

CHINA RENAISSANCE 2023 PRC PAYMENT: ASSET OR EXPENSE?

Background

Bea Mused and 'Skip' Tickel are analysts working for a financial services firm. In September 2024, Bea comes across an article in the Financial Times and shares the contents with Skip.¹

Bea: Have you seen this piece in today's FT, Skip? It concerns a payment that a Hong Kong-based bank has made to a government agency in the PRC (People's Republic of China). The bank's accountants and auditors disagree about how the payment should be accounted for.

Skip: No, Bea, this is news to me. Fill me in on the details.

Bea: OK. So, the bank is China Renaissance, an investment bank based in Hong Kong.² Its founder and then CEO, Bao Fan, disappeared in February 2023. It emerged later that month that he was "cooperating in an investigation" by the Chinese authorities. In October 2023, a government agency asked the company to send it Rmb78mn (\$11mn) in relation to the investigation. The company complied with the request.

Skip: Interesting. It sounds as if the payment is to cover the cost of the investigation. I like the way they 'request' the payment rather than order it. What's happened to Bao?

Bea: As of September 2024, the authorities have not formally charged him or made any public allegations against him. Earlier this year, the company announced that he had resigned his positions at the bank "for health reasons and to spend more time on his family affairs".

Skip: Lucky family. They're going to see more of him. So, what is the problem with the accounting? It sounds straightforward to me.

Bea: Not for the company's accountants. Apparently, they wrestled with this one. In the end, they decided to record the payment as a receivable on the group's end-2023 balance sheet. They noted the amount could be repaid. However, they accepted that it might not be. Lawyers for the bank stated the Rmb78mn could be considered "property associated with a case under investigation".

Skip: Spot on. And there could be more 'property' the bank has to hand over as part of the investigation. What do the auditors have to say about the company's accounting? My guess is they're not happy.

Bea: You're right. The external auditors issued a qualified opinion on the bank's 2023 financial statements, on the grounds they could not assess the recoverability of the receivable.³ I get the sense you agree with them.

Accounting treatment: Skip's proposal and Bea's response

Skip: Yes, I do. The odds of the bank recovering the Rmb78mn are slim. But I question the whole idea of recording the payment as a receivable. A receivable is a financial asset. Under IFRS, there are

¹ Leng C. & R. McMorro, 'Bao's bank baffled by \$11mn payment', *Financial Times*, 12 September 2024.

² China Renaissance was founded by Bao Fan in 2005. Its core business consists of investment banking, investment management and securities underwriting. The group performed poorly in 2023: revenues of Rmb1bn were 36% down on those in 2022 and losses increased to Rmb461mn from Rmb454mn. End-year total assets fell 29% to Rmb9,340mn. The group is well capitalised: group equity was Rmb7,177mn at end-2023.

³ China Renaissance Group, *Annual Report 2023*. The auditor's qualified opinion is on p. 137 of the report; the company's view on that opinion on p. 136. Information about the payment is given in note 49 'Contingent Liabilities' to the consolidated financial statements.

three main types of financial asset: cash; shares in another company; and a contractual right to receive cash (or another financial asset) from another entity.⁴ The payment to the government agency is clearly not cash or shares in another company. But it fails the third test, too. The bank has no contractual right to receive cash or other financial asset from the government agency. It hasn't lent money to the agency. It hasn't provided financial services to it for which it has a contractual right to receive payment.

So, I think the payment should be recorded as an expense – a cost of doing business. It could be thought of as a penalty or even a tax, although the bank won't label it as such in the financial statements. The payment should be included under 'other operating expenses' and, if material, disclosed separately in the notes.

Bea: Not all receivables are financial assets. You suggest the payment is like a tax. IFRS state explicitly that assets or liabilities that are not contractual – like income taxes receivable and payable – are not financial.⁵ The bank can legitimately recognise the payment as a receivable if management consider the Rmb78mn is recoverable.

And it's surely premature to conclude that the bank won't get the money back. Management had good reason to resist a full write-off in 2023. First, there was no evidence that the bank had done anything illegal. The request for payment related to an investigation of its then CEO, not the bank. Even now, management can bring legal action to recover the sum. Second, the bank had to consider the optics of a write-off. Management made the Rmb78mn payment because they felt they had to, given the source of the request. If they had written off the amount, the government agency – and investors – might have interpreted it as an admission that the request for payment was justified.

At this point, Skip is called away and the discussion ends abruptly.

Discussion question

How should China Renaissance have accounted for the government-requested payment in its 2023 accounts? What additional information, if any, would you like to have before deciding on the accounting and reporting of the payment?

⁴ IASB, *IAS 32: Financial Instruments: Presentation*, para. 11.

⁵ *IAS 32, op. cit.*, para. AG12.