6.1. Chinese Accounting (RC)

Introduction

The Chinese accounting system is based on the accrual principle and focusses on being useful for decisions. The general intention is to recognize expenses and revenues by period.

Accounting principles cannot be changed at will. If changes are being made, they should be done at the beginning of a calendar year and shall be disclosed in the notes of the accounts of the year of the change.

ASBE vs. CAS 2006

Currently there are two accounting standards in place in China: The Accounting System for Business Enterprises (企业会计制度, 2001) and the Chinese Accounting System (企业会计准则, 2006) which has is more similar to IFRS.
While listed companies have to adopt to CAS, smaller businesses can still voluntarily use the ASBE accounting system.
At some point there will be probably a forced transition from ASBE to CAS but the transition date has not yet been determined by the Ministry of Finance.

While the Accounting system for business enterprises is based on one document with adjustments in XXXXXX, the Chinese Accounting Standards are

Financial Statements

A full set of financial statements includes

- Balance sheet
- Income Statement (Profit & Loss)
- Cash Flow Statement
  (ASBE: Direct and Indirect Method;
  CAS 2006: Direct Method)
- Statement of changes in owner´s equities (only under CAS 2006)
- Notes to financial statement, including
    - Basis of preparation of the financial statement
    - Statement of Compliance with CAS 2006 (if applicable)
    - Description of significant accounting policies
    - Description of key accounting estimates (only under CAS 2006)
    - Descriptions of changes in accounting policies, accounting estimates and correction of errors
    - Additional descriptions of significant items in the financial statement
    - Disclosures of contingencies and commitments, non-adjusting events after balance sheet date, related party relationships and transactions

Basic important Principles

Business continuity and consistence

In the financial statements, continuity of the business operation is to be assumed, the valuation cannot be done using liquidation values. Methods should be used in a consistent manner.

Historical Cost

For the valuation in the balance sheet and Profit & Loss calculation, the initial valuation is to be done using the historical cost of the goods or fixed assets, which includes the goods itself and all related direct costs, e.g. Freight, Insurance and Import duties (if applicable).

Accrual Principle

All transactions shall be measured under the accrual principle, which attributes profits and losses to a single period. All transactions that do not lead to a profit or loss in a period shall not be considered in this period.

Economic Benefit and Measurability

Only items may be recognized, of which the economic benefit is likely to flow into the company and can be measured reliably

Prudence-Principle

For single items, e.g. especially in the area of current assets, the initial valuation is based on historical cost. At the balance sheet date, the lower value of the historical cost and the net realizable value has to be taken.

Language and documentation requirements

All relevant accounting documentation must be retained in Chinese language even while additionally a second language is allowed.
The accounting records, financial statements and supplementary documents have to be kept for 15 years.

Fiscal Year

The fiscal year equals always the calendar year and the tax year. Annual income tax statements and audited financial statements have to be filed within 5 months after the end of the tax year.

Stock Taking

At least once a year an annual stock taking has to take place and, if deviations are identified, adjustments to the inventories and fixed assets have to be made before the annual closing of the accounts and be reflected in the Profit and Loss.
The reasons must be analyzed.

Local Reporting vs. Group Reporting

Accounting for a Chinese company requires to follow the local GAAP while your group for consolidation reasons might require a reporting according to their GAAP.
In these constellations, a company usually prepares localized financial statements (local GAAP) and in parallel statements according to the group policy (foreign GAAP, e.g. HGB/IFRS).

Government grants

In general government grants get recognized when they are been received, unless otherwise specified by the government documents.

Currency and Exchange gains/losses

While the recording currency might be different in special cases, the financial statements have to be in Chinese Renminbi. To reflect this, the following rules apply for monetary transactions:

- Foreign currency transactions have to be recorded with the spot exchange rate on the date of transaction or
+ Spot exchange rate of the end of the period (ASBE) or an approximate spot exchange rate on the date of transactions

The differentiation between monetary and non-monetary transactions is also handled differently:

+ ASBE does not address monetary or non-monetary transactions
+ CAS 2006 distinguishes in
    - Foreign currency monetary items: Exchange rate at balance sheet date
    - Foreign currency non-monetary items: Spot exchange rate on the date of transaction
    - Foreign currency non-monetary items that are measured on fair value use the spot exchange rate when the fair value was determined

Due to most foreign invested companies generate their main business within China, they mostly also opt for Renminbi as bookkeeping currency in their accounting systems.

Others

There are additional provisions defined in the “Accounting System of the People´s Republic of China for Enterprises with Foreign Investment”, e.g.:

- Every transaction must be supported by (verified) evidence
- Journal, General Ledger, Subsidiary Ledger have to be kept, auxiliary books of accounts can be used

- Accounting Software is allowed but they must meet requirements of safety, secrecy and confidentiality.
  The data must be backed up and hard copies have to printed out on a regular basis.

Other Principles

Accounting should

- Be Carried out timely and should neither be in advance nor postponed
- Create clear and easy to understand reports
- Be done on the principle of importance
- Be consistent.

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 and cost 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 ware house are recognized in the balance sheet as stock movements.
This method is also called “Income Statement by function”.

Sales
- Cost of Sales
- Selling Expenses
- Administrative Expenses
+ Other operating Income
- Other operating expenses
= EBITDA

Total Cost Method (for comparison):

Total cost accounting the total cost happening 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
- Total Operating Expenses
= EBITDA

Balance Sheet

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

Profit & Loss Item Details

Revenue/Sales 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.
Operational revenues and other revenues, e.g. for freight out or freight insurance, have to be

separated from each other.
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.

Cost of Sales and Selling Expenses

As mentioned before, Cost of Sales and Selling Expenses must match the recognized Revenue and Sales recognition to the goods or services sold in the same period.

Balance Sheet Item Details

General valuation

The general rule of thumb is: ASBE requires Receivables/Payables /Borrowings to be valued as to be stated as cost and Investments as stated as cost less impairment.
CAS 2006 allows and specifies the fair value.

Accounts receivables

ASBE: Actual amounts minus provision for doubtful accounts, while the provision should only be made 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.

CAS: Fair value less Impairment.

Inventories

ASBE: FIFO, LIFO, weighted average cost method or specific identification method can be chosen.

CAS: FIFO, weighted average cost method or specific identification method can be chosen

Evaluation of the inventories at the balance sheet date at the lower of cost and net realizable value.

Fixed assets

Initial Valuation and Impairment

Fixed assets are measured at historical cost (Purchase Price + Transport cost + installation cost + 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 economical 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

According to Chinese GAAP, the residual value of a fixed asset at the end of it´s depreciation must be at least 10% of the cost. The depreciation therefore is calculated as:

Yearly Depreciation =
(Cost * 0,9)/depreciation years.

The historical cost of acquisition the accumulated depreciation have to be shown separately. Depreciation starts in the month when the fixed asset is used for operation and has to be stopped when the fixed asset is not used for operation anymore.

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 1: 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.
  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 life-time 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 Reasearch & 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.

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.

Other notable provisions