

A Comparative Analysis of Accounting Standards on Consolidation and Long-Term Investments

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Received date: February 19, 2014, Accepted date: May 02, 2014, Publication date: May 12, 2014

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Abstract

This study intends to make a comparative analysis of the accounting standards for consolidation and investment in the three Chinese regions, i.e. the Mainland, Taiwan and Hong Kong, against the international accounting standards and the U.S. GAAP in order to facilitate more informative financial reporting. We also discuss the disclosure and supervisory requirements for equity investments. Due to the differences in the historical backgrounds and stages of economic development among the three regions, it is inevitable and necessary for the regions to maintain their respective characteristics in the accounting standards. Our analysis would generate some insight into how the three regions could reduce unnecessary differences between accounting standards in order to provide international investors with better and more reliable business information for decision making.

Keywords Convergence with International Financial Reporting Standards (IFRSs); Long-term equity investments; Business combinations; Chinese regions

Introduction

The recent years have been witnessing increasingly close interactions among the enterprises in Mainland China, Taiwan and Hong Kong, coupled with gradual progress towards open financial markets as a result of the free trade agreements such as Closer Economic Partnership Arrangements (CEPA) and Economic Cooperation Framework Agreement (ECFA). Businesses grow fast in the three regions over the recent years, while cross-border mergers and acquisitions are increasingly common. With the gradual opening up of financial markets in the Mainland China, the government and businesses are having higher expectations for the benefits and synergy from cross-border listing. The closer economic ties highlight the importance of convergence in the accounting standards used in the regions.

Currently, the financial reporting standards in Hong Kong (Hong Kong-IFRS, HKFRS) have almost synchronized with the International Financial Reporting Standards (IFRS). In 2007 Mainland China and Hong Kong signed a joint statement declaring continuous equivalency of their accounting standards. The Hong Kong Stock Exchange announced on December 10, 2010 the acceptance of financial statements prepared under the Mainland accounting standards and allowed some large accounting firms in the Mainland to provide audit services for Mainland China companies listed in Hong Kong Stock Exchange (H share companies). In addition, the two sides implemented cross-border supervisory cooperation over the financial markets.

On the other hand, the Mainland China and Taiwan have established a communication platform designed to promote effective accounting standards convergence between the two sides. The

Mainland officially issued the new Enterprise Accounting Standards in 2006 and decided to continue with the convergence with IFRS. However, with regard to its unique economic and social environments, the Mainland does not demonstrate any intention for complete consistency with IFRS. In 2013 Taiwan formally apply its International Financial Reporting Standards (Taiwan-IFRS, TIFRS) to listed, OTC and finance industry companies (excluding credit unions, credit card companies, insurance brokers and agents), but its revision and implementation process is not fully synchronized with IFRS.

In fact, due to the differences in the historical backgrounds and stages of economic and cultural development among the three regions, it is inevitable and necessary for the regions to have their respective characteristics in the accounting standards. This study intends to make a comparative analysis of the accounting standards for consolidation and investment in the three Chinese regions, i.e. the Mainland, Taiwan and Hong Kong in order to facilitate more informative financial reporting. We also discuss the disclosure and supervisory requirements for equity investments in the regions.

Literature Review

Jones J and Finley A [1] examine the early adoption of IFRS in the European Union countries and Australia and found that the use of IFRS not only significantly reduced cross-border, cross-industry differences between the financial statements, but also narrowed the gap between the financial statements of large and small enterprises. Barth et al. [2] analyzed the financial reporting of enterprises in 21 countries. Their results show that the quality of financial statements prepared under IFRS are better than those prepared under non-IFRS accounting standards and that financial reporting quality improved after the adoption of IFRS.

Xie [3] argue that in the context of convergence to international accounting standards, accounting standards setting should be complemented with proper regulation of the capital market in order to

curb earnings manipulation and improve information disclosure. Chen J and Chen HW [4] investigate Shanghai and Shenzhen listed companies and find that the quality of accounting information is significantly affected by both accounting standards and corporate governance structure. The higher the quality of corporate governance, the higher the value relevance of earnings.

Comparison of Accounting Standards for Business Combinations

The three Chinese regions have either fully adopted or are converging to the international accounting standards. Therefore, we are going to first discuss the international accounting standards on consolidation and investment, followed by analysis of the differences and similarities of the accounting standards in the various regions. The international accounting standards applicable to consolidated statements are "International Accounting Standard 27 - Separate Financial Statements (Revised Edition)" (i.e. IAS 27R) [5], "International Financial Reporting Standard 3 - Business Combinations (Revised Edition)" (i.e. IFRS 3R) [6] and "International Financial Reporting Standards No. 10- Consolidated Financial Statements" (i.e. IFRS 10) [7]. We outline the main provisions of IAS on consolidated statements in the following.

Acquisition method for business combinations

Business combinations need to use the Acquisition Method for the accounting treatment of mergers and acquisitions, unless the subject is involved in a merger of businesses under common control. Under the acquisition method, the consolidated financial statements should be prepared based on the acquiring and the acquired companies' financial statements. All assets (tangible or intangible) and liabilities of the acquired company that can be separately recognized need to be recorded at fair value as of the acquisition date. The fair value refers to the amount to exchange for assets or settle liabilities under the normal trading conditions, with the involved parties having considerable understanding and willingness. The date of acquisition is the time when the acquiring company takes control of the acquired company. In principle, the acquiring company is the one that obtains control of the combined company.

Inter-company transactions

Earnings, expenses, claims and liabilities arising from internal sales and borrowings between the acquiring and the acquired companies should be removed from the consolidated financial statements.

Minority equity interests

If the merger transaction does not obtain 100% equity of the acquired company, the acquiring company may choose to determine the minority interest equity value either at the acquisition day fair value or based on its proportional share of identifiable net assets' book value of the acquired company.

Acquisition price and acquisition costs

If the acquisition price is paid in stock or other non-cash forms, the purchase considerations shall be determined in accordance with the fair value of the stock or non-cash forms at the acquisition date. Various expenses incurred in the acquisition process, such as consulting fees, accounting fees, are not included in the acquisition

price. They general should be recognized as an expense during the period. But the cost of issuing debt or equity securities shall be charged against the related securities account.

Contingent considerations

Contingent considerations should be recognized at fair value at the acquisition date as part of the acquisition price, and be classified as assets, liabilities, or equity according to their nature. In subsequent accounting treatment, contingent considerations classified as assets or liabilities need to be revalued with changes in fair value charged to profits or losses. Contingent considerations classified as equity are not subject to revaluation.

Mergers carried out in stages

If the acquiring company has made investments in the acquired company before taking control, the acquiring company should revalue the investments at the fair value at the date of obtaining control, with the changes in value included in profits or losses.

Goodwill

Goodwill is the amount by which the total purchase price (purchase price at the date of the transfer, plus the previously held interest in the acquired company, plus any minority interests) exceeds the fair value of the acquired company's identifiable assets and liabilities. If the purchase price is less than the fair value of the acquired company's net assets acquired, the difference shall be counted as a bargain purchase, with the gain credited as other income.

Currently, Mainland China, Taiwan and Hong Kong have all adopted to various extents the international accounting standards for consolidation, but differences still exist with the international accounting standards. Chinese companies need to prepare consolidated financial statements following "Enterprise Accounting Standards No. 20 - Business Combinations" [8] and "Enterprise Accounting Standards No. 33 - Consolidated Financial Statements" [9]. These two accounting standards issued in 2006 converged with the international accounting standards at that time. However, the international accounting standards for business combinations experienced relatively large changes in 2008. In this regard, China released "Enterprise Accounting Standards Interpretation No. 4" [10] in 2010 and "Enterprise Accounting Standards Interpretation No. 5" [11] in 2012 to modify its standards for business combinations to make it converge to the current international accounting standards. On the other hand, "Enterprise Accounting Standards No. 20 - Business Combinations" [4] classifies business combinations into the business combination under common control and those not under the common control. Accounting standards for business combinations of enterprises not under common control are consistent with the international accounting standards. Business combinations of enterprises under common control are unique to China's accounting standards, mainly for the presence of a large number of the government-led mergers of enterprises controlled under State-owned Assets Supervision and Administration Commission (SASAC). These mergers are different in nature from mergers and consolidation among independent enterprises. Therefore, China's accounting standards stipulate that in the business combinations of enterprises under common control, the assets and liabilities acquired shall be measured at their carrying value on the book of the acquired company as of the merger date, instead of at fair value.

Taiwan is currently in process of fully adopting the International Accounting Standards. In the first stage, public listed companies and financial companies supervised by the Financial Supervisory Commission (FSC) started the direct use of the Taiwanese version of the International Financial Reporting Standards (Taiwan-IFRSs, TIFRSs) since January 1, 2013. TIFRSs are the Chinese translation of IFRSs by the semi-official organizations, "Accounting Research and Development Foundation in Taiwan", authorized by IASB. After public comment and scrutinizing procedures, they are officially released as the basis of adopting IFRSs in Taiwan. Then the FSC would amend the relevant laws and regulations in accordance with TIFRSs to complete the process of officially adopting the guidelines. In the second phase, other non-listed companies continue to follow the original accounting standards until the end of 2014 and will adopt international accounting standards on January 1, 2015. In Taiwan's existing accounting standards, the consolidated financial statements are governed by "Statement of Financial Accounting Standards (SFAS) No. 7 - Consolidated Financial Statements" [12] and "Statement of Financial Accounting Standards (SFAS) No. 25 - Business Combinations - Accounting Treatment under Purchase Method" [13]. In variation from the international accounting standards, the Taiwanese original accounting standards designate the date when both parties agree to transfer rights and obligations, i.e. the contract release date, as the merger date to measure fair value. Non-controlling interests are recorded at the book value of the acquired company, and any investment in the acquired company prior to the merger is measured at original costs. All direct merger transaction costs except for those related to the issue of securities are included in the merger considerations. In bargain purchases, the amount by which the fair value of the acquired company's net assets exceeds the merger considerations need to reduce the fair value of non-liquid assets till zero, where any remaining balance will be charged into extraordinary losses. Contingent considerations based on future earnings are included in the price of the merger, while contingent considerations based on future securities price does not change the price of the combination.

Since 2013, the preparation of the consolidated financial statements in Hong Kong follows the "Hong Kong Financial Reporting Standard No. 3 - Business Combinations" (i.e. HKFRS 3) [14] and "Hong Kong Financial Reporting Standards No. 10 - Consolidated Financial Statements" (i.e. HKFRS 10) [15]. There is a high degree of convergence between the Hong Kong business combination accounting standards and the international accounting standards.

The guidelines for the consolidated financial statements in U.S. GAAP include "Accounting Standards Codification No. 805 - Business Combinations" (i.e. ASC 805) [16], and "Accounting Standards Codification No. 810 - Consolidated Statements" (i.e. ASC 810) [17]. U.S. GAAP in regard to consolidated statements largely converges with the international accounting standards. However, there exist some differences in non-controlling interests and treatment of contingent assets and liabilities and goodwill. Under the international accounting standards, the acquiring company may choose to determine the value of non-controlling interests either at the acquisition date fair value or at the proportional amount of the acquired company's identifiable net assets, while U.S. GAAP only allows recognition of non-controlling interests at fair value in consolidated financial statements. Under U.S. GAAP, all contingent assets and liabilities acquired in a business combination should be measured at fair value, whereas the international accounting standards only allowed the acquired contingent liabilities to be recorded at fair

value. Acquired contingent assets cannot get recognized. Although the calculation of goodwill in both accounting systems are the same, the international accounting standards require that goodwill be based on cash flow generating units, while under U.S. GAAP goodwill is calculated based on accounting reporting units in the enterprise. In addition, U.S. GAAP uses a two-step method to estimate the impairment of goodwill, and international accounting standards adopt the one-step method.

Comparison of Long-Term Investment Accounting Methods

International Accounting Standards applicable to corporate long-term investments include "International Financial Reporting Standards No.11- Joint Arrangements" (i.e. IFRS 11) [18] and "IAS 28 - Investments in Associates and Joint Ventures (Revised Edition)" (i.e. IAS 28R) [19]. International Accounting Standards classify long-term investment into two categories, namely, joint operations and associates and joint ventures, and provide different accounting treatments for these two types of long-term investments.

Joint operations and associates and joint venture are all joint arrangements. They are distinguished through the rights and obligations of the parties involved. Analysis of the joint arrangements needs to examine such factors as the establishment of a separate legal entity, the terms of the contractual arrangements, and other facts and circumstances. If the parties involved in a joint arrangement have rights to the assets and obligations to the liabilities relating to the arrangement, this is a joint operation. If the parties involved in the joint arrangement only have rights to the net assets of the joint arrangement, this is a joint venture. Associates refer to long-term investments in enterprises where the investors have significant influence over the investee enterprise. For long-term investments classified as joint operations, companies record their share of assets, liabilities, income and expenses in the joint operating arrangement in accordance with the relevant international accounting standards. For associates and joint ventures, companies should account for the interest using the equity method. Companies may choose not to account for long-term investments with the equity method under the following two exceptions, (1) when the investor is in line with the definitions of parent companies that are exempted from preparing consolidated financial statements in "IFRS No.10 - Consolidated Financial Statements" [3]; (2) if long-term investments in associates and joint ventures are held directly or indirectly by private equity funds, companies can choose to account for their long-term investments at fair value.

Under the equity method, investment value is set at initial cost and subsequently adjusted for changes in the investor's share of net assets in the investee company. Investors' share of profits or losses of the investee company is recognized as investors' income, and profit distribution received from the investee company reduces the carrying value of the investment. Changes in equity caused by other comprehensive income of the investee company should also adjust the carrying value of the investment. Profits and losses generated by any "upstream" and "downstream" transactions between the investor company and the associates and joint ventures should be eliminated according the investor's share in the equity.

Chinese companies need to follow "Enterprises Accounting Standards No. 2 - Long-term Equity Investments (2006)" [3] to identify and measure long-term investments. Different from the

international accounting standards, "Enterprise Accounting Standards No. 2" [20] makes classification of the long-term investments according to means of acquisition, and provides different methods for determining initial investment costs. The initial cost of long-term equity investments acquired in business combination of entities under common control shall be measured as its share of the carrying value of the investee company's equity. The difference between the initial investment value and the purchase price adjusts the capital surplus account. The accounting for initial cost of long-term equity investments obtained from business combinations of entities not under common control and from non-business combination sources is the same under the Chinese accounting standards and the international standards. However, the Chinese accounting standards require combination related expenses be included in purchase price, while the international accounting standards require the combination related costs be included in current income. For subsequent measurement of such investments, Chinese accounting standards are consistent with international accounting standards, both requiring using the equity method.

Taiwan's listed companies and FSC affiliated financial companies have directly adopted the international accounting standards for financial reporting since 2013, and thus the accounting methods for long-term investment are consistent with the international accounting standards. Other Taiwanese companies that still use the existing accounting system follow "Statement of Financial Accounting Standards No. 5 - Accounting for Long-term Equity Investments under the Equity Method" to record their long-term investments. In contrast with the international accounting standards, "SFAS No. 5 - Accounting for Long-term Equity Investments under the Equity Method" regards costs associated with obtaining investments as part of purchase considerations, while the international accounting standards have investment related costs recognized in profit or loss. For subsequent measurement, Taiwan accounting standards are in line with the international accounting standards, both requiring using the equity method. Different from the international accounting standards, Taiwan accounting standards require the application of "SFAS No. 25 - Accounting for Business Combinations - Purchase Method", according to which any difference where the net asset fair value of the acquired company exceed the purchase considerations will reduce fair value of the acquired company's non-current net assets till zero, with any remaining balance included an extraordinary gain or loss.

Hong Kong has been following "Hong Kong Accounting Standards No. 28 - Associates and Joint Ventures (2011)" (i.e. HKAS 28) and "Hong Kong Financial Reporting Standard No.11 - Joint Arrangements" (i.e. HKFRS 11) to record long-term investments. The new Hong Kong accounting standards for long-term investments are highly convergent with the international accounting standards.

Under U.S. GAAP, accounting for long-term investments follow Accounting Standards Codification No. 323 - Investments - Equity Method and Joint Ventures" (i.e. ASC 323)[21]. U.S. GAAP largely converges with the international accounting standards on accounting for long-term investments, however there are some differences. First, U.S. GAAP do not consider potential voting rights in determining whether investors have significant influence over the investee company, but the international accounting standards require consideration of the impact of potential voting rights. In addition, "Accounting Standards Codification 825 - Financial Instruments" (i.e. ASC 825) [22] allows companies to choose to measure certain investments at fair value, although these investments have a significant

influence and should be handled using the equity method under normal circumstances. The international accounting standards do not allow companies to measure investments with significant influence at fair value.

Comparison of Disclosure Requirements on Consolidated Statements and Long-Term Investments

Disclosure, as a complement to financial statements, belongs to segment reporting under Chinese accounting standards (CAS). It provides extra information for operating units under Taiwan accounting standards (TIFRS). The former focuses on reliability, and the latter focuses on relevance. CAS segment information requires application of the same accounting policy as that of the consolidated financial statements, while TIFRS requires disclosure to facilitate evaluation of each operating sector's performance and assets allocation for decision makers. In terms of the disclosure forms, CAS distinguishes primary and secondary segments based on risk and compensation and requires that segment information be articulated with the consolidated financial statement totals. TIFRS sets more specific and detailed rules than CAS. It regards operating divisions as independent profit centers and requires disclosure of division-specific revenue, expenses, assets and liabilities.

On the other hand, while Taiwan has more explicit and detailed regulations on related party transactions, Mainland China is more concerned with capital market regulation. In regard to the impact of debt restructuring on earnings, CAS requires gain from debt restructuring be recorded in current profit or loss and stipulates that donations and debt forgiveness received by companies usually should be recognized in current income, if such transactions meet the recognition criteria in CAS. Direct or indirect donations from controlling shareholders or controlled subsidiary companies should be treated as equity transactions and be recorded into paid in capital accounts, if such donations are capital contributions in economic substance.

Conclusions and Recommendations

The accounting systems in the three Chinese regions have achieved convergence in essence with the international accounting standards. A single set of global accounting standards can improve comparability of financial statements of domestic and international companies and reduce the cost of converting financial reporting between different countries' accounting standards, which will ultimately help improve the efficiency of enterprise management and promote international trade and investment. Hong Kong and Taiwan take the immediate adoption of international accounting standards (adoption) approach, while China makes the gradual upgrading of domestic accounting standards to converge with the international standards (convergence). Due to China's unique conditions and time delay in revising its domestic accounting standards, differences will exist between China's accounting system and those of Hong Kong and Taiwan in the foreseeable future.

Although Taiwan listed and financial companies have adopted TIFRS, it is still in the early stage of IFRS implementation similar to the Mainland. We believe that in addition to further effort toward the convergence of accounting standards, more attention should be directed towards promotion of good corporate governance, internal control and information disclosure in order to enhance financial statements quality.

Specifically, the Mainland can follow Taiwan's practice and expand the scope of intangible assets recognition. It should provide guidance on the definitions and measurement of cost of internally generated and externally purchased intangibles and requires companies to disclose intangible resources and common projects. Moreover, both the Mainland and Taiwan may expand the use of fair value measurement. The two economic entities are facing their own challenges. The Mainland is subject to the limit of a capital market at the developing stage, which makes it difficult to obtain reliable fair value. Taiwan faces the impact of valuation fluctuations and reserves shocks from the adjustment of the liabilities evaluation model. Taiwan can learn from the Mainland to set clear and restrictive rules on whether the difference between the normative and the fair value of assets can be recognized in current profit or loss. The Mainland can learn from Taiwan in regard to the accounting treatment for convertible bonds, subordinated debts with no maturity date and no guarantee and preferred stock. After the market and the professional expertise of the employees becomes more developed, the Mainland can follow Hong Kong to adopt more flexible criteria. The Mainland and Taiwan can adopt the U.S. regulatory initiatives in financial derivatives and risk management and require large financial institutions to disclose necessary information on their counterparties in derivatives trading, including significant risk factors, product characteristics, incentives and potential conflicts of interest.

This paper contributes to the literature through making an in-depth analysis of similarities and differences of the accounting standards for business combinations in the three Chinese regions and proposing ways to effectively improve the quality of information. We believe that in addition to the convergence of accounting standards, we should pay attention to improve the quality of financial statements through promoting good corporate governance, internal control and information disclosure. We acknowledge that our paper is limited with the absence of empirical analysis of the factors that affect the quality of consolidated financial reporting and capital market regulation.

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