Managing Your Accounting and Bookkeeping in China

P.04  “Accounting” for Differences in China’s Financial Reporting

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Be it for tax filing, regulatory compliance or internal tracking purposes, accounting is an important part of any business. This is as true for a business in China as it is anywhere else.

Relative to most of the world however, China has only recently embraced the market economy, and with that the practice of accounting. For this reason, some of the accounting and bookkeeping practices that are an everyday occurrence in China may seem unusual to foreign investors new to the country.

Despite these remaining idiosyncrasies, China has come a long way in converging its accounting standards with international practice. This significantly simplifies the integration of a foreign investor’s Chinese subsidiary into its multinational group of companies.

While the Chinese government is making steady progress on its way to RMB internationalization, strict capital controls continue to pose an obstacle.

As a means of controlling the currency flows into and out of the country, the Chinese government requires a special report from foreign-invested companies about their foreign currency holdings. Ultimately, foreign companies that do not comply with this requirement may lose the ability to remit foreign currency abroad. Therefore, keeping correct records of one’s foreign currency transactions is crucial.

In this issue of China Briefing, we discuss the difference between the International Financial Reporting Standards, and the accounting standards mandated by China’s Ministry of Finance. We also pay special attention to the role of foreign currency in accounting, both in remitting funds, and conversion. Lastly, in an interview with Jenny Liao, Dezan Shira & Associates’ Senior Manager of Corporate Accounting Services in Shanghai, we outline some of the pros and cons of outsourcing one’s accounting function.
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All foreign-invested enterprises in China are required to prepare financial reports throughout the year for tax and audit purposes. These reports need to be drawn up using the Chinese Accounting Standards (CAS).

China’s accounting system has a rather brief history. Prior to 1979, China was a planned economy and did not have general accounting standards or industry-specific standards to speak of. Instead, accounting was mostly used to track whether units were meeting their production targets. In the wake of the “Reform and Opening Up” policy launched in 1979, the need newly arose for accounting standards suitable for adoption by for-profit companies.

Over the years, measures were taken to integrate China’s accounting system with the International Financial Reporting Standards (IFRS). This first occurred in the area of foreign investment, and was later expanded to the whole economy.

In 2000 the Accounting System for Business Enterprises was released. Together with 16 accompanying specific standards and relevant supplementary rules, these are now collectively referred to as the Old PRC GAAP (Generally Accepted Accounting Practices).

In 2006, the Accounting Standards for Business Enterprises—Basic Standard was released (dubbed the New PRC GAAP) in which the 16 existing standards were revised and 22 new accounting standards were added.

The standards were again reviewed eight years later, resulting in the significantly revised 2014 version, in which the basic standard and five specific accounting standards were amended, and three new specific standards were released. Consequently, the New PRC GAAP now consists of:

- One basic standard covering other specific standards and providing guidance on more general practical issues.
- 41 specific standards and a relevant “Application Guide”, which deals with specific transactions or events within an enterprise.
- The Interpretation Guide for the PRC GAAP, published by the MOF, which offers detailed explanations and examples for requirements in the Standards and covers certain improvements regarding ongoing convergence with the IFRS.
- China Accounting Standards (CAS) Bulletins and other supplementary regulations, which deal with questions for implementing the New PRC GAAP and aim to facilitate ongoing convergence with the IFRS.
By the end of 2014, all A-share companies, banks, insurance companies, securities companies and state-owned enterprises in China had switched over to the New PRC GAAP, together with a portion of large and medium-sized enterprises in certain provinces. In fact, the New PRC GAAP is expected to be adopted by all medium and large-sized enterprises across Mainland China within the next few years.

Generally speaking, the New PRC GAAP is more principle-based than the Old PRC GAAP, meaning financial staff are required to exercise their discretion more often. For example, for the use of fair value measurement, the enterprise must itself determine whether the transaction has commercial substance and whether fair value can be reliably measured according to the circumstances. In addition, the New PRC GAAP contains more disclosure requirements, such as a sensitivity analysis of financial instruments.

**Chinese Accounting Standards vs IFRS**

Despite the far-reaching convergence of Chinese and international standards, the financial reports of a Chinese company cannot simply be merged with accounts produced using international standards. In addition to more straightforward obstacles such as the PRC GAAP’s mandatory use of the RMB in all financial reports, there are several technical differences to be aware of:

**Choosing a Valuation Method**

Under the IFRS, one may choose the valuation method for certain types of fixed assets. The company can value these assets either using the historical cost principle, or by applying a revaluation of assets. Chinese accounting standards however only allow fixed assets to be valued according to their historical cost.

**More Detailed Rules in Chinese Accounting Standards**

For certain items that are common in China, the Chinese accounting standards have more detailed rules than the IFRS. An example would be the merging of two companies controlled by the same entity and having similar interests. Chinese accounting standards require that the comparative figures be restated, whereas there is no specific rule for this in the IFRS. In practice, various methods are used.

**More Detailed Rules in IFRS**

Conversely, the IFRS have rules for situations that are uncommon in China, such as more detailed employee benefit plans. Apart from paying employees with company stock, Chinese accounting standards do not address certain types of employee benefits commonly offered by multinationals. Difficulties can arise when the parent company attempts to translate such a package to its Chinese subsidiary. In this case, the company may need to consult with the Ministry of Finance as to how this transactions should be recorded.

**Delayed Implementation of IFRS**

When new updates to the IFRS are released, the Ministry of Finance first reviews them to determine whether the new rules are appropriate for China, and whether it will decide to incorporate them into the Chinese accounting standards. As a result, the adoption of new IFRS standards is often delayed, or does not happen at all.

This can lead to further divergence if the countries where other entities of the corporate group are established, adopt the new IFRS rules earlier.

**Mapping: Converting Chinese Financial Reports**

The problem of differing accounting standards is most visible when an overseas parent company requests financial information from its Chinese subsidiary. As the two companies are required by law to follow different standards, the information from the Chinese subsidiary needs to be ‘translated’ to fit into the overseas parent company’s books, in a procedure known as ‘mapping’. Larger multinationals tend to have specialized software for assisting the corporate group with this process, but as this software tends to be very expensive, SMEs often need to do their conversions manually.

“Inserting information from the Chinese subsidiary into the parent company’s books may take just a few hours, or several days, depending on the complexity of its local operations.”

- Susan Ma

Susan Ma
Manager
Corporate Accounting Services
Dezan Shira & Associates
Shanghai Office
There are two major points a company needs to be aware of when ‘mapping’ its books. First is the divergence of accounting rules between Chinese and international accounting standards, as discussed previously. Whether performed in-house or outsourced to a trusted advisor, the company’s accountant will need to take a detailed look at the differences between the PRC GAAP and the target accounting system, as well as explore whether any of the firm’s activities are affected, often spending several days in the process.

If outsourcing accounting work, it is important to notify your accountant of the need to translate your accounts as soon as possible, and ensure that this information is shared throughout the company. If the accountant only learns of this request later on, this may significantly delay the process.

The second is the difference in accounting entry codes. Conversion is a one-time procedure that the outsourced accountant needs to complete when first contracted by a new company. Once the accountant determines which Chinese entry matches which foreign entry, these figures can be automatically converted.

How to File

**Accounting Software**

Up until 1998, government approval was required for the creation of accounting software for use in China. Today, however, enterprises are still required to file their accounting software with the tax bureau. Kingdee and Yonyou, two China-based software companies, currently hold the biggest share of China’s accounting software market, with Yonyou, the leader, controlling over 25 percent of the market, followed by Kingdee, Inspur and foreign providers such as SAP and Oracle.

China’s statutory filing requirements for financial and accounting reports are stipulated in a number of laws and related regulations. In principle, these reports must be submitted to the tax bureau and the enterprise’s local branch of the Ministry of Finance, either quarterly or annually. In practice, monthly filing is often required by the tax bureau, usually at the end of the month.

The annual filing report should be submitted within 45 days of the year-end for domestic enterprises or within four months for foreign-invested enterprises; quarterly filing reports are required within 15 days of the quarter-end. These deadlines may be extended upon approval from the tax bureau in charge.

Note: financial and accounting reports must still be submitted on time even if the company has no taxable income or other taxable items for the current period, or if the company is exempt from tax as part of an incentive period.

**Online Filing vs Filing in Person**

Enterprises can choose to physically file their financial reports at the tax bureau in person, or do so online. Reports can also be submitted through qualified agencies. Due to its convenience, online filing is becoming increasingly common, with some cities like Dalian no longer accepting physical filings.

The filing procedures do not differ substantially. When receiving a financial report, the tax authorities enter the information into a system called the "China Taxation Administration Information System" (CTAIS). This determines which accounting standards should apply. Additionally, the time requirements and formatting standards for the report are almost the same for both physical and online filing. One main advantage to online filing is that it automatically adapts to regulatory and legislative changes.

As the specific rules for filing can vary from city to city, company financial departments need to pay close attention to local regulations.
China Accounting
Quick Facts

ACCOUNTING STANDARDS
China has its own accounting standards, which have largely been harmonized with the International Financial Reporting Standards (IFRS) used globally (90-95% convergence).

READ MORE
China GAAP vs. U.S. GAAP and IFRS

ACCOUNTING LICENSES
Practicing accountancy in China requires a Chinese accounting license. Foreigners are eligible to take the Chinese accounting exam.

Following the release of the 2015 version of the Catalogue of Restricted Industries for Foreign Investment, foreigners are encouraged to make investment in accounting and auditing area, provided the main partner is a Chinese national.

READ MORE
Update: Latest Guidance Catalogue for Foreign Investment Industries Released

REGULATORS
Ministry of Finance: Sets accounting standards and supervises compliance.

State Administration of Taxation (SAT): Financial reports (monthly or quarterly, and annually) need to be submitted to the SAT.

State Administration of Industry and Commerce (SAIC): Financial reports companies are required to be submitted to the SAIC upon annual inspection.

State Administration of Foreign Exchange (SAFE): A report on foreign exchange needs to be submitted to SAFE upon annual inspection.

THE FISCAL/FINANCIAL YEAR
The fiscal year in China is from January 1 to December 31. All companies are required to follow this.

REPATRIATING FUNDS
Prior to repatriating profits or sending funds abroad, a company must have undergone the annual audit and paid tax.

RELATED READING
To learn more on how to repatriate funds from China, please refer to our Magazine: Strategies for Repatriating Profits from China

LIABILITY
The person-in-charge is responsible and liable for the accuracy and completeness of financial accounting reports.

The Legal Representative and those who by law or regulation represent the company exercising its rights and obligations are considered persons-in-charge.

If a financial accounting report contains false information or conceals important facts, the person-in-charge and other employees directly responsible may incur a fine of up to RMB 300,000 by the administrative authorities, in addition to a prison sentence in serious cases.

RELATED READING
To stay informed on China’s compliance requirements, see our related magazine: Annual Audit and Compliance in China
Foreign Currency Accounting

Choosing an accounting currency

In principle, accounting reports in China all need to be denominated in RMB. The only exception is when a company chiefly does business in another currency. Such a company may then choose one foreign currency to conduct its accounting in.

The factors that should determine this decision are:

- Which currency mainly influences the sales price of the company’s goods and services
- Which currency mainly influences the company’s labor, materials and other costs
- Which currency is used in the company’s financing activities and in its retained operating receipts

A company can have a separate accounting currency for a foreign operation, defined as one of the entities listed below that is either located abroad, or adopts an accounting currency that is different from the main company.

- Subsidiary
- Joint venture partner
- Associated business
- Branch

Additional factors for determining the accounting currency of foreign operation include:

- Whether the a foreign operation has a significant degree of autonomy
- Whether its transactions account for a significant degree of the main company’s business
- Whether the foreign operation’s cash flow directly affects the main company, and if this can be readily remitted
- Whether cash flow from the foreign operation’s activities is sufficient to serve its existing and foreseeable debt obligations

Once the accounting currency is chosen, it may not be changed unless there is a significant change in the nature of the company’s activities. If a company decides to change its accounting currency, it must change over all items into the new currency, using the exchange rate of that day.

Even if choosing to adopt a foreign currency, the company’s financial statements must still be converted into RMB, lest it risk fines of up to RMB 50,000 for the accountant at fault, and up to RMB 20,000 for the person(s) in charge.
Accounting for Foreign Currency Transactions

Under China’s accounting standards, a ‘foreign currency transaction’ is one that uses a different currency from the company’s accounting currency. These transactions should be recorded in the accounting currency, using the spot exchange rate on the day of the transaction.

If the foreign currency involved is the American dollar, Hong Kong dollar, or Japanese yen, the amounts can be converted into RMB directly, using the rate quoted by the People’s Bank of China. If not, the foreign currency first needs to be converted into US dollars, and then into RMB. In doing so, companies need to use the New York foreign currency market price as stated by the State Administration of Foreign Exchange (SAFE).

At the end of each month, the company needs to draw up its balance sheet, the last day of the month being the balance sheet date. At each balance sheet date, the company needs to convert its foreign currency monetary items. These are units of currency, as well as assets and liabilities to be paid in a fixed or determinable amount of foreign currency, for example loans in foreign currency, or account receivables. These items need to be converted into the accounting currency at the spot rate of the balance sheet date. Exchange rate differences arising from the conversion need to be recorded as profit or loss for the period in which they have arisen.

For non-monetary items denominated in a foreign currency that are recorded by historical value, the exchange rate adopted should be based on the transaction date. Because this does not use the exchange rate of the balance sheet day, no exchange rate difference arises. An example of this would be imported supplies purchased with a foreign currency.

If part of the company’s operations is foreign – e.g. the operation uses a different currency, or the main company has a subsidiary abroad, or a foreign joint venture partner – it should be converted as follows:

Assets and liabilities should be converted using the exchange rate on the balance sheet date. Owner’s equity should be converted according to the exchange rate of the transaction dates, except for undistributed profits. Entries on the income statement need to be converted according to the transaction date, or approximates thereof. Exchange rate differences should be logged separately under owner’s equity.

Annual Foreign Currency Audit

To the chagrin of foreign investors, China implements a strict system of capital controls, limiting the in- and outflow of foreign currency. This system distinguishes between transactions made under an enterprise’s current account and capital account, and requires foreign investors to open separate bank accounts for the two, as well as one specifically for loans.

Current account foreign currency transactions may involve the import and export of goods and services, earnings from interest or dividends from portfolio securities and regular transfers. Capital account transactions are mainly related to foreign direct investment (i.e. changes in a company’s registered capital), the purchase and sale of equity or debt securities, and trade credit or loans.

In general, capital account transactions need approval from the State Administration of Foreign Exchange (SAFE), whereas current account transactions can be made directly through the bank.

Foreign Exchange Registration Certificate

While not subject to direct scrutiny, current account transactions in a foreign currency are subject to a degree of control as well.

When a foreign-invested company is set up, it needs to apply for Foreign Exchange Registration with SAFE, prior to making the initial capital injection. Once approved, SAFE provides the foreign company with a Foreign Exchange Registration Certificate, which allows the company can to open a foreign exchange account with a bank.
Top 5 Accounting Issues in China

1. Properly managing fapiao: the importance of fapiao for proper bookkeeping is an oft-overlooked feature of accounting in China, especially by foreign investors.

2. Differences in the law as written and common practice in China: rules can differ per region or city, or even per city district.

3. Local Chinese accountants lacking international experience: at the same time, the overseas headquarters may be insufficiently sensitive to China-specific issues and requirements.

4. Range of taxes applicable in China: while many foreigners are familiar with VAT-like taxes, China levies a host of additional taxes and regional surcharges, which may be differently applicable to one’s industry.

5. Allowing fapiao to expire: Special VAT fapiao are printed with an expiry date, after which the buyer will be unable to offset the amount from their VAT payable. Sellers are often unwilling to re-pay the VAT on issuing a new invoice.

Annual Audit

This certificate is valid for one year and needs to be renewed annually with SAFE via a Foreign Currency Annual Inspection Report. This is part of the China’s annual audit, conducted simultaneously by a variety of government agencies. These include SAFE, but also the tax authorities and the Administration for Industry and Commerce (AIC).

If a foreign-invested company fails to renew its Foreign Exchange Registration Certificate, the certificate will be cancelled by SAFE, without which the foreign enterprise will lose the ability to send funds abroad.

The ‘Foreign Currency Annual Inspection Report’ contains details on:

- The Foreign currency registration
- Capital injections
- Foreign currency bank accounts
- Foreign currency bank balance
- Records of foreign currency purchases and sales
- Foreign currency debts (if applicable)

Crucially, the report needs to be audited by an accounting firm prior to annual submission.

Repatriating Profits

The remitting of profits is considered a current account transaction, and as such, does not need prior approval from SAFE. However, before a foreign company can send profits abroad, it needs to show that all taxes on the income have been paid up, including dividend withholding tax.

Therefore, the investor will need to present a number of documents to the bank before being able to wire the funds to the parent company. These include a valid Foreign Exchange Registration Certificate, a board resolution authorizing the distribution of dividends, a voucher given by the tax authorities stating that taxes have been paid up in full, a capital verification report issued by an accounting firm and an audited report stating the company’s annual profits and dividends issuance.

Related Reading

Tax, Accounting, and Audit in China 2015 (7th Edition)

This seventh edition of Tax, Accounting, and Audit in China, updated in 2015, offers a comprehensive overview of the major taxes foreign investors are likely to encounter when establishing or operating a business in China, as well as other tax-relevant obligations.
The Benefits of Outsourced Accounting in China

By Dezan Shira & Associates, Shanghai Office
Editor: Steven Elsinga

It is a question faced by both newcomers to China and seasoned players alike: whether to outsource their accounting function, or handle this in-house. To explain some of the reasons why a foreign-invested enterprise might want to fully or partly outsource its accounting, we spoke with Jenny Liao, Senior Manager of Corporate Accounting Services at Dezan Shira & Associates.

Steven Elsinga: What is the employment relationship formed between the contracting party and an outsourced accountant? How does this impact liability?

Jenny Liao: It is important to realize that regardless of who actually does the accounting, the company remains responsible for the content of its financial reports in China. Outsourcing accounting to an outside party does not relieve a company of its liability to the government in case of errors.

Even if a mistake is found to have been caused by the outsourced accountant, the company will still incur penalties as a result. However, if it can be proven that the outsourced accounting firm did not perform its contract properly, the company may sue the accounting firm for damages, which may be limited in the original outsourcing contract.

Unlike an actual employment relationship (which in China are notoriously difficult to terminate), the relationship formed with an outsourced accounting firm is a business contract. As such, it is easy to terminate in the case of unsatisfactory performance.

SE: At what point does it become cost efficient to bring on an in-house accountant rather than outsource?

JL: Medium-size firms tend to do most of their accounting in-house while still in the development stage, as a means to build their own finance team and retain closer guidance and supervision. In our experience, it is mostly smaller companies (fewer than fifty staff members) that benefit the most from outsourcing some or all of their accounting to a specialized firm. However, the larger ones (over five hundred staff members) or multinational companies may also find it feasible to outsource part of their accounting as well, such as Accounts Payable. This is known as process outsourcing.

SE: How can companies be sure of the credentials of their outsourcing partner?

JL: It is generally accepted practice to sign a confidentiality agreement when hiring an outsourced accountant. To ensure your information is safe, it is important to engage a reputable accounting firm.

Another issue is data security. Smaller companies especially may not have the IT infrastructure to adequately protect sensitive information from hackers or computer viruses. Larger accounting firms generally have more sophisticated IT capabilities that offer better data security.
Our China Practice
Beijing
beijing@dezshira.com
Dalian
dalian@dezshira.com
Qingdao
qingdao@dezshira.com
Tianjin
tianjin@dezshira.com

Shanghai
shanghai@dezshira.com
Suizhou
suizhou@dezshira.com
Hangzhou
hangzhou@dezshira.com
Ningbo
ningbo@dezshira.com

Guangzhou
guangzhou@dezshira.com
Shenzhen
shenzhen@dezshira.com
Zhongshan
zhongshan@dezshira.com
Hong Kong
hongkong@dezshira.com

Our Global Practice
India
india@dezshira.com
Indonesia *
indonesia@dezshira.com
Malaysia *
malaysia@dezshira.com
Singapore
singapore@dezshira.com

The Philippines *
philippines@dezshira.com
Thailand *
thailand@dezshira.com
Vietnam
vietnam@dezshira.com

Liaison Office, Germany
germandesk@dezshira.com
Liaison Office, Italy
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Liaison Office, United States
usa@dezshira.com

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