## 5.2. Financial Statements and Item Valuation

A full set of financial statements includes:

- Balance sheet
- Income statement (profit & loss)
- Cash flow statement
- Notes to financial statement, including:
    - Basis of preparation of the financial statement;
    - Description of significant accounting policies;
    - Descriptions of changes in accounting policies, accounting estimates and correction of errors;
    - Additional descriptions of significant items in the financial statement, and
    - Disclosures of contingencies and commitments, non-adjusting events after balance sheet date, related party relationships and transactions.

Only under CAS 2006, additional statements are required, e.g. Statement of changes in owner´s equities, Statement of Compliance and a Description of key accounting estimates.

While this set of financial statements should be the same everywhere in mainland China, local specifics for accounting rules can exist and even different auditors might disagree on how single cases are to be handled.

### Balance Sheet Details

#### Structure

In China, the balance sheet is sorted from the short-term/current items towards the long-term/non-current items, e.g. on the assets side:

Current Assets
+ Non-Current Assets
= Total Assets

And on the liabilities side:

Current Liabilities
+ Non-Current Liabilities
+ Owner´s Equities
= Total Liabilities

#### General valuation

The general rule of thumb is: ASBE requires receivables/payables /borrowings to be valued as to be stated at cost and investments as stated as cost less impairment.

CAS 2006 allows and specifies the fair value.

As mentioned before, offsetting is not allowed.

#### Accounts receivables

Accounts receivables are in general to be recognized at their actual value.

Impairments or provisions for doubtful accounts can be only recognized for doubtful accounts if it is highly unlikely that the debts will not be paid. This can be assumed if the debtor is bankrupt, the debtor died or if the debt has been outstanding for more than 2 years.

#### Inventories

For both ASBE and CAS the following methods are acceptable:

- First In, First Out (FIFO)
- Weighted Average Cost method
- Specific Identification method

For ASBE, the LIFO principle (Last In, First Out) is also acceptable.

At the balance sheet date, the inventories are to be revaluated to the lower value: Either cost or net realizable value.

### Profit & Loss Statement: Cost of sales accounting

While in other countries the total cost accounting format might be relevant (e.g. Germany), which recognizes all revenues, cost and inventory movements in one period. in China the cost of sales accounting method is relevant:

Only incomes realized and expenses occurred in one period must be recognized—income and expenses which cannot be attributed to the current period cannot be recognized, regardless of the actual goods or money flow.

While there is no difference in the EBT, the financial statements have to reflect this.

If you do not know what that means, here are two simplified examples:

### Sales Cost Method (Relevant in China):

Cost of Sales accounting recognizes only the goods that get produced and sold in one period.
All of the goods that might be produced and be added to the warehouse are recognized in the balance sheet as stock movements.
This method is also called "Income Statement by Function":

Operating Income
- Cost of Sales
- Taxes and Surcharges
- Selling Expenses
- General and administrative expenses
- Finance Expenses
- Asset impairment losses
+ Investment income
+/- Gains/Losses from asset disposals
+ Other income
= Operating Profit
+ Non-operating income
- Non-operating expenses
= Earnings before tax
- Income taxes
= Net profit

### Total Cost Method (for comparison):

Total cost accounting happens in one period, meaning it also recognizes if products are being produced and put into the warehouse as part of the profit & loss. Since these costs are also being recognized in the cost of goods, the profit (EBITDA) remains the same as under the Cost of Sales Method.
This method is also called "Income Statement by Nature":

Sales
+/- Increase/reduction in finished goods and work in progress
+ Other own work capitalized
+ Other operating income
= Total operating performance
- Material expenses
- Personnel expenses
- General and Administration Expenses
- Selling and Distribution Expenses
- Other expenses
- Depreciation on assets
=Operating result
- Interest gains/expenses
= EBT
- Income tax expenses
= Net profit

## Profit & Loss Item Details

### Income and income recognition

Revenues get recognized if the significant risks and rewards have been transferred to the buyer (for goods) and the revenue and their associated cost can be measured reliably.
This can have strong implications with the chosen INCOTERM, e.g. if you sell items as FOB, then only after the goods have passed customs and have been transferred to the ship the revenue can be recognized.
This also includes that for projects, that are going on over several periods, have to be measured according to the percentage of their completion at the period end.
Operational revenues and other revenues have to be separated from each other.
Additionally, freight and insurance revenues have to match the corresponding costs and cannot be (re-)sold with additional profits so that their effect on the profit & loss calculation is basically zero:

| | |
|---|---|
| Revenue of Freight | 50 |
| Cost of Freight | -50 |
| = Non-operating turnover | 0 |

### Cost of operations

For an enterprise whose business is based on production or trade, the cost of operations is the value of the goods sold during the period and price differences occurring in that period. These goods are valuated including all the directly-related cost in producing the finished goods, e.g. raw material, production wages, production-related depreciation, consumables, energy costs and even safety gear for the workers.
For example:

Year 1:
For the production of two articles, 100 RMB are being spent in total, cost per piece is therefore 50 RMB.
The stock value increases by 100 RMB:

$$2\,pcs * 50\,\frac{RMB}{pc} = 100\,RMB$$

Since no goods are being sold during the year, the total cost of operations is Zero.

Year 2:

The required money to produce the same product increased to 100 RMB per piece, again two articles get produced.

Total Stock Value without Sales would be therefore:

$$2\;pcs * 50\;\frac{RMB}{pc} + 2\;pcs * 100\;\frac{RMB}{pc} = 300\;RMB$$

This means by using the weighted average method the production price of

$$\frac{300\;RMB}{4\;pc} = 75\;\frac{RMB}{pc}$$

In this second year, three pieces get sold, leading to operating cost of

$$3\;pc * 75\;\frac{RMB}{pc} = 225\;RMB$$

The stock value is the remaining piece with a value of 75 RMB under the weighted average cost method.

Since there is not time delay for service companies between creating the service and providing the service, for service companies the cost of operations equals the cost of the core activities of the company during that period.

### Taxes and Surcharges

Some other taxes depend on your fixed assets, e.g. land-using right tax, or your sales, e.g. some stamp duties. These should be shown in the profit & loss calculation as operating tax below the operations cost.

### Selling expenses

These expenses are the expenses that are directly related to advertising the products, e.g. marketing costs, or delivering them to the customer, e.g. outgoing freight costs.

### General and administrative expenses

These include all the costs that are related to the administrative overhead of a company which is neither directly related to production nor selling expenses. They include e.g. salaries for office staff, depreciation for the fixed assets in the office, travel costs or cost related to research & development and consulting fees.

### Financial gains/expenses

This block contains e.g. cost for exchange rate losses, bank charges and earnings due to bank deposits.

## Fixed Assets

### Initial valuation and impairment

Fixed assets are measured at historical acquisitions cost which include Purchase Price, Transport cost, Installation cost and other related expenses. In the financial statements they are shown at cost while the depreciation and residual value are shown separately Possible depreciation methods are:

- Straight-line method
- Units of production method
- Double-diminishing balance method
- Sum-of-the-digits method

The method which best reflects the economic benefit of the company should be chosen.

Impairment tests should be carried out; if the impairment test shows that the value is lower than the current value, the impairment loss should be recognized in the profit and loss calculation.

While under ASBE the impairment loss of a previous year should be reversed, under CAS there is no reversal possible.

### Depreciation and residual value

In the past, due to taxation purposes, the residual value of a fixed asset at the end of its depreciation would have been set to 10% of the acquisition value, therefore the depreciation would have been calculated as following:

$$Yearly\;Depreciation = \frac{Cost * 90\%}{Lifespan}$$

While companies that have been active in China longer are still following this rule, a 100% depreciation without residual value seems to be possible now, too.

The historical cost of acquisition and the accumulated depreciation have to be shown separately:

| | |
|---|---|
| Acquisition cost | 100 |
| Accumulated depreciation | - 10 |
| = Current asset value | 90 |

Depreciation starts in the month after the fixed asset has been capitalized.

### Minimum straight-line depreciation years

For taxation purposes, the following minimum straight-line depreciation years shall be assumed:

| | |
|---|---|
| Buildings and structures | 20 |
| Machinery and production equipment | 10 |
| Appliances, tools, furniture etc. related | 5 |
| Electronic equipment | 3 |

*Figure 2: Depreciation Years (Tax)*

### Disposal and sales of fixed assets

The disposal of fixed assets is a regular transaction and can be done even while this is not mentioned in the business license.
The disposal can be done as:

- Sale of the fixed asset with profit: Especially for intercompany transfer of assets you should add some reasonable profit to avoid any incrimination regarding movement of profits.
  While domestic sales are rather unproblematic, for international transfers of fixed assets approvals of several government offices might be required and it is recommended to check beforehand.
- Scrapping: Low values can be scrapped without any problem. Higher value scrapping might require proofs for the local tax bureau to make them tax deductible, e.g. videos or pictures or even a special audit report.
  While the threshold can depend on the region as a rule of thumb 100.000 RMB can be used for orientation and over-documenting is always more preferable than not being able to provide enough documentation.

To avoid any issues regarding transfer pricing it is recommended to scrap fixed assets and sell their raw material value if it cannot be sold with profit.
The difference between the book value and the generated income has to be recognized as other income or other expenses, VAT for the revenue has to be charged and it also gets recognized in the corporate income tax calculation.

### Intangible assets

Intangible assets are measured with their initial cost and get amortized with the straight-line method.
If the lifetime of an intangible asset is infinite, ASBE amortizes it within a maximum of 10 years while CAS does not use amortization but requires yearly impairment tests.
Expenditures for research & development in ASBE directly are recognized in the profit & loss calculation of the respective period while CAS allows them to be recognized as intangible assets under certain conditions.
Land-using rights are recognized as intangible assets in both systems and should be amortized according to the length of the land-using rights.

## Liabilities

### Owner´s equity and statutory common reserve

Wholly foreign-owned enterprises have to recognize 10% of their yearly profits as a statutory common reserve if they want to distribute profits as dividends until this reserve reaches 50% of the registered capital.
As long as no dividend is being paid, this statutory common reserve has not to be built up.

### Contingencies

Contingencies have to be recognized if:

- The obligation is a current obligation of the enterprise
- It is likely to cause an economic benefit to flow out of the enterprise
- The amount of the obligation can be measured in a reliable way

Executory contracts that inevitably will lead to costs in excess of the economic benefit and that meet these criteria shall be considered as debts.
The estimated debt should be initially measured with the most likely outcome; if there is a range and if the range is equally likely to occur, the middle estimate of that range should be used. If more than one contingency is concerned, the estimate should be calculated with using all possible outcomes and the relevant probabilities.