WHY WESTERN ACCOUNTING METHODS ARE NEEDED IN CHINA NOW

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Tapen Sinha, Associate Professor of Finance at Bond University, Gold Coast, Queensland, Australia, looks at China's urgent need to interface with the capitalist world and its accounting methods

Communist China under Mao adopted the Soviet accounting method proposed by Marx over a century ago. The system, known as the Material Production System (MPS), failed to keep up with time. It rejected many capitalist terms: the word 'profit' was abolished. However, the concept of 'surplus' was born. If a production process (or a set of processes) produced 'extra' to what the process consumed, it was called surplus. For a simple economy the MPS may be viable. It relies solely on physical quantities--price does not enter the picture at all (and even if it does, the price of a commodity does not reflect its market value). Problems with the MPS cropped up when China opened up and started trading with the west. Multinationals were allowed to set up shop in China. It became necessary to adopt (or at least adapt) some of the long-standing western accounting concepts.

Dilemma of China

Two main problems arose with the economic reforms:

- It became necessary to measure the performance of the state-owned enterprises (SOEs). in some tangible way.
- Multinationals and joint ventures with the western countries demanded more transparent accounting methods.

Large SOEs still account for 25 per cent of GDP in China (down from 35 per cent in 1978). It is well known that SOEs are less profitable than the private sector firms.[1] To measure and monitor the performance of the large SOEs, it became necessary to adopt a better method suited to a more profit-orientated firm. The Ministry of Finance hoped that it would allow the SOEs to perform better.

However, performance cannot be closely monitored or measured without sophisticated accounting systems in place. That is precisely why China needs to have a better accounting scheme--even for the public-sector firms.

Raising capital through stock markets became necessary to finance large projects. Private financing is institutionalised through stock and bond markets. The functioning of such markets requires information about the underlying structures of prospective investments. This process in turn requires better accounting and transparent record keeping by the companies. Hence there was further pressure on adopting better accounting methods.

Foreign collaboration on joint ventures and multinational investment requires western-style accounting methods. Partly in recognition of this problem, in 1981 Coopers and Lybrand was the first major Western accounting firm to be allowed to open a representative office in China. Between 1981 and 1992, pressure on better accounting systems continued to build with economic growth in the private sector and the SOEs.

Another major but unanticipated development took place: small co-operatives started mushrooming in the rural areas to fill a niche market. These co-operatives, called Township and Village Enterprises (TVEs) became increasingly important to the economy contributing more than 10 per cent of the GDP. They posed special accounting problems for the government for taxation.

The World Bank began to take greater interest in the microstructure of the Chinese economy. A study by Bennett[2] showed that there were no formal legal responsibilities in both private and public sectors to stick to any standard accounting practice. Routinely, inconsistencies arose in the treatment of income, valuation of inventory and, more generally, asset valuation. There was no provision for independent audit to maintain the integrity of the system.

Chinese methods did not recognise many risks, such as bad debts, potential legal claims and other future contingencies. As a result, future projections were much more optimistic than they would have been for a company in a similar situation in the west.

Technical problems also exist:

- Chinese accountants tend to change standard cost structures every two to three years. China is experiencing rapid inflation (over 20 per cent per year). Thus, cost of production tends to be substantially underestimated because of this practice.
- The practice of depredation and obsolescence is non-existent. Again, this problem is compounded by high inflation.
- Ownership of property is not well defined in terms of the capitalist system. Who owns the factories? Who owns the land? Technically, they are still owned by the state.

The dual currency system created additional problems. China administers a managed, floating official exchange rate. This rate is nominally linked to a trade weighted basket of currencies. China issues Foreign Exchange Certificates (FECs); this is a hard currency-backed scrip for domestic payments by foreigners.

The Chinese currency, the renminbi (RMB), is not freely convertible. Any firm in the import/export business will have two accounts--a hard currency account and an RMB account. How should they be combined?

Some recent developments

The most important development is the introduction, in 1990, of an examination by the Chinese Institute of CPAs (CICPA), the professional accounting body of the People's Republic of China. Before that, the CPA in China was certified according to the subjective assessment by government authorities of the candidate's education and experience. Almost all accountants were retired accounting or financial officers from government agencies.[3,4]

At present there are some 8,000-9,000 members of the CICPA.[5] China has big plans for increasing the number of CPAs to 300,000 by the year 2000. This requires 40,000 new CPAs every year. In 1991, the first year the CICPA started its first standardised examination, 15,000 students took the examinations. Only 4 per cent passed.[3] One way to improve the professional standards is to bring big accounting firms into the country and develop the culture. In 1992 seven international accounting firms were allowed to open offices in China. In addition, eight branches were allowed into China.

A representative office of a foreign firm is allowed to provide consulting and accounting services to multinationals operating in China, and management consulting and advice for foreign clients on setting up accounting systems, international taxation etc.

A joint venture can provide a full range of accounting and auditing services to both Chinese and multinational clients (including technical aspects of overseas listings).

Foreign accounting firms are now allowed to recruit, employ, train and locate their employees, provided that they become China's own CPAs. There is one catch to becoming a Chinese CPA--all examinations are in Mandarin language. Therefore the scope for people of European origin is somewhat restricted. A list of the large foreign accounting firms operating in China at the beginning of 1994 is given in the table.

Regulations

Property laws are not well defined in most of China. Technically all land still belongs to the state. The Chinese government has recognised that ill-defined property rights are not conducive to the capitalist production process. For accountability, firms also need a well defined legal system. Criminal laws are well entrenched in the Chinese system (although they might be considered inhumane by western standards!). But other kinds of laws are not well developed. Unlike international accounting firms, international law firms are much more restricted in their activities in China. International lawyers are not permitted to appear in court on behalf of their Chinese clients. They are only allowed to represent their Chinese clients in other countries. This asymmetry has posed some thorny problems for the multinationals and joint venture

companies. The Ministry of Justice is undertaking a project (which began last August) in conjunction with the World Bank to set up a legal system that co-ordinates with the western-style legal systems. Several law schools from the United States are training some of the 50,000 lawyers practising in China.
The problem for the international legal profession in China is a very tricky one. They have to walk the tightrope of reforming the process without appearing to be meddling in the internal affairs of China. Without legal reform, development of accounting in China will not be very effective.

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Locations of large foreign accounting firms operating in China

Company	Location in China
Arthur Andersen	Beijing, Shanghai, Shenzhen
Coopers & Lybrand CIEC	Beijing, Shanghai, Guangzhou, Tianjin
Deloitte Touche Tohmatsu	Beijing, Shanghai, Shenzhen
Ernst and Young	Beijing, Shanghai, Shenzhen
Grant Thornton	Beijing
KPMG	Beijing, Shanghai, Shenzhen
Lipsher Accountancy Corp	Shenzhen
Price Waterhouse	Beijing, Shanghai, Shenzhen, Guangzhou