sources where the students get their internship offers:

Table 3: Internship in China	
Opportunities	Percentage
Mock Internship	21.26%
Arrangements by Institution	32.19%
GuanXi	34.08%
Others	12.48%

Table 3: <http://www.cqvip.com/read/read.aspx?id=23137944>

From the table we can see, within the sample group of students who get internship offers, only 32.19% of them are arranged by institutions. Thirty-four percent of them are using Guanxi relationship, normally from their family. Students who do not have strong Guanxi relationship are at the disadvantage point, no matter how high their GPA. Despite that, getting an internship is very hard, the experiences of internship may not as perfect as students expected. In China, the internship time normally ranges from 30 to 60 days, which is not long enough for graduated students to practice their accounting skills. Thus, there is a huge reason that Chinese university system can be improve.

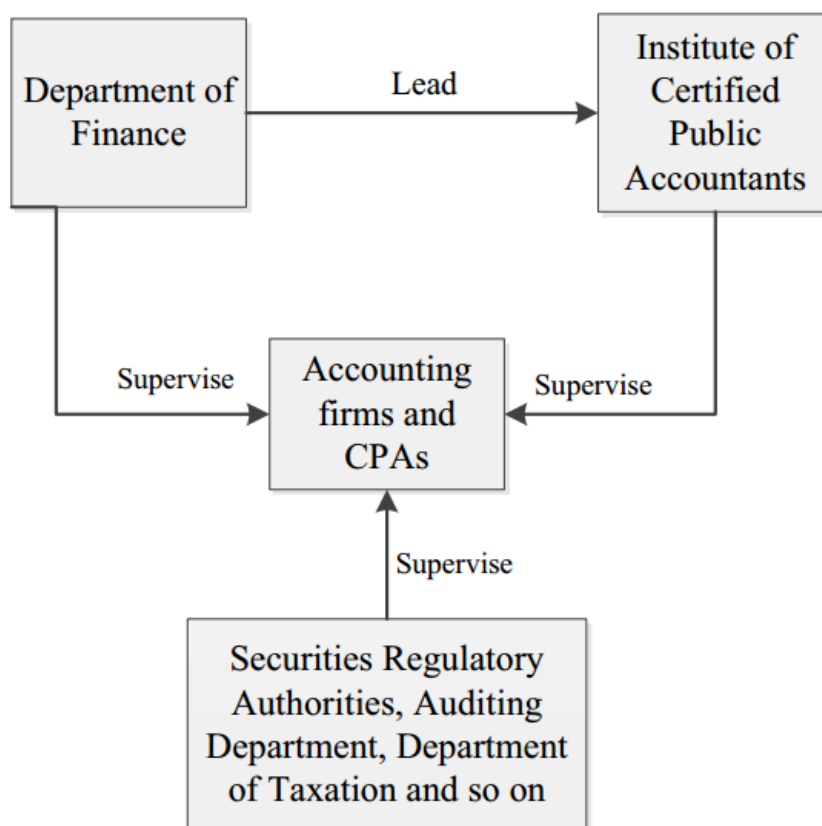
Lack of professional ethics issues of CPA and discouraged whistle-blowers.

According to Zhang & Liu (2015), “more and more auditing collusion cases have occurred frequently, reducing the integrity degree of CPAs in China.” The CPA industry is also facing a confidence problem in China. Although CICPA (The Chinese Institute of Certified Public Accountants) issued the code of professional ethics for CPAs on July 1, 2010, the fraud cases are still happening. Zhang & Liu (2015) claim that the reason that the code is ineffective is because that the code was based on overseas experiences. Thus,

due to China unique circumstance, the code of professional ethics for CPAs weren't suited to China.

Incomplete supervision and lack of consequences for professional misconduct

The second reason for why accountants lack professional ethics is that there is inadequate supervision and few, if any, consequences of professional misconduct. The following flowchart summarizes the accounting regulatory system in China:



Source: http://www.shs.org/articles/shsconf/pdf/2015/04/shsconf_icmetm2015_02007.pdf

The supervision system does not function well because the limits of power is unclear and functions overlap. Overall, this system results in poor supervision of accountants. In addition, “punishments to professional ethics are light. Punishments are

mainly administrative [and] compared with [the] benefits from auditing frauds, the costs are very low” (Zhang & Liu, 2005). Thus, the code of professional ethics is ignored by CPAs and fraud cases are discovered all the time.

Other factors that affect accountants’ professional behavior is there are no whistle-blowers. In fact, whistle-blowers are actively discouraged in China, which means accountants owe loyalty to the company. In addition, “in China, the proportion that [the] chairman and president is the same person is very high. The phenomenon damaged internal control system seriously” (Zhang & Liu, 2015). Thus, the lack of an internal control system is another problem that occurs in most Chinese corporations. Therefore, it is not surprising that it will take some time to fix the Chinese accounting system.

Conclusion

China, a developing and transitional economy, adopted IFRS in a very short period of time. Although the rapid development of new accounting standards improved the quality of financial reporting in China, the process of convergence of accounting standards does not mean that accounting practices also changed. Traditional Chinese culture has a huge impact on implementation of new accounting standards and this culture did not change, and cannot change, in such a short time period.

IFRS was designed for use in developed countries with mature capital markets. Although China has experienced remarkable economic growth since adopting IFRS, it does not have a liquid and efficient market to support the fair value measurements required in many IFRSs. Furthermore, insufficient understanding of IFRS within Chinese

local firms and lack of qualified and experienced accounting professionals are major factors affecting the overall convergence process.

Is the convergence process enhance the accounting quality in China?

Most of the existing literature claims there have been many obstacles to full implementation of IFRS, which still exist today, including implementation of fair value measurements. However, according to Forsberg & Ojala's research, adoption of fair value measurement is the main factor that has affected accounting quality in China. If the fair value method were used correctly, it would increase the value relevance of accounting information. The majority of survey respondents believe that the consequence of using fair value measurement will be positive if China implements it carefully (Forsberg & Ojala, 2007).

Did China really complete the convergence process with IFRS?

“Convergence” is a dynamic process to create consistency of CAS with IFRS, both in principle and in substance. The concept of convergence does not mean either a “direct adoption” of IFRS or a word-for-word translation of IFRS into Chinese. Therefore, China actually needs more time to achieve true convergence of CAS with IFRS, especially due to China's unique market conditions and traditional culture.

What will the future development or trend of Chinese Accounting Standards be over the next ten years?

On November 24, 2015, “the Chinese Ministry of Finance [MOF] announced the formation of a joint working group to explore ways and steps to advance the use of IFRS Standards within China, especially for internationally oriented Chinese companies. The 2015 Joint Statement:

- establishes a joint working group to explore steps and ways to advance the use of IFRS within China, especially for internationally oriented Chinese companies;
- identifies the vision of Chinese Accounting Standards to become fully converged with IFRS Standards, consistent with the G20-endorsed objective of a single set of high quality, global accounting standards; and
- encourages continued co-operation between the IASB and Chinese stakeholders in the future development of IFRS Standards.” (IFRS Foundation press release)

The accounting standard convergence process is essential for China. Mr. Liu Yu Ting, the former head of the MOF’s Accounting Regulatory Department, has emphasized that the New PRC GAAP’s convergence with IFRS is not a “direct adoption”, but is intended to achieve a consistency between the accounting principles and substance of New PRC GAPP and those of IFRS, with due consideration of China’s political, economic and legal environments.

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