

**The influence of the Chinese tax regime on IFRS
convergence process in China: aligning the tax
standards, CAS18 and IAS12**

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**The influence of the Chinese tax regime on IFRS
convergence process in China: aligning the tax
standards, CAS18 and IAS12**

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Attestation of Authorship

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

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The influence of the Chinese tax regime on IFRS convergence process in China: aligning the tax standards, CAS18 and IAS12

ABSTRACT:

China affirmed the adoption of International Financial Reporting Standards (IFRS) in 2006 and developed a schedule of convergence concluding in 2011. However the departure from the planned schedule of convergence suggests the existence of a number of obstacles that may prevent an otherwise smooth and more rapid rate of convergence. This study will examine one of the obstacles, namely, the influence of the Chinese tax regime on the convergence with IFRS tax standards. The study uses both observations and secondary data analysis. In particular, it analyses the key features of the Chinese tax regime, its link to state owned enterprises (SOEs) and other companies that have significant government ownership, together with China's relatively unique and yet developing socialised market economy. Findings suggest that China's social and economic environment together with its complex tax regime has negatively influenced the convergence with IFRS tax standards. The study will provide some insights to both the academics and regulators on how the tax regime might affect the convergence with IFRS tax standards in China.

CHAPTER 1: Introduction

The current study addresses the issue of IFRS convergence in China. In particular, the research focuses on the impact of the Chinese tax regime on the convergence process with IFRS tax standards (IAS12). While many of the issues discussed in this study would have broader application to the IFRS convergence process in general, this study focuses only on the tax standard. The following chapter discusses the background, the research focus and the methodology used in this paper.

1.1 Background

The harmonization of International Financial Reporting Standard (IFRS) has become a much debated topic in recent years. Due to the growth from international capital flows and the development of global economic integration, the harmonization of IFRS seems to be an inevitable choice as an increasing number of countries have chosen to adopt it.

In 2005, the European Union (EU) required all its member nations to adopt IFRS for all consolidated financial statements for listed companies. As of 2010, more than 100 countries around the world have elected to adopt the IFRS (Nobes & Parker, 2010). In 2006, China announced its commitment to converge with IFRS. Following this date, the new Chinese accounting standards (CAS) for Business Enterprises were issued in 2007. The standards have substantially converged with the IFRS, but the Chinese government still incorporates many of the socialised market economy features into the standards. In November 2009, China's Ministry of Finance (MOF), who is responsible for developing and issuing accounting standards, released a proposed roadmap for IFRS convergence. The roadmap outlined that full convergence with IFRS would be achieved by 2011 (Ding & Su, 2008). However, the current situation shows that the new CAS issued since 2007 are only mandatory for listed companies,

financial institutions and certain SOEs ("Use of IFRS by jurisdiction," 2011). The departure of the planned schedule of convergence suggests that there are a number of obstacles that may have prevented an otherwise smooth and more rapid rate of convergence.

1.2 Research focus

This study focused on one of the obstacles that affect the convergence process with IFRS tax standards in China, namely, the influence of the Chinese tax regime. Nobes and Schewencke (2006) suggest that the differences in international financial reporting between countries have been linked to differences in taxation and taxation regimes. As a rules-based civil law country, the tax system in China has a dominant impact on financial reporting. The lack of separation between accounting and tax systems made the principles-based IFRS convergence challengeable. In addition, the current tax system in China was established in 1994 as part of the move towards formatting a socialist market economic system. Nonetheless, the progress is still primary as it has strong transitional characteristics, thus subject to future improvement. Because of the complexity of the tax system, the law making, tax filing and administrative environment are very different from countries in the west. These factors could all strongly impact the IFRS convergence process in China. Furthermore, the shift towards IFRS convergence would potentially clash with the desire to maintain sovereignty and ensure tax revenues and economy where much of the ownership rests with the government. As a large proportion of companies in China are government owned or significantly controlled, the study will also examine the potential tax effect in relation to these companies and the flow on influence with the convergence process of IFRS tax standards in China. Due to China's relatively unique social and economic environment, this research is different from other IFRS related studies as it presents a new angle to examine the convergence with IFRS tax standards in China from the tax point of view. Hence the study will provide some insights to both the academics and regulators.

1.3 Research method

This research is a qualitative study. The methodology used in this research is a comparative case study. United Kingdom (UK) is used as a contrasting example, as this research compares the IFRS convergence process in China and UK. The reason to choose the UK is because the IFRS adoption is relatively smooth in the UK, since IFRS are primarily emerged from the UK's pre-existing accounting standards. In addition, as a common law country, the tax and accounting systems in the UK is very different from China.

Secondary data is used in this study as it compares the income tax section between IFRS and the new CAS. The differences between these two standards could suggest the potential tax influence on the IFRS convergence. Furthermore, the SOEs' ownership and the dividend-tax distribution structures are discussed through examining SOEs' financial statements, as it would also shed some light to the research topic. Observation, on the other hand, is used to capture the practicality of the Chinese tax rules included in the secondary data. The use of the Chinese language is vital during the research as translations of the literatures, financial information and standards are part of the data analysis. An understanding of the culture and language also enables smooth and effective communication during data collections.

The remainder of this paper is organised as follows: chapter two provides the background of the tax and accounting systems in China and the UK. Chapter three presents research questions and methodology used in this research. Chapter four reviews relevant literatures on international harmonization of accounting standards. Chapter five examines the tax related influence on the convergence with IFRS tax standards in China. Chapter six discusses the overall findings and limitations of this study.

CHAPTER 2: Background of tax and accounting system in China and comparisons

2.1 *The taxation system in China*

2.1.1 The tax sharing system in China

The Chinese tax regime is a complex and evolving one. The formation of the tax regime is largely influenced by communism, as well as China's unique culture and traditions. The current tax system in China was established in 1994 as part of a move towards formatting a socialist market economic system. The tax reformation in 1994 was the largest and most extensive in the last 50 years. The aims of the reformation included revising the sales system, implementing standardized VAT (Value Added Tax) and business tax system, unifying income tax system, adjusting the rate and scope of tax collection (刘佐, Liu/2009).

Prior to 1994, China's tax regime was based on a centralised system. All tax revenue collected by the central government which a portion was allocated to the provinces to fund local initiatives (李林木, 韩霖, & 刘馨颖, Li, Han, & Liu/2009). The financial control and power of this regime rested with the central government. The shift away from exclusive central government control in 1994 was not only a recognition of a need to directly address the concerns of the individual provinces, but a redistribution of power away from the central government.

Following the reform, tax was divided into two groups including central and local. The central revenue was collected through the State Administration of Tax (SAT) offices. Similarly the local tax was collected through the offices of the local taxation bureau. These two taxation

authorities, SAT and the local taxation bureau represented the collective taxation system in China. The focus of the SAT is the collection of tax revenues aimed at funding national initiatives. In contrast, local taxes are primarily aimed at funding initiatives specific to a city or province (刘佐, Liu/2009).

Despite the separation between the central and local tax authority, the process for collecting tax is carried out cooperatively. For example, central tax may be paid at the local bureau and then surrendered to the central office. Similarly, local tax collected at the SAT offices is subsequently forwarded to the local bureau. This cooperative arrangement serves both authorities by allowing taxpayers to assess and pay their taxes at locations which are convenient to them. While the cooperative arrangements between the two authorities appear to be efficient, in reality, there are tensions surrounding the amount of tax transferred between each authority. Secondly, there is on-going debate as to what constitute a local initiative and a central or national initiative (李林木 et al., Li, Han, & Liu/2009). For example, during the recent Olympic Games hosted in China, people outside Beijing (where the Olympic games were hosted) complained that too much of the national tax revenue was directed at financing in Olympic stadiums and other amenities that in the end would be to the exclusive benefit of those only live in Beijing. China's dual tax system is similar to that in other countries but take on the form of local council rates and central tax. As with other countries around the world, the two tax authorities in China are empowered through law or statutes.

2.1.1.1 Central tax revenue and Local tax revenue

The rationale behind the changes that occurred in 1994 was recognition by the central government that China's economic prosperity will only be realised if greater power and resource were given to the provinces. Encouraging economic innovation and growth required additional resources and financial incentive (刘佐, Liu/2009). This financial incentive was in

the form of establishing the local tax bureaus to collect taxes for local initiatives. Each regional province was effectively given the taxation authority of that of a small country.

The tax funds which are controlled and collected by central government and are closely related to the country's economic sovereignty would be classified as central tax revenue. Central tax revenue include consumption tax, income tax levied from state-owned enterprises, custom duties and so on. Local tax revenue includes business tax, income tax levied from local enterprises, real estate tax and incremental tax on land value and so on (refer to table 1). Taxes funds with great flexibility and are closely related to production and distribution which are classified as central-local shared tax revenue. It includes Value Added Tax (VAT), individual income tax, stamp tax, resource tax and so on (刘佐, Liu/2009).

Table 1

Classification of central and local tax revenue

Central tax revenue in China	Local tax revenue in China
Consumption tax;	Business tax;
Value Added Tax (75%);	Value Added Tax (25%);
Individual income tax (60%);	Individual income tax (40%);
Custom duties;	Income tax levied from local enterprises;
Income tax levied from state-owned enterprises(SOEs), financial institutions and foreign enterprises;	Individual income tax;
Motor vehicle acquisition tax;	Land appreciation tax (LAT);
Resource tax from oil mining companies;	Other stamp tax;
	Real estate tax;

Stamp tax from security trading;	Deed tax;
Tax on interests;	Vehicle and vessel tax;
Fines.	Urban and township land-use tax;
	Other resource tax;
	Inheritance and gift duty;
	Agricultural tax.

Note: From State Administration of Taxation. Copyright 2009 by State Administration of Taxation in People's Republic of China.

As the above table shows, revenue from VAT, individual and enterprises income tax is shared between central and local government. 75% of the VAT revenue attributes to central and the rest attribute to local. For individual (exclude SOEs) income tax, 60% of the total revenue attributes to the central government, and 40% attribute to local. Stamp Tax relating to security trading belongs to central, while other categories of stamp tax are levied within local jurisdictions. Similarly, Resource Tax associated with oil mining is levied by the SAT, while others are taxed by the local taxation bureau.

2.1.1.2 The power of local tax bureaus in China compared to councils in the West

The power of local tax bureaus in China is much greater than the power of councils in some western countries. In China, the central government has given legislative and administrative rights over certain taxes to the local governments. That means each regional government (including province, city, and county) has the power to start levying or stop levying certain taxes (刘佐, Liu/2009). In addition, local tax bureaus also have the rights to adjust appropriate

tax rates and the scope of tax collection within the jurisdiction. For instance, two regions (Shanghai and Chongqing) started to implement the Land Appreciation Tax (LAT) in order to reduce the housing market bubbles in 2011(Zhang, 2012). The LAT rate varies between the two geographic regions as local tax bureaus set the rates in accordance with the different housing market situations. In Shanghai, the LAT rate is within the range of 0.4% -0.6%, while in Chongqing, the rate varies from 0.5%-1.2%. The statistics shows that, after one year's implementation, the LAT had brought around ¥1 billion yuan of revenue to these two regions (Zhang, 2012). China's central government believes that economic innovation and growth will be encouraged by giving local governments more flexibility.

The tax sharing system in China is similar to federalism (李林木 et al., Li, Han, & Liu/2009). For example, in the US, each federal, state and local government has its own tax legislative and administrative rights. In contrast, in other western countries like France, Germany and New Zealand, local councils only have limited financial power as compared to China. In these countries, only council rates and revenue from amenities are collected by local councils. In the case of New Zealand, other taxes including company and individual income taxes are all levied by the Inland Revenue Department (central governments). However, there are still a number of differences in terms of local tax regime between each country. The nature and types of taxes, the tax base and tax rates all varies, therefore reflects the unique conditions of each country.

China's tax sharing system may create some problems during the convergence process with IFRS tax standards, a detailed discussion is included in chapter five (refer to chapter five, section 5.2.1).

2.1.2 China's taxation reform after 1994

The 1994 tax reform had a great impact on China's tax structure and the whole economy. In 2000, China's GDP and tax revenue increased to ¥9.92 trillion yuan and ¥1.26 trillion yuan respectively. Although the absolute amount of tax revenue had increased, the proportion of tax revenue as a percentage of total revenue had decreased. About 93.9% of the revenue came from tax revenue, which was 3.9% lower than in 1993. In terms of tax structure, the income tax share of total tax revenue had increased by 1.1% since the reform and the proportion of GST had decreased by 3.4% to 68% in 2000. GST revenue still contributed a great proportion to the total tax revenue in 2000 (国家税务总局课题组, S. A. o. Taxation/2009).

Following the reforms in 1994, a series of further improvements were made to the tax system. The first of these changes came in 2001. In 2001, a Vehicle purchases tax was introduced. In 2005, the National Congress, the highest legislative and governing body in China, decided to abolish the agricultural tax. From 2005 to 2007, the National Congress reviewed the income tax law and decided that the company income tax law would apply uniformly to both domestic and overseas companies. Through these reforms, China's tax system became more simplified, standardized and equitable (刘佐, Liu/2009). By 2008, there were only 17 categories of tax compared to the 37 in 1994.

2.1.2.1 Classifications of taxes in China

The 17 types of taxes can be further classified into several categories. These categories include Turnover/Circulation Tax, Income Tax, Property Tax, Resource Tax and Behaviour Tax and more. Turnover/circulation tax can be levied from the exchange of goods or services. The amount of tax collected is unrelated to the cost of goods or services being provided but rather on the price level. In China, Value Added Tax (VAT), consumption tax, business tax and customs duty are all turnover/circulation tax. Income tax in China is similar with other

countries, it includes Individual Income Tax and company income tax. The main feature of income tax is, taxable amount equals to total revenue minus cost or other deductible amounts.

Property tax is based on the number of taxpayer-owned property or the value of the property. In China, property tax includes Real Estate Tax, Vehicle and Vessel Tax, an Inheritance Tax (not yet enforced). Resource Tax (tax on the exploration and use of natural resources) is levied based on production volume instead of sales revenue, thus preventing the government from benefiting from energy and commodity price increases. Tax levied on the use of urban land is also a type of resource tax.

Due to the continuous reforms in Chinese economy, tax revenue doubled in 2008, as compared with the same figure in 2000. Tax revenue as percentage of GDP rose to 18% and the proportion of VAT revenue as a percentage of total tax revenue decreased to 58.9%. The income tax share of total tax revenue increased to 29.7%. The evidence shows that China's taxation reform had made tremendous progress since 1994 (国家税务总局课题组, S. A. o. Taxation/2009).

2.1.3 Value Added Tax (VAT)

Value Added Tax (VAT) is a form of Consumption Tax. Every time there is a transaction, the VAT is assessed on the value of goods or services that have been provided. A feature of the VAT is that only the end consumer is taxed. Businesses may therefore claim the VAT on purchases. That means that from a seller's perspective, it is a tax only on the value added to goods or services, the seller charges the buyer the VAT, and the seller then pays the required tax to the government. China's current VAT provision was implemented in 1994. At the end of 2008, new amendments to the provision was established, the transition from production-based VAT to consumption-based VAT has achieved (刘佐, Liu/2009).

The VAT taxpayers include those businesses or individuals who sell or import goods in China, or those who provide processing, repayment and replacements services in China. Individuals or businesses' following actions are equivalent to the selling of goods: Firstly, consignment sale; secondly, the same taxpayer with two or more agencies, transfer goods from one agency to another for sale; thirdly, Consumer self-produced or processed goods; fourth, Provide self-produced or processed goods to other companies, shareholders, investors or individuals; fifth, engaged in production, wholesale and retail mixed sales practice (刘佐, Liu/2009).

Currently, China has two types of VAT rate for general taxpayers. One is 17% and another one is 13%. VAT on Export goods are currently zero rated (0%). The 13% tax rate applies to following taxable items: agricultural products; food; vegetable oil; water, heat, natural gas, coal gas, methane gas; coal products used by residents; books, newspapers, magazines; fertilizer, pesticides; metal and non-metal mining products and coals. The 17% tax rate applies to all other items that are not included in the 13% category, including all domestic and imported products and services. There are also some VAT exempted items, such as self-produced agricultural products; antique books; imported equipment or instruments for research purpose; imported equipment for disabled individuals; second hand goods and so on (龚辉文, H. W. Gong/2009). The introduction of VAT with potentially three different rates would have been a complicated hurdle for China when introduced in 1994. This would have compounded the complexity of the business environment.

For Small-scaled taxpayers, the VAT rate is 3%. Small-scaled taxpayers include those who are mainly engaged in the production business and the taxable amount is less than ¥ 500,000 (equivalent to \$100,000 NZD) per year (¥ 1,000,000/year before 2009, ¥ 500,000/year thereafter). For other taxpayers, the taxable amount must be less than ¥ 800,000 per year (¥ 1,800,000/year before 2009, ¥ 800,000/year thereafter) to be qualified as small-scaled taxpayers (刘佐, Liu/2009).

The methods of the VAT calculation for general taxpayers and small-scaled taxpayers are different as well. For general taxpayers, tax payable equals the current output VAT minus current input VAT, while the current output VAT equals the current sales revenue times appropriate VAT rate. For small-scaled taxpayers, the input VAT is non-deductible, therefore the proper formula to calculate tax payable is tax payable equals the sales revenue times the VAT. If taxpayers import goods, input VAT is non-deductible, hence the tax payable equals the composite assessable value times the appropriate tax rate. Composite assessable value here means customs dutiable value plus consumption tax for imported goods plus custom duty. This also added to the level of complexity in the Chinese tax system (李林木 et al., Li, Han, & Liu/2009).

2.1.4 Income tax

As mentioned above, income tax includes Corporate Income Tax and Individual Income Tax. However, there is no official definition on corporate income tax, even the Chinese Enterprise Tax Law issued in 2008 did not give a clear definition. Generally, corporate income tax can be classified as tax levied on production and operation income (刘佐, Liu/2009).

2.1.4.1 Corporate income tax

Companies or enterprises in China are taxpayers of Corporate Income Tax. The Corporate Income Tax law does not apply to sole proprietorship or partnership. Enterprises are divided into residence enterprises and non-residence enterprises. According to the law, enterprises established in China, or enterprises established overseas but are actively managed in China, are deemed as residence enterprises. On the other hand, non-residence enterprise means the enterprise was established and managed overseas, but has generated income within China. For

residence enterprises, Corporate Income Tax should be levied on income generated in China or overseas (刘佐, Liu/2009). For non-residence enterprises, if the enterprise has branches or institutions in China, then Corporate Income Tax should be levied to all income that are related to the operations of the branches or institutions, no matter whether the income was earned in China or not. If the non-residence enterprise does not have any branches or institutions in China, or the income generated does not relate to the operation of the branch or institution, then Corporate Income Tax should still be levied on income earned within China. This was a significant step given for more in China to engage in greater commercial activities with the rest of the world.

2.1.4.1.1 Income tax for small businesses

According to the “People’s Republic of China Corporate Income Tax Law”, the general rate of Corporate Income Tax is 25%, 20% for small businesses, and 15% for government aided high-tech enterprises. Non-residence enterprises without branches or institutions in China, or the income generated does not relate to the operation of branches or institutions, the appropriate Corporate Tax rate is 20%, the same as for small businesses. To be qualified as a small business, the following conditions must be met: first, for industrial enterprises, taxable income must be less than ¥300,000, number of employees shall not exceed 100, the total assets shall not exceed ¥30 million; second, for other enterprises, taxable income must be less than ¥300,000, number of employees shall not exceed 80, total assets shall not exceed ¥10 million (国家税务总局课题组, S. A. o. Taxation/2009). The lower income tax rate for smaller businesses may indicate the Chinese government’s encouragement of growth in relation to smaller businesses.

2.1.4.1.2 Income tax for high technology businesses

Government aided high-tech enterprises must have core intellectual property, and following conditions must also be met: first, products (or services) are under the scope of “government aided high-tech industries”; second, research and development costs as a percentage of sales revenue should not be less than the required ratio; third, the revenue from high-tech products (or services) as a percentage of total revenue, should not be less than the required ratio; fourth, the number of scientific research and technical personnel as a percentage of total employees should not be less than the required ratio; fifth, other conditions required by the law (国家税务总局课题组, S. A. o. Taxation/2009). The government’s favourable policy clearly indicates the intention to promote high-tech companies.

2.1.4.1.3 Deductible vs. non-deductible items

The calculation method for Corporate Income Tax is tax payable equals taxable income times appropriate tax rate minus tax reliefs or credits, while taxable income equals total income less non-taxable and tax-exempted income minus deductions and allowable offset of previous years’ losses. Total income does not only include income from selling goods and services, transfer of property, but also includes interest and equity investments gains, rental income, donation income and other income. Financial allocation, income from administrative fees and other state council prescribed non-taxable income shall not be included in the total income. For items like interest from government bonds, dividends and other income from non-profit organizations, these are tax exempted items. The last element in the calculation formula is the allowable offset of previous years’ losses. Costs, expenses, losses and other expenses can be deducted when calculating the taxable income. Enterprises make donations to charities, the

deductible amount should not exceed 12% of annual total profit. The following items are non-deductible: one, dividends or other equity investment gains paid to investors; two, Corporate Income Tax; three, tax overdue payments; four, fines; five, donations; six, sponsors expenditure; seven, other expenditures that are not related to earnings (国家税务总局课题组, S. A. o. Taxation/2009). These allowances are similar to other western countries with the exception of donations, where often no limit is set. This is indication of China's partial recognition of the role and responsibility of charities and the philanthropic sector.

2.1.4.1.4 Depreciations

When calculating the amount of taxable income, enterprises should calculate fixed assets depreciation and deduct accordingly. The following depreciation of fixed assets shall not be deducted: one, non-occupied fixed assets other than houses and buildings; two, fixed assets leased under operating lease; three, fixed assets leased under financial lease; four, fully depreciated fixed assets but still in use; five, fixed assets that has nothing to do with the operation; six, land valued as fixed assets and seven, other non-deductible depreciation of fixed assets(刘佐, Liu/2009). In addition, enterprises should calculate amortization on intangible assets and deduct accordingly.

2.1.4.1.5 Amortizations

The following amortization of intangible assets shall not be deducted: one, development expenditure on intangible assets that has been already deducted; two, goodwill; three, intangible assets that has nothing to do with the operation; four, other non-deductible amortization of intangible assets (国家税务总局课题组, S. A. o. Taxation/2009). These rules

are consistent with IFRS and therefore may not represent obstacles in the harmonization process.

2.1.4.2 Individual income tax

Individual Income Tax is another important part of income tax. China's individual income tax law regulates that individual who lives in China for a year and generates income either in China or overseas, must pay individual income tax accordingly (刘佐, Liu/2009).

Individual income tax payable is calculated by using taxable income times the appropriate tax rate, minus a quick deduction factor. There are 7 levels of cumulative tax rate. The rates vary from 3% to 45%. For example, if the monthly taxable income is less than ¥1,500 per month, then the rate is 3% and the quick deduction factor is ¥0. If the monthly taxable income is more than ¥80,000, then the tax rate is 45%. According to the law, taxpayers should pay tax and file returns to authorities within 7 days of the following month. If individual income tax is levied from wages and salaries, then the withholding agent (usually the employer) should pay tax and file returns to authorities within 7 days of the following month (李林木 et al., Li, Han, & Liu/2009).

The law also specifies that the scope of taxation includes: salaries and wages; income generated by self-employed individuals; income earned by contractors; income earned from services; income from article or book written; royalties; interests and dividends; rental income; estate income; incidental income; other taxable income approved by the States Council. The following items are exempted from paying individual income tax: prize (relating to science, education, technology, culture, sports, environmental protection and so on) awarded by government or foreign organizations; interest from government issued bond; subsidy and allowance issued by government; pension and benefits; insurance claims; demobilization costs; retirement payments; income from diplomatic representatives; exempted income specified in international conventions or treaties participated by Chinese government; other exempted

income approved by the States Council (刘佐, Liu/2009). Although these are examples of personal income tax, they are largely administered by the employing company.

2.1.5 Tax reporting

The existence of tax service hall is a unique feature in China. Generally, every suburb in the city has two tax service halls. The one which is managed by State Administration of Tax (SAT), usually deals with tax issues within the jurisdiction of the State Administration of Tax. The one which is managed by the local taxation bureau, usually handles tax issues within its jurisdiction. Tax service hall is a place where taxpayers, especially corporate taxpayers can come and meet tax officials in order to file tax returns. The “hall” is translated directly from Chinese. The word is appropriate to use given the large public nature of these facilities. Generally, accountants and tax consultants usually have to come to the tax reporting hall at least twice a month. The main functions of the tax service hall not only to include tax registration, tax reporting, tax returns, tax consultation, but also to include accepting tax related applications, selling and reviewing VAT invoices and so on.

To file tax returns in a tax service hall, generally, taxpayers should fill the appropriate application forms and then report to the taxation authorities on time. The declaration procedure for VAT is more complicated than other taxes. It has two steps. The first step is called Chaoshui (copy tax). It means that the government uses ‘Golden taxation project’ to control VAT invoices. The rationale behind this project is that tax evasion or fraud arises from issuing false VAT invoices for deductions. Hence VAT invoice is designed and issued by the State Administration of Tax (SAT). It is used as a certified taxation document for deductions. The SAT also uses security systems, central databases, tax swipe cards or flash drives to avoid tax evasions. If the enterprise is a general taxpayer, then the taxpayer should use security taxation system and a swipe card to issue VAT invoices. At the end of each month, taxpayers copy the information relating to the issued VAT invoices to the swipe card by using the security taxation system and then printout the report. Taxpayers or taxation agents bring the

report along with the swipe card to the Tax Reporting Hall, the officers will copy the information from the swipe card to the tax administration system, the system will match the information with the central database, detect any mistakes or potential fraudulent opportunities. Authentic information stored both in the swipe card and tax administration system will become evidence for filing tax returns and calculating tax payable.

2.1.5.1 Timeframe for filings

Different tax categories have different reporting time frames, formats and contents. For example, taxpayers should declare individual income tax before the seventh of each month and report business tax, VAT, Urban Construction Tax, education and local education surtax before the 15th of each month; Stamp tax is filed once a year, usually at the end of a tax year; real estate tax and land use tax should be declared before 15th of April and October; Enterprises should declare Corporate Income Tax before 15th of the following month or quarter (刘佐, Liu/2009).

Corporate Income Tax is calculated annually. The tax year begins on January first and concludes December 31. An enterprise who starts or terminates its business at the middle of a tax year (actual operating period less is than 12 months), then the actual operating period should be deemed as a tax year. For liquidated enterprises, the liquidation period is deemed as a tax year. Corporate Income Tax is paid in advance according to the prepayment schedule (either monthly or quarterly). Enterprises should prepay Corporate Income Tax and file returns to tax authorities within 15 days at the end of each month or quarter. Enterprises should file annual tax returns and settle any unbalanced accounts within five months after the end of each tax year. Corporate Income Tax can be prepaid on the basis of actual profit in each month or quarter. If enterprises have difficulties prepaying tax according to actual profit, they may prepay income tax on the basis of average their profit in each month or quarter. Enterprises may also use other method recognised by tax authorities to prepay tax. These timeframes are

similar to those formed in western countries. However in the Chinese context this is problematic as discussed in chapter five (refer to chapter 5, section 5.2.2.1).

2.1.5.2 Electronic filing

It is also possible for taxpayers to use electronic options. For instance, file tax returns online or through automatic machines located in Tax Reporting Halls. Taxpayers use a computer to log into the website, declare all necessary information. The website will review the information, deduct appropriate amount of tax payable from taxpayers' bank accounts automatically. Declaring taxes online is an easy and efficient way. It improves the quality of service, reduces the labour intensity of corporate employees, and eases the work pressure of officers in Tax Reporting Halls (刘佐, Liu/2009). Nonetheless, electronic filings are rarely used by taxpayers for several reasons as discussed in chapter five (refer to chapter 5, section 5.2.2.2).

2.2 Tax system in other countries including the UK

Direct tax is the principle part of the tax structure in OECD countries. Direct tax includes personal income tax, company income tax, social security tax, PAYE and property tax. More than 60% of the total tax revenue are levied from social security tax, individual and company income tax. In contrast, only about 30% of the total tax revenue are indirect tax revenue (国家税务总局课题组, S. A. o. Taxation/2009). Social Security Tax, Individual Income Tax and VAT are the three main parts of the total tax revenue. The social security tax has become the largest source of tax revenue in most OECD countries. In 1965, the proportion of social security tax only contributed 17.6% of the total tax revenue. This proportion was raised to 26% in 2005. In some European countries (like France, Germany, Netherland, Spain), the proportion is around 40%. For Individual Income Tax, it is still the largest part of the total tax revenue in countries like the UK, Australia and New Zealand. Individual Income Tax usually

constitutes about a quarter of the total tax revenue in OECD countries, while company income tax only constitutes about 10% in 2005. For VAT, the proportion of VAT rose from less than 14% in the 1960s to 18.9% in 2005, was mainly because of a steady rise in the VAT rate (龚辉文, H. W. Gong/2009).

In the United States of America, taxes are imposed at three levels. Individual and company income tax, payroll tax are mainly imposed at the federal level, together with gift duty, custom duty and so forth. Business tax is mainly imposed at the state level, together with some income tax and exercise tax. Taxes on property are imposed at the local level, with some individual income tax, business tax and other tax. That means income tax and business tax may be imposed on the same income, property or activity by federal, state and local government, often without offset of one tax against another. Each level of government imposes taxes to fully or partly fund its operations. 60% of the total tax revenue is collected by the federal government, 25% is collected by the state government and 15% is collected by the local government. Internal revenue service administers all the federal taxation on domestic activities, state and local government has its own tax administration rights, and tax returns are filed separately, not with federal tax administrations. Therefore, taxpayers sometimes must deal with several tax authorities (龚辉文, H. W. Gong/2009). However the national congress has the right to revise or amend federal tax laws and the supreme court also has the right to monitor state and local tax laws, and determine whether these laws are valid or not.

Germany also uses a tax sharing system. The system ensures a smooth tax distribution among its federal, state and local governments. There are over 40 types of taxes in Germany, including not only tax imposed by federal, state and local government, but also includes tax shared between federal and state government. Generally, the proportion of tax revenue collected by federal government is higher than its financial expenditure; hence it would ensure federal government's macroeconomic regulation and control of the economy. Federal government has the legislative power, which means tax laws are enacted by the congress.

State and local governments are responsible for collecting tax. For some local taxes, especially local consumption tax, the state and local governments have the rights to start/stop collection or give tax incentives. In certain areas, federal and state governments both have tax legislative power, but the federal government has the priority. Hence the tax system in Germany reflects the characteristics of decentralised self –management, and also maintains some extent of full range of financial management within the country (龚辉文, H. W. Gong/2009).

In developed countries, income tax and social security tax usually constitutes a large proportion of the whole tax revenue. However, in developing countries like China, about 40% of the total tax revenue is income tax and social security tax; about 60% of the total tax revenue comes from goods and services tax (GST) and other value added tax (VAT) (刘佐, Liu/2009). Due to the rise in GDP level and the improvements on tax administration standard in developing countries, it is well expected that the income tax and social security tax will constitute a larger proportion of the total tax revenue in the future.

The law making and tax appeal procedure in developed countries seem to be tougher than in China. For instance, in the UK, any amendments to the existing tax laws must go through strict procedures. Generally, the IRD department may find some problems during the law enforcement process, and then they consult with taxpayers (especially large corporate taxpayers) and tax agents to form a proposal. The proposal will be handed to the Ministry of Finance. After the consideration of economic situation and government budget, the Ministry of Finance will submit the proposal to the congress as the tax policy for the following year (李林木 et al., Li, Han, & Liu/2009). The proposal will be reviewed at least four times by both the upper and lower houses before promulgated by the Queen. Apart from tax laws, court's decision (case law) shall be complimentary for explanation purpose (李林木 et al., Li, Han, & Liu/2009). Decisions are binding for both tax authorities and taxpayers. Tax negotiations rarely happen in the UK because the tax appeal procedure is robust. If taxpayers do not agree with the tax authorities' decisions, they could appeal to the tax ombudsman. Generally, both

parties will be resolved through consultations. If the consultation fails, taxpayer could appeal to the court, and the court's decision usually tend to protect taxpayers' interests.

2.3 *Accounting system in China*

Before 1978, as a planned economy, financial reporting in China was designed for macro-economic planning. In 1978, China started its economic reformation, accounting practice and regulations were changed in a way to provide stakeholders with useful information for decision making (Ding & Su, 2008). However, the preparation of accounting standards to replace accounting rules did not start until 1988. During 1997 to 2001, 16 accounting standards (the old Chinese Accounting Standards) was introduced by the Ministry of Finance. The new Chinese Accounting Standards (new CAS) was published on 15 February 2006. The new CAS consisted of 16 old standards plus 22 new specific standards, it further extended the old standards to areas including finance, insurance, agricultural and resource management. In 2006, China announced its commitment to converge with IFRS (IFRS, 2006). Following this date the new Chinese accounting standards (CAS) for Business Enterprises, have substantially converged with IFRS. ("Use of IFRS by jurisdiction," 2011). In November 2009, China's Ministry of Finance (MOF), who is responsible for developing and issuing accounting standards, released a proposed roadmap for IFRS convergence. The roadmap outlined that full convergence with IFRS would be achieved by 2011 (Ding & Su, 2008). However, the current situation shows that the new CAS issued since 2007 are only mandatory for listed companies, financial institutions and certain SOEs, and there are still many differences between the new CAS and IFRS. Other companies continue to use the old CAS, and there is no clear time frame for the implementation of the new CAS to all companies ("Use of IFRS by jurisdiction," 2011).

2.4 *Accounting system in the UK*

In the UK, the requirement of “true and fair” view in financial statement is supreme. It has a direct and strong impact in the UK accounting practice. An important content of the UK’s accounting standard is that the standard must be consistent with the law. In addition, in most financial statements prepared under the UK’s Financial Reporting Standard (FRS), there is one independent section which discusses the legal requirements associated with these accounting standards. Hence laws especially company laws in the UK have a large influence on financial reporting standard. Furthermore, standard setting bodies in the UK attach great importance to the relationship with the International Accounting Standards Committee (IASC). Every section in the financial statement prepared under the UK’s FRS, there is a small section to address the same issues under the IFRS. At most times, to comply with the UK’s financial reporting standards will automatically ensure compliance with the relevant international accounting standard. When the difference arises between the UK’s standard and the IFRS, the main body of the financial statement should comply with the standard within the scope of application of the UK’s Accounting Standard Board (ASB). In recent years, ASB has strengthened its cooperation and liaison with IASC. For instance, FRS 11 (impairment of fixed assets and goodwill) and FRS 14 (earnings per share) are greatly influenced by IFRS 36 (impairment of assets) and IAS 33 (earnings per share).

By now, as an European Union (EU) member country, all listed companies in UK must prepare their financial statements under the IFRS. For other non-listed companies, they have the option to choose between the UK’s Generally Accepted Accounting Principles (GAAP) and IFRS. Comparisons and discussions relating to tax and accounting systems between China and the UK are included in chapter five.

CHAPTER 3: Methodology

3.1 Introduction

The following chapter discusses the methodology and research design of this study. The study is a qualitative research that examines the influence of the Chinese tax regimes on the convergence of IFRS tax standards in China. Comparative case studies are used as the current study compares China with countries where adoption and convergence with IFRS has been relatively smooth (For example, the UK). In particular the study focuses on similarities and differences between the tax regimes and how these differences and other interrelated issues influence the convergence of IFRS tax standards.

The structure of this chapter is as follows: section one of the chapter illustrates the research topic and questions relating to the present research; section two focuses on the methodological framework applied and supported theory in this study; while the last section of this chapter presents the research design, data process and analysis.

3.2 Research topic and question

3.2.1 Definition of terms

This research focuses on international harmonization of IFRS, especially in the case of China. There are a number of technical terms used throughout the study and the definition of each term is slightly different from one to another. ‘Harmonization’ means the adjustment of differences or inconsistencies among different financial reporting standards around the globe. In this study, it means both adoption and/or convergence, as harmonization is the process of

adjustment. 'Adoption' means countries implement IFRS either for all companies or certain companies. For instance, in South Africa full adoption was initially only required of listed companies (Nobes & Parker, 2010). Unlike 'adoption', 'convergence' means the national standard is deemed to be equivalent to IFRS, but there are still many differences between national standards and IFRS. In the case of China, although the Chinese government did not adopt IFRS, they chose to align themselves more closely with IFRS. Therefore this situation in China is classified as 'convergence'. The word 'permitted' is also widely used both in prior literatures and in this study. It generally refers to the situation where the national standards are required for certain enterprises, but the use of IFRS is optional and permitted. Lastly, 'compliance' often refers to the degree of effort of each individual entity in complying with IFRS.

3.2.2 Research topic and the aim of the study

China has affirmed its converging with IFRS in 2006 and developed a schedule of implementation to conclude in 2011. The new Chinese Accounting Standards (new CAS) has been substantially aligned with IFRS. However the Ministry of Finance in China has delayed its full adoption("Use of IFRS by jurisdiction," 2011). This research is motivated by the departure from the planned schedule of convergence and suggests the existence of a number of obstacles that may prevent an otherwise smooth and more rapid rate of convergence.

The research question is: How does the tax regime influence the rate of convergence between IFRS tax standards (IAS12) and the income tax section of the local accounting standards in China (CAS18)? China's economy is currently the world's fastest-growing and the process of opening-up to the world market has resulted in significant growth in trade. However as a communist country, the Chinese economy continues to shift away from a planned economy towards a socialised market economy (Ding & Su, 2008). This unique market structure along with the Chinese communist government results in a less smooth convergence situation as

compared with other western developed countries. This paper is also different from other studies as it examines one of the obstacles, namely, the influence of the Chinese tax regime on the rate of convergence with IFRS tax standards. In particular, it analyses the key features of the Chinese tax regime, its link to state owned enterprises (SOEs) and other companies that have significant government ownership. Many literatures discussed in chapter two and chapter four addresses the issue of IFRS convergence in China, but these literatures rarely link the convergence of IFRS tax standards in China with the impact of local tax regime and the existence of SOEs. The study will provide some insights to both academics and regulators on how the tax regime potentially affects the convergence with IFRS tax standards in China.

The research topic of the current study is the influence of the Chinese tax regime on IFRS convergence process in China: aligning the tax standards, CAS18 and IAS12. The research topic is also tied to studies including international accounting harmonization, accounting, taxation and taxation regimes in China and the comparisons with the UK, the impact of SOEs in terms of IFRS convergence and more.

3.2.3 Research question

The key research question is: How does the tax regime influence the rate of convergence between IFRS tax standards (IAS12) and the income tax section of the local accounting standards in China (CAS18)? By answering this research question, the broad research topic may be linked to the following questions:

1. What is the difference between Chinese accounting, tax systems and those in the west, for example the UK's?
2. Why does the IFRS convergence seem to be less smooth in China as compared to other western countries like UK?
3. What is the difference between the income tax section of IFRS and the new CAS (which was substantially aligned with the IFRS in 2007)?

4. How does the taxation regime impact the convergence with IFRS tax standards in China?
5. How does the existence of SOEs, particularly its dividend-tax distribution system impact the convergence with IFRS tax standards in China?

By discussing and analysing the above questions, themes are emerged from these related issues. These themes will be able to add insight into the linkage between tax and IFRS and therefore readdress the key research question.

3.3 Research Methodology

This section discusses the methodological framework used in this study. It also discusses the ontological, epistemological and methodological positions relating to the current research.

3.3.1 Theories relating to ontology, epistemology, axiology and paradigms

The current study focuses on similarities and differences between the tax regimes and how these differences influence the convergence with the IFRS tax standards. The nature and the aim of the research topic classifies that the present study is a qualitative study. Nonetheless, the decision to apply qualitative methodology in this study is influenced by many factors, as business researchers are largely influenced by their ontological, epistemological and axiological positions. Paradigms (including positivism, post-positivism, constructivism and critical theory) are the basic belief system or the worldview that guides the researcher based on ontological, epistemological and methodological assumptions, helping researchers to determine appropriate methodologies (Guba & Lincoln, 1994). The following paragraphs provide extensive discussions of paradigms.

3.3.1.1 Ontology

Ontology is defined as the basic view and beliefs of the social world and it reflects the nature of the reality. Positivists believe that the reality is objective and independent, which could not be influenced by observers (Myer, 2010). Post-positivists are similar to positivists, but they suggest that the reality is subject to a variety of examinations and therefore is not unchallengeable (Guba & Lincoln, 1994). Critical theorists are subjectivists who advocate for changes. They assume that reality is historically constituted and that the current social environment could prevent the achievements from various prospects, hence it is very likely that they will challenge the existing beliefs and values (Myer, 2010).

Unlike the paradigms discussed above, constructivists (that is interpretive researchers) believe the world has multiple and sometimes conflicting realities that are bounded by particular time and context (Diaz Andrade, 2009). In contrary to the positivists' belief of single reality, constructivists suggest that multiple realities exist in people's mind (Guba, 1990). Therefore the ontological characteristic of constructivism in this research suggests that qualitative study is the appropriate one to use.

In this study, the IFRS convergence experience in other countries like the UK cannot be fully assumed of China, as China is unique both in terms of circumstances and environment. This idea is consistent with a constructivist's view of multiple realities. Furthermore, Guba & Lincoln(1994) believe the same word can have different meanings across different social and economic context, knowledge is accumulated through sophisticated reconstructions in a relative way, multiple knowledge could coexist as well. For instance, the degree of "smoothness" of the harmonization could be different across different context. For instance, the IFRS convergence in China seems to be less smooth as compared to the UK. This example could also illustrate the aim of inquiry for constructivism is not only to aim toward consensus but also willing to accept new interpretations (Guba & Lincoln, 1994). In this study, the tax influence on the convergence with IFRS tax standards in China would be a new interpretation which contributes to existing literatures.

3.3.1.2 Epistemology

The ontological position of a researcher determines his/her epistemological position as epistemology refers to the relationship between the researcher and the reality or knowledge (Grant & Giddings, 2002). Positivists are objectivists, they are able to learn from the research without interacting with participants. Constructivists on the other hand, are subjectivists. They are linked with the investigation object, to grasp the subjective meanings instead of maintaining an independent stance from the subject (Bryman & Bell, 2007).

For this study, in addition to analysing and discussing the research questions, based on secondary data, observation is used as a tool to interact with the research object. Given China's socialised market economy condition, together with its unique culture of secrecy and trustiness, it is vital for the researcher to use language, culture and visual advantage to build relationships with participants instead of remaining distant from them. These advantages would help the researcher to be accepted as part of the Chinese society. The observation and interaction would then provide meaningful findings for the research topic.

3.3.1.3 Axiology

For the axiological position, it raises the question of whether a constructivist should include or exclude his/her values in research. Guba and Lincoln (1994) suggest values create inquiry outcomes for constructivists. For this research, because of China's unique economic environment, tradition and culture, the existences of multiple realities are bounded by the values of the researcher and participants. As constructivism relies on interpretations and multiple realities, it is therefore essential for researchers to use values to identify the facts and interpretations.

3.3.2 Methodology - comparative case study

The choice of methodology in the current research is strongly influenced by the constructivist belief system. Guba (1990) believes that the methodology of constructivism consist of two aspects, hermeneutics and dialectics. These two processes involve depicting, comparing and contrasting constructions. Yin (2003) finds that case studies are useful for answering the “how” and “why” questions. Therefore the methodology of this research is comparative case study.

In the current study, apart from analysing China’s tax, accounting regimes and how these may influence IFRS convergence, the research also compares the IFRS convergence process in China and the UK. There are several reasons to choose the UK as a comparative example. Firstly, the UK is an Anglo-Saxon country, and a substantial part of IFRS are emerged from the UK’s pre-existing accounting standards. The International Accounting Standards Board (IASB) framework are consistent with those of the UK (Nobes & Parker, 2010). Secondly, it is observed that the adoption of IFRS has been relatively smooth in the UK than in other countries. Lastly, as a common law country, the accounting and tax systems in the UK are relatively independent from each other, while in civil law countries like China, tax regimes have a dominant impact on financial reporting. The UK represents a group of common law countries in the west where adoption and convergence with the IFRS has been relatively smooth. In addition, the social and economic condition in the UK is very distinct from China’s situation, therefore it is appropriate to use the UK as a comparative and contrasting example in this research.

Although comparative case study is applied in this research, it is not a side by side comparative case study, as it mainly focuses on issues relating to China. Findings in prior literatures along with the discussion of the UK’s accounting and tax systems would be used as a yardstick to explain the obstacles of convergence in China. Furthermore, the influence of SOEs in China especially the dividend-tax distribution structure can also be discussed through comparative case studies as it would shed some light to the research topic. Hence

the comparative case study as a methodology is appropriate to use in this study. Theory building in case study is strongly attached to empirical reality (Eisenhardt, 1989). Therefore inductive reasoning is used through theoretical generalization.

3.4 Research design, data collection and analysis

The following section of the chapter outlines the data collection and analysis of this study. This research is inspired by the research study by Gee, Haller and Nobes (2010) as discussed in chapter four, but with specific application to the case of China. The methodology used in Gee et al (2010) involves the comparisons of national accounting standards with IFRS. This research partly replicates the methodology in Gee et al (2010) by examining the potential tax influence on financial reporting through studying the tax regulations and accounting standards.

3.4.1 Data collection

The data collected from two main sources including secondary data and observation is used in this research. Secondary data is mainly used as the nature of the study involves comparing of tax and accounting standards as well as analysing financial statements of SOEs. Observation, on the other hand, is used to get better understanding of China's real situations from government agencies and enterprises, therefore supporting the findings from the secondary data which was analysed. The option of using interviews and examining the transition process is difficult to use in this study, given that many of the issues being explored are still unfolding.

3.4.1.1 Observations

The reason observation is used is because constructivists always focus on participants' actions, languages and description (Grant & Giddings, 2002). In this study, observations were taken

place in the city of Xi'An, China, a District SAT and the associated tax reporting hall is the first place of observation. The District SAT is a branch of the State Administration of Taxation in Xi'an. The reason for choosing this tax reporting hall of SAT is because it is the tax authority where taxpayers can get face to face contact with tax officials. It is also vital to get a feel as to the practicality of the Chinese tax rules included in the secondary data. The observation includes capturing the environment for tax transactions and activities, watching conversations and actions between taxpayers and tax officials. The observation not only presents the procedure of tax reporting in China, but also raises the issue of tax negotiations between taxpayers and tax officials, thus providing meaningful suggestions towards the current tax regimes in China.

The second place of observation was a holding company of a major supermarket chain in Xi'an. It is also one of the biggest corporate taxpayers in the district. The reason for choosing this company is because the company follows the new CAS (which was aligned with the IFRS) as their accounting standards. By observing the company, it provided some insights regarding the influence of tax regimes on the convergence with IFRS tax standards in China from the company's perspective. The observation took place with two tax officials from district SAT, during their follow up visit to the company. The visit included observations of their accounting and tax departments. It also includes an interview between tax officials and the chief of the tax department of the company. The researcher was a party involved in this interview although all the questions were asked by two tax officials. In addition, the company was reluctant to supply their annual reports to anyone else except the tax officials. These difficulties faced during the data gathering process were mainly due to the company's preservation of secrecy. Therefore it was difficult to conduct an in deep analyse of the company. Nonetheless, there were still several notable issues that are worth discussion, which would again support the findings from secondary data and provide some insights towards the influence of China's tax regimes over IFRS convergence.

3.4.1.2 Secondary data

Secondary data are mainly public documents (in Chinese and English). For this research, four main sources are used. Academic literature, media commentary articles and data from selected organisational websites are included as part of the dataset: first, the latest version of the IFRS and Chinese accounting standards and tax regulations used as the yardstick for measuring the degree of convergence; second, the Chinese government official policy statements or reports related to the development of accounting standards and tax regulations, are also part of this study's dataset; third, commentary from international accounting firms is used to triangulate the data analysis from a practitioner's perspective; four, financial data (financial statements of 50 top listed companies) for both public and private companies is used to examine the ownership structure of SOEs in China. These financial statements have been limited to the years 2008-2010 to align with the convergence timeframe announced by the Ministry of Finance in China; five, financial statements from Petro China in 2010 are as an example to examine the tax-dividend distribution scheme in China and finally, a substantial part of the data analysis involves translation of literature, standards, financial data and other useful documents from Chinese to English, which will fill current gaps in the existing available English literature.

3.4.2 The use of the Chinese language

Because of the nature of the qualitative study and the fact that the research is aimed to study the influence of IFRS convergence in China from a tax perspective, the use of Chinese in this research is crucial. Guba and Lincoln (1994) suggest that an inquiry with good quality must incorporate both trustworthiness and authenticity. In this research, the familiarity and understanding of the Chinese culture and language would create a greater advantage in doing this research than someone who does not understand. The understanding of Chinese written language enables the accession of Chinese literature, government policy statements, media

commentaries and so forth, filling the current gap in existing English literature. Moreover, because of the Chinese tradition and culture of secrecy, people tend to not communicate with strangers, especially non-Chinese speakers. To communicate fluently in Chinese and to be familiar with the Chinese people's way of thinking would help the researcher to be treated as an insider, as a part of the community. The trustworthiness and authenticity therefore enables smooth and effective communication with tax officials, accountants and company executives. Overall, the understanding of Chinese language, culture, the political system and common knowledge would create great advantage in doing this study.

3.4.3 Data analysis

In terms of data analysis, thematic analysis is used. Thematic analysis involves creation and application of codes to data (Bryman & Bell, 2007). The reason for using thematic analysis is that this research involves a significant degree of documentary analysis. Thematic analysis is used as a filter to determine what is relevant. Relevant data could be sorted into concepts. Concepts with common grounds are further grouped into categories and themes. Then it is crucial to go back to the literature that is specific to these themes and provide a context for the analysis. By analysing the themes that are linked to specific reference, the relationship between themes are examined and structured into broad topics toward answering the research question. Possible themes that contribute to answering the research question include differences between Chinese local standards and IFRS, ownership structure issues arising from SOEs and compliance issues for small unlisted companies. However, some of the other themes may emerge from the data and were not known until the actual research was conducted. By using this technique, the research would be able to add insight into the linkages between tax and the IFRS and addresses the research question.

CHAPTER 4: Literature Review

The harmonization to International Financial Reporting Standards (IFRS) has become a much debated topic in recent years as a result of the increasing number of countries that have chosen to adopt/converge with it. This inevitable trend has triggered numerous studies in relation to the challenges and issues surrounding IFRS adoption.

This chapter presents the prior research on international accounting harmonization. The first part of this chapter covers the motivation and background of harmonization, the rate of adoption of IFRS around the world and the culture, regulation, compliance and culture influence on IFRS adoption. The second part focuses on tax or tax regime impact on IFRS adoption. The last part of this chapter relates previous studies with the case of China.

4.1 International harmonization of financial reporting standards

4.1.1 Motivation and benefits of international accounting harmonization

The harmonization of globalized accounting standards is significantly motivated by the growth of world trade, the increasing number of multinational companies, the flow of capital and labour. (Carey, March, 1990; 1992) .

In addition to these motivations, a number of studies focused on accounting earnings showed in financial statements, under different accounting standards in association with share prices, they found that international accounting harmonization influence share prices (Alford, Jones, Leftwich, & Zmijewski, 1993; Barth & Clinch, 1996; Harris, Lang, & Moller, 1994). Barth and Clinch (1996) further concluded the magnitude of the impact of the harmonization depends on the quality of financial reporting standard in different countries.

Research found that harmonization is beneficial to companies and investors as harmonized accounting standards usually ensures its quality and improves forecast accuracy. Ashbaugh and Pincus (2001) used a sample of 80 US companies to evaluate the impact on earnings forecast accuracy resulted from the difference between IAS (International Accounting Standards) and the US GAAP. The result shows that the forecast accuracy improves after firms start to adopt IAS. Furthermore, Beke (2010) believes that the use of harmonized accounting standards results better quality of financial information, thus lead to information symmetry between investors and managers.

4.1.2 The formation of IASC and the harmonization of globalized accounting standards before 2000.

From the 1960s, as the national boundaries of capital markets began to blur, participants in financial markets started to complain about the lack of comparability and transparency of financial statements across different countries (Alfredson et al., 2007). In 1966, professional accountancy bodies in the United Kingdom, the United States and Canada established the Accountants International Study Group (AISG) to develop harmonized accounting standards for these three countries (Alfredson et al., 2007). In 1973, the rate of international harmonization of accounting standards was significantly progressed with the establishment of the IASC, three AISG countries together with Australia, France, Germany, Japan, the Netherlands and Mexico were the earliest members of IASC. They had made a commitment to try their best to adopt International Accounting Standards (IASs) as their national GAAP (Alfredson et al., 2007). In 1990s, especially in 1998, the Asian financial crisis had spread to other regions, the world had recognised the urgent call for a single set of financial reporting standard to replace national standards. By 2000, IASC had significantly expanded with 152 professional accounting bodies in 112 countries. The IASC board which is responsible for establishing IASs consists of 16 seats (48 people in all), in addition, a number of groups as observers were represented around the board as well. These observers include the European

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Commission (EC), the US Financial Accounting Standards Board (FASB), the Basel Committee, IOSCO and the Ministry of Finance of China (Alfredson et al., 2007).

4.1.3 The establishment of IASB and IFRS

Nonetheless, after more than 20 years of working towards a single set of accounting standards, the IASC suffered a number of shortcomings including lack of convergence of IASs and national GAAPs in major countries, weak relationship and lack of recognition by standard setters in each country, shortage of sponsorship and resources (Alfredson et al., 2007). After comprehensive reviews and discussions, the International Accounting Standards Board (IASB) was established in 2001. IASB comprises over 20 accounting professionals with a budget around US\$21 million per year, which is about five times higher than IASC. Seven of the IASB members including Australia, New Zealand, the US and the UK were appointed as liaison countries and the board meet with major national standard setters three or four times a year to identify the steps for the convergence of accounting standards (Alfredson et al., 2007).

The IASB has since started to amend a number of IASs, and a new series of accounting standards – International Financial Reporting Standards (IFRS) were formed. IFRS are a principles-based approach, it encourages professional judgments, and hence IFRS only include a limited amount of guidance for typical transactions. The IASB announced that IFRS should be understood to include old IASs and interpretations as well as new IFRS ("Use of IFRS by jurisdiction," 2011). IASB as the globalized financial reporting standards setter has also been committed to promote the concept of “convergence”. At present, convergence to IFRS has been widely accepted in accounting profession, more and more countries are willing to coordinate with IASB, reduce barriers and converge with IFRS (Pacter, 2005).

4.1.4 Summary of IFRS adoption around the world

As of 2010, more than 100 countries around the world have elected to adopt/converge with the IFRS. Table 2 shows the summary of the use of IFRS in major geographic regions and countries. For the European Union (EU), nearly all listed companies of EU member countries were required to use IFRS by 2005. In Australia, the adoption of IFRS also took place in 2005. In China, the Ministry of Finance drew the roadmap of convergence in 2006. At present, the new Chinese Accounting Standards (new CAS) has been substantially aligned with IFRS. The new CAS is mandatorily used by financial institutions, listed companies and certain state owned enterprises (SOEs), but the full scaled convergence has been delayed from 2011 to 2012("Use of IFRS by jurisdiction," 2011). In 2008, the US SEC (Securities Exchange Commission) published a proposed road map of convergence. However IFRS are still not permitted for listed and unlisted companies. In Canada, a plan to adopt IFRS in full, as Canadian Financial Reporting Standards has been proposed, to be effective in 2011 ("Use of IFRS by jurisdiction," 2011). In Latin American countries, evidence suggested that Latin American businesses may not be ready to adopt/converge to IFRS (Berríos, 2012). Mexico as one of the IASC board member still does not allow IFRS to be used. However partial adoption has been observed in Brazil since 2010, while Argentina is expected to adopt in 2012.

4.1.4.1 Degree of harmonization in major geographic regions

The degree of harmonization is different across different countries or geographic regions. As the table 2 shows, the requirement usually differs depending on whether the company is listed or not. For listed companies, the use of IFRS can be permitted, not permitted, required for some listed companies or required for all companies.

For the Asia-pacific jurisdictions, a variety of approaches have been used to converge/adopt with the IFRS. In Australia and New Zealand, the national standards they adopted are described as IFRS-equivalents (equivalent to IFRS, IASs and international interpretations).

The notes to the financial statements in both countries state that the financial statements are prepared according to IFRS, as well as Australian or New Zealand national standards. Nonetheless, there are still some differences between IFRS and IFRS equivalents. For instance, the effective date and transitional requirements may be different; additional disclosure is required and wordings had been revised to accommodate legislative environments (Alfredson et al., 2007). Hong Kong and Singapore also decided to adopt new national accounting standards that are equivalent to IFRS. Similarly, in South Africa full adoption of IFRS was required, but only for listed companies (Nobes & Parker, 2010). For Eastern Asian countries like Korea and Japan, IFRS is permitted for listed companies in Japan, and required in Korea. For unlisted companies, Korea permits the use of IFRS whereas the use of IFRS is prohibited among unlisted companies in Japan. In the case of China, the new CAS reflects China's unique economic situation and environment, that means the new CAS has certain modification to the IFRS. The Ministry of Finance delayed the plan to have all large and medium enterprises (both listed and private) adopt the new CAS, which somehow indicates that there are some obstacles that may prevent the rather smooth convergence ("Use of IFRS by jurisdiction," 2011).

For the American jurisdiction, the use of IFRS for listed companies is not permitted in Mexico and the US. For Brazil, IFRS is required for all listed companies and financial institutions, but does not allow the use of IFRS in unlisted companies. For Canada, IFRS is required for listed companies, and permitted for unlisted companies. In the case of Argentina, they aim to require the use of IFRS for all listed companies in 2012.

In 2005, the European Union (EU) required its member nations to use IFRS for all consolidated financial statements for listed companies, even though the IAS 39 is modified and there is a time lag in adopting some recent IFRS. Statutory accounts for unlisted companies must be prepared in line with national standards, even they are given the option of using IFRS ("Use of IFRS by jurisdiction," 2011). Nonetheless, the requirements for unlisted companies in EU countries are slightly different from one country to another. As the table

states, in France and Austria, IFRS permitted in consolidated statements, prohibited in separate company statements for domestic unlisted companies and in Germany and the UK, IFRS are permitted in both consolidated and separate company statements, but for German unlisted companies, statutory accounts that conform to national GAAP are also required.

Table 2

Harmonisation of IFRS by jurisdictions

Jurisdiction	IFRSs not permitted	IFRSs permitted for some unlisted companies	IFRSs required for some unlisted companies	IFRSs required for all unlisted companies	Audit Report states compliance with IFRS	Unlisted companies
Argentina				Starting 2012		IFRS not permitted
Austria				X	No, as adopted by EU	IFRSs permitted in consolidated statements, prohibited in separate statements
Australia				X	Yes	Australian IFRS equivalents required for some large unlisted, permitted for others.
Belgium				X	No, as adopted by EU	IFRSs required in consolidated statements of unlisted banks and credit institutions, permitted for other companies. IFRSs not permitted in separate company statements.
Brazil				All listed companies and all financial institutions starting 2010. Optional for listed companies prior to 2010.	Yes, except... Undecided for unlisted banks for 2010 only because, for them, comparative IFRS financial statements for 2009 are not required	IFRSs not permitted
Canada				X (starting 2011)	Yes	IFRSs permitted (starting 2011)
China				NOTE 14		
France				X	No, as adopted by EU	IFRSs permitted in consolidated statements, prohibited in separate company statements.
Germany				X	No, as adopted by EU	IFRSs permitted in both consolidated and separate company statements. Statutory accounts that conform to national GAAP are also required.
Hong Kong				X	Yes for companies incorporated outside HK. HK incorporated companies refer to 'Hong Kong FRS'	Hong Kong IFRS equivalents permitted
India		permitted for consolidated financial results only			Yes	IFRSs not permitted
Indonesia	X					IFRSs not permitted
Japan		X			depends on the status of designation	IFRSs not permitted
South Korea				X	Yes	IFRS required for financial institutions and state-owned companies; IFRS permitted for other unlisted companies
Mexico	X					IFRSs not permitted
New Zealand				X	Yes	New Zealand IFRS equivalents required for large unlisted, permitted for others
Russia			X			
Singapore	X					No. Singapore FRSs required
South Africa				X	Yes	IFRS permitted or IFRS for SMEs
United Kingdom				X	No. 'As Adopted by EU'	IFRSs permitted in both consolidated and separate company statements
United States	X					IFRSs permitted

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4.1.5 Prior research on international accounting harmonization

4.1.5.1 Regulation impact

A number of prior research focused on the impact of regulations on international accounting harmonization. Emenyonu and Gray (1992), Doupnik and Taylor (1985) and Herrman and Thomas (1995) studied the impact at a particular time. Doupnik and Taylor (1985) examined how EU regulations could impact the adoption/convergence of international accounting standards among 16 Western European countries in 1979. The study found many differences still existed among Western European accounting practices. Emenyonu and Gray (1992) did a similar study that examined the EU regulation impact in France, Germany and the U.K in 1989. The study revealed that there were still significant differences among these countries in respect of practices evaluated.

There are some studies that have focused on the harmonization process with IFRS following the formation of the IASC in 1973 (Archer, Delvaille, & Mcleay, 1995; Evans & Taylor, 1982; Yang & Lee, 1994). For example, Evans & Taylor (1982) studied the influence of IASC initiatives on accounting harmonization in France, Japan, UK, West Germany and the US from 1975 to 1978. Their study found that IASC initiatives have very little impact on financial reporting practices in these countries during that time period. These studies indicate that harmonizing accounting standards across the globe initially experienced a slow pace. Many countries continue to follow local GAAP and are unconvinced of the benefits of standardizing accounting practice across the globe.

4.1.5.2 Adoption patterns

Following the establishment of IASB and IFRS, the convergence to IFRS has been widely accepted in the accounting profession. Studies had revealed that the transition to IFRS has

been relatively smooth for some countries but not others. The following discussion explores the reasons behind these differences.

Gee et al (2010) compared the convergence process of IFRS in Germany and UK. They suggest that although both Germany and UK followed EU regulation to converge with IFRS in 2005, UK experienced a smoother convergence compared with Germany. Gee et al's finding was not surprising given that the IASC's secretariat was in London and the working language was English. Furthermore, many of the IASs were similar to the pre-existing accounting standards for the UK (Nobes & Parker, 2010). The impact of language on the IFRS adoption has been widely discussed (Nobes & Parker, 2010). English speaking countries are likely to find IFRS adoption smoother as some concepts expressed in English do not exactly translate to those other languages.

In addition, studies revealed that western market economies were better aligned to adopting IFRS than other countries (Nobes & Parker, 2010). The UK is one of the two countries that firstly presented Anglo-Saxon ideas of financial reporting to EU in 1973. The idea of "true and fair view" plus the UK's four principles of accruals, prudence, consistency and going concern were all introduced to EU by the UK (Nobes & Parker, 2010). As the UK GAPP is closely associated with IFRS, it is reasonable to believe that the UK experienced a smoother adoption of the IFRS than some other countries.

In contrast with countries that transition has been relatively smooth, like the UK, the harmonization seems to be less smooth in Eastern European countries. Poland had experienced a transitional phase from a command economy to a market economy (Nobes & Parker, 2010). Even though Poland had converged with IFRS in 2005, Polish accounting was still rule based and tax orientated, the concept of substance over form had not been implemented properly, there were still many inconsistencies between the Polish accounting standard and the IFRS, government regulations and domestic accounting standards still significantly influence the convergence (Kosmala, 2005). Similar to Poland, China is exercising the transition to form a

socialised market economy. The institute of Chartered Accountants of Scotland found China's regulatory authority is unwilling to give up all accounting sovereignty, hence a smooth convergence may not be easily achieved ("Chinese accounting reform: Towards a principles-based global regime.," 2010). Kvaal & Nobes (2010) concluded that IFRS practices are different in different countries and domestic accounting standards and regulations will continue to play a very important role in the impact of IFRS convergence.

4.1.5.3 Compliance issues

In addition to the impact of regulations on harmonization, compliance is another issue that many studies focused on. IASB as a private-sector standard setter, does not have enforcement power, hence enforcement of financial reporting may be carried out by regulators of stock exchanges, stock exchanges, government agencies or other private sector bodies (Nobes & Parker, 2010).

In the U.S, non-U.S companies that listed on a US stock exchange have options to file IFRS financial statements with the SEC. As SEC is the strictest and best resourced enforcement authority, the enforcement compliance of the IFRS by SEC is as rigorously as its enforcement compliance of the US GAAP(Nobes & Parker, 2010).

In contrast, Chatham (2008) assessed the extent of compliance with International Accounting Standards (IAS) in France, Switzerland and Sweden, they found that Switzerland had the highest compliance score, while Sweden had the lowest. Street, Gray, & Bryant (1999) found compliance levels in EU countries especially in France and Germany are even lower than non-EU countries (Switzerland and China). Nobes & Parker (2010) concluded enforcement and supervision are weak in a number of EU countries as there are no EU-wide enforcement bodies.

4.1.5.4 Culture issues

A number of existing studies examine international accounting harmonization from a cultural perspective. They try to use culture diversity to answer the question why some countries have adopted the IFRS, but for other countries, they chose to not adopt, at least at this point of time. Gray (1988) and Hofstede (1980) suggested culture elements influence accounting systems. Mukoro and Ojeka (2011) argued that national traditions, cultures and practices will continue to be the challenge and pressure for global convergence of the IFRS. Hofstede (1980) outlined four national cultural dimensions including power distance, uncertainty avoidance, individualism versus collectivism and masculinity versus femininity. Western countries can be concluded as being individualistic, having small power distance and uncertainty avoidance. In contrast, China can be concluded as a society that favours collectivism, has strong power distance and uncertainty avoidance. Zhang & Liu (2010) further examined the cultural impact of the IFRS convergence in China. Their study revealed that the narrow gap between Chinese Accounting Standards and the IFRS is due to cultural factors as well as the socialized market economy character. While Clerments, Neill and Stovall (2010) found they are unable to document any cultural influence to the decision of the IFRS adoption/convergence, but suggested that the size of a country significantly impacted the decision of adoption/convergence.

4.2 The impact of taxation and taxation regimes on IFRS adoption/convergence

4.2.1 Common law vs. Civil law

Differences in international financial reporting between countries have been linked to differences in taxation and taxation regimes (Nobes & Schwencke, 2006). Ball, Kotharis and Robina (1998) expanded the market based international accounting convergence research. They studied how accounting information could be affected by the changes in environment.

They concluded that common law countries and civil law countries responded differently to the introduction of IAS/IFRS. This in turn impacted the convergence on the quality of accounting information.

In common law countries (where law is developed by judges through decisions of courts) including the US, UK, Australia, New Zealand and Canada, the accounting profession and the way it is practiced is relatively independent of the tax regime (Gee et al., 2010). In the case of the US, there is a comprehensive set of tax accounting principles governed by the Inland Revenue Service (Nobes & Parker, 2010). As an investor oriented country, financial accounting is set to provide investors with useful information for decision making, while tax accounting is aimed to provide government or tax authorities with information relating to tax collection, hence the accounting principle for tax purpose is quite distinct from the US GAAP (Lin, 2007).

For civil law countries (where core principles are codified into a referable system which serves as the primary source of law), including China, Germany, France, Italy and Japan, the tax regime has a dominant impact on financial reporting. For these countries, the preparation and presentation of financial statements appears to focus on producing financial information that targets the calculation of assessable income. Companies' financial reports must therefore comply with tax laws and the tax statements produced are those that are available to the investors (Hoogendoorn, 1996).

Burgstahler, Hail and Leuz (2006) find that in civil law countries, especially those in Europe, the tax authorities use the financial statements as the basis for calculating a company's tax liability. This created a motivation for accountants to prepare the financial statements primarily for the tax authorities and not their investors. This lack of focus on investors is inconsistent with the underlying framework of the IFRS. Furthermore, it compromises the adoption, convergence and harmonization process of the IFRS.

The adoption of the IFRS in civil law countries is affected by the tax regime in two ways. The first is based on the premise that companies are motivated to minimizing their tax liability in the same way that they manage their expenses in order to maximize the profit. Since the reported profit is the basis for the calculation of the tax liability, companies will be motivated to use the maximum allowable deductions in order to reduce their profit. However, this aggressive level of expenses is inconsistent with the economic reality of the company. As a result, the financial statements become less useful for decision making purposes (Guenther & Young, 2000).

The second impact on the IFRS adoption by the tax regime is related to the tax rate. Guenther & Young (2000) suggest that the impact of the tax rate can be found in both common and civil law countries. They outline that in countries where there is relatively high tax rates, companies would be encouraged to report less profit. Again this compromises the authenticity of the financial statements in terms of reporting a true and fair view.

Similar to previous studies, Nerudová (2011) examined the influence of tax and accounting rules on assessable income. The study divided countries into groups, where Anglo-Saxon countries' (USA, UK and so forth) represent disconnection of systems (that is, taxation does not have any impact on the decision in accounting); and continental European countries represent connections of both systems (that is, there is no difference between tax and accounting rules). The comparative analysis found that for both groups, there are significant differences between accounting and tax rules. These differences influence the size of the tax base or assessable income. The quantification of the tax effects is however subject to future research. Eberhartinger and Klostermann (2007) using data from Austria found that for most of the companies studied, there appeared to be little difference between the calculated tax base using the IFRS and the local tax rules. In the case of Belgium, Haverals (2007) found that the assessable income (tax base) calculated using IFRS was higher on average. Haveral however acknowledged that the magnitude of the differences (tax base under IFRS and local tax rules) was different across different sectors. These studies highlight potential differences between

assessable income calculated under IFRS and local tax rules, but these differences are country specific and in some cases sector specific.

The adoption of IFRS for some civil law countries has been a slow process. Lin (2007) found that although Germany had made the decision to adopt the IFRS in 2005, and that the “true and fair views” were widely accepted as a standard to evaluate the quality of financial statements, governments and tax authorities still maintained significant control over accounting standards. Despite the initial clash between local GAAP (basis for taxation calculations) and the IFRS, recent studies have indicated a shift towards greater harmonization. Gee et al (2010) compared the influence of taxation on IFRS adoption in Germany and the United Kingdom. They found that the influence had changed over time with a shift, in the case of Germany, towards accounting standards that supported an investment focus rather than a tax one.

4.2.2 Differences between IFRS and domestic tax rules

A number of studies have been carried out to compare the differences in tax between countries using the IFRS with those using their local GAAP. Kager, Schanz & Niemann (2011) estimated the tax obligation of selected companies on the German stock exchange (DAX30) with those on the Australian stock exchange (ATX). Their study specifically compared the tax obligation of the selected companies based on local tax rules and the IFRS. Their results suggested that intangibles and provisions contributed the most to the tax rules and IFRS differences among DAX30 firms. On the other hand, fixed assets and provisions represented the cause of the divergence between tax rules and the IFRS among Australian ATX listed companies. Rood and Kinney (2008) examined potential tax effects resulted by the adoption/convergence of IFRS in the US. They found LIFO, inventory write-downs, advanced payments and research and development costs as being the main areas that may result in tax differences. These studies suggest that irrespective of whether or not they are common law or

civil law based, there continued to be significant difference between the calculated tax obligations when using tax laws and the IFRS. Furthermore, the reasons for the differences appear to be different across different countries.

4.3 China's experience

4.3.1 IFRS convergence in China

In the case of China, before 2007, Chinese accounting standards were substantially different from IAS. Chen, Gul, and Xijia (1999) did an empirical research to examine the earnings under the Chinese old accounting standards and those based on IAS. They found that reported earnings under Chinese accounting standards were higher by 20% -30% than earnings reported according to IAS. It is therefore possible that reported earnings under the old CAS might be biased and overstated.

In 2007, China's new CAS (Chinese accounting standards) had been substantially converged with the IFRS. After the convergence, Peng and Bewley (2010) analyzed the divergence between the new CAS and the IFRS, and they also examined the extent of fair value accounting adoption in China. They found that there was a high degree of IFRS FVA adoption in the new CAS. However there is still significant divergence in terms of long-term assets investments, thus challenging the Chinese official's claim of "substantial convergence" with the IFRS. They concluded that the benefits desired by Chinese regulatory bodies from converging with the new CAS to IFRS may not be easily realized.

4.3.2 The impact of state-owned enterprises (SOEs) on IFRS convergence in China

Another reason to explain why substantial convergence cannot be achieved easily is the existence of state-owned enterprises (SOEs). Many researchers argue that the IFRS is primarily designed for private sectors and it may be inappropriate for SOEs to use the IFRS. Related party standards should be changed to make it easier for China's SOEs (Gettler, 2011).

For many years, SOEs in China are viewed with suspicion. For example, different business tax rate levied for different categories of companies, SOEs pay more taxes as they are levied to higher tax rates (Zeng, 2010). State owned or significantly controlled companies do not pay or only pay a small portion of dividends to the government (Economist, 2006). However, at present, SOEs have been losing some of their advantages through the policy of zhengqifenkai (separation of state control and enterprises), as a result, the government has started to demand dividend payments from SOEs since 2008 (Woetzel, 2008). It seems that the government's favouritism over SOEs is fading, nonetheless, it is still questionable that whether those dividend payments are real, because dividends and taxes are both collected by governments. The proportion of dividends and tax paid to the government is not clear and may be subject to manipulation.

Despite the unclear dividend and tax distribution arrangement, SOEs are very much different from other private sector enterprises in several aspects. Ferri and Liu (2010) and Gui-qiu and Zuo (2011) find SOEs' cost of financing is significantly lower than other companies because SOEs control some fundamental factors of profitability. If SOEs finance at market rates, their existing profits may be completely wiped out. Lin, Lu, and Zhang (2011) used simulated marginal tax rate as an indicator of a firms' earnings management incentives, to examine possible earnings management following the issuance of the new Chinese Accounting Standards and New Enterprise Income Tax Law in 2007. They found significant tax induced earnings management in 2007. Lin et al's (2011) research is consistent with the findings of Lin and Yen (2008). They found that SOEs pay lower incremental audit fees than other

companies after their convergence to the IFRS. This may indicate that SOEs have a lower demand of financial reporting quality and they tend to hire smaller auditors. These literatures suggested that the existence of SOEs may somehow influence the convergence of IFRS in China, but there is lack of complete explanation to link the impact of taxation and SOEs with IFRS convergence.

These studies contribute a lot to the literature. Nonetheless, there is also a lack of study on the power of regulation authorities in China, and how the power influent the rate of convergence. In addition, they provide little explanation for the tax system's influence on the convergence with IFRS tax standards in emerging markets, especially with the existence of SOEs, and the relationship between its questionable dividend distribution system and tax revenue. Therefore this paper will focus on the influence of the Chinese tax regime on convergence with IFRS tax standards in China.

CHAPTER 5: Discussion and Analysis

5.1 Introduction

This chapter discusses the empirical data collected in this study within the context of the extant literature and background outlined in chapters four and two respectively. The discussions are framed in such a way as to provide an answer to the broad research question and a way forward in relation to this important topic.

5.2 The influence of tax regime on IFRS convergence in China

It is well acknowledged that China has made tremendous progress in reforming the taxation system, but the progress is still primary and subject to future improvement. Due to the complexity of the tax regime, together with China's unique social and economic environment, the IFRS convergence might be challengeable in China's case.

5.2.1 Impact of the tax sharing system on IFRS convergence in China

The tax sharing system resulted from the tax reform in 1994 may influence the IFRS convergence in China. As discussed in chapter two, the main feature of the dual tax systems in China is to enable tax sharing between the central and the local governments. The power to tax at the local level was more than that of councils in the west. As IFRS are primarily designed in western context, the IFRS convergence in China can be problematic.

The enterprises' income tax is collected either by SATs (State Administration of Tax) or local Tax Bureaus depending on whether the government have ownership of them or not. A significant portion of the tax collected by the SAT is from State Owned Enterprises (SOEs). The number of SOEs in China is small relative to the number of small privately owned enterprises. However despite their relatively small number they are industry leaders and often represent monopolies in their respective industries. Although the revenue collected from the SOEs is significant, the SATs deal with fewer companies. Moreover, smooth collection of taxes from SOEs is expected as they are owned by the state, both dividends and taxes are paid to the government. In contrast with local tax bureaus, they deal with millions of individual taxpayers and local businesses. The size of these local businesses is much smaller compared to SOEs. In this case, tax collection and administration seems to be less smooth as the government does not have ownership or control of them. At the local level, filing business tax and assessing a business taxable income becomes a subjective exercise that is determined by negotiation rather than precise calculation. This practice although strictly outside the ideal set of administrative protocols appears to be a pragmatic way forward that is able to manage the high volume of customers filing their tax returns. This practice was observed in a number of the local tax bureau offices. The less smooth tax collection and the potential tax negotiations in local levels might be some of the reasons to explain why the new CAS (substantially converged with IFRS) has not been implemented to all companies in China.

5.2.2 Concerns with timeframes of tax reporting and electronic filing

5.2.2.1 Timeframes of tax reporting

The timeframe of tax filings in China are similar as it is in western countries. Nonetheless, due to the high volume of tax returns together with the lack of electronic filings, the reporting timeframe is less strict in China and subject to negotiations. For instance, taxpayers who fail to declare VAT on time may face serious consequences (taxpayers use VAT invoices to deduct

VAT. However if they do not file VAT returns on time, that is, if they do not correctly report the VAT invoices on time, they cannot claim for VAT deductions. The VAT deductions for the current month cannot be claimed in the following month). As every piece of information should be entered into the computer, once the deadline is passed, the database for this month will automatically close. Nonetheless, as observed in tax reporting halls, it is still possible for taxpayers to avoid losses through tax negotiation with tax officials. This behaviour is inequitable and may cause corruption issues. Hence, the chaos of the tax administration system could only be detrimental to the IFRS convergence in China.

The rigid periodic tax periods discussed above are aimed at improving efficiency in relation to the collection of tax. This rigidity however create potential hurdles for the tax authority and taxpayers, in so far as it reduces the flexibility available. However, observed practice in the tax reporting halls provide evidence that despite this rigidity, taxpayers and tax officials continue to negotiate their way forward. In relation to the convergence process with IFRS, this practice of negotiation provides an interesting angle on the implementation of any new changes introduced by the IFRS. In particular, the introduction of new processes and procedures consistent with IFRS are likely to take a back seat to the pragmatic and common practice of compliance through negotiation.

5.2.2.2 Electronic filing

Electronic tax filing has been made available to taxpayers in line with the spread of the internet and availability of computers. Electronic filing is an efficient and easy way for taxpayers to file tax returns online or through the automatic machines located inside the tax reporting halls. However, not many taxpayers have opted to use this electronic facility to file their returns.

The lack of take-up by taxpayers of the electronic filing option is partly explained by Chinese culture and tradition. Chinese people value concrete evidence and verification, this is

demonstrated by the prolific use of the red stamp as a symbol of authenticity. In many Chinese documents, the red stamp, representing the official common seal of the authenticating organisation, provides users of these documents with assurance that they are genuine. This practice dates back many centuries and is observed to have continued through the present day. For taxpayers, having physical proofs of payment or filing of returns is consistent with this red stamp mentality. Despite the efficiency afforded by the electronic filing option, taxpayers have shied away from using it, because of they do not being able to see to provide them the verification and proof that they have filed and paid their tax. In many western countries the take up of electronic filings have been more prevalent, allowing the introduction of tax standards to be adopted more readily. However, in China, the IFRS convergence is likely to be slowed down by the entrenched behaviour of many taxpayers to personally file their tax and to have it validated by a tax official.

The lack of use of electronic filings means that the tax reporting halls in China are always busy, noisy and overcrowded. The hall is similar to a small stock exchange in a western context. Tax officials always wear uniforms which also represent their official authority. Taxpayers on average have to wait at least one hour in the queue, and the whole tax reporting procedure seems to be complicated and time consuming. Tax officials are extremely busy and they only communicate with taxpayers in cases of tax negotiations. In contrast if electronic filings are widely applied, the chances of potential negotiations may decrease, because it is impossible to negotiate with computers. As the IFRS is primarily designed for developed countries, which the tax systems are mature and standardised, the lack of take up of electronic filings resulted from Chinese culture and tradition represent the immaturity of the tax system, this would also become another obstacle to impact IFRS convergence.

5.2.3 Influence of the tax law making on IFRS convergence in China

5.2.3.1 Tax legislative impact on IFRS convergence

The tax-law making process in China has strong socialized market characteristics, which may impact the IFRS convergence process. As compared with matured tax systems in other countries, China's taxation system was established on the basis of a socialized market economy. Tax laws are formulated by the state council, the State Administration of Tax (SAT) and the tax policy department of the Ministry of Finance.

Many tax officials consider the tax laws in China to be extremely complicated and subject to regular changes. For instance, tax regulation for VAT is still a provisional regulation, and is not a permanent part of the set of tax laws. Tax officials complained that they received over 900 notices/instructions/policy statements last year, averaging three notices per day. Most of these notices/instructions/policy statements represent amendments to the current tax rules. Tax administrators felt these amendments created unnecessary confusion and difficulty for them. They comment that "even we cannot understand the changes properly, so you can imagine taxpayers." The confused state of affairs associated with the administration of tax is likely to hinder the IFRS convergence process. Tax practitioners and tax administrators will see those changes introduced through the convergence process as adding to an already muddled compliance environment.

5.2.3.2 Concerns with VAT and income tax

China's tax laws have been developed in part to suit emerging private enterprise and the economic diversity in China's massive population. This has however resulted in a complex set of tax rules. For example, there are three different VAT rates in China, compared with a single rate in other IFRS countries including New Zealand. The calculation methods for VAT also differ between general businesses and small-scaled taxpayers (刘佐, Liu/2009). While these

variations in the VAT regulations are arguably suited to China's economic and demographic environment, this complexity will potentially frustrate the IFRS convergence process.

While an efficient tax system will include sanctions for non-compliance, the rules should also be simple and meaningful so as to encourage compliance. This has been problematic in the case of personal income tax. The responsibility of administering personal income tax rests with the employer. Tax administrators note that some employers do not deduct employees' individual income tax from their salaries. These employers deem this behaviour as welfare, and treat the amount of individual income tax as operation cost, thus cause tax evasions. Thus the loophole resulted from China's special tax structure along with enterprises' illegal practices could be problematic in relation to IFRS convergence.

5.2.3.3 Concerns with large companies

Large companies especially those who operate across several districts experience difficulties in dealing with multiple taxation authorities. Therefore, problems arises from these problems strongly affect the integrity of the tax system and thus the IFRS convergence. The observation took place in the holding company of a major supermarket chain in the city of Xi'An, China. The company has more than 30 supermarkets operating across the whole city and is one of the biggest taxpayer in the district. They claimed that they have fully complied with the new CAS. There are about 60 accountants working in their accounting departments with various duties, and they all use an accounting software to record financial information of the company.

During the visit to the company, it is observed that they have a tax department to deal with various tax issues, including negotiating with tax officials. The staffs of the company complained to tax officials from the district SAT that they acquired another major supermarket chain last year, but they could not merge the newly acquired subsidiary with the parent. The reason behind that is the subsidiary mainly operates in another district of Xi'an, the merge would result in loss of tax revenue for another district SAT as tax revenue from both the

parent and the subsidiary should be collected by the district SAT where the parent operates. Therefore, the company received a lot of pressure from that district government and SAT where the subsidiary operates. Regardless of the tension between the company and SATs from the two districts, the company still have to keep two separate books, file two tax returns and deal with tax officials from two districts. They feel the current situation creates a lot of extra costs and confusion for them. Tax officials expressed their concerns over this problem, but they also insist that given the current social and economic condition, problems between two districts SATs over the sharing of tax revenues from the same company but operating in different districts commonly exist.

The case discussed above clearly shows large companies face problems in dealing with multiple taxation authorities. The integrity of the taxation regime could be damaged as there might be a greater chance of tax negotiations and bribery between companies and tax authorities. Furthermore, from the company's perspective, it not only influences the general operation of the company, but also influences the truthfulness of the financial statement. The two financial statements prepared by them under the new CAS (substantially converged with IFRS) may not precisely present the financial position and performance resulted from the acquisition. Hence, without doubt, it is a departure from the primary objective of IFRS.

5.3 Divergence of tax systems between China and UK

This section compares and contrasts the tax systems in China and the UK. As many IFRS standards are emerged from pre-existing UK standards, the discussion would provide some insights on why the IFRS convergence process seems to be less smooth in China than in western countries like the UK.

Firstly, the tax structures between these two countries are different. Direct tax is the main source of tax revenue in the UK, and it includes both individual and corporate income tax. Although the proportion of indirect tax has increased in the UK, direct tax revenue remains the

main source. In contrast, VAT (part of indirect tax) is China's largest tax category. VAT in China is largely production based, which covers industrial production, wholesale, retail, processing, repair and replacement services (龚辉文, H. W. Gong/2009). A smaller proportion of VAT in China is gathered from the delivery of services. VAT in the UK is consumption-based and the proportion collected from services is greater. Currently, The VAT system in China is transforming from production-based to consumption-based (刘佐, Liu/2009). China is also aiming to gradually increase the proportion of direct tax (mainly income tax) and reducing the proportion of indirect tax (mainly VAT). The reformed tax structure would be beneficial for IFRS convergence, because it is consistent with the matured tax systems in the west. However the conversion will take some time and the advantage of the reformation will only show in the long run.

Taxation at the national level is overseen by two authorities including the Ministry of Finance and the State Administration of Taxation (SAT). These two authorities (unlike other western countries) are positioned at the same level and both are represented as part of the government. The role of the Ministry of Finance is to administer the government's expenditure and tax. The SAT on the other hand is tasked with the responsibility of collecting tax revenue in order to finance this expenditure. This division has necessarily painted a picture with SAT to collect the money but that the expenditure is then the privilege of the Ministry of Finance. Han and Liu (2009) note that these two authorities have not always worked together harmoniously. Rivalry over which is more senior has often resulted in confusion. Given the decision to adopt IFRS was that of the Ministry of Finance, co-operation from the SAT in terms of convergence is not guaranteed. The tensions between these two authorities are likely to frustrate the IFRS convergence process for China.

Differences between the regulatory environment in China and that in the UK are a potential cause for divergence between accounting and tax standards. In the UK, the rate of tax evasion is very low compared with that in China (龚辉文, H. W. Gong/2009). This is because the tax administration authorities in the UK have established a rigorous system to monitor tax

compliance. The implementation of tax resource monitoring, tax returns and tax codes management through computer databases also ensure the smooth collection of tax. In contrast, the tax and legal awareness is not strong in China. Tax evasion, especially for corporate taxation is common.

Government revenue from non-tax sources including penalties and fines for infringements is proportionately higher in China compared with the UK (龚辉文, H. W. Gong/2009). Although, this outside the tax classification indicates that the regulatory environment in China is complex and onerous. This is consistent with China's communist history and the rules based environment that characterizes Chinese society. Introducing IFRS into an already complex and demanding regulatory environment is likely to add to the confusion. The process for convergence to IFRS will potentially take longer in such an environment.

Preferential tax policies are prevalent in China compared with the UK. This is another reason that explains the IFRS divergence between China and the UK. While it is common for the central government to assist infant industries and sectors for the overall good of the economy, this assistance in western countries is in the form of tax credits and subsidies. In China, this assistance has been in the form of lower tax rates for the targeted industry or sector. Using the tax rate as a vehicle to achieving this goal is problematic as it is open to abuse, difficult to administer and is inherently a blunt tool. For example, IT companies in China are taxed at 15% compared with other companies who are taxed at 25%. This arrangement placed the burden clawing back the tax benefits received by these IT companies on the government. In the west, the onus would normally be on the company to apply for the subsidy on an individual basis. Furthermore, there are three different VAT rates for general taxpayers and small scaled taxpayers in China. The use of differential tax rates in this manner is likely to frustrate the IFRS convergence process in a number of ways. Firstly, the introduction of IFRS to an environment where tax administrators are already overburdened with administering differential tax rates, is likely to be slow. Secondly, the underlying principles behind IFRS are consistent with those of a free market where the tax rate is consistent and constant for all

companies. Since it is not the case in China, the implementation of IFRS is likely to be misaligned.

Overall, the structure of the tax systems, the regulatory environments and the various tax policies contribute to explaining the divergence between the IFRS convergence process between China and the UK in relation to tax. China has already taken steps to achieve a more standardized and simplified tax regime. However these improvements and reforms to date are going to take some time to settle in and its impact on assisting the IFRS CAS tax convergence process is likely to be in the long term.

5.4 Divergence of the tax accounting systems between China and UK

Divergence between the accounting systems between China and the UK is another reason that explains the difference in the pace of convergence to IFRS in these two countries. In terms of the standard setters, the accounting standard setting body in UK is a “semi-independent” civil authority, while the standard setting body in China is not independent of the government at all. Financial reporting standard in UK is enacted by accounting professional bodies and the courts provide support for the enforcement of accounting standards. In contrast the management of the Chinese accounting system and the development of accounting standards is the responsibility of the State Council and the Ministry of Finance.

The lack of influence by the private commercial sector is likely to create tension and unwilling participation by businesses to move to the new foreign based standards. Furthermore the IFRS standards, having been developed in a free market environment, are not likely to align with the controlling attitudes of the Chinese government. While this sense of misalignment between IFRS and CAS are not specific to the area of taxation, the Chinese government’s reluctance to relinquish their control over their primary source of revenue is likely to only further entrench their reluctance to give up control. The introduction of IFRS tax laws in China is likely to be

filtered through the philosophical filters of the Chinese government and therefore detract from its original scope and purpose.

The standard setting process in China is a closed process. The exposure drafts and meetings that are carried out during the standard setting process are not open to the public. In contrast, the standard setting process in most IFRS countries involves public consultation. The outcome of the IFRS standards is therefore a partial reflection of the views and concerns of the market. Implementing a set of rules (IFRS) in a country that continues to be dominated by central government control is likely to be problematic. Views and concerns regarding taxation by the private sector are not reflected in the Chinese accounting standards. Moving to IFRS is will introduce the private sector views that are inherent in the west and not those in China. For this reason the convergence process is likely to be frustrated from two viewpoints. The first is that introducing IFRS tax laws into china continues to ignore the peculiar needs of the private sector tax payer. Secondly the private sector views that are inherent in the IFRS tax rules are those of western markets and not of China.

IFRS tax standards are a product of the financial accounting reporting framework. In particular the IFRS framework is not only a guide for the development of accounting standards but act as a fall back where there are gaps in the specific scope and coverage of the accounting standards. While this is the case in the UK, there is not specific conceptual framework in the case of China. The development of accounting standards, including those for tax, is based on the political agenda and current economic and social policies of the present government. While the Chinese government has indicated that it intends to move towards IFRS, it continues to be entrenched in its rules based heritage. This is the case for all accounting standards in China including those for taxation.

The purpose of general purpose financial reporting (GPFR) in IFRS adopting countries is to provide external stakeholder with financial information so as to allow them to make informed investing decisions. GPFR has the overarching aim of creating investment stability in a free

market economy. The system is designed for corporate structures where the owners are scattered and divorced from the day to day running of the business. The Chinese economic model is far from this and the central government continues to cast a dominant role in the management of commerce through its SOE and the regulatory development. The dominant purpose of financial reporting is providing a process for the assessment of taxable income. The dominance of these tax rules is fundamentally at odds with the free market heritage of the IFRS standards including those for tax. Since the dominant driver for financial reporting is income tax, convergence with IFRS tax standards is likely to be frustrated.

The ownership structure of many large businesses in China is inconsistent with that in western countries including the UK. IFRS assumes a market structure where there are disempowered shareholders that rely on the mandatory disclosures in the financial statements to determine the performance of their investment. This is not the case in China where for most large corporations are SOEs and the dominant single owner is the government. The lack of separation between the owners and managers of the business together with the fact that these large SOEs are directly under the control of the government renders the purpose behind GPRF redundant. Furthermore the administration and levying tax for Chinese SOEs seems a academic exercise that does not promote a level playing field for private and public businesses. The dominant ownership structures of the Chinese SOE together with the large proportion of the Chinese economy that they represent, if allowed to continue, will always cast shadow of doubt over the true freedom of a China's growing market economy. Despite the fact that the Chinese government has declared that the new accounting standards (CAS) will be aligned with IFRS, and will be made mandatory for SOEs, it would appear that in such a market, there will always exist two sets of standards and tax rules. There will be one set of rules for the government and its SOEs, and the other for the private sector. While this is allowed to continue convergence with IFRS may never be fully achieved.

5.5 *The UK's experience of IFRS convergence in terms of taxation regime*

The relationship between tax and accounting regulations are an important factor influencing the convergence process with IFRS. In the UK the accounting standards and tax regulations have been independently developed in order to maintain the objectives of each. While the accounting standards are developed with the aim of providing investors and other stakeholders with financial information that will allow them to make investment decisions, the tax rules are aimed at fulfilling the revenue and social policies of the central government. When determining the assessable income for a company, adjustments are made to reflect the differences between the accounting and tax rules. However the assessable income is not the same as the reported profit to the external stakeholders. Accounting standards in the UK are developed by independent professional accounting bodies, while the tax laws and regulations are enacted by the government. The separation of the development process for accounting standards and tax laws has supported a speedy integration process towards IFRS adoption in the case of the UK.

The accounting standard setting process and the establishment of tax laws is a responsibility undertaking and controlled by the Chinese central government. Adjustments to align taxable income and reported accounting profit are less frequent. Merging with IFRS accounting standards may well be welcomed by the private sector. However, as long as the Chinese central government continue to insist on aligning the two sets of rules so as to preserve the dominance of the tax rules, then the convergence process is likely to be slow.

Tax relief targeted at first time adopters of IFRS provides an incentive for businesses both large and small to make the transition. Part of the difficulty faced by regulators in the UK when implementing IFRS was the managing the shift for small businesses. To assist this transition process, the government in the UK offered tax rebate or relief for enterprises to reduce the additional cost of adopting IFRS. There were also some preferential tax policies for SMEs and high-tech enterprises to minimize the impact of the convergence process to IFRS. The flexibility in the UK tax system in terms of it being used as a vehicle to encourage IFRS

adoption has contributed positively to the exercise. The tax incentives are also a clear indicator of the commitment by the UK government to adopt IFRS (李林木 et al., Li, Han, & Liu/2009). In the case of China this commitment has been signalled through the announcement by the Ministry of Finance to the adopt IFRS. However this commitment has not been extended to include shouldering the financial burden of the transition through offering businesses tax relief. IN the absence of such tax relief, the convergence process in China is likely to be slower.

Given the analysis of China and UK's accounting and tax system, in order to enable smooth convergence of IFRS, it is crucial to reform China's current tax system. But, at the same time, the reformation must suit China's current political and economic environment. In this case, the coordination and interaction among government, accounting, tax professions and academics is necessary to ensure a smooth transition. The participation of these groups in the UK has contributed positively to the adoption process. The same is likely to occur in the China if buy-in is gained from these other non-government stakeholders.

The accountability environment on China is comparably more rigorous than that in the UK. Observations and conversations made with tax payers in the tax halls in China suggest that there is a lack of trust between the tax authorities and tax payers. This lack of trust has translated to a complex set of tax regulations that are both hard to administer from the tax authority's perspective. Similarly these regulations are onerous to comply with from the perspective of the tax payer. This dilemma is particularly true in the case of SMEs as they represent a significant proportion of the tax-paying population.

5.6 *Tax as a Revenue Source*

The proportion of tax revenue from personal and corporate income tax may potentially impact the IFRS conversion process in China. For many countries including the UK and New Zealand, the largest tax revenue source is from personal income tax. Given these proportion the dominance of the accounting standards over those of tax is understandable. The accounting

standards ensure that investors (personal tax payers) are provided with appropriate information so as to allow them to make informed investing decisions. This takes priority over the tax law that ensure corporations pay those amounts that they should. In the case of China the main source of tax revenue is from corporations or businesses. Given the significant proportion that is collected from businesses, it is likely that the Chinese government will continue to focus on ensuring that the tax laws are reflected in the accounting standards. For this reason complete alignment with IFRS is unlikely.

Although the Chinese government encourages greater disclosure of tax related financial information, there is no clear requirement in the new Chinese Accounting Standards (CAS) regarding what tax information should be disclosed in SOEs' financial statements. For example, tax payable in balance sheet only represents the amount of tax that should be paid but is still outstanding at the end of the financial year. It does not represent the annual amount of tax paid and tax due. Current tax disclosures do not clearly differentiate between the periods in which they have been incurred and settled. It is also impossible to distinguish which parts of taxes are borne by the enterprise itself and which parts are not. For example, the enterprise does not carry all economic burden of VATs, a great proportion of VATs are collected and paid by the enterprise on behalf of the government. An item called "deferred VAT asset" should be added under the item "deferred tax assets" in the balance sheets to reflect the effect of deductible temporary differences caused by VAT calculations. It is also suggested that "statement of corporate tax position" should be added into financial statements, in order to provide meaningful information not only to management and stakeholders, but also to tax authorities and law makers. Overall, given China's unique socialised market economy environment, the disclosure of tax related information in the financial statements is appropriate (Tao, 2008). These additional disclosures are consistent with the IFRS framework and likely to support the convergence process.

5.7 *Education of tax and accounting practitioners*

Due to the unique and the complex nature of China's tax and accounting system, the education of accounting and tax practitioners is challenging and provides an additional obstacle to the convergence process.

5.7.1 Tax practitioners

Following the major reform of 1994, the tax system has experienced several further developments aimed at reducing its complexity, for example, the number of tax categories has been reduced from 37 to 17 in 2008. Nonetheless, many tax officials still consider the tax laws in China to be complicated and dynamic. Amendments to existing tax laws create extra confusion and difficulty for tax practitioners to comply with. Hence education of tax practitioners is crucial.

The education issue of tax practitioners can be discussed in three aspects. Firstly, the educational backgrounds of tax officials in China are disparate. Tax officials from the regional office complained that tax regulators who are responsible for issuing and amending tax laws generally come from a strong research background. Nonetheless, they do not have enough experience in tax enforcement level, thus the tax laws or amendments issued by them may not be practical. On the other hand, tax officials who worked in tax reporting halls are the first point of contact with taxpayers. However, only a few of them have a tax related qualification and they are only capable of doing routine jobs. Their lack of understanding of current tax laws prevents them from providing help to general taxpayers, especially in China's fast-changing environment. Therefore the on-going education of tax officials should include both tax regulators as well as the tax officials at grass roots levels.

Secondly, education of certain accounting knowledge to tax officials is vital. It has been five years since China has announced the commitment to converge with IFRS. Surprisingly, from a

tax perspective, many of the tax officials are still unfamiliar with the influence of IFRS convergence. Although it is not expected that tax practitioners be aware all the accounting standards (IFRS), it is appropriate that they are familiar with those standards that impact on tax so that further confusion arising from the convergence process is avoided.

Lastly, it is crucial to improve tax officials' working ethics and attitude, as it may restraint the possibility of illegal activities such as bribery and tax negotiations. In China, although there are several set of rules to guide tax officials' behaviour, tax negotiations between taxpayers and tax officials still happens as there are many loopholes and grey areas that existed in the current tax laws. Tax laws and regulations should be constructed in a way to reduce their loopholes or grey areas. Continuous education on tax officials' working attitude and ethics would also improve the current situation of tax negotiations and bribery.

5.7.2 Accounting practitioners

Accounting practitioners in China are familiar with the rules based environment and the dominance that the tax laws currently has. This mind set is going to be difficult to change in the short term and the convergence process needs to incorporate this into its implementation design. The objective of IAS12 (income section of IFRS) may be achieved by training them in the rules based manner that the Chinese commercial practitioners are familiar with.

Shortage of professionally qualified accountants is another obstacle to the IFRS convergence process. Yip (2011) revealed that the majority of accountants in China do not have a professional qualification. As of 2011, there were only 160,000 certified public accountants in China (Yip, 2011). Consider the huge population and rapid rate of economic growth, China faces a skill shortage, especially those professionally trained and internationally recognised accountants. Accountants with a professional qualification together with experience in the international market can adapt quickly to the change associated with the IFRS convergence

process. An obvious solution is for the Chinese government to encourage more and more accountants to work towards their professional qualifications.

5.7.3 Volume of population

The large number of self-governed local tax bureaus in China is another issue that may impact the IFRS convergence process. There are 33 provinces/regions in China and due to the existence of local tax bureaus, each of them have their own set of local tax regulations. Each provinces/regions act like a small country, therefore it is a challenge for each individual provinces/regions to comply with the new CAS (substantially converged with IFRS) as the tax rules differ between regions and potentially with the new standards.

China's large and diverse population introduces a set of challenges not prevalent in the west (or at least to the same degree). China's 1.3 billion populations make disseminating any new standard a mammoth exercise. In addition, regions and provinces have developed at different rates. This development disparity has resulted in major cities such as Beijing and Shanghai enjoying a greater level of economic prosperity, with a greater proportion of its population being educated and familiar with the economic challenge facing the global market. By comparison, many of the rural provinces are in shortage of professionals to lead the way. In the case of tax and the introduction of IFRS, the obligation to adopt offers no concessions to less developed regions, making the convergence process all the more difficult for them.

5.8 Language barriers and the convergence process

5.8.1 Characteristics of the Chinese language

The unique feature of the Chinese language could be another barrier that prevents an otherwise smooth convergence to IFRS. The Chinese language is characterised by its high

level of internal diversity. There are seven main dialect groups in China, and within each regional group, there are hundreds of dialects used by smaller sub-populations. Although more than 90% of the Chinese population speak mandarin (dialect of Beijing), Cantonese, Wu and Min are widely used in Canton, Shanghai, Fujian and other southeast regions. In writing, “Simplified Chinese” is generally used in China mainland, while “traditional Chinese” is widely used in Hong Kong and Taiwan. The complexity and the internal diversity of both spoken and written Chinese has made the implementation of Chinese laws and standards problematic. With the convergence to IFRS, the translation process is difficult in terms of reaching the whole population. Furthermore many of the concepts included in the IFRS standards are not easily translated into China’s multiple languages and dialects. Similarly the nuances and conventions that characteristic of China’s culture are not easily translated into English. This is discussed below in section 5.8.2. These translation challenges will invariably make the convergence process to IFRS a slow one.

5.8.2 Potential difficulties arising from IAS12 translations

Nobes & Parker (2010) suggest that language is an important element to consider during the harmonization of international accounting standards. Because of the unique characteristics of the Chinese language, loss of meaning in the translation exercise from English to Chinese is a significant challenge. For example, the main criterion to recognize deferred tax assets for deductible temporary differences under both IAS12 (income tax section of IFRS) and CAS18 (income tax section of CAS, which is translated from IAS12) is:

“To the extent that it is probable (most likely) that taxable profit will be available against which the deductible temporary differences can be utilized.”

In CAS18, the word “most likely” is used instead of “probable”. This is a typical example of lost in meaning through the translation process. The slightly different use of words under both

standards could result in anomalies and loopholes when they are applied. Therefore the translation challenge poses a significant potential barrier for IFRS convergence. Those responsible for the adoption process in China will need to consider carefully the intent and significance of each accounting standard if the purpose behind each one is to be preserved.

5.9 Differences between the new CAS and the IFRS in terms of income tax reporting.

The new Chinese Accounting Standards (CAS) was established in 2006 with the intent that it will fully converge with the International Financial Reporting Standards (IFRS) in 2011. The new CAS considers China's particular political, economic conditions, and the current development of accounting practice, ensures the reliability as well as the relevance of information. Although the deadline for the convergence (2011) has now passed, there are still significant differences between these two sets of standards. The original timeframe underlined the difficulty for China to give up all its accounting sovereignty in such a short period of time. These differences could somehow influence income tax reporting. This section will discuss the similarities and differences between the new CAS and the IFRS. IAS12 (International Accounting Standards No. 12) is the Income Tax standard within the set of IFRSs, whereas CAS18 is the Income Tax section within the new CAS.

5.9.1 Objective of IAS12 and CAS18

For the purpose of reporting, the objective of IAS12 is to ensure the normality of accounting treatment in income tax reporting. The principle issue in IAS12 is to account for the current and future tax consequence of :

The future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and

transactions and other events of the current period that are recognised in an entity's financial statements (IAS12).

These two clauses in IAS 12 refer to the process for assessing an entities income tax liability based on its future and current taxable activity. CAS18 also works with these two principles and outlines the recognition and measurement requirements, even though the interpretations of these requirements are less detailed.

Although the purpose behind IAS12 and CAS18 are very similar, the presentation and tone are very different. IAS12 is worded in such a way as to articulate the principles behind the recognition and measurement of income tax. Several examples are provided to assist practitioners to appropriately apply these principles to the potentially varied situations that may exist in their businesses. CAS18 on the other hand, is worded in a much stronger tone and appears to project itself from a rules based mentality. No examples are offered as these may limit the interpretation and application of the standard to just those situations outlined in the example. Many of the articles are worded using 'shall not' or 'shall be' suggesting a definitive command rather than broad guidance. CAS18 makes continuous references to the tax laws provisions. In contrast, there is no such reference to the tax legislation under IAS12. This reinforces the rules based on the heritage of the Chinese tax standards.

In terms of objectives behind the two standards, they appear very similar. However the communication of these objectives in the case of CAS18 maintains the rules based approach that is prevalent in Chinese society (Nobes & Parker, 2010). This presents a unique form of convergence where the objectives are realigned and yet the philosophical underpinnings continue to be different.

5.9.2 Scope of IAS12 and CAS18

The scope of the two standards (that is who or what it applies to) appears to be similar. Both exclude the treatment of government grants and investment tax credits (IAS12) and government subsidies (CAS18). Similarly, both standards apply to domestic and overseas tax in relation to a resident enterprise.

Although the scope of the two standards are similar, the implications of the exclusions mentioned above are likely to be more significant in the case of China, where the government has significant control of many enterprises. Unlike many other western countries, the Chinese government has maintained ownership and control of many essential service industries including the utility, transport, communication and financial services. In particular, the Chinese government not only controlled the central bank, but also four of the largest commercial banks. The exclusions in the Chinese tax standards, potentially provide the government with a means to participating in the business sector without triggering compliance with the tax standards.

The significant presence of the Chinese government in the business sector together with the scope of CAS18 appears in academic debate as the government will ultimately collect dividends and taxes from those enterprises that it controls. The same cannot however be set in many western countries, where the government revenues are more from tax rather than dividends.

In terms of the scope of the tax standards (IAS12 and CAS18), convergence appears to have been successful. However, the implications for China compared with economies of the west are very different as discussed above. Given the twin revenue streams received by the Chinese government, converging with the IFRS does not prevent any substantial obstacles to the government and hence the relatively smooth transition that has been observed.

5.9.3 Deferral vs. Balance sheet liability method

One of the differences between IAS12 and CAS18 is the deferral and balance sheet method used in the calculation of assessable income. Under the liability method, income tax effects of timing differences are reported as either liabilities or assets, which represent income tax payables or income tax benefits. Any changes to the income tax rate should also be adjusted to reflect the tax effect of cumulative timing difference. Under deferral method, income tax effects of timing differences from current period should be determined using the current income tax rate. If income tax rate changes, deferred taxes that have been already reflected in balance sheet would not be adjusted to reflect the changes (NZSA, 1991) .

From 1998, IAS12 only permitted the use of the balance sheet method to calculate a firm's tax liability. In the case of China, CAS18 continues to allow both (the balance sheet and deferral method) to be used. The implications of this difference are three fold and include; the flexibility to negotiate tax, the significant ownership or control of many businesses by the government, and lastly the greater alignment between accounting and tax profit in the case of China.

Firstly, the flexibility to use either balance sheet liability method or deferral method may create potential tax negotiations. In the Chinese rule based environment, there is limited interpretations and broad guidance in CAS18. Therefore loopholes or grey areas arise as the rules may not cover every aspect of the business practices. In this case, the permission to use the deferral method may not produce useful information about the effects of timing differences on the balance sheet and performance of an entity (NZSA, 1991). In contrast, the balance sheet liability method does provide information relating to the amounts of economic benefits that are expected to flow to or from the business through the income tax system (NZSA, 1991). By allowing both methods in CAS18 allows taxpayers to choose the method that is most beneficial for them, and to negotiate the amount of their tax liability with the tax authorities.

Secondly, the existence of state-owned enterprises (SOEs) may also cause divergence between CAS18 and IAS12. In western commercial markets, most of the businesses are privately owned. This is not the case in China where the largest companies are state owned enterprises (SOEs). In western markets where the government is primarily found on taxation as its source of income, businesses are required to report their financial performance to their private owners and also to the government for tax purposes. Generally, businesses in the west tend to report higher accounting profit and lower tax profit. Therefore the balance sheet liability method is a more appropriate method as it produces useful information relating to the effect of temporary differences between accounting and tax profit. However, the divergence between accounting and tax profit is not a big issue in China. For SOEs in China, both taxes and dividends are paid to the government, hence the tax and accounting profits of SOEs in China are more closely aligned than businesses in western countries. The incidence of temporary differences between accounting profit and tax profit is less frequent since the Chinese government represent both the tax authority and equity owners, there is little motivation to different profits for tax or accounting purposes.

Lastly, the alignment between accounting and tax profit in China may also explain the non-convergence issue between CAS18 and IAS12. As a rule based country, the income tax section of the Chinese accounting standard (CAS18) is entrenched on tax laws and legislations, as many of the CAS18 articles make repeated reference to tax law provisions. Accounting and tax profits are closely aligned as tax has dominated accounting for many years in China. In this case, the incidence of temporary differences between accounting and tax profits seems to be smaller and less frequent. Therefore the use of either deferral or balance sheet liability method seems to be irrelevant under China's unique ownership circumstances.

In terms of the assessable income calculation method used in CAS18 and IAS12, the continued use of the deferral method to calculate assessable income in CAS18 is an example of non-convergence between the two systems. The flexibility to use both methods under

CAS18 allows for the continued practice of determining taxable income through a process of negotiation.

5.9.4 Treatment of Subsidiaries under IAS12 and CAS18

The treatment of investments in subsidiaries, branches and associates and interests in joint ventures under IAS12 and CAS18 is similar. Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base, triggers the need to create a deferred tax asset or liability. Both standards require the recognition of a deferred tax liability or asset resulting from temporary differences.

The recognition criterion for subsidiaries under IAS12 is more specific compared with CAS18. IAS12 includes a few exceptions to this principle of recognition. For example, if the parent company determined that the undistributed profits from subsidiaries or associates will not be distributed in the foreseeable future, the parent does not recognise a deferred tax liability. There is no such exception under CAS18. This suggests when taxable temporary differences arise from subsidiaries, associates and joint ventures, the corresponding income tax liabilities should also be recognized. Under Chinese tax laws there is no tax benefit or otherwise for retaining profits with a view to re-investing long term in a business.

This divergence between IAS12 and CAS18 in terms of the treatment of subsidiaries is consistent with the idea that the incidence of temporary differences tend to be smaller and less frequent in China. Because of the absence of the exception in CAS18, either the parent or the subsidiary could recognise the deferred tax liability. The current difference is in part a reflection of the current tax environment in China. Because of the relatively low incidence of deferred tax assets and liabilities, there is little motivation on the part of China to converge with the IFRS in this respect as it poses no significant advantage.

5.9.5 Tax rate applied under IAS12 and CAS18

The determination of tax rate when measuring the current and deferred tax assets and liabilities under IAS12 and CAS18 is similar. Under both standards, on the balance sheet date, current income tax liabilities or assets incurred in current or prior periods, the expected amount of income tax to be paid or returned shall be calculated according to the tax law. For deferred income tax assets and deferred income tax liabilities, the applicable rate should be the rate at the period which assets can be realized or liabilities can be settled.

Nonetheless, the tax rate measurement requirement is less detailed under CAS18 than IAS12, especially when dealing with tax rate changes. Under IAS12:

“When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse” (IAS12, paragraph 49).

It is clear that IAS12 requires the use of average rates in the above circumstances. There are no specific requirements under CAS18, as the standard only states that the deferred income tax assets and deferred income tax liabilities which have been recognized shall be re-measured. CAS18 does not mention whether average rates or other rates should be used. In this case, with the absence of a clear indication of which rate should be used encourages the practice of assessing tax liability through negotiation. This environment is inconsistent with that associated with IFRS and therefore is likely to frustrate the process for convergence.

CAS 18 makes repeated and frequent reference to Chinese tax laws. These cross references to tax laws are so frequent that it is impossible to administer and implement CAS18 without an appreciation for Chinese tax laws. The alignment of the Chinese tax standard with Chinese tax law is indicative of the continued dominance of legislated tax rules over tax accounting standards. For many IFRS countries, accounting rules have maintained a status equivalent to

that of tax legislation (Nobes & Parker, 2010). Since this is clearly not the case in China, the convergence process is likely to be less smooth.

5.9.6 Rules vs. Principle based accounting

The Chinese accounting system is a rules-based regime, while in western common law countries, the accounting system is principles-based (refer chapter 4.2.1). Under the rules-based system, in the absence of a specific standard for a transaction, the user is allowed greater flexibility in the recognition and measurement of that transaction. In the principles-based environment, this freedom is not as great as the rules-based environment. Financial accounting framework will continue to influence the recognition and measurement process. In comparing IAS12 and CAS18, a number of areas refer to in IAS12 were absent in CAS18. In regard of tax planning opportunities, IAS12 provides a number of examples of possible tax planning opportunities, while under CAS18, there is no clear indication of what should be included as potential tax planning opportunities. This situation might indicate the rules-based CAS provides limited guidelines or interpretations of the standard to accounting practitioners. Hence it is reasonable to conclude that, the rules based environment in China encourages negotiations between tax officials and taxpayers in the absence of principles that would otherwise restrict the scope and degree of these negotiations.

5.9.7 Items recognised outside profit or loss under IAS12 and CAS18

The requirements for items recognised outside profit or loss are clearer and more detailed under IAS12 compared with CAS18. IAS12 states that if current tax or deferred tax relates to items that are credited or debited directly to equity, then the tax items related should also be debited or credited directly to equity. IAS12 further regulates that if the tax related items are recognised in other comprehensive income, then current tax and deferred tax that relates to

items shall be recognised in other comprehensive income ("Use of IFRS by jurisdiction," 2011). Several examples of items that can be classified into other comprehensive income is provided in IAS12, including changes in carrying amount arising from the revaluation of property, plant and equipment and exchange differences arising on the translation of the financial statements of a foreign operation.

The requirement for items recognised outside profit or loss under CAS18 are vague in comparison to IAS12. It states that all income taxes and deferred income taxes should be included in the owner's rights and interests (that is owners' equity) if the transactions related are included directly to the owner's rights and interests. CAS18 does not provide a clear interpretation on whether non-owner changes and the tax related non-owner changes shall be recognized in as an owner's rights and interests or not. The International Accounting Standards Board (IASB) requires all reporting entities to present a statement of comprehensive income and display items of other comprehensive income under the IFRS ("Use of IFRS by jurisdiction," 2011). The vague provision under CAS18 may contradict to the existing IFRS requirements. Business entities may have the options to allocate non-owner changes items and tax related non-owner changes items into owners' equity, because there is no mandatory requirement to classify them as other comprehensive items. Therefore businesses might be motivated to report items and tax related items according to what is advantageous to them rather than the economic reality of their activities. The financial statements prepared may not best represent entities' true equity position, thus result in a distortion of true and fair view of financial reporting. Tightening the current flexibility afforded by CAS18 is unlikely to be welcomed by corporate taxpayers and therefore frustrate the speed of the IFRS convergence process.

5.9.8 Presentation and Disclosure under IAS12 and CAS18

The presentation and disclosure requirements under both standards are similar. For example, both standards include a detailed list of tax expense component that should be included when

calculating assessable income. However the requirements are more detailed and comprehensive in IAS12 than in IAS18.

In terms of offset, IAS12 requires that an entity shall offset current/deferred tax assets and current/deferred tax liabilities only if several conditions are met. However there is no requirement regarding offset under CAS18. This indicates entities may offset their current/deferred tax assets and liabilities without meeting any prescribed requirement. The absence of offsetting requirements could in turn distort the transparent and reliance of financial statements prepared under CAS18. IAS12 also specifies that a number of items should be disclosed separately, including explanation of changes to applicable tax rates. There is no clear indication in terms of what should be disclosed separately in CAS18. The flexible disclosure requirements under CAS18 may lead to confusion and potential manipulation of financial statements. Increasing the rigidity in the rules covering tax offsets is unlikely to be welcomed by Chinese tax payers as it removes the flexibility that they currently enjoy.

5.9.9 Deferred tax arising from a business combination under IAS12 and CAS18

Businesses shall recognise the acquired deferred tax benefits that arise from business combinations. The recognition criteria under both standards are different. Under IAS12:

“Acquired deferred tax benefits recognised within the measurement period that results from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition.” (IAS12)

IAS12 further regulates that if the carrying amount of goodwill is zero, then the remaining part of deferred tax benefits shall be recognised in profit or loss. There are no such requirements in the CAS18. That means businesses may not use the deferred tax benefits recognised in

business combinations to reduce the carrying amount of goodwill relating to the acquisition. This action may result in an inflated number of acquired goodwill presented in financial statements that are prepared under the CAS18. These are very specific examples but they all seem to indicate that there is greater flexibility under CAS18 because of the fact that it is comparatively less specific and therefore moving to a more rigid regime is unlikely to be welcomed by the Chinese tax payer.

5.9.10 Current and deferred tax arising from business combinations under IAS12 and CAS18

The tax consequences relating to business combinations are different between CAS18 and IAS12. If the tax arises from a business combination that is an acquisition, IAS 12 requires recognizing it as an identifiable asset or a liability at the date of acquisition in accordance with IFRS 3 Business Combinations. Purchaser's tax rate is used to account for the acquisition impact on deferred income tax. The reference to IFRS3 indicates businesses should not only obey the requirements under IAS12, but also IFRS3. On the other hand, even though CAS20 is equivalent to IFRS3, this specific standard on business combinations (CAS20) is not referenced by CAS18 and CAS18 does not clearly state which rate should be applied in events of an acquisition. The lack of reference and clarification in presenting the standards under CAS are unlikely to assist the IFRS convergence process in China.

5.10 How does the existence of State-owned Enterprises (SOEs) impact the convergence of IFRS?

5.10.1 History of profit distribution plans of SOEs

In China, the shift towards globalization, trade and foreign investment (Ding & Su, 2008) is inevitable. However this will potentially clash with the desire to maintain sovereignty and ensure tax revenues in an economy where much of the ownership rests with the government.

As a communist country, a large number of companies or enterprises are state-owned enterprises (SOEs). Implementing the IFRS will need to appreciate the impact it is likely to have on this very significant and commercially dominant public sector.

Before 1978, China's economy was in the form of a planned economy. From 1949 to 1952, China used the Soviet Union's economic model as a template for designing the profit sharing system between the government and state owned enterprises (Xu, 2010). That means economic power was highly centralized and the government maintained control over the operation of the businesses it owned. During this period much of the operational processes and details including, employee wages, production plan and capital were formulated and provided by government. Products were purchased and sold by the states and profit or loss was the right and responsibility of the government. (Du, 2007). From 1952 to 1978, China used business incentives to fund the system. The main feature of this system was the state set output and profit targets. Once the target was reached, enterprises might extract a certain percentage of profit as business incentive fund, the fund was used for employee bonuses and benefits. Therefore, the enterprises have little discretion of profits.

From 1978 onwards, central government decentralized authority and profit retention system were implemented among state-owned enterprises. The system required that in addition to handing over part of the profit to the national budget, enterprises must retain a set proportion of profit for employee benefits, incentives and R&D cost (Xu, 2010). The profit retention system was later improved in the following ways: firstly, it provided better incentives for SOEs. Well-managed enterprises had better productions, thus can retain more profit. Secondly, the government did not only consider the needs for employee incentives and benefits in determining the profit retention rate, but also took into account the effect R&D cost, labour protection and so on (Zhu, 2010). The profit retention system was considered as a major improvement to the existing profit distribution system. However the profit retention system had some drawbacks. The main problem was, the system gave enterprises too much flexibility and it heavily influenced the national financial revenue.

In order to improve the profit retention system, a further reform was introduced in 1983. The first step of this system was called “tax and profits co-exist”. Corporate income tax was introduced in the system. Generally, corporate income tax rate was 55% for all profitable enterprises (Zhu, 2010). For after-tax profits, part of profits were retained by enterprises, the rest were paid to central government. At this stage, only part of the profit was levied in the form of corporate income tax, and the remaining after-tax profit were shared between SOEs and government.

In 1984, the second step of the “turning profits into taxes system” was implemented. 55% of corporate income tax was levied to the SOEs, but they can retain all after-tax profits (Zhu, 2010). During 1990s, SOEs in China had experienced hard times. Production efficiency was low and most of the SOEs were unprofitable. Hence, from 1994 to 2007, China maintained the “turning profits into taxes system”, SOEs retained all after-tax profits and the corporate income tax was lowered to 33% (Tao, 2008). This policy was beneficial and most of the SOEs have improved in terms of their financial performance. In 2007, the total profit gained by SOEs was ¥1.62 trillion yuan, which was 31.5% higher than last year. As state owned or significantly controlled companies still did not pay dividends or profits to the government (Economist, 2006), a number of these enterprises had risk of losing business competitiveness and innovation. Furthermore, SOEs did not have the mandate of paying dividends or profits to the government. Instead, they had high incentives of paying high remunerations to managements which in turn created inequality. As a result regulators in China have reached consensus for a further reform of the tax system to fit new economic conditions and order SOEs to pay more dividends (Jun & Tong, 2010).

In 2007, the 13 years non-profits or dividends paying period were over. The Ministry of Finance (MOF) and the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), who is responsible for managing China’s state-owned enterprises, implemented a new provision. The provision states that all enterprises (under SASAC’s direct supervision) which are solely funded by the state should pay a proportion of profits to the

state. For 18 enterprises with resource characteristics, like China National Petroleum Corporation, China Mobile, State Grid. 10% of the profit must be paid to the state as dividend. For the other 99 general enterprises, including airlines, civil constructions and so forth, the rate is 5%. Lastly, military enterprises and research based enterprises did not have to pay any amount for the first three years (Tao, 2008). For other SOEs that the government had significant control, dividends should be paid to state-owned investors and the payable amount must be decided in board meetings, through profit distribution resolution (Tao, 2008).

The mandatory requirement for SOEs to pay dividends is inconsistent with the practice in the west. Because both dividends and taxes are paid to the government by SOEs, the amount and proportion of taxes and dividends paid might be negotiated between SOEs and the government. This is clearly contrary to the general practice of IFRS, thus making the IFRS convergence process challengeable.

5.10.2 Tax and dividend distribution issues in SOEs

China's decision to converge with the IFRS in 2006 was partly due to China's commitment with the World Trade Organisation (WTO). However, as a communist country China's accounting and taxation system are much more complicated than western countries. The existence of SOEs significantly influenced taxation and the taxation regime in China, and thus IFRS convergence. It seems like SOEs should not be taxed because SOEs are earned and controlled by government. The government can always acquire earnings from SOEs through dividends. If profits are taxed, then the amount of dividends would be reduced by the amount of tax paid. Nonetheless, tax is still levied on SOEs because firstly, all resources belong to the public. SOEs have already used resources of the country and they are often monopolies in their fields, thus SOEs must distribute some of its earnings to the public through tax. Secondly, if SOEs are not taxed, then they will have competitive advantage over private firms.

Thirdly, the tax levied are directly paid to national finance, but the dividend or profit extracted from SOEs are collected by SASAC and the money can be reinvested back to SOEs.

The government authority, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) has power to appoint the top executives in these SOEs, including chairman, CEOs and managers. These top executives are often not professional managers and are government officials and politicians, usually equivalent to ministers or vice-ministers. When they are retired from chairman or CEO's position, many are appointed as ministers (刘佐, Liu/2009). Similarly, government ministers can also be appointed as CEOs and chairmen. Politicians in China do not all have a business background and their decisions may not be the best for SOEs. SOEs are more like government departments or ministries rather than companies. Political lobbying heavily influences the corporate governance of these organisations. For instance, top executives' salaries and bonuses are much higher than non-SOE firms. Their remunerations are not tied up with performance, which means they always enjoy high bonuses and salaries even though the firms are in financial and operational difficulties. As top executives have close relationships with the government, they have strong bargaining power over the amount of tax paid. This model of corporate governance is inconsistent with that which underpins IFRS and is therefore likely to stifle the convergence process.

Cui (2010) suggests that managers in SOEs respond in a similar way as private enterprises over the amount of tax paid. That indicates they are just as tax-sensitive as private enterprises are, because taxes are mandatory and it will reduce the amount of funds they control. Tax planning, tax avoidance, even tax negotiations and evasions may arise during the bargaining process. Indeed, tax credits are given to SOEs through tax negotiations. In 2010, over ¥90 billion of tax credits are given to China National Petroleum Corporation (refer to appendix 1) by the government. To ensure stability and profitability of SOEs, China's government has political preference over them, especially in terms of tax. According to the notice issued by the Ministry of Finance, from 1st November 2011 onwards, domestic oil levy income threshold

raised from \$44 USD per barrel to \$55 USD per barrel. Because of this policy, China's three state-owned oil giants would reduce tax payments by over ¥ 500 billion (Li, 2012). Maintaining these differential tax rates between state and non-state controlled companies is contrary to the idea of ensuring a level playing field for China's commercial sector. This underlying difference is inconsistent with that in the west and is unlikely to assist the IFRS convergence process.

In summary, the significant size and role of SOEs in China strongly influences the development and enforcement of tax laws. Political lobbying and tax negotiations between the government and SOEs significantly increased the uncertainty over the amount of tax paid. The profit distribution arrangements between the government, the SOEs and their listed subsidiaries, is not clear. As both taxes and profits are paid to the state, the proportion of taxes and profits paid can easily be manipulated through negotiations, but it does not mean that SOEs always pay more tax and less dividends. The amount of tax paid by SOEs may be less than the figures showed in their financial statements, because many tax items (For example, VAT and individual income tax) are included in the calculations. The lack of transparency over the disclosure of tax related financial information in SOEs has caused many problems as discussed in section 5.6. The market and organizational structures in China differs significantly in the west. The predominate role of the central government in terms of its ownership of the SOEs and responsibility over the development of the standards makes a shift towards IFRS difficult. While some of the measures undertaking in the west to speed up the IFRS convergence process, they may not be suitable in China given the size of the population, its current market structure and geographic distribution.

CHAPTER 6: Conclusions

6.1 *Introduction*

This chapter summarises the research findings in the context of the research question and topic. The study examines the influence of the tax regime and other related matters on China's convergence of the IFRS tax standards. The findings suggest that China's social and economic environment together with its complex tax regime has negatively influenced the rate of adoption and convergence with International Financial Reporting Standards (IFRS). The findings outlined in chapter 5 have been summarised below into two broad themes. The first refers to those factors influencing the convergence process, that are related to the culture, history and demographic of China. The second captures the complexity of the Chinese tax regime and components of this complexity.

6.2 *The influence of Chinese culture, language, history and demographic issues*

As a communist country, China's taxation regime was established on the basis of a socialised market economy. China's unique culture, background and demographic issues significantly influence the convergence with IFRS tax standards (i.e. the IAS12).

The culture of verification means taxpayers always prefer "red stamping" as a solid proof instead of electronic filings. As the IFRS is primarily designed in western context, where electronic filings are widely implemented, the lack take up of electronic filings in China may result potential tax negotiations between taxpayers and tax authorities. The chaos of the tax administration system could be detrimental to the convergence with IFRS tax standards.

The size of the population and language barriers may also impact the IFRS convergence process in China. The diverse population introduces a set of challenges not prevalent in the

west. In addition, regions have developed at different rates. This development disparity has resulted in major cities enjoying a greater level of economic prosperity. The decision to converge with the IFRS offers no concessions to less developed regions, therefore making the convergence of IFRS tax standards more difficult for them. Moreover, due to the complexity and internal diversity of both spoken and written Chinese, issues arising from translating the IFRS tax standards are notable to consider as language opposes a potential barrier to the IFRS convergence process.

Because of China's relatively unique and yet developing socialised market economy, the structure of the tax systems and regulatory environments are very different from western developed countries like the UK. The structure of China's current tax system has strong transitional characteristics. It is not mature or comprehensive and thus subject to further reforms. Non-compliance issues like tax negotiations and tax evasions are common. Furthermore, standard setting process in China is largely government influenced. Due to the culture of secrecy, the standard setting process is never opened to the public. These features of the tax system are closely aligned with China's communist background and culture, but are contradict to the general practice in western developed countries. Thus the convergence process with IFRS tax standards might be less smooth in China than in the UK.

One major difference between the IFRS and the new CAS (Chinese Accounting Standards) is that the IFRS is principles-based, while the new CAS is rules-based. For example, CAS18 (income tax section of the new CAS) is worded in a much stronger tone and appears to project itself from a rules-based mentality. In addition, as one of the civil law countries, tax has a dominant impact on financial reporting in China. CAS18 makes continuous references to the tax laws provision while there is no such reference to the tax legislation under IAS12 (income tax section of IFRS). As the IFRS is originally designed in western context, the principles-based IFRS tax standards might be difficult to implement in rules-based civil law countries like China.

Furthermore, the rules-based CAS18 provides limited guidelines or interpretations to accounting practitioners as compared with IAS12. For example, there is no clear indication of which tax rate should be used when measuring deferred tax assets and liabilities. The requirement for items recognised outside profit or loss under CAS18 are vague in comparison to IAS12. In terms of the assessable income calculation used under both standards, the continued use of deferral method under CAS18 represents non-convergence between IFRS and the CAS. The flexibility to use both methods under CAS18 allows for the practice of determining taxable income through negotiations. Moreover, the flexible disclosure and presentation requirements under CAS18 may lead to confusion and potential manipulation of financial statements. Therefore it may indicate that the rules based environment in China encourages negotiations between tax officials and taxpayers in the absence of principles that would otherwise restrict the scope and degree of these negotiations. The greater flexibility and the lack of clarification under the CAS18 are inconsistent with that associated with IFRS and therefore are unlikely to assist the IFRS convergence process in China.

It is notable to consider that due to China's relatively unique socialised market environment, it is unlikely for China to give up all its accounting sovereignty in the short run. In this case, the divergence between IAS12 and CAS18 in terms of the treatment of subsidiaries is consistent with the idea that the incidence of temporary differences tend to be smaller and less frequent in China. Hence there is little motivation for China to converge with IFRS in this respect as it poses no significant advantage.

The significant presence of Chinese government in the business sector is a main feature of communist government. The mandatory requirement for SOEs to pay dividends is inconsistent with the practice in the west. Although the scope of the two standards is similar, the implication under the standards is likely to be more significant in the case of China, as the government may ultimately collect dividends and taxes from those enterprises that it controls.

In addition, top executives of SOEs usually have close relationships with the government. Hence there are potential negotiations over the amount of tax and dividends paid between SOEs and the government. This practice is clearly outside the general practice of IFRS, but would influence the convergence process with IFRS tax standards in China. Moreover, SOEs enjoy preference from the government in the form of tax credits. Maintaining different tax treatments between SOEs and non-state controlled companies is contrary to the idea of ensuring a level playing field for China's commercial sector. This underlying difference could also make the convergence process problematic.

6.3 The complexity of China's tax regime and its impact on the convergence with IFRS tax standards

The complex and the evolving nature of China's taxation regime is another obstacle that prevents an otherwise more rapid rate of convergence with IFRS tax standards.

In terms of the VAT rates, there are three different VAT rates in China and the calculation methods for VAT are also different between general taxpayers and small-scaled taxpayers. Although the tax laws have been developed in a way to suit China's economic environment, the complexity will potentially frustrate the convergence process with IFRS tax standards.

The tax sharing system in China is complex. There are a large number of self-governed local tax bureaus, and each of them has their own set of local tax regulations. Changes introduced through the IFRS convergence process would make the already complicated tax system even more confusing. Therefore it is challengeable for each individual region to comply with the IFRS tax standards.

Furthermore, the tax sharing between central and local government results chaos for large companies. Large companies, no matter state owned or not, usually have to deal with multiple taxation authorities. This complex arrangement may create extra confusions for them. The

integrity of tax regime may also be damaged, as negotiations and bribery between companies in dealing with multiple tax authorities may happen.

The fluid and the changing nature of the tax laws are also likely to hinder the convergence process with IFRS tax standards. As mentioned earlier, the tax regime is in transition. That means both tax and accounting practitioners have to face regular changes to the existing tax law. The changes introduced through the convergence with IFRS tax standards would create more difficulties to an already muddled compliance environment.

The education of accounting and tax practitioners provides an additional obstacle to the convergence process. The nature of the current Chinese tax system is very complicated and the education background of tax officials in China is disparate. Because of the IFRS convergence, education of certain accounting knowledge to tax officials is crucial. For accounting practitioners in China, shortage of professionally qualified accountants is the main problem to the IFRS convergence process. Most of accountants in China are familiar with the rules-based environment and the dominance that the tax laws currently has. This mind set is going to be hard to change in the short term, therefore make the convergence process with IFRS tax standards all the more difficult for them.

This research reveals that the culture, history, language and demographic issues together with the complexity of the Chinese tax regime, heavily influences the convergence process with IFRS tax standards in China. Given China's unique political, social and economic environment, it is unlikely that China will give up all its accounting sovereignty in the short run, a slower convergence process with IFRS tax standards is expected.

6.4 Limitations and future research

This study is a qualitative study mainly based on observations and secondary data. The option of using interviews is difficult to conduct in this study, given that many of the issues been explored are still unfolding. The findings of this research are specific to China and may not be applied to other countries in evaluating their IFRS convergence process. Future research

opportunities may include studies on the influence of tax regimes on IFRS convergence with tax standards in other countries, especially in those who experience less smooth process of convergence like China.

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Appendix 1: The case of China National Petroleum Corporation

Unlike other listed or unlisted private enterprises, the structure of SOEs, especially listed SOEs are very different. For example, China National Petroleum Corporation (CNPC) is one of the enterprises with greatest market capitalization in the world. It controls crucial natural resources and is the biggest monopoly in China. CNPC is solely owned and controlled by SASAC, and SASAC represents the country as the only shareholder of CNPC and exercise shareholder rights on behalf of the country. CNPC is not directly listed, rather it controls 86.2% of state-owned shares of Petro China Company Limited. The nature of these shares are state-owned shares, which means these shares are not for sale and non-tradable. Petro China is listed in the US, Hong Kong and China mainland, the rest of its main shareholders are either SOEs or controlled by SOEs. Petro China prepared three versions of financial statements, each complied with the US GAAP, IFRS and CAS.

(1) Shareholdings of the top ten shareholders

Unit: Shares

Name of shareholders	Nature of shares	Percentage of shareholding (%)	Number of shares held	Increase /decrease during the reporting period (+, -)	Number of shares with selling restrictions	Number of shares pledged or subject to lock-ups
CNPC	State-owned Shares	86.200 ⁽¹⁾	157,764,597,259	0	0	0
HKSCC Nominees Limited ⁽²⁾	H Shares	11.37 ⁽²⁾	20,801,208,420	-18,203,409	0	0
NSSF	A Shares	0.219	400,000,000	0	400,000,000	0
Industrial and Commercial Bank of China-China Universal SCI Index Fund	A Shares	0.031	57,326,103	-3,277,957	0	0
China Life Insurance Company Limited-Dividends-Personal Dividends-005L-FH002 Shanghai	A Shares	0.030	55,047,859	-14,446,441	0	0
China Construction Bank-Changsheng Tongqing Detachable Transaction Securities Investment Fund	A Shares	0.025	45,719,759	-358,344	0	0
Guangxi Investment Group Limited	A Shares	0.022	39,560,045	+230,536	0	0
Industrial and Commercial Bank of China-Shanghai 50 Index ETF Securities Investment Fund	A Shares	0.019	35,312,598	-2,443,334	0	0
China Merchants Securities -Client Account of Collateral Securities for Margin Trading	A Shares	0.019	35,114,494	+35,114,494	0	0
Bank of Communications-Yi Fang Da 50 Index Securities Investment Fund	A Shares	0.018	32,482,052	+7,367,005	0	0

Note 1: The number of shares excludes the H shares indirectly held by CNPC through Fairy King Investments Limited, an overseas wholly-owned subsidiary of CNPC.

According to the profit distribution scheme promulgated by the SASAC, CNPC as a solely funded enterprise must pay 10% of the profit to the state. However CNPC is not listed and non-listed companies in China do not have to disclose their financial statements. Although CNPC has 86.2% of shareholding in Petro China and Petro China's financial statement states that in 2010, ¥ 139,992 million yuan of profit was attribute to all state owners of the company, Petro China is not directly controlled by the SASAC, hence there is no requirement for Petro China to pay 10% of the profit to the SASAC directly. Therefore how much is the "10% of profit" is not disclosed in the financial statement. According to "State-owned assets

supervision and management measures for implementation of information disclosure” issued in 2009, SOEs has duty to disclose their general operational situation to the public. Unfortunately, there is no clear definition on “operational situation”. Hence most of SOEs use this loophole and only reveal some accounting figures to the public. For instance, total revenue and cost, total assets and liabilities, total equity etc. In other words, the amount of profit paid by CNPC to the state is unknown. Furthermore, even though the government urges SOEs to distribute profits, SASAC as the official institution to exercise shareholders’ rights, redistribute the money back to SOEs, especially some big SOES, and rarely make any distributions to national finance. In relation to tax and profit are both paid to the state, and the non-transparent distribution of profit may also cause distortions and manipulations over the proportion of profit and tax paid to the government.

As mentioned before, China’s government has policy preference over SOEs, thus SOEs generally receive special tax advantages. Nevertheless, SOEs claim that their tax burdens are very heavy. In 2009, total taxes paid by 132 SOEs were ¥930.52 billion yuan, which were about 10% of total revenue. The total tax paid had increased by 9.5% as compared to 2008. Surprisingly, the total profit for 132 SOEs in 2009 had decreased by 6% to ¥633.8 billion yuan and total revenue had decreased by 0.4% as compared to the previous year (Tang, 2009). That indicates the 132 SOEs paid tax more than the total profit by nearly ¥300 billion yuan. At the time when total revenue and profit had declined, total tax paid had increased significantly. In 2011, SOEs in coal production and electricity supply field claimed that they faced similar problems. The increased in taxes had put a lot of pressure over their operations. From January 2011 to July 2011, the total cost had increased by 36.7%, and the total tax payments had increased by 28.5% as compared to 2010 (Guo, 2011). The officials in SASAC told the press that the statistics were based on financial figures reported by SOEs, SASAC cannot specifically explain why.

This particular phenomenon is well debated, one possible reason may explain this strange situation might be that the expansion of SOEs triggered other types of taxes, which were not

levied based on profit, but other financial figures like sales. Furthermore, the tax figure reported and published in financial statements by SOEs does not only include corporate income tax. It may also includes various types of tax such as resource tax, VAT, stamp tax etc. It is also noteworthy that some enterprises do not deduct employees' individual income tax from their salaries. Instead, they deem this behaviour as welfare, and treat the amount of individual income tax as operation cost, thus cause tax evasions. Furthermore for VAT end users like consumers, they bear the economic burden instead of SOEs. If SOEs include deductible (but not yet deducted) VAT input tax amount into the amount of tax paid, the tax figures showed in financial statements become less meaningful as the tax amount may be overstated.

It is clear that the frustration situation mentioned above indicates the tax reporting under the new CAS is not quite transparent. For example, in CNPC's financial statement prepared under new CAS, various taxes including VAT, business tax, resource tax, consumption tax, mineral resources consumption fee, crude oil special levy are included in tax calculations. Based on taxable income, corporate income tax expense is disclosed as a separate item in the Income Statement. The total amount of "tax and levies on operations" and the amount of each individual tax categories were available in the notes. However, although VAT is included in tax calculations, the amount of VAT payment was not disclosed, neither in the body of the financial statement nor in the notes. VAT causes temporary differences and create deferred tax asset, but what proportion of deductible temporary differences and deferred tax asset are caused by VAT is unknown. On the other hand, the tax section in CNPC's financial statement prepared under the IFRS seemed to be less detailed. Similar to the new CAS, "taxes other than income tax" is classified as part of the operation cost, but the amount calculated under IFRS was about ¥7,000 million yuan higher than the amount prepared under the new CAS. Neither notes prepared under IFRS nor the new CAS provides an explanation or reconciliation of the difference. The notes of the IFRS financial statement did not mention the treatment regarding the VAT payment. It only stated that the consumption tax and crude oil special levy were

included as part of the “taxes other than income tax”. It seems that both financial statements only provide limited information about the amount of tax paid. This different degree of disclosure can be explained in terms of the difference between the accounting, tax systems in China and western developed countries.