

CONVERGENCE OF ACCOUNTING STANDARDS: NEW
PRC GAAP AND ITS IMPACT ON FINANCIAL
REPORTING QUALITY IN THE PEOPLE'S
REPUBLIC OF CHINA

by

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INTRODUCTION

In response to globalization in today's economy, accounting professionals from all over the world have worked diligently over the decades to develop a worldwide common accounting language. The International Financial Reporting Standards (IFRS) was therefore born under such efforts. Today, IFRS are widely used in many parts of the world. As of August 2008, more than 113 countries around the world, including all of Europe, require or permit IFRS reporting and 85 require IFRS reporting for all domestic, listed companies (U.S. Securities and Exchange Commission, 2008).

The Chinese government has also been actively engaged in the process of converging the Chinese accounting standards with IFRS. On February 15, 2006, the Chinese Ministry of Finance announced the introduction of the new Chinese accounting standards for business enterprises, to be effective on January 1, 2007. The new accounting standards are collectively known as the New PRC GAAP, which consists of one Basic Standard and thirty-eight special treatments for specific issues. The China Accounting Standards Committee (CASC), while developing the New PRC GAAP, involved the International Accounting Standards Board (IASB) in confirming the extent to which New PRC GAAP converged with IFRS. And the joint statement by CASC and IASB issued on November 8 2005 stated that New PRC GAAP had achieved convergence with International Financial Reporting Standards (KPMG, 2011). (See table 1 for a complete list of the New PRC GAAP and corresponding IFRS). "Although not fully complying with International Financial Reporting Standards (IFRS), the new Chinese Accounting Standards nonetheless

adopt the same principles contained in IFRS and are therefore considered to be substantially converged with IFRS” (The Institute of Chartered Accountants in Scotland).

IFRS are widely regarded as an accounting system that is intended to provide “a high degree of transparency and comparability of financial statements and hence an efficient functioning of the community capital market and of the internal market” (European Communities, 2002). The convergence in the accounting standards in China represents a big leap from the traditional accounting system. Specifically, the New PRC GAAP is different from the old PRC GAAP in that it is more principal-based rather than rule-based; it has a greater use of fair value measurement; and it contains significantly more disclosure requirements. The new PRC GAAP represents the tremendous efforts from the government to improve the overall accounting and financial reporting quality in China.

However, there have been concerns that the convergence of accounting standards does not necessarily mean the convergence of accounting practices. Such convergence of accounting standards might not have achieved its intended objective of increased comparability and transparency. In December 2012, the Securities and Exchange Commission (SEC) took aim at the Chinese affiliates of the Big Four accounting firms and accused them of not handing over documents needed for investigations of alleged frauds at some Chinese companies. The SEC maintains that firms that audit U.S.-traded companies must adhere to U.S. regulatory standards and the Sarbanes-Oxley Act requires foreign audit firms to provide documents upon the

SEC's request. Whether Chinese affiliates can continue to audit U.S.-traded companies depends on how the administrative law judge rules, but accounting malpractices can occur even with the improved accounting standards.

This paper seeks to answer the overall question: does the convergence of Chinese accounting standards with IFRS improve the quality of financial reporting? This paper examines IFRS and the China GAAP (referred to as the New PRC GAAP in this paper), aims to compare the two sets of standards, and discusses how issues specific to China might impact the quality of financial reporting in China. I will use China Eastern Airlines as an example to explore those questions and attempt to build theories based on my findings and existing literature.

China Eastern Airlines (CEA) is a major Chinese airline operating in international, domestic, and regional routes. It is China's second largest airline by passenger number and the world's third largest airline by market value. China Eastern Airline Corp. Ltd is listed on Shanghai Stock Exchange, Hong Kong Stock Exchange, and New York Stock Exchange. CEA represents a good case here because the company is listed on multiple stock exchanges in different countries that follow different reporting framework. The company prepares financial statements each year under the New PRC GAAP, IFRS, and also files Form 20-F and Form 6-K with the SEC. I will include a discussion of the company's reconciliation from New PRC GAAP to IFRS.

RESEARCH QUESTION

On September 29, 1997, then the Chairman of the U.S. SEC, Mr. Arthur Levitt, gave a speech in Washington D.C about the importance of high quality accounting standards. He pointed out that in order for international accounting standards to gain acceptance, the standards must: 1) include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting; 2) they must result in comparability and transparency, and they must provide full disclosure. Investors must be able to meaningfully analyze performance across time periods and among companies; 3) the standards must be rigorously interpreted and applied. Otherwise, the comparability and transparency, which are the objectives of common standards, will be eroded (Levitt). In this paper, I seek to analyze how the convergence of accounting standards in China addresses the issues mentioned above. Specifically, how do the characteristics unique to the Chinese society affect the quality of financial reporting? What are the major differences between the New PRC GAAP and IFRS? The use of fair value accounting is controversial in the accounting academia. How does the broader use of fair value accounting in the new standards impact the quality of financial reporting?

The issue of financial reporting quality is relevant to many parties both inside of China and in the global arena. It is especially relevant to the following three groups of people:

The first group includes business owners and entrepreneurs seeking expansion opportunities in the Chinese market. Globalization is not a new phenomenon; rather, it

is a sign that marks the business landscape today. Globalization affects the economic, social, political and environmental aspects of our everyday lives. “The current wave of globalization is unmatched due to the involvement of a large geographical area, the complexity and different level of communication, relation, and the participation of many nations among the developing countries” (Buang, Lim and Samimi, 2011). As a result of globalization and international collaboration, more and more companies in the United States are establishing close ties with China - one of the fastest growing economies. Many American companies opened their franchises in China. American brand names quickly diffused the Chinese market, and some brands have already become the icon for fashion leaders and technology gurus, and ardently pursued by the new generation of Chinese people. When companies analyze a market with expansion opportunities, they might analyze their potential competitors’ financial statements to gain market information. Companies can hardly get valuable information if the quality of financial reporting is poor.

The second group includes foreign investors investing in stocks issued by Chinese companies and traded in the foreign stock exchanges. Because of the many benefits associated with cross listing, a lot of companies choose to attract foreign capital by trading their shares in foreign stock exchanges. In 2007 alone, thirty-one Chinese companies completed U.S. listings, about twice as many as 2005 and 2006 combined.

Listing shares in foreign exchanges is becoming a more popular venue for companies to attract capital. Some advantages associated with listing overseas include,

first of all, improved liquidity. Listing on a more liquid market can potentially increase a stock's liquidity. From another perspective, trading in different time zones and currencies provides companies more liquidity. Cross listing could also attract a broader audience and thus increase the company's ability to raise capital. Listing overseas strengthens investor protection as well. Registration on a U.S. exchange acts as a mechanism that voluntarily commits the firm to a higher standard of corporate governance and investor protection, as exemplified by the Sarbanes-Oxley Act of 2002.

When making investment decisions, individual investors or portfolio managers are likely to perform financial statements analysis in order to gain relevant information about the company's profitability, operating conditions, liquidity, debt structure, etc. Investors need high quality information from the financial statements in order to conduct high quality analysis for their investment decisions.

The third group is domestic investors in China. Because of the unique equity markets structure in China (see table 2), companies that issue A-shares prepare their financial statements following the Chinese GAAP and companies that issue B-shares follow IFRS. If the convergence of Chinese accounting standards with IFRS means improved financial reporting quality, the convergence will no doubt increase A-share investor confidence.

Overall, the quality of financial reporting is critical to numerous people around the world. By investigating issues I have identified earlier, I hope to provide an insight into the Chinese accounting system and address how convergence might have

affected financial reporting quality. I hope that interested parties, such as entrepreneurs and investors, can benefit from the analysis.

ANALYSIS

Two decades ago, China was essentially a closed, command economy. Standard accounting practices and internal controls were almost nonexistent. Professional practices that are highly applauded today, such as whistleblowing, were in fact discouraged. Many accounting professionals who transferred from the United States to China experienced significant frustration with Chinese firms who still employed outdated and simple accounting software, which lowered efficiency and exposed serious risks to the business itself and accuracy and faithfulness of financial reporting.

This is especially true because China is now at this critical phase where the economy is quickly transforming from a closed command government-controlled market to a more open socialist market. The huge market is now open to investors from all over the world. At the point of transition, the Chinese society has some unique features that not every society will have. According to Li (2006) from China Ministry of Finance, the New PRC GAAP “suits the development process of market economy in China.”

Proposition 1: The unique social/business environment in China hinders the improvement of accounting information quality although the Chinese accounting standards are converging with international accounting standards.

When a business expands to a new country, certain changes are expected. We, as the consumers in the market, are often familiar with some obvious changes. For example, McDonalds changes its menu for their foreign restaurants and the first all

vegetarian McDonalds is about to debut in north India in 2013. Clothing companies alter their sizing to fit the different body types of people in different regions. More subtle changes, such as how people conduct businesses in different countries, are more difficult to adapt to. Subtle changes in corporate culture are necessary and might affect the success of the company's operations in certain countries.

There has also been concern that “the convergence of accounting standards may not lead to the convergence of accounting practices if the firms do not comply with the standards” (Chen & Zhang, 2010). Researchers have also shown that the “institutional differences in infrastructure, culture, legal requirements, and socio-economic and political system may lead to non-comparable accounting figures despite similar accounting standards” (Chen & Zhang, 2010). The concern is especially significant in emerging economies because they may not have a regulatory enforcement system that facilitates quality financial reporting. Chen, Sun, and Wang (2002) have suggested that the lack of an effective financial reporting infrastructure, especially regulatory enforcement in China, may result in the gap between standards and practices.

Corruption is common in China. Guanxi (Li, J. & Wright, 2000), or relationship building, is the core of the problem. In addition, the business landscape has been characterized by documented cases of corruption, poor planning, little regard for shareholder rights, and even market manipulation (Tam, 2002, Chandler, 2004). Specifically, companies spend large amount of money to entertain potential clients. Some companies even bribe government officials to win bids. The utilization of

Guanxi is so pervasive in businesses that companies that do not use it are at disadvantage. Guanxi can be utilized to further one's position and get work done faster. It might lead to the release of private information, expedited work, and even faster debt collection (Barnathan, et al, 1996). A study has indicated that guanxi in China can add anywhere from 3- 5% to business costs (Oriental Daily News, 1993). The upside benefits are hard to quantify.

The problems with these business practices are two-fold. First of all, many countries enacted strict laws to forbid such behaviors. For example, the Sarbanes-Oxley Act of 2002 is enacted to improve corporate governance and financial reporting quality, and managers of public companies are required to design and report on the company's internal controls. However, there are no such forceful rules put in place by the Chinese government to curb such behaviors. Second, these practices in China create difficulties for documenting the costs and potential benefits associated with these behaviors. If a salesperson uses his company's money to bribe the manager at another company to increase his personal sales, these costs might be ignored, erroneously expensed, or buried in inappropriate accounts.

Nowadays, the overall accounting environment in China is still lagging but slowly improving. The business practices unique to the Chinese society are likely to erode the quality of accounting information and damage financial reporting faithfulness.

Until 2009, there was no empirical research investigating the relationship between regulatory enforcement and converging accounting practices. In 2009, Chen and Zhang (2010) filled the gap by testing the following hypothesis:

“The convergence of the accounting practices of Chinese listed firms with IFRS significantly improves with the issuance of CSRC 2001 policy.”

The CSRC 2001 policy that Chen and Zhang mentioned is a policy implemented by China Securities Regulatory Commission (CSRC) in 2001 that prohibits companies from using different accounting estimates for their Chinese GAAP based reports and IFRS based reports. This is considered to be the most influential regulatory enforcement policy issued by the Chinese government. Chen and Zhang supported the hypothesis based on univariate tests that separate financial statement line-items into three categories and they examined the fluctuations across categories before- and after- the implementation of the CSRC 2001 policy. The results showed that it is the firm’s application of the standards that resulted in reduction of earnings rather than the differences in the standards themselves. “The CSRC policy should largely be responsible for this reduction” (Chen & Zhang, 2010). This result suggests that the regulatory environment and compliance play a vital role in helping the government achieve the level of quality reporting it wishes to achieve.

Nowadays, the Chinese regulatory agencies have already been working to create an environment compatible with IFRS. The issuance of the policy mentioned above is one example. In the past, independence is often compromised in China. The rules and ethical guidance for independent auditors are less stringent as well. Establishing a

responsible audit committee and imposing more strict supervision on external auditors would increase investor confidence. Overall, converging with IFRS has started to affect the culture, ethics, and compliance in the workplace, especially in the accounting profession, and will continue to do so.

Proposition 2: a number of the financial statement items are unique reflections of the Chinese society. The differences between the New PRC GAAP and IFRS associated with those items cannot be eliminated in the short-run.

As mentioned earlier, the Chinese government has undergone a series of reforms that aimed to transform the once government controlled economy into a more open market economy. What is distinctive about the reform is that “it is the result of a process of administrative transformation run by the State, starting from economic reforms of the late 1970s. This was not the autonomous development of market forces, neither the invisible nor the visible hand; this was not the result of the collapse of the State, as it was the case in several East Europe socialist countries and the USSR. Through the internal process of changes in thirty years, the Chinese leadership has been able to move from a centrally planned economy to the second world economy” (Xue and Zan, 2011).

When the People’s Republic of China was founded in 1949, under the political influence of Soviet Union, the government set up a planned economy. As the government restructured the economy, a lot of state-owned enterprises were privatized. But even till today, a large proportion of the Chinese economy still comes from state-owned enterprises. These enterprises are backed by the government and

has certain unique features. For example, state-owned enterprises offer strong employee security. The older generation of Chinese workers used to say, “Once you get into a state-owned enterprise, you no longer need to worry about your job for the rest of your life.” This is called the “Iron Rice Bowl” phenomenon. Also, promotions were not awarded based on performance but rather on seniority only.

These characteristics associated with the Chinese government and economy sometimes represent inefficiency and affect the accounting environment in many ways. Some accounting rules and standards were set to cater to the unique situations mentioned above. A few cases are presented here:

One instance would be the accounting for land. In China, land is ultimately owned by the State or by collectives (the latter pertains to rural areas only). Private parties can gain the right to use the land through leasing but they can never own the land. “Although the state still owns all the land in the cities, public land is now leased to private parties by the city governments under relevant laws on leasing and using urban land, especially the 1991 ‘Provisional Regulation on Granting and Transferring of Use Rights of Urban State-Owned Land’. The leasing periods of urban land are fixed at 40 years for commercial use, 70 years for residential use, and 50 years for industrial use” (Wang, 2007). Therefore, the accounting for land use in China is different from that in many other countries. For example, for companies following the U.S. GAAP, land is recorded as a fixed asset and is not depreciated. However, under the New PRC GAAP, land use rights are normally classified as intangible assets and not operating leases. Land use rights can also be classified as investment property

using the cost model or the fair value model. Where the land use rights meet the criteria to be accounted for as an investment property, the accounting is not restricted to the fair value model as in IAS 40. The cost model may be used. Investment properties are either accounted for as fixed assets or other long-term assets (Deloitte, 2006).

In both situations, land use rights are subject to depreciation or amortization. Land use rights recorded as intangible assets should be amortized to “reflect the pattern in which the asset’s future economic benefits are expected to be consumed” (Deloitte). Land use rights accounted for as fixed assets are subject to depreciation as well.

IFRS has different rules regarding the accounting for land use rights. Under IAS 17, leasehold interest in land shall be classified as an operating lease unless it meets certain criteria and is accounted for as an investment property. For operating leases, the lease payments should be recognized as an expense in the income statement over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern of the user's benefit (IAS 17.33).

China Eastern Airlines’ financial statements prepared under IFRS included a limited reconciliation from the New PRC to IFRS (see table 3). A significant difference with material effect to the net profits is “reversal of additional amortization due to the revaluation surplus relating to land use rights” for RMB 8,420,000 for the year of 2011. The effect to the net assets is RMB (343,769,000) under “reversal of revaluation surplus relating to land use rights.” In the note explaining the difference,

the company stated that “Under the PRC Accounting Standards, land use rights injected by the parent company as capital contribution are stated at valuation less accumulated amortisation. Under IFRS, land use rights are recorded as prepaid operating leases at historical cost which was nil at the time of listing” (CEA, 2011).

The term of rights to use State land is forty years for business purposes under current laws. While specific rules might change over time, the basic fact that the land is owned by the State is unlikely to change in the short-run. The differences between the New PRC GAAP and IFRS in this regard will not be eliminated in the short term.

Another significant difference attributed to the unique environment of the Chinese society is the accounting for defined benefit plans. China lacks an effective employee retirement system that protects the old when they retire, so the accounting rules and regulations associated with the retirement system is still somewhat lagging in comparison with the international standards.

During the days of China’s planned economy, most workers enjoyed a cradle-to-grave social protection. “Wages were low, but the state-owned enterprises guaranteed lifetime employment along with social benefits, including pensions, health care, and housing” (Jackson, Nakashima & Howe, 2009). In the early 1990s, the government started to lay the foundation of a more modern pension system. In 1997, “it initiated a transition from the original pay-as-you-go plan to a two-tiered system consisted of a scaled-back pay-as-you-go benefit and a personal retirement account” (Jackson, Nakashima & Howe, 2009).

They system aims to provide a decent level of protection to the old while maintaining an appropriate burden on the young. However, Jackson et al. (2009) pointed out that the basic pension system in China suffers from serious structural problems that hinder the government from achieving its goals. A few weaknesses that Jackson noticed include high payroll contribution rates, which encourage evasion and make coverage expansion difficult. Contributions to the personal account tier of the system were often diverted to the pay-as-you-go tier, leaving accounts largely unfunded.

Because of all the problems associated with the retirement system, we could conclude that the retirement system in China is largely flawed. In the New PRC GAAP, ASBE 9 addresses employee benefits. ASBE 9 requires an enterprise to “recognize a liability in the period the services are provided at the amount of employee benefits payable for that service. Under current PRC GAAP, a liability is only recognised for salaries, bonuses, allowances and subsidies, staff welfare, union running costs and employee education costs. Other employee benefits are expensed when they are paid” (Deloitte, 2006). ASBE 9 does not address the accounting requirements for defined benefit plans. Under IFRS, IAS 19 requires “the recognition of a defined benefit liability and an expense through the expected service period of the related employees” (Deloitte, 2006).

As of December 31, 2011, China Eastern Airlines recognized a liability of employee benefits totaling RMB 3,047,095,000. This amount captured the unpaid salaries and bonuses, social welfare (including all kinds of insurance premiums), staff

housing benefits, union costs and employee education costs. Nothing about defined benefit plans was included. In the reconciliation that China Eastern Airlines prepared for the year 2011, an adjustment caused by the accounting difference mentioned above is recorded as “provision for post retirement benefits.” The effect to the net profits is a RMB 326,145,000 deduction to the net profits and a RMB 2,943,428,000 deduction to the net assets.

While a retirement reform will be instrumental in ensuring social stability and fostering a healthy economic growth environment in China, the change is not immediate and the problems in the current retirement system will stay unsolved for a while. We will probably see the differences in accounting for post-retirement benefits between the New PRC GAAP and IFRS until China establishes a more complete retirement system.

Besides these differences, other differences between the New PRC GAAP and IFRS do exist. Accounting professionals and interested parties should be aware of the differences. Some of the major differences are listed below (KPMG, 2011):

On the financial statements level, IFRS allows enterprises to prepare either a single statement of comprehensive income or an income statement followed by a statement of comprehensive income, the New PRC GAAP allows only the single statement approach. Also, the new PRC GAAP contains more rules and requirements regarding the items that must be presented on the financial statements and their format. The start of a fiscal year has to be January 1 under the New PRC GAAP. Under the New PRC GAAP, only the direct method is allowed to present the cash flow from

operating activities, while IFRS allows both the direct and indirect methods. IFRS allows companies to classify their expenses based on either the nature or the function of the expense; the New PRC GAAP only allows enterprises to classify their expenses based on their function.

Regarding business combinations, the New PRC GAAP contains specific rules relating to business combinations involving enterprises under common control; however, IFRS only provides such definitions to scope out such situations. Business combinations not involving enterprises under common control should be accounted for using the acquisition method under IFRS; the New PRC GAAP treatment is similar but lacks certain guidance.

On the balance sheet, intangible assets should only be accounted for using the cost model under the New PRC GAAP; however, an enterprise under IFRS could choose to use either the cost model or the revaluation model. IFRS allows companies to reverse impairment losses recognized in prior periods for an asset other than goodwill. The New PRC GAAP forbids the reversal of impairment losses once it has been recognized. Under the New PRC GAAP, non-controlling interest should always be recognized at the minority shareholders' proportionate interest in the acquiree's net identifiable assets. Under IFRS, fair value is allowed in the event of liquidation.

On the income statement, under IFRS, an enterprise is allowed to recognize government grants relating to assets using either the deferred income method, in which profit or loss is recognized on a systematic basis over the useful life of the asset,

or deduction method, in which the grant is deducted in arriving at the carrying amount of the asset.

Proposition 3: the New PRC GAAP's moving towards fair value accounting aims to improve the accounting information quality, but the circumstances in China might present difficulties in fulfilling the goal.

As the Chinese GAAP move towards convergence with IFRS, the New PRC GAAP made significant changes to the old Chinese GAAP. One significant leap is the switch from historical cost accounting to fair value accounting in certain treatments. For example, in business combinations not involving common control, the acquirer's cost of a business combination must include the aggregate of the fair values, at the acquisition date, of the assets given and liabilities incurred or assumed, in exchange for control of the acquiree. Among the 38 standards in the New PRC GAAP, "25 require or allow the direct or indirect use of fair value. Of these 25, 17 require the use of fair value in the initial measurement of assets and liabilities, eight require its use in subsequent measurement of assets and liabilities, 11 require it in asset impairment testing, and 17 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. For the first time, fair value is defined and listed in the conceptual framework as an acceptable measurement attribute, alongside historical cost, replacement cost, net realizable value, and present value, in the 2007 GAAP" (Peng & Bewley, 2010). This shows the extent to which the New PRC GAAP has adapted to fair value accounting. More specifically, the New PRC GAAP has fully

adopted the use of fair value accounting in valuing financial instruments and restricted the use of fair value accounting in non-financial investments (Peng & Bewley, 2010).

Mr. Hongxia Li, from the Accounting Regulatory Department, Ministry of Finance in P.R. China, said that “introduction of fair value contributes to the faithful representation of value of assets and liabilities, timely reflects the movement of market and thereby realizes the objective of financial reporting.”

The superiority of fair value accounting over historical cost accounting has been gaining more momentum among professionals and scholars. Christensen and Nicolaev (2009) have argued that in certain conditions, historical accounting is a less informative measure of economic performance: in particular, “fair value can supply lenders with up to date liquidation value of companies’ assets.” Their study also shows that fair value accounting can be used to effectively curb overinvestment in fixed assets.

The former chair of Canadian Accounting Standards Board, Mr. Paul Cherry, pointed out that fair value accounting dramatically increases information quality by enhancing relevance. Fair value is more relevant because it is “unaffected by when or how an asset was acquired, by who holds the asset or by the intended future use of the asset. It is not entity-specific and is not dependent on management's intentions. Fair values are comparable at any measurement date and can be added together to produce a meaningful total. In contrast, cost-based measures hamper the ability to compare because they make similar items look different and different items look alike.”

However, according to Peng and Bewley (2010), the theoretical basis supporting fair value accounting assumes that FVA will be implemented in a well-functioning capital market and financial reporting environment. Whether emerging economies are capable of adapting to FVA is still a question to be answered. Because of China's complex economic conditions and political system, the switch to the fair value system might not be as successful as it was intended to be. For example, according to PRC Corporate Law, a public company which reports loss for two consecutive years should add "ST", meaning special treatment, to the stock name; a company reporting losses for three consecutive years receives a warning and faces the risk of being delisted. This regulation encourages earnings manipulation among the public companies. Overall, compatibility between a country's institutional setting and accounting standards is critical to ensuring successful achievement of the intended benefits of accounting standards. In an emerging market, such as China, the intended benefits through implementing FVA, including improved transparency, may fail to materialize or, worse, unintended consequences, such as more earnings manipulation, may arise (He, Wong, and Young, 2012).

Proposition 4: Convergence with IFRS narrows earnings gap and makes accounting information more value relevant.

As mentioned in previous sections, Chinese companies listed in Shanghai Stock Exchange and Shenzhen Stock Exchanges are allowed to issue A-shares to domestic investors and B-shares to foreign investors and domestic investors. A-shares are quoted in RMB and B-shares in foreign currencies. A-shares follow the Chinese

accounting standards and B-shares follow IFRS. Ideally, A- and B- shares of the same company should have identical values, but in fact, the prices of B-shares were usually lower than the prices for A-shares. Financial reports based on international accounting standards appeared more relevant to investors than those based on Chinese accounting standards (Bao & Chow, 1999; Chen, Firth & Kim, 2002).

The potential investors – domestic or foreign – viewed these finding negatively. They viewed them as evidence of low transparency and weak governance. A-share investors seemed to solve this problem of perceived weak governance by relying on cues derived from the performance of B-shares (Chui and Kwok, 2008). Consequently, investors in A-shares preferred companies that also had listed H-shares or B-shares. This preference was an implicit recognition that financial reports under IFRS rules were more reliable than those under the previous Chinese accounting rules.

A prior study by Foo, Liu, and Davey (2006) suggests that “B share (IAS-dominant) parameters are more value relevant than A share parameters. This is in line with the a priori belief that reports under the IAS regime are generally more influential than reports under the CAS regime” (Foo, Liu, and Davey, 2006). With the convergence of the two sets of accounting standards, domestic and foreign investors in China will feel more comfortable obtaining information from the financial reports following Chinese accounting standards. Companies that only listed A-shares used to lose investors because the investors did not trust the quality of their financial statements; with the convergence of accounting standards, they will become more attractive to potential investors.

CONCLUSION

Doing business internationally has never been easier with all the improvement in technology and increased purchasing power worldwide. Companies seeking to expand to foreign markets, or investors looking for new venues to invest, should carefully analyze the business environment in the targeted country before making any decisions. Accounting plays a crucial role in this process. Business professionals should take into account the differences that exist in different accounting standards and be familiar with their implications.

The Ministry of Finance in China has announced that the accounting standards in China have achieved significant convergence with IFRS. This paper analyzed the impact that convergence of accounting standards would have on the Chinese accounting system. I have analyzed how the issues specific to the Chinese society and business environment would impact the convergence process. Specifically, the unique social/business environment in China hinders the improvement of accounting information quality even though the Chinese accounting standards converge with international accounting standards. I also argue that a number of the financial statement items are unique reflections of the Chinese society. The differences between the New PRC GAAP and IFRS associated with those items cannot be eliminated in the short-run. The New PRC GAAP's moving towards fair value accounting aims to improve the accounting information quality, but the circumstances in China might present difficulties in fulfilling the goal. Lastly, convergence with IFRS will help to narrow earnings gap and make accounting information more value relevant.

In this paper, I used China Eastern Airlines to demonstrate my research questions. Future researchers could use more sample companies and extend the analysis to industries beyond the aviation industry. In the past, foreign companies listed on the New York Stock Exchange as a private issuer needed to provide a reconciliation of the financial statements prepared under their respective domestic standards to the U.S. GAAP. But the SEC no longer requires it if the company prepares their financial statements under IFRS. Future researchers could extend the discussion to the implications that this new change would have.

TABLES

Table 1: New PRC GAAP and corresponding IFRS (Deloitte)

ASBE	Title	Corresponding IAS/IFRS	ASBE	Title	Corresponding IAS/IFRS
	Basic standard	IAS 1	21	Leases	IAS 17
1	Inventories	IAS 2	22	Recognition and measurement of financial instruments	IAS 39
2	Long-term equity investments	IAS 27, IAS 28, IAS 31	23	Transfer of financial assets	IAS 39
3	Investment property	IAS 40	24	Hedging	IAS 39
4	Fixed assets	IAS 16	25	Direct insurance contracts	IFRS 4
5	Biological assets	IAS 41	26	Reinsurance contracts	IFRS 4
6	Intangible assets	IAS 38	27	Extraction of petroleum and natural gas	IFRS 6
7	Exchange of non-monetary assets	IAS 16, 38	28	Accounting policies, changes in accounting estimates and correction of errors	IAS 8
8	Impairment of assets	IAS 36	29	Events after the balance sheet date	IAS 10
9	Employee benefits	IAS 19	30	Presentation of financial statements	IAS 1
10	Enterprise annuity fund	IAS 26	31	Cash flow statements	IAS 7
11	Share-based payment	IFRS 2	32	Interim financial reporting	IAS 34
12	Debt restructuring	IAS 39	33	Consolidated financial statements	IAS 27
13	Contingencies	IAS 37	34	Earnings per share	IAS 33
14	Revenue	IAS 18	35	Segment reporting	IAS 14
15	Construction contracts	IAS 11	36	Related party disclosures	IAS 24

16	Government grants	IAS 20, IAS 41	37	Presentation of financial instruments	IAS 32, IFRS 7
17	Borrowing costs	IAS 23	38	First-time adoption of accounting standards for business enterprises	IFRS 1, IFRS 5, IAS 29
18	Income taxes	IAS 12			
19	Foreign currency	IAS 21			
20	Business	IFRS 3			

Table 2: Structure of the Equity Markets in the People's Republic of China (Zhang & Thomas)

Structure of PRC Equity Markets						
Place of Issue	Type of shares	Official Nickname	Ownership	Denominated In	Payable In	Markets Traded
Hong Kong		Red chips	Foreign investors	H.K. dollar	H.K dollar	Hong Kong
PRC	Individual	A	Chinese public	RMB	RMB	Shanghai Shenzhen
PRC	Individual	B	Chinese public or foreign investors	RMB	U.S. dollar H.K. dollar	Shanghai Shenzhen
PRC	Foreign	H ^b	Foreign investors	RMB	H.K dollar	Hong Kong
PRC	Foreign	H or N	Foreign investors	RMB	U.S. dollar	New York

- a. Individual shares (A-shares) are denominated in Chinese RMB and can only be owned by Chinese citizens. They are traded on the Shanghai and Shenzhen stock exchanges, which were established in the early 90s when some of the state-owned enterprises faced serious financial problems.
- b. B-shares are individual shares and are also denominated in RMB. But B-shares are traded in U.S. dollars in Shanghai and Hong Kong dollars in Shenzhen. B-shares were originally designated for foreign investors only, but recently the market was opened to domestic investors also.
- c. Non-tradable and non-transferrable state shares and legal person shares. The existence of these shares is to ensure state ownership and control over those state-owned enterprises.
- d. Foreign shares are denominated in Chinese RMB and are designated to be held by foreign investors only. Foreign shares are traded in multiples places around the

world. Some common foreign shares include the N-shares, which are traded in New York Stock Exchange and L-shares, which are traded in London.

Table 3.1: A reconciliation of CEA's financial statements from PRC GAAP to IFRS (CEA)

(二) 境内外会计准则下会计数据差异

1、同时按照国际会计准则与按中国会计准则披露的财务报告中净利润和净资产差异情况

单位：千元 币种：人民币

	净利润		净资产	
	本期数	上期数	期末数	期初数
按中国会计准则	4,886,702	5,380,375	20,437,377	15,577,109
按国际会计准则调整的项目及金额：				
高价周转件折旧费用及减值准备的差异(a)		-74,183		
由于不同折旧年限而造成飞机、发动机折旧费用及减值准备的差异(b)	-9,288	-9,582	74,859	84,147
退休后福利的准备(c)	-326,145	-347,936	-2,943,428	-2,617,283
商誉(d)			2,760,665	2,760,665
冲销土地使用权的评估增值(e)	8,420	8,420	-343,786	-352,206
其他			79,393	79,393
递延税项调整(f)	998	4,686	31,991	30,993
少数股东权益/损益(g)	15,045	-3,791	28,821	-291,531
按国际会计准则	4,575,732	4,957,989	20,125,892	15,271,287

Table 3.2: Table 3.1 Translated

(Unit: thousand Yuan Currency: Chinese RMB)		Net Income		Net Assets	
		2011	2010	2011	2010
As stated in accordance with New PRC GAAP		4,886,702	5,380,375	20,437,377	15,577,109
IFRS adjustments:					
Differences in the depreciation of flight equipment	a		-74,183		
Differences in the depreciation of planes and engines	b	-9,288	-9,582	74,859	84,147
Defined benefits	c	-326,145	-347,936	-2,943,428	-2,617,283
Goodwill	d			2,760,665	2,760,665
Land use rights	e	8,420	8,420	-343,786	-352,206
Other	f			79,393	79,393
Deferred taxes	g	998	4,686	31,991	30,993
Non-controlling interest	h	15,045	-3,719	28,821	-291,531
As stated under IFRS		4,575,732	4,957,989	20,125,892	15,271,287

Notes:

- a. Flight equipment is classified as liquid asset under Accounting Standards for Business Enterprises announced before February 15, 2006 and are depreciated using the straight-line method over a useful life of five years. Under IFRS, flight equipment is regarded as fixed asset. Since July 1st 2007, both New PRC GAAP and IFRS considered flight equipment as fixed asset and it is depreciated over ten years. Because the recorded cost for the flight equipment is different under the Chinese accounting standards and IFRS, even though the difference in the useful life has been eliminated since 2007, the undepreciated portion remained different. As of Dec. 31st 2010, this difference has been completely eliminated.
- b. Under the Accounting Standards for Chinese Enterprises, before June 30 2001, planes and engines were depreciated over a useful life of 10-15 years with a 3% remaining value. Starting from July 1st 2001, planes and engines are depreciated over a useful life of 15-20 years with a 5% remaining value. Under IFRS, the useful life for planes and engines has always been 15-20 years, which resulted in a difference in the recorded value for planes and engines on the balance sheet.
- c. Under New PRC GAAP, employee benefits excluding social security are recorded when paid. Under IFRS, employee benefits excluding social security are defined as defined benefit plans, and firms must recognize an expense for defined benefit plans over the employees' expected service years.

- d. The New PRC GAAP and IFRS allowed different values for the company's net assets on the acquisition date. Goodwill arising from the acquisition is therefore different.
- e. Under New PRC GAAP, land use rights are recorded at cost minus accumulated depreciation. Under IFRS, land use rights are recorded at historical cost.
- f. This is the impact on deferred taxes that all differences mentioned above caused.
- g. This is the impact on non-controlling interest that all differences above caused.

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ABSTRACT

The purpose of the research is to examine how convergence of Chinese accounting standards with international accounting standards affects financial reporting quality. In this paper, I analyzed the special business environment in China and explained how those special circumstances would hinder the process of convergence. Specifically, convergence of accounting standards does not mean convergence of accounting practices. I also discussed some major changes to the former PRC GAAP and attempted to answer how those major changes would impact financial reporting quality.