COMMENTARY

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Bumpy Road Leading to Internationalization: A Review of Accounting Development in China

Today's accounting in China is strikingly different from 20 years ago. The old accounting system China inherited from the former Soviet Union was designed to serve the centrally controlled economy (Tang et al. 1996). Its main task was to report to the central government information required for planning and control purposes. The economic reform that changed the planned economy to a market-oriented economy created a demand for accounting information by capital providers (investors and creditors) and by business managers. Chinese accountants quickly looked to international accounting practice as the basis for re-engineering the accounting system. Recently issued accounting standards closely resemble those developed in many market economies, although with some compromise that this paper will address later.

DRIVING FORCE OF INTERNATIONALIZATION

Two main factors driving Chinese accounting toward internationalization are its economic reform and increasing international exchange activities.

Economic reforms in China begun in the 1970s have brought about structural changes in the national economy. The government has moved from being the owner and manager of the large majority of enterprises to serving mainly as the macro policy maker. A large number of enterprises are now privately owned and managed. The joint stock company is recognized by the state as the desired way to reform original state enterprises. The number of listed companies has increased from 13 in 1990 to 851 at the end of 1998. The total market value has reached RMB 1950 billion, which is equal to 24.5 percent of GDP (X. Li 1999). More listed companies are expected. Listed companies

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whose shares also trade overseas are required to use International Accounting Standards (or Hong Kong GAAP if they trade there). Companies whose shares trade only in China must follow Chinese GAAP.

To realize its ambitious modernization plan, China needed capital and advanced technology. This led China to adopt a policy to attract foreign direct investment. By the end of 1997, China had approved 303,000 projects of foreign capital, with a total contracted amount of $742 billion. In some industries, such as real estate and geological prospecting, foreign direct investment has become the main source of capital (Tang and Lin 1999). During the period, Chinese companies started to raise funds on the international capital market by issuing shares and bonds. The internationalization of economic activities has accentuated a move to conform to international accounting practice.

CHOOSE A RADICAL APPROACH

China realized that its old accounting system could not meet the demands for financial information from lenders, outside investors, investment bankers, and financial analysts. It considered trying to adapt the traditional accounting system as the basis for market-oriented accounting. But in the end it decided to abandon most of the traditional accounting system and adopt a system developed elsewhere in market economies.

Accounting standards setting began in 1988 under the auspices of the Ministry of Finance, which has authority over accounting affairs under the law. The Ministry announced a policy that Chinese accounting standards would conform to international accounting practice (Chen 1989). Measures that have been taken to realize that objective include the following:

1) The first accounting standard drafted was one that we call the Basic Accounting Standard. It is similar to IASC’s Framework and FASB’s Conceptual Framework to a certain extent. An international accounting conference was held to discuss the draft, and international accounting bodies and scholars were invited to comment. The purpose of this first standard was to use it as the basis for future development of accounting standards. China learned from other countries the importance of agreeing initially on basic accounting concepts and qualitative characteristics. In fact, the basic accounting standard is built on the concepts and characteristics adopted by IASC, FASB, and other national standard setters. However, our focus is broader than investors and creditors. As will be discussed shortly, this is both good and bad.

2) The Ministry of Finance engaged an international accounting firm as an adviser to the accounting standards-setting program. Among other things, it introduced and explained accounting standards of major countries and international organizations. The firm continued as advisers during the early stage development of individual standards.

3) Two advisory committees were established. One consists of international accounting experts and other consists of Chinese accounting experts. Each of these groups comments on drafts of individual accounting standards.

After the basic accounting standard was promulgated in 1992, China quickly published approximately 30 proposed accounting standards. The Ministry of Finance hoped to complete numerous accounting standards within three years. In that way,
the Ministry could quickly bring China's accounting in line with international standards. This idea soon proved to be over optimistic. After seven years of wrestling with various obstacles, China issued eight accounting standards. The standards-setting body started to realize that the road leading to internationalization was not that smooth.

**Issue One: Difficulty in Accounting Standards Setting**

Although the basic accounting standard has played an important role in the development of other accounting standards in China, there have been some difficulties.

First, many accountants in China did not have a thorough understanding of the theoretical reasoning behind the conceptual frameworks that were developed in other countries. This highlighted a need for improvement in accounting education. Second, many accountants in China did not understand how to change the existing accounting practices in China to achieve conformity with the new basic accounting standard. Also, many people did not understand why it was so important for accounting to change in a market-based economy—why the old accounting system could not continue to serve people's needs for financial information. Concern was also shown by some academics on the applicability of international practice in Chinese-unique institutional arrangements (Xiang 1998). It is not easy to introduce new and somewhat alien accounting concepts and principles in a short period of time.

**Users of Financial Information must be Clearly Identified**

Three groups of users were identified in the basic accounting standard: the government; investors, creditors, and other relevant parties outside the enterprises; and management. Compared with the framework of other countries, this is an obvious difference. Conceptual frameworks in other countries state clearly that the special needs of government and management are subordinate to the overriding focus on investors and creditors. Our Ministry of Finance said that accounting standards must serve all three groups.

Clearly, an accounting system that satisfies all three groups must be significantly different from a system that focuses on outside investors. We found that we could not simply adopt many accounting concepts and principles developed in other countries—where accounting is designed primarily for outside investors—to satisfy government and enterprise managers equally well.

We debated whether to develop a single set of standards that meets the common needs of these three groups or to develop three separate sets of standards. Some people suggested that we should ask the Ministry of Finance to revise the basic standard. The debate is still going on but the standards issued recently are focusing mainly on outside investors.

**Reliability and Relevance of Accounting Information must be Appropriately Weighted**

These two concepts are derived from decision usefulness. They are usually carefully described in conceptual frameworks because of their important impact on recognition and measurement of accounting information, although it is always difficult to appropriately weight the two. In China there are two factors that have great impact on the consideration of this issue. One is the “responsibility system” that was a dominant concept in China for many years. Accountants are required to provide reliable information to discharge their responsibility, mainly the custodianship responsibility. The other is the concern of the government and public regarding the truthfulness of accounting
figures. Enterprises are often blamed for providing false accounting information. Numerous management fraud cases surfaced in recent years. This led to a judgment that reliability must be put before the relevance in developing accounting standards. This judgment is addressed by the basic accounting standard.

Accounting standards of the IASC and in many countries are moving more toward relevance. This reflects people's awareness of the dynamic economic environment where timely and forward-looking information is crucial. It is also the real-life experience in the business practice where the decision making depends more on the relevance of accounting information than on the reliability. This trend is evidenced by the acceptance of fair value in many cases.

Historical cost has its merits of objectivity, applicability, and verifiability. Its main weakness is its failure to reflect current dynamic economic reality in many cases. Therefore various modifications have been adopted in practice. A mixture of historical cost and current value becomes common and is recognized by accounting standards-setting bodies in many countries. However China's current basic accounting standard strictly adheres to historical cost, and any deviation to historical cost is prohibited. To illustrate:

The values of all assets are to be recorded at historical costs at the time of acquisition. The amount recorded in books of account shall not be adjusted even though a fluctuation in their value may occur, except when State laws or regulations require specific treatment or adjustments. (Article 19)

 Marketable securities shall be accounted for according to historical cost as obtained. Marketable securities shall be shown in book balance in accounting statement. (Article 26)

All inventories shall be accounted for at historical cost as obtained...All the inventories shall be disclosed at historical cost in accounting statement. (Article 28)

This basic standard seems to leave no room for any possible modification in the more detailed standards that build on the basic standard, and could cause difficulty when conditions justify change. This occurred when several specific standards were promulgated. For example the standard on Investment states:

Current investment should be carried at the lower of cost and market value at the end of each period and any reduction of cost to market should be recognised as an investment loss in the current period. (Paragraph 10)

Lower-of-cost-or-market departs from a pure historical-cost basis of measurement for good reason. It is well expected that other standards relating to assets under consideration would face similar difficulty.

Current values or fair values increasingly play a more important role in accounting standards recently issued by FASB, the IASC, and other boards. The IASC, for instance, requires that many financial instruments be reported at fair values and has recently proposed that investment property and agricultural assets also be measured at fair values. Fair valuation of property, plant, and equipment has long been an option under International Accounting Standards, and even certain commodity inventories are allowed to be measured at fair values.
I believe that China will soon have to modify its basic accounting standard, and this general trend of moving away from historical cost principle must be taken into account.

I also believe that several other conceptual issues must be decided in the revised basic accounting standard, including whether China should adopt primarily an asset/liability view or a revenue/expense view, which concept of capital maintenance we accept, and the degree to which accounting standards should also be used to measure taxable income. These issues are either insufficiently dealt with or neglected entirely in our current basic standard.

The development of specific accounting standards is still in its early stage. More than 20 such standards are in the stage of exposure draft. The influence of the basic accounting standard on promulgated specific accounting standards is observable. The closeness of these standards to international standards is being evaluated. The accounting statements prepared according to Chinese standards are found to be different from those prepared under International Accounting standards, but the gap between the two is narrowing, along with the issuance of more standards and rigorous implementation of these standards (Chen et al. 1999). With the improvement of the basic accounting standard, and the specific standards under its guidance, Chinese accounting is going to move ever closer to international standards.

**DUE PROCESS**

The due process of accounting standards setting in China is another matter that needs to be reconsidered. In a country where government is responsible for standards setting, an open channel enabling free expression of opinions by practitioners, preparers, and academics must be established. The role of the Accounting Standards Committee, which is now defined as a consultative function, must be strengthened. Various steps of opinion solicitation, draft preparation, and approval must be formalized in order to avoid subjectivity and to increase transparency.

**Issue Two: Acceptance of International Accounting Practice**

Although accounting reform is driven by the economic structure reform, the acceptance of internationally recognized accounting practice varies among different groups.

Academics were the group first to realize the necessity of adopting international accounting practices. Actually it was the Chinese Accounting Society, China’s largest academic body, that first initiated the accounting standards program and raised the issue of internationalization.

The government has accepted the change because its own role is changing, from direct control to indirect guidance and policy making. They can no longer require enterprises to provide information based on standards designed solely to serve the needs of government, as it used to be, because the ownership structure is diversified. Government officials recognize the importance of attracting foreign investment and other international activities, and the importance of a common global business language. The Ministry of Finance therefore actively supports the internationalization move. Suspicions are sometimes aroused, however, when the international practice goes in a way with which the Ministry is not familiar, or causes inconveniences in their data collection and administration. When the basic accounting standard went public in 1992, government officials at various levels found it strange, and it was criticized by some people as “exotic.” The skepticism of their applicability is partially responsible for the
delayed promulgation of specific accounting standards. The first specific accounting standard was established five years after the basic accounting standard was issued.

A new group of users of financial information has emerged in China—the shareholders of joint-stock companies, especially those of listed companies, which are increasing rapidly in number. They demand high-quality financial information in their decision making. They demand transparency and reject secrecy. Internationalization has generally raised the quality of such information. The acceptance varies among investors depending on their background. Institutional investors have not been developed sufficiently in China; many individual investors are not familiar with the new accounting system, and they sometimes feel at a loss as to how to evaluate and use the information.

Preparers are reluctant to adopt new accounting standards for various reasons. Most accountants working in the industries received education that is not compatible with new approaches. It is more so with the management. Accountability to outside investors and the public is still new to many corporate managers. More detail and transparent disclosure requirements are deemed troublesome rather than beneficial. In the early stage of implementation, some managers felt that the cost of preparation and audit outweighed the benefit.

**Issue Three: The Accounting Profession Is Not Ready**

Compliance with a set of accounting standards depends not only on the acceptance of the constituency, but also on the competency of the audit profession that makes judgments on how they have been applied. China’s first accounting firm was established in Shanghai in 1980. The CPA examination started as late as 1991. Thousands of accounting firms mushroomed in a few years, and more than 100,000 accountants rushed to the accounting profession to provide services. It is exciting to look at the numbers, but it is frustrating when you look at their performance as a whole. There are several difficulties to be overcome.

**Independent Status must be Established**

In early 1980 when China’s CPA system was re-established, most of the accounting firms were funded and managed by different government agencies such as the finance bureau, the tax bureau, and bureaus of line industries. They were not the kind of private-sector CPA firms that existed in the United States.

The involvement of the government in the CPA profession was understandable in the unique situation in China when Chinese accountants did not have sufficient personal assets to bear full responsibility and the legal liabilities that accompany accounting practice. The sponsoring government agencies served as a shield for the fledging firms and allowed for the rapid development of the profession. However, as owners of the accounting firms, the sponsoring agencies tended to influence the decision-making process because of the interests involved. It is not uncommon that government agencies use their power to direct business to their sponsored accounting firms. At the same time, CPAs’ audit judgments and the types of audit reports issued are also affected by the bureaus in charge (Zhong 1998). As a result, the independence of the CPA firms is greatly compromised.

Another issue affecting the independence of the accounting profession is the status of the Chinese Institute of Certified Public Accountants (CICPA). At present, most of the council members of the CICPA are appointed by the government and have a background in government service rather than in accounting. The CICPA works
under the direct supervision of the Ministry of Finance. Government officials regard accountants as “economic policemen,” a mere supplement to, and extension of, government control. Thus, it is not easy for the CICPA to make independent decisions in many situations. This in turn has a negative impact on the independence of the accounting profession.

To solve the independence issue, the Ministry of Finance and the Chinese Securities Regulatory Commission have issued regulations to restructure the Chinese CPA firms. The goal of the reform is to sever the CPA firms’ ties with related government agencies and to form either limited liability partnerships or corporations. Resistance to reform is conceivable. When the reform is completed, the additional source of income of sponsoring agencies will disappear. Disputes also focus on the treatment of accumulated retained profit in firms.

However, real independence is not given. The accounting profession must demonstrate through its own work the ability to serve the public well and the ability of self-regulation. At this stage of development, the government (and maybe even the accounting profession itself) regards the CICPA as not having sufficient ability and authority to lead the professional organizations. Therefore it is the dilemma that while the CICPA needs independence in order to become a self-regulatory professional body, it still needs the support of the government in order to maintain its authority.

**Professional Competency of CPAs**

Before the CPA examination started in 1991, CPAs were certified through evaluation. There was great variation in the quality of CPAs who gained qualification under this system. Moreover, many of the retired government officials joined the accounting profession through sponsorship. According to the latest statistics of CICPA, 52 percent of CPAs are 60 or older and only 18 percent of CPAs hold university degrees. In addition to this, the lack of continuing professional education and the lack of knowledge of modern business activities in China has hindered the development of the profession.

Measures have been taken to improve the competency of accountants. The unified CPA examination is administered each year, with hundreds of thousands of candidates sitting the examination. Passing the CPA examination and practical experience are now required for CPA license. Curricula are designed for CPA training. Two huge national accounting training centers are under construction, and outside technical assistance is being sought through a World Bank project.

**CPAs’ Professional Ethics**

China’s economic reform also changes the way of life, even the way of thinking, of many people. During the long period of planned economy, egalitarianism dominated people’s lives. Seeking personal interests in their work was criticized as individualism and one person could not become richer than another. Business ethics were not a serious issue in such an environment. Today, pursuing personal interests has become acceptable and people are encouraged to get rich through their work. In this transitional period, moral standards are not well established, either in business or in people’s daily lives. The Chinese accounting profession is developing in this period of “moral vacuum.” CPAs do not have a clear understanding of ethical and unethical behavior in their practice. In addition, the intense competition and lack of an orderly market also contribute to CPAs’ neglecting professional ethics. The CICPA has made tremendous efforts to raise the moral standards, but improvement takes time.
From July 1997 to March 1999, the Ministry of Finance launched a clean-up campaign through practice review of CPA firms. Results of the review indicate that the lack of professional ethics in the industry is serious. The licenses of 360 accounting firms were withdrawn, and punishments such as warnings and suspension of operation were meted out to 1187 accounting firms; 735 accounting firms were ordered to make improvement within a given period of time; and another 342 were to be disciplined after further inspection. This accounted for 42.46 percent of the total number of accounting firms (X. Li 1999).

Lack of ethics is a pervasive issue in business activities. As a supervisory body, the CICPA plays a critical role in protecting the CPA’s professional reputation and improving the ethical standards of the industry. Recently the CICPA issued three important standards on “Professional Ethics,” “Quality Control,” and “Continuing Professional Education.” These standards provide a basic framework for professional ethics and quality. It is crucial that the CPAs realize the importance of these standards and abide by them.

**Issue Four: Academics Could Contribute More to the Accounting Development**

Accounting academics have been catalysts of the movement toward modernization and internationalization of accounting in China. During the period between 1980 and 1997, there are 222 articles in the top Chinese journal, *Accounting Research*, devoted to introducing, explaining, and analyzing the Western accounting development and research results, mostly from the United States. This helped greatly in reaching the consensus of adopting international accounting practice. As was pointed out above, it was the academic organization that initiated accounting standards program.

However, the contribution of academics to the development of accounting theory and practice has been limited due to certain weaknesses in China’s academic system.

**Strong Government Influence on Academic Activities**

China’s first national academic organization, the Chinese Accounting Society, is directly managed by the Ministry of Finance. Its journal, *Accounting Research*, is financed by the Ministry and edited by Ministry officials. This model is copied by all provinces where the Accounting Society and journals are controlled by provincial finance bureaus. This scenario stems from the law that prescribed that the Ministry of Finance is the authority to administer all accounting affairs in China, presumably including accounting research activities. Government officials make use of accounting journals as a forum to promote government policies. Two hundred fifty such articles are found in *Accounting Research* during the period between 1980 and 1997. Research papers are influenced by such an institutional arrangement in the way of topic selection and the policy defending the nature of papers.

Things started to change after the founding of Chinese Accounting Professor’s Association in 1994. This Association makes academic excellence its main objective, and is devoted to promoting academic research and education, as well as practice improvement. It is independent also because the members are academics only.

The charter of the Association recognizes the importance of international exchange activities in upgrading the standard of Chinese accounting education and research. Progress has been made in this regard. As the president of the Association, I would like to take this opportunity to express my gratitude to American Accounting Association for its
strong support. Since its first Annual Meeting, the presidents of American Accounting Association have participated in our every single annual meeting. American scholars bring in up-to-date information on accounting research and education happening in the United States. Their speeches and presentations are always enlightening and educating and are warmly welcomed by Chinese accounting academics. The impact they have on China’s accounting development is strongly felt. In general, the academic-exchange activities give Chinese academics the chance to be exposed to the international academic communities and research, which help in their future development.

**Casualness of Accounting Research Methodology**

Another issue in China is that modern empirical-research methodology has not attracted the attention of Chinese scholars until very recently. In the past, most researchers did not follow strict scientific procedures. Academicians used their wisdom and logic to reach conclusions, but unfortunately the casualness of this research methodology resulted in achievements that are far from excellent. There are several reasons for the situation.

For a long time, research methodologies in any field of inquiry in China, particularly social sciences, have been highly ideological and highly abstract in thinking, not scientific rigor.

Second, many researchers in China consider their mission of research is to justify government accounting policies and regulations. Here conclusion comes first, justification follows.

Additionally, research methodology was not taught in universities, not even in Ph.D. programs. Accounting faculty members knew very little about scientific research procedures before they were introduced into China a couple of years ago. Things are changing, thanks to help from scholars in more developed countries.

**The Field of Vision Needs to be Broadened**

Another hurdle of accounting research in China is the vision of researchers. In the period of the planned economy, accounting was regulated by a strict uniform accounting system. It prescribed every detail of accounting practice, from forms of accounting statements to bookkeeping procedures. Even the journal entries were standardized. In that environment, researchers can hardly challenge the legitimacy of the regulation. The only thing they could do is to justify the accounting procedure. It may take years for that kind of attitude to gradually disappear.

**Lack of Motivation**

One of the most important factors motivating academic research is the recognition of research accomplishment. The closeness of the relationship between promotion and research achievement varies among universities. At this time in China, most universities are focusing on raising teaching standards, including curriculum development, textbook writing, and teaching-method improvement, among other things. The weight assigned to research is relatively light. That will change, but it will take time. Currently Chinese universities are short of financial means to promote high-quality research (the budget is extremely tight, and the salary for all professors is same and decided by government). Fortunately at the business schools to which we belong, things are usually less difficult. Some department heads are making use of their “second budget” to
encourage high-quality research. Some schools have started to rate the journal in which the research is published and assign points just as is being done in American universities. Points combined with promotional and financial incentives are becoming popular in some schools.

CONCLUSION

Accounting practice, research, and education in China are in a period of rapid change. The general trend is from a planned-economy oriented, self-contained tradition toward an outward, open attitude. Internationalization is recognized as an appropriate route through which the level of accounting can be upgraded. Although recent experience shows that improvement has been great and fast, there is still long way to go.

In accounting standards setting, it is probably right that we started with a general framework, however, it is hardly possible to be perfect without cumulated practical experience and the support from general education and research efforts. Gradual improvement is expected. In a country with a long history of planned economy, traditional thinking is deeply rooted, which could delay the acceptance of change by people concerned.

The Chinese accounting profession is rather young. The education background of the majority of practitioners is insufficient and is difficult to change in a short time period. Professional ethics is a serious issue waiting to be dealt with. Real professionalism takes time to form.

In the long run, through education and training, I believe it will be the academics who will play the most important role in upgrading the national standards of accounting practice.

REFERENCES


