DEZAN SHIRA & ASSOCIATES

Your Partner for Growth in Asia

Understanding China's New Accounting Standards: Key changes and Impacts

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1. An overview of the new accounting standards

Effective Dates of New Chinese Accounting Standards for Business Enterprises (CAS)

	Revenue (CAS No. 14)	Leases (CAS No. 21)	Financial instruments (CAS No. 22, 23, 24, 37)
Enterprises listed both at home and abroad as well as enterprises listed overseas adopting IFRS or the CAS to prepare financial statements	January 1, 2018	January 1, 2019	January 1, 2018
Other enterprises listed at home which are subject to the CAS	January 1, 2020	January 1, 2021	January 1, 2019
Non-listed enterprises which are subject to the CAS	January 1, 2021		January 1, 2021

The Impact of New Accounting Standards on Financial Statements

<Extracted from CRRC 2019 Annual Report>

Current Assets:

- Cash and bank balances
- Placements with banks and other financial institutions
- Held-for-trading financial assets
- Bills receivable
- Accounts receivable
- Receivables at fair value through other comprehensive income
- Prepayments
- Other receivables
- Inventories
- Contract assets
- Assets classified as held for sale
- Non-current assets due within one year
- Other current assets

Total Current Assets

Non-current Assets:

- Loans and advances to customers
- Debt investments
- Long-term receivables
- Long-term equity investments
- Investment in other equity instruments
- Other non-current financial assets
- Investment properties
- Fixed assets
- Construction in progress
- Right-of-use assets
- Intangible assets
- Development expenditures
- Goodwill
- Long-term prepaid expenses
- Deferred tax assets
- Other non-current assets

Total Non-current Assets

The Impact of New Accounting Standards on Financial Statements

<Extracted from CRRC 2019 Annual Report>

Current Liabilities:

- Short-term borrowings
- Borrowings from the central bank
- Deposits from banks and other financial institutions
- Placements from banks and other financial institutions
- Bills payable
- Accounts payable
- Receipts in advance
- Contract liabilities
- Employee benefits payable
- Tax payable
- Other payables
- Non-current liabilities due within one year
- Other current liabilities

Total Current Liabilities

Non-current Liabilities:

- Long-term borrowings
- Bonds payable
- Lease liabilities
- Long-term payables
- Long-term employee benefits payable
- Provisions
- Deferred income
- Deferred tax liabilities
- Other non-current liabilities

Total Non-current Liabilities

TOTAL LIABILITIES

2. Revenue

Revenue – Major Changes

Two revenue recognition models	One model
Transfer of significant risks and rewards of ownership	Transfer of control
Principal based standards	More guidance on special transactions

Revenue – The Five-Step Model Framework

1. Identify the contract(s)
2. Identify performance obligation(s)
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize revenue

Revenue – The Five-Step Model Framework

Identify the contract(s) → Identify performance obligation(s) → Determine the transaction price → Allocate the transaction price → Recognize revenue

Example:

- Smith Company enters into a contract with a customer to sell a piece of equipment, install it, and provide training on the equipment at a total contract price of CU1,200,000.
- The customer has the expertise to install the equipment and train its employees but has chosen to contract Smith to complete those tasks.
- In other sales transactions, Smith sells the equipment alone for CU1,100,000 and offers installation service for CU70,000 and training for CU130,000 each. Installation and training services are performed when the equipment is delivered.

Equipment → Installation → Training

Revenue – The Five-Step Model Framework

Identify the contract(s) → **Identify performance obligation(s)** → Determine the transaction price → Allocate the transaction price → Recognize revenue

A performance obligation is a promise to transfer a distinct product, or a series of distinct products that are substantially the same, to a customer.

In our example:

- Three performance obligations identified.

Equipment → Installation → Training

Revenue – The Five-Step Model Framework

Identify the contract(s) → Identify performance obligation(s) → **Determine the transaction price** → Allocate the transaction price → Recognize revenue

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised products to a customer.

In our example:

- The transaction price is CU1,200,000.

Equipment → Installation → Training

Revenue – The Five-Step Model Framework

Identify the contract(s) → Identify performance obligation(s) → Determine the transaction price → **Allocate the transaction price** → Recognize revenue

At the inception of the contract, allocate the transaction price in proportion to the stand-alone selling price of the distinct product underlying each performance obligation.

	Standalone price (CU)	Contract price proportion	Allocation	Allocated price (CU)
Equipment	1,100,000	84.62%	1,200,000 * 84.62%	1,015,385
Installation	70,000	5.38%	1,200,000 * 5.38%	64,615
Training	130,000	10.00%	1,200,000 * 10.00%	120,000
Total	**1,300,000**			**1,200,000**

Revenue – The Five-Step Model Framework

Identify the contract(s) → Identify performance obligation(s) → Determine the transaction price → Allocate the transaction price → **Recognize revenue**

Recognize revenue when the entity satisfies a performance obligation.

- For a performance obligation performed at a point of time, an entity shall recognize revenue at the point in time at which a customer obtains control of a relevant product.
- For a performance obligation performed over time, an entity shall recognize revenue based on performance progress over time.

Revenue – Presentation and Disclosures

- Contract assets
    - The right to consideration in exchange for products that the entity has transferred to a customer when the right is conditional on something other than the passage of time.
- Contract liabilities
    - The obligation to transfer products to a customer for which the entity has received consideration (or the amount is due) from the customer.
- Additional disclosure requirements

Revenue – GAAP differences

There is no material difference among CAS14, IFRS15, and ASC606 (under US GAAP).

Subtle differences include:

- Different definitions of “probable” and “high probable”;
- CAS14 Application Guide (2018) provides more guidance related to non-monetary exchanges among entities than IFRS15.
- Constraints regarding applying the residual approach when determining the stand-alone selling price under IFRS15.
- Transitional accounting treatments.
- Shipping and handling activities.

Revenue – Overall Impacts

- ✓ Changes in the revenue recognition policy.
- ✓ Modified revenue recognition process.
- ✓ New requirements on specific types of transactions
- ✓ Impact on value-added tax (VAT)
- ✓ Other indirect impacts.
  - ✓ Bank covenants
  - ✓ Compensation and bonus plan
  - ✓ Ability to pay dividends

3. Leases

Leases – Major Changes

1. New concept “right to control”
2. For lessees, no longer differentiate operating lease and finance lease
3. More guidance on special arrangements
4. More guidance on lessor accounting

Leases – Impact on Financial Position and Financial Results (Lessee)

Example:

- Lease commences on 1 January 2021
- Lease term: 5 years
- Monthly payment: CU40,000 (due at the beginning of each month)
- The implicit interest rate in the lease 5%
- No other cost associated.
- No purchase option involved.

Leases – Impact on Financial Position and Financial results (Lessee)

Impact on financial position and income – Existing rule

	On inception	31/12/2021	31/12/2022	31/12/2023	31/12/2024	31/12/2025	Total
Right-of-use asset	0	0	0	0	0	0	N/A
Lease liability	0	0	0	0	0	0	N/A
Rental expense	0	480,000	480,000	480,000	480,000	480,000	2,400,000
Net profit (loss)	**0**	**(480,000)**	**(480,000)**	**(480,000)**	**(480,000)**	**(480,000)**	**(2,400,000)**

Leases – Impact on Financial Position and Financial results (Lessee)

Impact on financial position and income – New standard

	On inception	31/12/2021	31/12/2022	31/12/2023	31/12/2024	31/12/2025	Total
Right-of-use asset	2,128,460	1,702,768	1,277,076	851,384	425,692	0	N/A
Lease liability	(2,128,460)	(1,704,155)	(1,300,189)	(875,555)	(429,196)	0	N/A
Depreciation expense	0	425,692	425,692	425,692	425,692	425,692	2,128,460
Interest expense	0	95,695	76,034	55,366	33,641	10,804	271,540
Net profit (loss)	**0**	**(521,387)**	**(501,726)**	**(481,058)**	**(459,333)**	**(436,496)**	**(2,400,000)**

Leases – Simplified Treatment

- ✓ Short-term leases (12 months or less)
  - ✓ A lease with a purchase option is not a short-term lease.
- ✓ Leases of low-value assets
  - ✓ According to IASB, an indicative amount of less than $5,000 when new as the value of assets that would normally qualify for the exemption.

Leases – GAAP differences

- Notable differences between CAS No. 21 and ASC842 (under US GAAP)
  - US GAAP differentiates operating lease and finance lease for lessees;
  - Under ASC842, the overall impact on income statement remains constant for each period.
- Land use right is governed by CAS No. 6 – Intangible Assets.

Leases – Overall impacts for lessees

- ✓ Financial ratios and performance metrics (i.e., EBITDA, gearing ratio)
  - ✓ Compensation and bonus plan
  - ✓ Bank covenants
- ✓ Repayment of the principal and interest of lease liability will be included in cash outflows from financing activities
- ✓ Non-lease component
- ✓ Accounting judgement is involved in determining the lease term
- ✓ Impact on Corporate Income Tax (CIT)

4. Financial Instruments

Financial Instruments – What’s new

- ✓ Three categories of financial assets:
  - ✓ Financial assets measured at amortized cost
  - ✓ Financial assets measured at fair value through other comprehensive income (FVTOCI)
  - ✓ Financial assets measured at fair value through profit or loss (FVTPL)
- ✓ The expected credit loss method (ECL) in the impairment assessment.
- ✓ Amendments on hedge accounting to better reflect the risk management activities of an entity.

Financial Instruments – Overall impacts

- ✓ Changes in the classification of financial assets depending on the business model an entity's management of the financial assets.
- ✓ The expected credit loss model requires management judgement in assessing the credit risks of the financial instruments.
- ✓ The expected credit loss model may result in more impairment being recognized earlier in the income statement than it used to be.

5. Preparing for the next step

How to prepare for the new CAS

- ✓ Fully understand the changes.
- ✓ Review and assess the impact on your business.
- ✓ Update your accounting information system, internal control process, and accounting policies.
- ✓ For foreign-invested enterprises, communicate with the headquarter, learn about GAAP differences, update the mapping with group management account.
- ✓ Set up a timeframe for the adoption of new standards.
- ✓ Learn from the best.
- ✓ Start preparation as early as possible.

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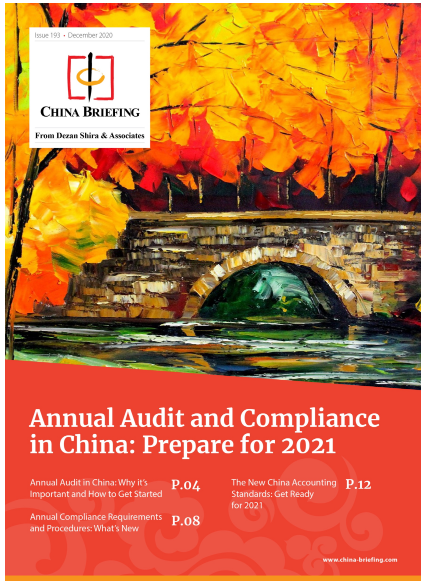

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