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Accounting Practices for Financial Instruments: A Theoretical Framework of IFRS 9 Adoption in China

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Abstract: The banking industry is commonly considered as an important part of the economy since it facilitates the capital flow and thus resources could re-allocate effectively in a region or even in the world. And just because of this vital function to the financial market and economy, banks are also criticized by their contribution to the financial crisis. IFRS 9: financial instruments is the international accounting rules set to make up for the deficiency. practice since 2018. This paper intends to study the international and national context for Chinese banks adoption of IFRS 9. In addition to filling the gap of the IFRS research, the result of this paper should be constructive for the decision-making process of foreign institutional investors, Chinese accounting standards setters and banking industry regulators.
Keywords: IFRS 9; Banks disclosure; FVA

1. Introduction

The tendency of globalization affects every aspect of life: economics, politics, society, and culture. Particularly, globalization of the economy leads to more trades and investments across borders which requires a uniform economic language of business around the world: a single and international set of accounting standards (Nolke, 2005)as developed by the International Accounting Standards Board (IASB. International Financial Reporting Standards (IFRS) is set to rectify this deficiency and it aims to make the international financial market more transparent, accountable and efficient (IASB, 2015). In 2014, IFRS 9 – *financial instruments* was released under the urge of a new accounting method to classify and to measure financial instruments after the 2008 financial crisis (Novotny-Farkas, 2016)the IFRS 9 ECL model incorporates earlier and larger impairment allowances and is more closely aligned with regulatory expected loss. The earlier recognition of credit losses will reduce the build-up of loss overhangs and the overstatement of regulatory capital. In addition, extended disclosure requirements are likely to contribute to more effective market discipline. Through these channels IFRS 9 might enhance financial stability. However, due to the reliance on point-in-time estimates of the main input parameters (probability of default and loss given default.

By 2020, there are 144 jurisdictions require IFRS standards for all or most companies. Although Chinese accounting standards-setting authority, the Ministry of Finance (MOF), does not require listed companies to comply with IFRS directly, it agreed to work with the International Accounting Standard Board (IASB) to eliminate the differences between Chinese accounting standards and IFRS as early as 2005. As a result, a new set of accounting standards: the Chinese Accounting Standards for Business Enterprises (ASBEs) was released in 2006 and it is said ASBEs has already converged with IFRS substantially, which means that Chinese listed firms' financial reports have already disclosed based on IFRS Standards (IFRS Foundation, 2018). According to IFRS 9, Chinese MOF promulgated ASBEs No.22 - *Recognition and measurement of Financial Instruments*, No. 23 – *Transfer of Financial Assets*, and No. 24 – *Hedge Accounting* (MOF, 2017). Listed enterprises in both China and abroad are required to comply with new rules from 1 January 2018 and the deadline for only domestically listed firms is 1 January 2019.

The banking industry is commonly considered as an important part of the economy since it facilitates the capital flow and thus resources could re-allocate effectively in a region or even in the world (Gebhardt, Reichardt, & Wittenbrink, 2004)Current IAS or US GAAP, and the Full Fair Value (FFV. And just because of this vital function to the financial market and economy, banks are also criticized by their contribution to the financial crisis (Acharya & Schnabl, 2010). Especially, there are several unique accounting factors in banking sector leading to financial crisis: how assets in the balance sheets convert into the market; how to value complex assets and to what extent fair value accounting is applied. IFRS 9 released in 2014 intends to solve those problems by clarifying the assessment of financial assets and liabilities.

In terms of China, many researchers think it is quite outstanding for Chinese banks to avoid the damage under the 2008 financial crisis and they attribute this to the Chinese bank reform from 1998 to 2006 (Luo & Yao, 2010; Luo, Yao, Chen, & Wang, 2011). whereas different opinions are held by others. Leung and Mok consider that the Chinese banking system has failed to make notable progress since 1997 and commercial banks' business still influenced by the government largely. Moreover, there are inadequacies in terms of financial globalization and innovation in China (Huang, 2010). With the bank system reform deepening, problems within the banking sector would surface and since the financial crisis in 2008 exposed problems within the financial system, it is a compelling

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requirement for banks to adopt IFRS 9 when disclosing financial information. The main purpose of this study is to propose a theoretical framework for IFRS 9 adoption in China.

2. Literature review

There are studies evaluating the effects of IFRS in terms of financial reporting quality, market reaction, and decision making (De George, Li, & Shivakumar, 2016). Whereas outcomes vary due to different geographical regions, time and methodologies. As to reporting quality, the most directly affected sphere, an early research shows no improvement in value relevance or timeliness after adopting IFRS in Germany（Hung & Subramanyam, 2007）. Barth, Landsman, Lang and Williams (2012) test the comparability of IFRS and US GAAP and the result supports that the comparability of American enterprises' financial reports which adopt IFRS increases remarkably. Nevertheless, some studies show that IFRS raises the comparability cross-country but less comparability is found within-country (Ball & Shivakumar, 2005; Cascino & Gassen, 2015) In terms of transparency, Shroff, Verdi and Yu (2014) and Loureiro and Taboada (2015) conclude a more transparent information environment within IFRS adopters for international investors to make decisions.

The existing research on stock market effects generally shows that IFRS is superior to stock market investors. An influential work by Daske, Hail, Leuz and Verdi (2008) exhibits a strong empirical proof that IFRS adoption has a positive effect on the market. As to the effect of the IFRS on corporate decisions, Hail, Tahoun and Wang (2014) study IFRS's influence on firm's dividend policies, and the result is week to illustrate a significant change after adopting IFRS.

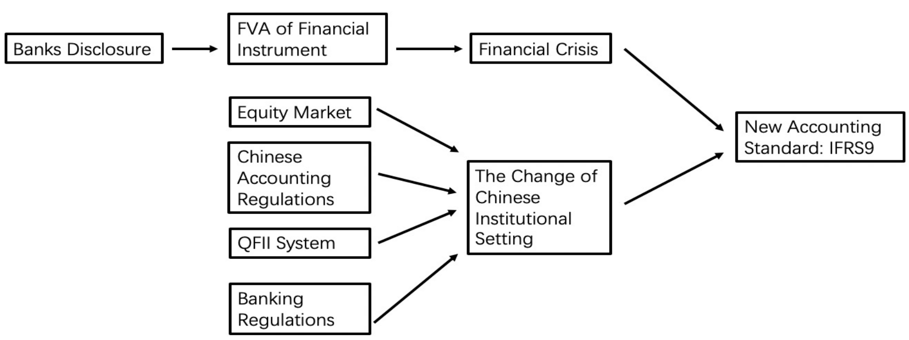
Similar tests have been run within China. DeFond et al. (2018) examine the effectiveness of IFRS in China and they find no increase in foreign institutional investment through improved financial reporting quality. Instead of testing the influence of IFRS, a longitudinal analysis from 1992 to 2006 is conducted by Peng and van der Laan Smith (2010). They find the convergence is quite successful in spite of several unsuccessful converging items. Differently, Zhang and Andrew (2010) analyze the comparability of IFRS and Chinese accounting standards and they point out that now we are just "creating the illusion of similarity" and there are still many problems that need to be worked out during the convergence.

Overall, the results about IFRS's influence are mixed. Since accounting is a tool for companies to record their financial transactions and present financial status, and IFRS just demonstrate an accounting principle for firms to follow, the economic influence should be very limited (Arnold, 2009; Barth & Landsman, 2010). But the contribution of IFRS to the international market cannot be denied and it is supposed to be profound and lasting (Jeanjean & Stolowy, 2008). This paper believes that IFRS adoption in beneficial and intends to discuss the changing environment for Chinese banks adoption of IFRS 9.

3. Theoretical framework

The necessary theories for the purpose of this paper are presented in this section, including the disclosure of banks, financial crisis, fair value accounting method, and the Chinese institutional setting. Accordingly, the theoretical framework in this paper is developed as shown in Figure 1.

Figure 1: Theoretic synthesis of IFRS 9 adoption in Chin



3.1 Banks' disclosure and the financial crisis

A systemic collapse of the banking industry had occurred during the 2008 financial crisis. And there is a link between banks' financial reporting and the 2008 financial crisis since the banks' disclosure is the most important tool to present its situation to regulators and the market, and it also reflects the whole economic situation to some extent. Bushman and Smith (2001) also suggest that an efficient financial accounting system can promote economic performance by optimizing risk estimation and reducing information asymmetry. According to Kordlouie, Mohammadi, Naghshineh, and Tozandejani (2013), financial reporting has four objectives:

To provide information that could help investors and creditors to make financial decisions effectively.

To present proper evaluations and timings on the expected returns.

To present information on the economic resources and liabilities of the business.

To reflect the financial achievements.

The banking sector had failed to meet all of those objectives during the financial crisis since the information provided by them is not timely and lack of accurate assessment. Especially, the fair value accounting method utilized by banks criticized most after the

2008 financial crisis.

3.2 Fair value accounting

Fair value accounting (FVA) also known as market-to-market accounting and hedge accounting, is defined as an accounting method that an asset or a liability is measured and valued based on current market conditions, including assumptions about risk (IFRS Foundation, 2013). And IFRS standards are regarded as FVA-based and FVA is mostly utilized when assessing financial assets and liabilities. Whereas, both the positive and negative influence of FVA on banks are still discussed. It is believed that FVA makes a better exposure of risks in volatile times than non-fair value measurements. In contrast, FVA is argued to result in write-downs in busts and excessive leverage in booms and thus the financial system is more fluctuant and vulnerable (France, 2008). Moreover, research also shows that more leeway for earnings management has been given under FVA (Bratten, Causholli, & Myers, 2012). In order to fix those problems, IFRS 9 is released based on a modification of IAS 39 and provides one single model instead of multiple impairment models to evaluate the financial asset and liability.

3.3 Chinese institutional setting

Before 1978, the Chinese economy was completely based on a central and planned system and the purpose of accounting and financial reporting is to assist the government to make economic plans (Adhikari & Wang, 1995). And China still regards as a weak institution with a relatively poor legal environment and heavy government involvement in the economy (He, Wong, & Young, 2012) we find empirical evidence on unintended consequences of fair value accounting (FVA. Whereas improvement of the institution had been made. The accounting reforms began with the establishment of new stock exchanges, namely Shanghai stock exchange (SHSE) in 1990 and Shenzhen stock exchange (SZSE) in 1991. Four versions of Chinese accounting standards had been released in 1992, 1998, 2001 and 2006 to meet the market's need. The Qualified Foreign Institutional Investors (QFII) system has changed step by step since 2002 and the Chinese market is more open to international investors, which also urges the internationalization of financial reporting. The adoption of IFRS 9 is not only to meet the market's need but also to achieve the accounting and banking regulators' requirement.

4. Conclusion

As KPMG (2018) addresses, the new standard IFRS 9 will have the most significant impacts for the banking industry since the starting point of IFRS 9 in 2009 is to respond G20's call for bank accounting rules reform. After the first-year adoption, a vision of how banks doing with IFRS 9 compliance should be demonstrated. After studying the changing financial environment, accounting custom and Chinese institutional setting. This paper is set to discuss the context of Chinese banks adoption of IFRS 9. Despite the inherent limitations of the research design, this paper tries to help IASB get a portrait of IFRS adoption in a different jurisdiction – mainland China. Also, this paper should have an auxiliary function for foreign investors who attempt to invest the financial companies in China to make decisions based on disclosed financial information.

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