



Land in China: Re-considering comparability in financial reporting

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Abstract

This paper re-considers the notion of ‘comparability’ as it has been applied to the accounting standard harmonisation project and its implications for accounting practices that are emerging in China. Comparability is a concept that has been widely referred to within the accounting literature, but has remained largely unexplored. In order to encourage what Zeff (2007) described as “genuine comparability” we argue that the underlying economic substance of an event should be the focus of our accounting choices in order to enable appropriate comparisons. If we focus too heavily on regulatory standardisation that prescribes comparable techniques without considering the broader economic context in which these are applied, the accounting representations could mislead users. The techniques may distort representations of the underlying economic substance of business activities, which would hinder the level of a genuine comparability in global financial reporting. In order to explore this, given the unique legal status of land in China, we consider how it is classified and represented in Chinese financial reports. This example shows that there are still significant challenges that need to be overcome in order to implement IFRS in China and there are still substantial comparability problems for cross-border users.

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Introduction

In 2007, Zeff (2007) raised the issue of global financial reporting comparability and convergence in his plenary address at the British Accounting Association's annual conference. In his address, he challenged the uncritical acceptance of 'comparability' as an unproblematic outcome of the IFRS project. By defining some factors that could impede or interfere with promoting genuine worldwide comparability he raised issues that researchers and practitioners have only considered in very limited ways. Given that Zeff (2007) challenged researchers to critically evaluate and explore the issue of comparability as it presents itself through efforts to harmonise accounting, this paper contributes to this discussion by offering an example of how different economic and legal contexts lead to different accounting representations.

Specifically we look at a particular institutional factor – the legal arrangement of land ownership to illustrate the problems associated with new Chinese Accounting Standards (CAS) after they are converged with the IFRS. The ownership of land has not only been the subject of fierce ideological controversy, but also the chief source of power in human history (Ellickson 1993). Despite the continuous opening and privatising of its domestic economy, China still maintains a very strict collective ownership of land. The reality is very different to mainstream Anglo-American legal frameworks because these are organised to support de-centralised land ownership. By demonstrating the impacts of the different land ownership in China on accounting and reporting practices, this paper illustrates some of the challenges and obstacles that confront IFRS convergence if a genuine comparability is to be achieved.

The Problem of Comparability

Achieving comparability has been a major consideration underlying the project of IFRS convergence for cross-border financial reporting (FASB 2002). In the accounting literature the issue of comparability has, for the most part, been presented as attainable through the global harmonisation or convergence of national accounting standards through the wide adoption of IFRS. As a result, the concept of comparability itself has been subject to little critique and limited theoretical explanations. As Zeff (2007; p. 290) indicated:

[w]e have not really had much literature that helps us understand what is meant by comparability – when we have it, and when we do not.

A view of comparability that is widely cited is from American Institute of Certified Public Accountants (AICPA)'s definition – "Comparability means to have like things reported alike, and unlike things reported differently" (AICPA 1971; p. 59). However, the definition is so open that we are given little

guidance on what 'like' and 'unlike' things are, in fact, we don't even really know what the 'things' are that are under discussion. Do they refer to business transactions; or types of accounts; or is the concern with the underlying economic substance? Different interpretations of this definition are likely to influence the standard setting process and hence accounting practices.

Much of the literature that raises the issue of comparability is connected with the internationalisation of accounting standards. Many researchers supporting harmonisation through international accounting standards have referred to 'accounting uniformity' which has often implied comparability. According to Zeff (2007; p. 294) "(t)here are those who believe, and many have believed this for a long time, that comparability is promoted, or assured, by all companies being required to use the same accounting methods, that is to say, 'standardisation' or 'uniformity' of method." Early researchers (see Wilkinson 1965, Morgan 1967, Bromwich 1980, Fitzgerald 1981, Dopunik 1987, Goeltz 1991, Wallace 1990, Schweikart et al. 1996) indicated a strong interest in the achievement of greater levels of international harmonisation, with the eventual goal of achieving uniformity in accounting practice. Wilkinson (1965; p. 11) even suggested that "each company presents only one set of accounts for all investors, of whatever nationality". Along with the accelerating trend of convergence toward International Financial Reporting Standards (IFRS) since the late 1990s, one of the primary arguments for IFRS, on the ground of economic rationality, was to achieve a global accounting uniformity which brought about an open and accountable world (Lehman 2005). Saravanamuthu (2004; p. 296) argued that "the IFRS project(s) an aura of objectivity by transcribing complex local reality into universal recognisable and acceptable information". A major assumption of these arguments, as indicated by the IASB (2008), is that accounting uniformity leads to comparable financial information across international boundaries.

On the other hand, many have questioned the possibilities of a single regulatory framework that could meet the financial reporting needs of all societies. There have been considerable counter-arguments that have focused on environmental factors, such as difference in culture (Violet 1983, Riahi-Belkaoui and Picur 1991, Belkaoui 1983, Taylor-Zarzeski 1996), economic factors (Gray 1988, Chow and Wong 1987, Ampofo and Sellani 2005, Chand and White 2007) and political systems (Luther 1996, Chandler 1992, Ahadiat and Stewart 1992, Craig and Diga 1996). Some of these studies have raised issues such as the impact of language; the historical development of a nation; the different legal systems; the different nature of property rights; the size, structure and complexity of the economy within a nation; the education system; the social stabilities; and differences in capital markets – all of which present challenges to the development of uniform accounting practices.

The research shown above has been largely descriptive in arguing that international differences in reporting and disclosure has been attributed to

the different economic and political environment of each country and has consistently presented challenges to the globalisation of accounting standards. This prior research has not actually provided evidence of the perceived costs or benefits of harmonisation by concrete cases or empirical analysis of real data. Further, the major weakness of the existing literature, in the context of this paper, is that they have not explained specifically the underlying assumption of what ‘comparability’ is and how the definition would influence any studies on the topic of global harmonisation of accounting standards.

Zeff (2007) raised this issue more specifically and gave examples of the obstacles to what might be termed ‘genuine’ comparability, and to convergence at a high level of quality. The first obstacle that Zeff (2007) defined related to the business and financial culture. He argued that the different cultural attitudes lead to differences in the way that specific countries conduct business and in their supporting financial markets. For instance, in the USA, partly because of tax benefits, it is commonplace in airline companies to raise financing through long-term leases. Therefore, airplanes would not normally be owned by the airline companies but financial institutions that provide the lease, which leads to a situation, in the vast majority of cases, where the aircraft do not appear on the balance sheet of the operating company. Zeff (2007) argued that this kind of practice of omitting major tangible operating resources from the balance sheet is “one of the reasons for a considerable lack of comparability even within my country, let alone between my country and others” (Zeff 2007; p. 291).

Another example Zeff (2007) described for the different business and financial culture is the application of consolidated financial statements in Japan and Korea, where the *keiretsu* and *chaebol* represent networks of companies with inter-locking relationships, which is substantially different with those Western companies that have a clear hierarchical relationship between subsidiaries and the ultimate parent or holding company. Zeff (2007; p. 291) believes that “an identical standard in such circumstances would do little more than accentuate the differences between the countries’ different way of structuring intercorporate enterprise.”

The second obstacle that Zeff (2007) raised related to culturally contextual attitudes towards tax. Zeff (2007) recognised tax minimisation as a significant factor in the choice of financial reporting practices in many Western countries.

In addition, individual nations have developed different auditing cultures that could lead to a diminution in comparability, especially if a company knew that it could depart from IFRS without having to suffer an auditor’s qualification. Zeff (2007) pointed out that companies may be more willing to depart from the IASB’s standards and interpretations in certain countries than in others because of the difference in auditing culture.

Finally, the regulatory culture is important to world wide comparability. As noted by Zeff (2007), in countries where the regulator is stronger and more forceful, companies may be less willing to depart from a strict construction

of IFRS, because the regulator will object and may insist upon changes in their financial reports; whereas in countries where the regulation is softer, companies may be more inclined to apply their own constructions of IFRS, believing that the regulator would not take any adverse action.

Those problems, derived from contextual differences, might be resolved by providing flexible options in the standards “to take into consideration differences in ‘circumstances’ among companies or among countries” (Zeff 2007; p. 294). But there is a dilemma – the existence of options might impede the attainment of comparability. Zeff (2007; p. 294), therefore, asserted that:

[t]his becomes a philosophical question: what fitting of accounting methods to circumstances promotes genuine comparability?”

The question is whether the same method to be used by all companies around the world produces ‘*genuine comparability*’ or ‘*superficial comparability*’. This is a debate that has not been adequately taken up in our literature. Referring to the simplistic desideratum that ‘like things should look alike, and unlike things should look different’ does not address the essence of the conundrum of accounting comparability and how it is to be achieved.

In light of Zeff’s commentary, this paper seeks to add a new dimension to the discussion by providing a practical ‘real world’ example of how financial reporting comparability can be impeded by different contextual factors if there is a uniformity of reporting despite real economic differences. The relevant analysis will be based on the theoretical arguments presented in the works of Gray (1973) and AICPA (1971).

What Is Comparability?

Gray (1973) set out to evaluate two directives on company accounts in the UK by comparing the relative merits of the two positions in terms of the objective of comparability. He argued that:

[W]hat is meritorious will be determined by reference to the information needs of investors¹ who use information from company accounts as an aid to making comparisons between companies, and within a single company, in the process of deciding whether to buy, sell or hold shares in public quoted companies. (Gray 1973; p. 2)

Despite some possible shortcomings, such as the limitations of accounting information in allocation decisions and recommendation that Gray has defined, this argument might be a good foundation for answering the key question –

when do we or do we not have comparability?

The first premise of this argument is the ‘investors’, or we can replace this word with ‘users’. The core value of our accounting standards should be to provide information for users. However, from the users’ perspective, referring back to the aircraft example mentioned by Zeff (2007), it is difficult to see how a user could distinguish between the reported value of the operating assets of an American airline company which leases aircraft and that of an overseas airline company which capitalises the aircraft in its balance sheet. If we agree that this presents comparability problems, how should the information be disclosed in order to facilitate better comparability?

Further, there is a significant theoretical question – what is the information that users need if comparability is to be achieved? Gray describes it as those that aid in “making comparisons between companies, and within a single company” (Gray 1973; p. 1). The AICPA also states in its study of the objectives of financial statements that “one reason for financial statement objectives is to guide the development of accounting standards that will increase the ability to make comparisons.” (AICPA 1971; p. 59) Further, the AICPA asserts that:

[f]inancial information should facilitate the comparisons needed to make investment and other decisions...with information that facilitates interpretation; users are able to compare and assess the results of similar transactions and other events among enterprises. Classifying information by relative risk based on assessments of uncertainties should permit the user to compare information from many enterprises and make decisions more effectively within the context of his own risk preferences. (AICPA 1971; pp. 59–60)

If the desirable information is the one that ‘facilitates interpretation’, what kind of information could facilitate users’ interpretation? In the aircraft example, would the practice of omitting major tangible operating resources from the balance sheet in American airline companies facilitate users’ interpretation and comparison of financial reports across borders? Unless users are familiar with contextual differences and are sophisticated enough to decipher the accounting information presented on financial statements with almost identical account names, it is likely that it would be difficult to compare companies both within country borders and internationally.

There is a range of possible reasons for the problem. Firstly, in the eyes of the users, the economic substance underlying the aircraft of an American airline company would have no difference to that of an overseas airline company in terms of the business operation, i.e. they both generate cash flows which determine the value of the firm. Gray (1989; p. 95) argues that “a uniform or preferred treatment was not necessarily the answer. It was the comparability

of the information content that was important". So the information content and 'the economic substance' both matter to the users making decisions based on accounting numbers. This is why Zeff (2007) regarded the aircraft example as a problem of comparability, and also explains why he distinguishes '*superficial comparability*' from '*genuine comparability*'. Insisting on technical correctness might lead to '*superficial comparability*'. This is the position of our current standards in its insistence to account for 'different transactions differently' without considering its economic substance. Focusing on the economic substance of what is measured and reported is also emphasised by the AICPA in its statement that:

[g]iven the development of financial statement objectives, however, industries can establish standards that serve users' information needs and also provide comparability. Choices between alternatives can then be based on the economic substance of what is measured and reported rather than out of a desire to produce a particular financial statement result. (AICPA 1971; p. 60)

Additionally, users are significantly guided by the representational disclosure of financial statements such as a Balance Sheet or an Income Statement. This has far more influence than the disclosure of economic transactions on specific accounts. Given this, if two different transactions that are of the same economic substance occur, it could be argued that they should be measured and reported in a similar way in order to enhance comparability. An approach that focuses on cross border comparability should present different transactions with the same economic substance in such a way as to support decision making.

Gray (1973; p. 4) held a similar position that:

[p]ersons who intend to establish relations with companies in other Member States, or who have already done so, have the greatest interest in being able to obtain sufficient and comparable information concerning the assets, financial position and results of such companies.

Gray (1973) suggested that the focus should be on comparative and trend analysis of financial position, both ratio and statistical (covering such issues as liquidity, leverage, capital safety) and performance (such as activity, profitability, income regularity). He believed that:

[i]f investors are to make valid comparisons of ex post financial position and performance then company accounts must present comparable information, in both quality and quantity, about the actual financial position and performance of companies at particular points of time and over time. (Gray 1973; p. 2)

Further, he suggested that “comparability, which is the ability to bring things together so as to assess how they differ, will be achieved when financial differences between companies, as perceived by ratio and statistical analysis, arise from differences in their actual financial position and performance and not from differences in accounting treatment” (Gray 1973; p. 2). If we are to accept Gray’s analysis, the financial position and performance of a firm are critical to comparability. For us to achieve the ‘genuine comparability’ raised by Zeff (2007), then it is essential that these areas are the focus of standard setters.

Therefore, in order to engage critically with the concept of comparability, this paper adopts a normative theoretical lens, based on views presented by Gray and the AICPA, that what is meritorious in pursuing financial reporting comparability should be determined by reference to the information needs of users to make comparisons in their economic decision-making. The usefulness of financial accounting information is thus dependent on whether or not it would facilitate users’ interpretation and comparison of the economic substance underlying business operations among organisations. Those accounts of financial position and performance with similar economic substance should be reported in the same way in the financial reports. The way that we account for apparently similar, though economically different, transactions needs to be reconsidered because there is the potential that the presentation will distort the underlying economic substance of business activities, which would hinder the level of comparability in cross-border financial reporting.

The problem, however, is very difficult to tackle. It has, as Zeff (2007; p. 294) described, become a “philosophical question”. It is important to work out how we treat apparently similar transactions that are of different economic substance in a way that enables meaningful comparisons. It is only then that we would be able to shift towards ‘genuine comparability’. The remainder of this paper examines the problem of comparability in China in order to explore some of these issues in more detail. The following sections evaluate the effects of one specific institutional factor – the legal arrangement of land ownership in China - on the potential for comparability of this asset across borders. The analysis will show that ‘*genuine comparability*’ cannot be achieved by uniform presentation, and that it is in fact a casualty of the ‘*superficial comparability*’ that is a key problem in the IFRS convergence project (Zeff 2007). It is hoped that this will inspire further research on this issue.

The Implications of Different Land Ownership Concepts For Accounting Practices

China, as the world’s fourth-biggest economy, has aligned itself with the accounting practices of Western countries since the Ministry of Finance (MOF) of China released the new Chinese Accounting Standards (CAS) in February 2006. This has become mandatory for all listed companies after 1

January 2007. The new CAS substantially changed the nation's old accounting system and covers nearly all topics under the current IFRS (Deloitte 2006). The convergence of accounting standards with IFRS in China has been a consequence of ongoing socio-economic reforms and developments cross-fertilised by internal and external factors. The mainstream discourse of the convergence in China, like that of other countries, emphasises technical and economic benefits such as the benefits of improving the quality of Chinese listed companies' financial reporting; enhancing the transparency and comparability of financial reports in China, and encouraging international investment. However, as we have outlined previously, achieving comparability remains a significant challenge. In order to explore this in detail, this paper considers the impact of China's unique legal framework for land ownership to illustrate the impact this has on accounting practices and hence the achievement of '*genuine comparability*' in cross-border financial reporting.

A view of land property ownership in the West and that in China

In common law countries,² land is characterised as real property – one of the major classes of property. The law recognises different sorts of interests, both legal and equitable, in real property. Although in the law of almost every country, the state is the ultimate owner of all land under its jurisdiction, because it is the sovereign or supreme lawmaking authority (Ting et al. 1999). The most common and perhaps most absolute type of estate in land is Fee simple (or interchangeably called Freehold³) which gives persons an estate of indefinite duration that can be freely transferred. Under the freehold system, the tenant enjoys the greatest discretion over the disposition of the property. Generally the Fee simple is the most common estate that the tenant has in most Western countries although there are jurisdictional peculiarities in different countries (Stoebuck and Whitman 2000). For instance, In Australia around 63 percent of land is held under Freehold ownership (Stutt 2008). Most of the real property transactions addressed in contemporary transactions in common law countries will fall into this 'freehold' category. How land is acquired, used and disposed of is significantly controlled by the reporting entities and transactions are generally not restricted by governments.

There is a fundamentally different legal framework for land ownership in China. Although the new Property Law which was introduced in 2007 diverges to a certain extent from the old ideology, the most fundamental aspect of land rights – public ownership - did not change in the newly reformed legislation. The old arrangement of land ownership seems still far too important to be challenged.⁴

In China's land policy, private ownership is strictly outlawed and replaced by state or collective property. As has been stipulated in Article 2 of the *Land Administration Law of the People's Republic of China*⁵ (2004; p. 1):

[T]he People's Republic of China resorts to a socialist public ownership i.e. an ownership by the whole people and ownerships by collectives of land. In ownership by the whole people, the State Council is empowered to be on behalf of the State to administer the land owned by the State. No unit or individual is allowed to occupy or trade or illegally transfer land by other means.

More specifically, Article 8 of the *Land Administration Law of the People's Republic of China* (2004; p. 2) stipulates:

[L]and in urban districts shall be owned by the State. Land in the rural areas and suburban areas, except as otherwise provided for by the State, shall be collectively owned by peasants including land for building houses, land and hills allowed to be retained by peasants.

Units or individuals, thereby, only have the right to use land under the law.

Implications for the application of International Standards

In light of the IFRS objective of comparability, consistency in financial reporting requires that accounting reports the same economic situation in similar ways across contexts. It is also important that different economic circumstances are reported in different ways. For those attempting to compare the financial reports of Chinese firms, this presents a significant challenge, as a substantial asset, land, has a very different legal status to the equivalent asset in most contemporary Western societies. We believe that accounting standards need to be flexible enough to allow for the different reporting of this asset in different social contexts, but this will have a significant impact on the ability to directly compare firms internationally. This in itself strengthens the argument that has been presented in Section II – *The Problem of Comparability* that IAS developed in one context may be un-suitable for reporting unforeseen situations arising in a different context. It, however, does not mean that the IAS project is redundant, but that it must incorporate an understanding of socio-economic differences within its broader charter.

The different legal status of land ownership provides an example of one significant socio-economic difference that arises from context and impacts on accounting practices. The first two standards that would be affected by China's legal definition of land are IAS 17 *Leases* and IAS 40 *Investment Property*.

Firstly, there are gaps between the real situation and the definitions of investment property in China. It is impossible for a company to hold land for capital appreciation or without a purpose that has been approved by the authority, according to Article 37 of the *Land Administration Law of the People's Republic of China* (2004; p. 7):

[N]o unit or individual is allowed to let the land lie idle or go wasted,

if construction work fails to start for over one year, land idling fees shall be paid according to the provisions of various provinces, autonomous regions and municipalities. Where construction work fails to start for two successive years, the people's governments at and above the county level shall revoke the use right of the land with the approval of the original organ of approval.

The State places strict legal control on the transfer of land. Each tract of land has been assigned a plan of usage for (or by) the State which shall be implemented strictly. Any changes of 'owners' and usages of land should be approved by various levels of authorities and go through very complicated land alteration registration procedures. For instance, Article 21 of the *Land Administration Law of the People's Republic of China* (2004; p. 4) indicates that:

[G]eneral plans for the land use at the township level should define the areas for the utilisation of land and define the purpose of each tract of land according to the actual conditions for the use of land and make an announcement.

Further, Article 25 of the *Land Administration Law of the People's Republic of China* (2004; p. 5) states:

[T]he people's governments of provinces, autonomous regions and municipalities shall report the implementations of their annual plans for the use of land to the people's congresses at the same level as part of the implementation of their economic and social development plans.

And Article 26 of the *Land Administration Law of the People's Republic of China* (2004; p. 5) "revision of the general plans for land use shall be approved by the original organ of approval. Without approval the usages of land defined in the general plans for the utilisation of land shall not be changed."⁶ In reality, the primary market for land is not free but controlled entirely by the State. In essence, the kinds of investment property based on land that coincide with the meaning stipulated in IFRS do not exist in China.

In addition, the IFRS permit a property interest that is held by a lessee under an operating lease to be classified and accounted for as investment property under certain circumstances. This, however, would not be the case in China when it relates to transactions associated with land. Under the current legal framework, there would be no finance leases of land for Chinese companies. According to IAS 17 *Leases* (IASB 2008), a lease is classified into either a financing lease or an operating lease based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Referring to land, IFRS assumes that:

[A] characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. (CPA Australia 2005, p. 451)

A payment made for acquiring the operating lease should be amortised over the lease term in accordance with the pattern of benefits provided. And the land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification.

Because of the state ownership of land in China, neither lessors nor lessees could obtain ownership through any lease contracts. Instead, they acquire a property right which is similar to an operating lease. This systematically excludes the possibility of classifying any leased land as a finance lease. And being classified as a finance lease is a pre-condition “in order to account for a property interest under a lease as investment property in the operating lease is accounted for as if it were a finance lease in accordance with IAS17 *Leases*” (CPA Australia 2005, p. 951). Chinese companies, therefore, would not be able to transfer any land under a lease contract into an investment property as has been done by peer companies in the West. This might be the reason why the previous CAS 21 *Leases* (prior to the new CAS) was not applicable to transactions of land under an operating lease. The Chinese Accounting Standards Committee (CASC) recognised that: “even though the land use right has been permitted to lease out in China, the relevant transactions should be considered under CAS 6 *Intangible Assets*, therefore this standard (CAS 21 *Leases*) does not deal with matters of land use right under a lease.” (CASC 2007)

This rule has been removed from CAS 21 *Leases* in the new CAS. And it adds, “This standard does not apply to the measurement in a lessor’s financial report of investment property provided to a lessee under an operating lease (see CAS 3 *Investment Property*)” (CASC 2007). However it does not explain how a lessee deals with the land use right under an operating lease, neither does CAS 3 *Investment Property*.

As has been illustrated, IFRS prohibit a lessee from recognising a property interest as an investment property if it is under an operating lease even if the interest meets the rest of the definition of investment property. If this rule fully applies to CAS, no company holding land as a lessee could recognise the leased land use right as an investment property. The new CAS seemed to avoid this problem by changing the definition of investment property in CAS 3 *Investment Property* as “land use right or a building held to earn rentals or for capital appreciation or both” (CASC 2007). It does not mention whether the land use right is held by the owner or by the lessee under a finance lease as stipulated in IAS 40 *Investment Property*. In China a lessee,

therefore, could capitalise lease payments as assets in a balance sheet rather than recognising them as an expense even if in the nature of the business it is an operating lease.

Asset recognition and the income statement

More practically, the different legal status of land ownership has a major influence on the assumptions made about asset recognition. Under China's land ownership law, the physical form of land is not recognisable in Chinese accounting standards, only an intangible land use right could be measured and reported. The right to use is the cornerstone of value, so a leased asset will be reported in the books of a company in certain circumstances and this is similar to the Chinese situation where a right to use generates the economic substance of the asset. Remember also that when you buy a block of land in Common Law countries you only acquire the right to exclude others from the surface of the land (Stutt 2008). The Crown retains all mineral rights in the UK for instance and a range of other access rights which arise from easements. This rationale to a certain extent strengthens our assumption that the economic substance of the land use right in China is similar to physical land in Common Law countries. If this kind of 'economic substance' has to be measured and disclosed differently in accounting, we could hardly establish that we would achieve a 'genuine comparability' in current financial statements.

Specifically, the difference manifests as follows. The IASB defines an asset as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity" (CPA Australia 2005, p. 28). Land is measured as a non-current Asset in the financial reports of Western companies when they have control over the land. Chinese reporting entities, however, do not control the land but hold only a right to use the land. The companies do not report land in financial reports but a 'land use right' which has normally been classified as an Intangible Asset in the balance sheet.

This leads to an immediate controversy about the comparability of financial reporting because, based on the theoretical arguments presented in Section III – *What is Comparability*, a significant real asset has been excluded (shown partly as an intangible) from the financial statements. The ownership and control of land is a significant component of wealth and its representation in the financial reports of organisations is significant. It is very hard to establish the value of land in China by using Western criteria. IFRS require the use of fair value accounting; it is difficult to determine the 'fair value' of land if there is no market for land 'ownership' in China.

It would also be naïve to assume that the considerations Chinese companies paid for the land use right are equal or comparable to those that Western companies paid for acquiring the land. As has been stipulated in the Law⁷ (State Council of China 1990; Article 12),

[T]he maximum term with respect to the assigned right to the use of the land shall be determined respectively in the light of the purposes listed below:

- (1) 70 years for residential purposes;
- (2) 50 years for industrial purposes;
- (3) 50 years for the purposes of education, science, culture, public health and physical education;
- (4) 40 years for commercial, tourist and recreational purposes; and
- (5) 50 years for comprehensive utilization or other purposes.

Upon expiration of the term of use, users may apply for a renewal. Where such a renewal is necessary, a new contract shall be signed and the land user shall pay the fee for the assignment of the right to the use of the land and undertake registration. The initial right of using land has a maximum term lasting between 40 years to 70 years. This is indicative of the lack of comparability between the nature of the right that Chinese businesses acquire and those of Western companies, which usually acquire the land in perpetuity, normally without such a prescribed term of use.

Although the land use right is disclosed as an intangible account in China, the accounting method is not the same as the land account shown in a Western company's financial report. Although the economic substance underlying these two accounts in relation to companies' business operation might not be so different, if we shift the focus to the reported financial position and performance as discussed in Section III – *What is Comparability*, the problem of comparability becomes more apparent. The Property, Plant and Equipment (PPE) asset account (in the West) and the Intangible land use right account (in China) are the only corresponding accounts where a comparison could be made for the same kind of asset – land in financial reports. Therefore an evaluation of the influences that the different accounting treatments would have on financial position and performance reported in financial statements could enable us to establish whether or not there is a comparability problem based on the theoretical assumptions this paper adopts. One significant impact is reflected in the bottom line of the income statement due to the different asset classification. If comparability is assumed between the land being reported as a 'non-current asset' and the land use right as an 'intangible asset', there could be significant differences in the representation of the asset between China and the West. This could have a significant impact on a company's reported profits.

When a Western company acquires land, all necessary costs incurred in making land ready for its intended use are recorded as an increase (debit) in the Land account. This account will be reported as a Property Plant and Equipment account in the Non-current Assets section in the balance sheet. For measurement after recognition, an entity shall choose either the cost model or

the revaluation model⁸. Unlike buildings or other non-current assets, land is not a depreciable asset. Therefore no depreciation or amortisation is required. The historical cost (or value as stated above) of land normally will be carried unchanged in the balance sheet until it is sold or disposed of by the entity or if written down as a result of a change in 'fair value'.

Land use right, on the other hand, is classified as an Intangible Asset in the balance sheet in a Chinese company's financial reports⁹. According to the IFRS, Intangibles must be recognised at cost, the same as PPE assets (but see comments above). However, unlike PPE assets, intangibles cannot be subsequently measured at fair value or re-valued unless there is an active market. An active market is one where the items traded in the market are homogeneous; willing buyers and sellers can normally be found at any time; and the prices are available to the public¹⁰. By their nature, most intangibles would not have an active market and therefore would not be permitted to be re-valued (Kimmel et al. 2006). By using a cost model, after initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses¹¹. As has been shown, the land use right in China has a finite maximum useful life from 40 years to 70 years. An entity has to amortise the asset on a systematic basis over its useful life which incurs an amortisation expense in the profit or loss account for each period. The cost for a company to acquire land rights has been increasingly expensive in China. For those Chinese companies who need to recognise this expenditure, the requirement to amortise the cost generates a periodic expense which adversely influences the reported profits in the income statement.

Some empirical evidence would shed further light on this. Xinjiang Talimu Agriculture Development Co., Ltd (XTAD) is a major national cotton producer listed on the Shanghai Security Exchange. The company also has the largest production base of liquorice extract in China. The company reported a net loss of RMB26,493,996.68 for the 2008 financial year (XTAD Annual Report 2008; p. 38). The company attributed the loss to 'natural disasters' that occurred in its major production bases in Western China and the plunge in the prices of raw materials in global market. A closer look at its annual report, however, revealed a remarkable affect of the different accounting treatment on one of its major operating assets – land. XTAD Annual Report (2008; pp. 76-77) shows that the company had a carrying amount of the intangible asset – Land Use Right of RMB 3,621,234 accompanied by relevant expenditure of developing the land to meet production demands of RMB259,746,590.94. The land use right and development expenditure are subject to an annual amortisation expense which led to RMB 18,433,542.70 being written off in 2008¹² which accounts for 69.58 percent of the total net loss.

The amortisation expenses could not have been recognised in an equivalent company in the West since the land would have been capitalised without annual amortisation and the major development expenditure would

have been viewed as part of the costs of the land according to *IAS 16 Property, Plant and Equipment*:

[T]he cost of an item of property, plant and equipment comprises:
 (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. (IASB 2008; <http://www.iasb.org/IFRSs/IFRS.htm>)

A similar situation could be found in another agriculture company – Xinjiang Sayram Modern Agriculture Co. Ltd (XSMA). The company reported an amortisation expense of RMB 1,734,430.84 (XSMA Annual Report 2008; p. 97) for the ‘land use right’ (carrying amount was RMB 36,847,265.14) (XSMA Annual Report 2008; p. 96), which was 3.6 times its net profit – RMB 481, 343.80 (XSMA Annual Report 2008; p. 61). Of course, there are many other factors that affect the significance of this accounting treatment for the performance of the firm. The proportion of the value of the land use right in the company’s total assets, or the company’s actual business performance may mean the impact appears minimal, but this does not discount the fact that this treatment is significantly different to these firms’ international counterparts.

We could also evaluate the effects of this on the financial reports of Western companies in the same agricultural industry by using a simple mathematical example. For instance, Associated British Food (ABF) had Land and Buildings with a carrying amount of £ 1,553 million which included the freehold, long-leased and short leased parts amounting to £ 1,278 million in 2008 (ABF Annual Report 2008; p. 67). Hypothetically if this amount was to be amortised with a useful life up to 40 years as a Chinese company has to, ABF would have an annual amortisation expense of £ 31.95 million, which would reduce its profit by 5.72 percent - £ 559 million (ABF Annual Report 2008; p. 59). The hypothesized amortisation expense for Dairy Crest would be £ 4.95 million which equals 5.62 percent of its net profit in 2008¹³. Similar cases could be continuously quoted¹⁴.

These UK companies have not specified whether the ‘freehold, long-leased and short-leased’ is for the Land only or whether it is for the Land and Buildings together. Although buildings are often depreciated in the West, it is not expected that a company split the value between the land and the building as normally they are viewed as an integrated part of an asset. This, however, creates a practical difficulty for Chinese companies to implement Western standards if we want to make a comparison. A Chinese company has to separate the value between buildings and land and recognise them in different accounts. This is not often practical in many situations, especially when the company is not the developer of the real estate. The application guide of the new CAS addresses this issue, Article 6 – *Intangible Asset* of the new CAS application guide indicates that “the consideration of an acquisition

shall be reported separately between the land and the building; however, in the case where such a division is not practical, all the costs shall be recognised as non-current assets” (CASC 2007; <http://en.casc.gov.cn/internet/internet/en/kjfg2.html>). It is significant that this presents another difference in the accounting treatment, presenting yet another comparability problem. If this standard is followed the measurement of the land use right could be distorted by some Chinese companies. When the company is unable to distinguish the costs between buildings and land, the implementation of the CAS seems to result in the same outcome as that of the IFRS given the land now is reported as non-current asset. In practice, this allows for significant accounting choice and has the potential to create a significant comparability problem within China and also internationally. Given that CAS do not require a disclosure to clarify this classification decision, it is likely that few companies would bother to report such details.

As we have shown, the legal definition of land in China is unusual and its accounting treatment reflects this. This, in and of itself, is not a problem, but as we have shown it does impact upon our capacity to compare similar firms internationally, as it impacts the reported performance of the firm. In China, the physical part of land is not reported; instead it is recognised as an intangible asset because a company acquires only the right to use it (this reporting is the only unique feature, as leased land in the West is normally reported as a fixed asset). This presents challenges because the underlying economic substance of the firm might not be so different for many international companies such as those in the agricultural industry, but it will be depicted in a significantly different manner because of this classification decision and the obligation to amortise land use in China. Adding to this problem is the fact that CAS allows firms who cannot decouple land from buildings to classify it all as a non-current asset in the same way that one would under IFRS without clearly differentiating this decision through supplementary disclosure which is another arbitrary and confusing point. The comparability issues that arise have received little critical investigation and without this, it is difficult to develop appropriate disclosure requirements to support the kind of genuine comparability that Zeff (2007) refers to.

In this section we have provided some specific examples that illustrate how contextual issues impact the appearance (performance) of the firm. These differences are deeply rooted within the Chinese legal framework and they will continue to create challenges to the operational effectiveness of the new CAS. Under current practice, the kinds of disclosures that may help users understand the contextual differences between Chinese financial reporting and that in the West have not been mandated. As a result, therefore, we argue that convergence without proper disclosure of contextual influences would inhibit our capacity to achieve the kind of comparability that is desired by the IFRS project.

Conclusion

This paper responds to Zeff's (2007) commentary on the issue of comparability in on-going efforts to promote the globalisation of the IFRS. Like other aspects of the contemporary globalisation movement, a significant proportion of academics and practitioners in the accounting community have supported harmonisation in order to achieve greater comparability in financial reporting. It is believed that this kind of comparability could facilitate the movement of funds in global capital markets and enhance the transparency and comparability of general purpose financial statements. Many researchers, however, have questioned the possibility of satisfying the financial reporting needs of all societies by taking the same single regulatory framework. Unfortunately, little existing literature has investigated the level of comparability that is emerging as a result of these new regulatory arrangements. In this paper, we have argued that what is meritorious in pursuing financial reporting comparability should be determined by reference to the information needs of users in making comparisons of the actual economic substance of accounts of the financial position and performance of business entities. Our standards, therefore, should be devised in a way that promotes the reporting of the financial positions and performances of entities with similar economic substance in the same way.

This paper has selected a developing country (China) to shed further light on this issue. By looking at a specific institutional factor – the ownership of land in China and the limitations that this places on the application of IFRS, this paper has demonstrated that the exclusion of private ownership of land in China has substantially changed the meaning of land rights. In turn, this creates a significant implementation problem for the adoption of IFRS in China and a comparability problem for cross-border users. The first two standards under investigation are IAS17 *Leases* and IAS 40 *Investment Property*. A Chinese company cannot transfer any land under a lease into an investment property and IAS17 *Leases* cannot be strictly implemented due to the different legal right to land. The new CAS made certain changes in definitions but this creates another dilemma. A lessee is able to capitalise lease payments into balance sheets rather than recognises them as expenses even if the lease is an operating lease by virtue of the nature of the business. Also there are significant gaps between the real situation and the definitions of investment property in China due to these different legal rights. There are also more practical impacts when we examine the influence on asset recognition. Land has a unique legal definition in China, requiring a Chinese company to classify land as an intangible asset rather than recognising it as a non-current asset. The consequence of such an accounting treatment is evident in its impact on the bottom line because of the amortisation of an intangible which follows.

These issues, which are so deeply rooted into the legal and ideological underpinnings of Chinese society, provide an example of the challenges facing

the globalisation of accounting. The *'genuine comparability'* that Zeff (2007) suggests can only ever be achieved if we investigate the differences that are present as a result of the context in which the accounting information is emerging. And that is why this paper embodies an argument that we should emphasise the representational consistency of transactions with similar economic substance in terms of an entity's business operation. Under certain circumstance, we might have to account for different transactions in a similar way if the transactions contain similar economic substance, such as the land example this paper explores.

The acquisition of land in China is different from that in most Common Law countries. In China the acquisition of land is in nature like a lease, i.e. Chinese companies lease the land for 40 years from the state. However, it is not exactly the same as a lease because Chinese companies split land into two parts: (1) physical land (not recognised in accounting); (2) and the intangible land use right, but they only recognise the intangible part of the right to use land. The physical part is left off balance sheet. Apparently, there are still differences between land acquisition and lease in China. Like many other examples, such as the aircraft one discussed by Zeff (2007), we could only make such a clear distinction between these transactions if we focus on the economic substance underlying those accounts in the company's business operation. This is why we suggest shifting the focus to accounts of financial position and performance and taking a consistent treatment of financial position and performance based on the underlying economic substance.

The problem of current IFRS harmonisation is that we try to create an appearance of 'uniformity' and the appearance of 'comparability'. Many financial numbers look alike in the accounts, but in fact, they may be subject to substantially different treatment. If we are satisfied with the current practices that are achieving comparability by treating different transactions in different ways, we may be undermining our own objective by creating the illusion of similarity. As pointed out above, there are many obstacles to overcome for genuine international convergence and comparability to be achieved. The issue of comparability needs further investigation, and some of the significant institutional differences and subsequent impacts on accounting numbers need to be addressed properly in financial reports. We might accept that we can work towards better comparability but that absolute uniformity of reporting practice and disclosure may be beyond this globalisation effort.

Endnotes

- 1 The importance of this use, as proposed by Gray (1973), is not to deny the existence of other uses such as in management planning and control.
- 2 This paper focuses on Common Law societies such as the UK, the US, Canada, etc, when referring to "Western countries".

- 3 Some other types of estates in land include: Conditional Fee simple, Fee tail, Life estate and Leasehold, all of which contain less authority for the tenant over the land.
- 4 Under rural reforms passed on October 12, 2008 by the Chinese Communist Party, peasants may for the first time be allowed to trade or rent out their land tenancies. The new policy stops short, however, of granting private ownership of land or allowing farmers to sell the land they work, as leaders struggle to preserve one of the fundamental pillars of the country's communist system (Forbes, 2008, available on the internet at http://www.forbes.com/markets/2008/10/13/china-land-reforms-markets-econ-cx_tw_1013markets04.html).
- 5 The Law of Land Administration of the People's Republic of China (issued by the National People's Congress of the PRC and came into force starting from January 1, 1999).
- 6 For further examples see Article12, Article17, Article20, and Article21 of the Land Administration Law.
- 7 The relevant law namely Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-Owned Land in the Urban Areas.
- 8 Cost model: after recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
Revaluation model: after recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.
- 9 This is also an interesting point. CASC does not explain the reason of this treatment. However, it itself implies that the acquisition of land use right in China is not exactly equal to a lease, otherwise it could be standardised under CAS 21 Leases.
- 10 See IAS 38 Intangible Assets.
- 11 Ibid.
- 12 $\text{RMB}18,433,542.70 = \text{RMB}369,525.26$ (amortisation expense of land use right) + $\text{RMB}18,064,017.44$ (amortisation expense for development expenditure) (XTAD Annual Report 2008, pp. 76-77).
- 13 Dairy Crest reported a carrying amount £195.8 million for Land and Building and net profit of £87.1 million in 2008. (see Dairy Crest Annual report 2008, p.70, p.48, available from internet: <http://www.dairycrest.co.uk/media/18559/annual2008.pdf>).
- 14 The expense would occupy 6.29 percent of the net profit for Delhaize Group: Delhaize Group reported a carrying amount £1,206 million for Land and Building and net profit of £479 million in 2008 (see Delhaize

Group Annual report 2008, p.85, p.66, available from internet: <http://www.delhaizegroup.com/LinkClick.aspx?fileticket=Fg5ybNfx2Ug%3d&tabid=231&mid=1016>); 8.31 percent for Total Produce: Total Produce reported a carrying amount £86.97 million for Land and Building and net profit of £26.12 million in 2008. (see Total Produce Annual report 2008, p.73, p.51, available from internet: http://ww7.investorrelations.co.uk/totalproduce/uploads/reports/Total_Produce_AR_2008.pdf); and even 14.83 percent for Devro Plc: Devro Plc reported a carrying amount £78.83 million for Land and Building and net profit of £13.29 million in 2008. (See Devro Plc Annual report 2008, p.32, p.31, available from internet: <http://www.devro.plc.uk/documents/devroannualreport2008.pdf>).

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