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CHINA BRIEFING

From Dezan Shira & Associates

Annual Audit and Compliance: Get Ready for 2022

Introduction

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With the scope and penalties of China's social credit system being further clarified in 2021, legal and regulatory compliance has become more important than ever. More attention should be given to the annual compliance procedures as mandated by various governmental departments.

The start of a new year is be a hectic time for foreign companies in China. To meet the various compliance deadlines scattered throughout the year, they need to begin the long and complicated process of financial reporting, months in advance. Failure to comply will risk them being hit with deteriorating credit, additional fines and penalties, and such companies might not be able to remit their profits overseas.

Beyond facilitating compliance requirements, the annual audit also presents an opportunity for the entity to conduct a deep dive into their finances and internal operations. A comprehensive audit might reveal unexpected irregularities or suboptimal business practices, or discover eligibility for tax incentives that had not previously been captured.

In this issue of China Briefing magazine, we walk foreign businesses through the annual audit and compliance process from start to finish. We begin by exploring the significance of annual audit on FIEs and how to prepare for an effective audit. Then, we offer a comprehensive step-by-step guide to completing the annual compliance process. Finally, we provide a comparison of the Chinese Accounting Standards (CAS) and International Financial Reporting Standards (IFRS), which lays the basis for GAAP conversion.

We hope this magazine helps your business add value to its annual statutory audit and compliance reporting in China. If you and your company want to learn more about how to get ready for the annual audit and compliance, you are welcome to get in touch with Dezan Shira & Associates. For more information, please email us at **China@dezshira.com**.

With kind regards,

Sabrina Zhang

Reference

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This Issue's Topic

Tax Incentives in China

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Annual Audit in China: What is it and Why is it Important?

Author: Qian Zhou

A financial audit is an objective examination and evaluation of the financial system and statements of an organization to make sure that the financial records give a true and fair view of the financial position of the company.

According to the Company Law of the People's Republic of China, "Companies shall prepare financial accounting reports at the end of each accounting year and such financial accounting reports shall be audited by an accounting firm in accordance with the provisions of the law." This applies to all FIEs, irrespective of their corporate structure.

As such, almost all companies receive a yearly audit of their financial statements – which includes an examination of the income statement, balance sheet, cash flow statement, and statement of changes in equity, among others – as the first step of the annual compliance.

While tedious, this process is also a good opportunity for companies to conduct an internal financial health check to reveal irregularities and suboptimal business practices, optimize tax efficiency, as well as improve internal control mechanisms for fraud prevention.

Why is annual audit important?

Though the annual audit report is generally not required to be submitted in current practice, as abovementioned, it is by law a necessary requirement for all FIEs.

Annual audit provides a good opportunity for FIEs to find mistakes within their accounting and tax management. In this way, FIEs can improve their financial reports in accordance with Chinese accounting standards and ensure that their tax liabilities are managed appropriately. This, in turn, informs better business decision-making, based on an accurate representation of their financial and tax situation.

Beyond this, there are various other reasons for FIEs to undergo an audit annually. In some cases, an audit may be a necessary step or will enable the firm to be better equipped to complete a certain business transaction. In other situations, constant changes in the external environment deem an audit a prudent business decision. We discuss the most common considerations below.

Prerequisite for profit repatriation

Generally speaking, FIEs can only repatriate profit once a year after the annual audit and tax compliance process has been completed. During this process, tax authorities will use annual audit reports to ensure that a business is compliant with local law and regulations and will probe into whether the corporate income tax (CIT) has been paid on the profit to be distributed. At the same time, tax authorities will confirm the maximum profit amount that can be repatriated based on the net profit indicated in the financial reports.

Required in customs and tax investigation

In cases where the tax authority or the customs authority initiates an investigation due to irregular records or where a whistleblower reports the matter to the authorities, the company investigated may be required to submit an audit report of a certain period in a short turnaround (subject to case-by-case analysis, but usually around 10 days). This is especially true in lower tier cities where tax bureaus or customs rely heavily on audit reports to learn about the financial state of a business and its potential liabilities.

At such a time, if the company does not have an updated annual audit report at hand, it will need to produce the report within short notice, which can lead to a stressful, mistake-prone environment, delay the overall process, result in additional costs, and offer companies less scope to correct discrepancies in their financial statements.

Required by overseas HQ for group consolidation purpose

If an overseas headquarter is required by law to complete an audit, the domestic subsidiary will also be required to provide an audit report where the asset or revenue of a domestic company within a company group reaches the reporting threshold stipulated by the overseas regulations.

Internal control considerations

For companies that don't have separate internal control reviews, an annual audit serves as a good chance to test whether the implemented internal control system works as designed, to evaluate whether it's enough to manage the risks that the company may face in its day-to-day business, and to identify deficiencies in the internal control structure that could be strengthened to maximize efficiency. Although internal control effectiveness is not evaluated in the audit report, auditors usually communicate with management about their findings and suggestions regarding the company's control in the process.

What does the annual audit involve?

A typical audit involves a risk assessment, an evaluation of the operating effectiveness of controls, the substantive audit procedures, and the reporting process. For many companies, especially the large ones, these steps are usually divided into two stages—the preliminary audit before the year-end and the formal audit after the year-end.

Preliminary audit (November to December)

The preliminary audit is designed to plan the audit, spot the potential issues, and leave enough time for companies to make self-corrections.

Companies generally start the preliminary audit in November or December, during which auditors will do risk assessment and internal control review by understanding the internal and external environment of the company, and making inquiries to relevant personnel, both financial staff and the operational team.

A company that has completed a preliminary audit of their finances for the first nine or 10 months can significantly reduce the amount of substantive audit work to be conducted in the annual audit. They can therefore avoid the 'rush period' in late January and February, when businesses are scrambling to get their audit reports finished, and will therefore have ample time to conduct a more comprehensive audit and to implement changes in terms of how finances are run, or internal control is managed, as needed.

Auditors will also make audit plans and communicate the significant audit matters with the company in advance, which will help companies to prepare and improve the audit efficiency.

Formal audit (January to April)

The formal audit usually starts after the year-end, during which auditors will conduct substantive procedures on the company's finances for the whole year. This forms the basis of the audit report. To catch the annual CIT filing deadline in May, the formal audit is strongly recommended be completed before the end of April.

Auditors will also communicate with the management and those charged with governance (TCWG) on significant issues arising from the audit. It is thus a good opportunity for the company to obtain an independent opinion as to the overall financial-related matters of the company.

Following the completion of audit fieldwork and when the financial statements are issued along with the auditor's opinion, the external auditor will require the company to sign a management representation letter, to attest to the accuracy of the financial information that the company has submitted to the auditor for their analysis. It will also include significant issues that may appear in the audit report and the financial statements of the company.

In some cases, there are additional matters for auditors to complete in this stage, such as converting the Chinese Accounting Standards (CAS)-based financial records to records following the International Financial Reporting Standards (IFRS) or the Generally Accepted Accounting Principles in the United States (US GAAP), based on the instructions and requests of the group auditors of the headquarters.

For the substantive procedures, the auditor will typically do a systematic review of the following:

- **Bank and cash verification**: The auditors will examine the cash on hand, checking to see whether this matches the accounting records and whether the company unreasonably holds too much cash as compared to the stated total capital amount. The auditor will also arrange bank confirmations.
- **Asset existence and valuation**: The auditors will perform a random check or a full-scale check on the goods in stock and the fixed assets to determine whether this lines up with the records of the accounting books, whether the documentations are complete, and whether the impairment of the assets have been properly assessed by the management.
- **Debtors and creditors checking**: The auditors will check the receivables and payables to verify the transactions recorded, arrange confirmations on random basis, assess the risk of bad debts by reviewing the management's assessment on the credit risks of the debtors, and check whether the profits need to be adjusted.
- **Related-party transaction evaluation**: The auditor will examine if there are historically unidentified related parties, arrange related-party transaction confirmations to make sure they are properly recorded and disclosed, and understand the company's control over related-party transactions. Similarly, the auditor will assess whether the related-party transaction is in line with the arm's length principle to avoid potential tax adjustments and penalties.
- **Expenses checking**: The auditor will check whether the expenses are recorded in the account before then end of December to achieve proper cut-off and whether the accrued expenses are properly recorded in the books. The auditor will also check if a company's relevant invoices and other documentation have been obtained for the recorded expenses.
- **Tax analysis**: For the pre-tax deductible expenses, auditors will check whether the deduction caps are met and whether the deductions are accurate. Auditors will also help to evaluate whether the company satisfies relevant qualifications for enjoying the claimed preferential tax policies.
- **Financial statement analysis**: Financial statements are not only important in determining tax liabilities, but are also key to helping firms understand their own financial position and situation. Auditors generally focus on the balance sheet and the income statement analysis to identify unusual fluctuations.

How to Prepare for an Effective Annual Audit?

Author: Qian Zhou

Whether an audit is effective or not makes a big difference on a company's governance and development in the long run, though it is not easy to identify the audit effectiveness right after the process.

From the company's perspective, an effective audit can help maintain its financial health and offer advice on how certain processes may be improved. To be more specific, an effective audit can:

- ensure that financial statements of the company present a true and fair view of its financial situation;
- reveal irregularities and suboptimal business practices;
- identify risks in different functional areas; and
- offer advice on improving internal control.

An effective audit should also complete to schedule and with minimal disruption to the company.

To achieve audit effectiveness, besides choosing a qualified audit firm, it is vital for companies to make preparations in advance, among others. An audit will be more meaningful for companies if auditors have adequate time to analyze accounts and evaluate control procedures, instead of being occupied with simple checks. This article is designed to provide some practical guidance based on our professional on-the-ground experiences.

What do companies need to prepare in general?

For companies, preparing for the annual audit goes beyond simply providing the accounts and ledgers. In general, companies can help to improve the audit effectiveness by taking the below measures:

Make a thorough inventory of the assets

Before the auditor conducts a spot check of the company's assets in the substantive audit, companies are suggested to make a full-scale stock take of the assets by themselves, to verify the existence and completeness of their assets. This is especially recommended if companies never check their assets on a regular basis.

Companies should arrange cash count, inventory count, and fixed assets inspection, among others. If obsolete inventory items, idling assets, and defective products are found during the check, they should let the auditors know and start to think about making impairment assessments.

The thorough stock take is suggested to be arranged as close to year-end as possible. Otherwise, companies may need to provide stock-in and stock-out information to roll back or roll forward to reconcile the actual stock take results and year-end accounting books.

Arrange confirmations

Bank confirmation is a primary focus in verifying bank balance of the financial audit. Before the auditor's investigation, companies are suggested to get relevant information ready in advance, including bank statements, bank reconciliations, bank balance, borrowings, guarantees, time deposits, bank mailing address, and contact number, etc. This will shorten the time spent at this stage and provide the auditor a good impression.

Besides bank confirmations, auditors may arrange confirmations for the current accounts to verify the existence and accuracy of the selected amounts, such as the related-party balances and transactions, trade receivables and payables, inventory on consignment, advancements to employees, etc. From the companies' perspective, they are suggested to check accounts with current customers before the annual audit, if they didn't do this regularly. This will save much time for their auditors.

Analyze recoverability of receivables (credit risks)

Credit risks analysis on financial assets often involves management's judgement. While many companies find it difficult to conduct such an analysis, it is nevertheless essential to assess the recoverability of financial assets such as trade debtors.

Under the newly effective accounting standard on financial instrument, the expected credit loss model should be adopted when making the analysis. The accounts receivable aging analysis alone is no longer sufficient for impairment assessment of financial assets.

Companies should make clear accounting policies on what factors are to be taken into consideration when assessing credit risks, look for reasonable and supportable forward-looking information that is available to the management, and determine the risk of default.

If there are indeed such default risks based on companies' self-evaluation, it will very likely be noticed and inquired by the auditor during the audit. Companies are suggested to think about how to justify the risks when being asked.

Prepare for expense checking

It's important for companies to obtain and maintain tax-deductible expense vouchers, which, in China, mainly refers to VAT invoices. Companies are suggested to check and prepare relevant invoices and other documentations in advance. When the year-end approaches, for invoices that should have been but are not yet obtained, companies should try to see if there is any chance to get them ready before the financial audit. Should companies fail to obtain legitimate expense vouchers before filing the annual CIT returns, relevant expenses will become non-deductible for CIT purpose in the current year.

For outbound expenses paid to overseas vendors, relevant taxes must be withheld, or else such expenses will not be pre-tax deductible.

Besides obtaining VAT invoice and other legitimate tax-deductible vouchers, companies should also make full provision of the expenses in their accounting books, irrelevant of whether they have received the VAT invoice or not. All expenses should be properly recorded before the end of December.

Remember to bind your accounting vouchers and keep them tidy and organized. By making a good impression on the auditors, companies may expect less questions from the auditors.

Analyze profits and justify fluctuations

Companies should analyze their profit ratio in advance. In case significant changes are found for essential indicators, such as gross margin fluctuations or selling expenses increase, companies should have valid explanations to justify the fluctuations, as such irregulates will definitely be noticed by their auditors and lead to queries during the audit.

Corporate income tax (CIT) related preparations

Under the current policy, companies decide whether they are qualified for certain CIT incentives based on their self-assessments. This simplifies the process for enjoying tax incentives but increases potential tax risks where there have been misjudgments. So, auditors generally will help to make CIT relevant evaluations in the annual audit, although they do not express an opinion in this regard.

From the companies' perspective, they are suggested to prepare relevant sub-ledgers, and gather and retain supporting documents for such items in advance. On the other hand, they are suggested to carefully examine if they have exhausted all possible tax reductions.

Make sure relevant staff are on duty

As introduced above, beyond providing documentations prior to the actual audit, companies should prepare for offering additional information and details behind the figures, which requires close support of all key staff during the audit.

Thus, companies should plan around the audit to ensure that all key finance and accounting staff and other key staff of the operational teams haven't booked time off and have a general free schedule during the audit. Ideally, these staff should be available at any time when required.

Additional preparations for the 2021 newly effective accounting standards

Starting January 1, 2021, several new accounting standards have been applied to all entities that have adopted the Chinese Accounting Standards for Business Enterprises (CAS), including the CAS No.14 regarding revenue, CAS No.21 regarding leases, and accounting standards regarding financial instruments (CAS No.22, 23, 24, and 37).

The implementation of new accounting standards is likely to pose new challenges to the accounting work of relevant enterprises, and could impact their daily business decisions, internal control, financial performance, and other aspects.

Companies that are obligated to adopt the new CAS but have not yet due to their insufficient understanding of the accounting standards or practical difficulties, should seek professional advice as early as possible to see how they can prepare.

Even companies that have adopted the new CAS will still need to prepare for the extra queries and documentation requirements from auditors regarding the implementation details of the new accounting standards.

For example, as a lessee, based on CAS No.21, your auditors may need you to provide the amortization table for lease liabilities and depreciation schedule for right-of-use assets. They may also ask you to explain and justify the discount rate you have been using and how do you calculate the implicit interest rate in the lease.

Special considerations due to the COVID-19 pandemic

Travel restrictions

Under China's zero-tolerance approach in combating the COVID-19 pandemic, strict quarantine and travel restrictions are applied whenever there is an outbreak, which will be of comparatively high frequency during the audit season when the cold environment is more suitable for virus survival and transmission.

To prepare for this situation, companies are suggested to start the preliminary audit and formal audit as early as possible. Especially for those whose auditors are based in a different city from them, they should leave enough buffer time in case sudden travel restrictions.

Business continuity

Despite the fact that the global economy is on recovery mode and uncertainty over COVID-19 is no longer the foremost economic concern to many executives, the pandemic has still taken a toll on businesses. Companies may suffer cash flow difficulties because it takes longer to collect debt from the customers. The reliability of income and cashflow forecasts may become questionable due to unexpected developments associated with the pandemic in certain areas.

Under this situation, auditors will pay special attention to business continuity or "going concern" during the annual audit. Companies might be asked questions like "Have you assessed the impact of COVID-19?" "How did the management respond to the changing economic conditions", etc. If significant, this information may even be disclosed in the financial reports of the company.

To prepare, companies should analyze in advance about:

- if they have sufficient liquidity to remain solvent through the pandemic and beyond;
- if they have any access to financial support from parent company or a banking facility not yet utilized; or
- if they are qualified for any government subsidies.

Internal control and fraud

Besides the impact of domestic travel restrictions on annual audit, the travel restriction between China and the rest of the world may result in foreign general managers being stuck outside of China, which in turn will affect the implementation of the internal controls and cause disruption in the reporting line.

Moreover, the company management may have greater incentive to override controls due to increased pressure on growth under COVID-19, or to correspond to changes in the business environment, such as inflation and supply chain disruption.

All these will lead to higher risk of irregularities and fraud.

Given this, auditors will likely increase the risk assessment level and come up with more inquiries, more tests of controls, and more substantive tests. Companies should be mentally prepared and get ready for collaborating with the auditors more closely for the additional inquiries and tests.

Accounting digitalization

Accounting digitalization, or tech-powered accounting solutions, means the use of information technology to optimize the finance and accounting processes. "Shift to digital" has been an emerging trend, especially since the outbreak of COVID-19.

Different from other preparations that are directly related to the annual audit and can be made right before the process, accounting digitalization is more like a long-term investment that has multiple benefits, including making the financial audit easier and more effective.

To be more specific, compared to traditional methods, finance and accounting technology has advantages in efficient allocation of work hours, accurate accounting through real-time capture of information and computerized calculation, system integration with compliance/reporting mechanisms, and more optimal (rather than one-time) use of company data.

For example, a lot of information that needs to be prepared for the audit, such as how much money is owed to each vendor and what is the aging schedule / accounts receivable aging for each outstanding transaction, can be displayed on a searchable accounts payable list. This information itself is delivered from a specific module of the tech-powered accounting software, which in turn gets populated automatically from the digitalized expense management app.

Another example relates to fixed assets management. Important questions during audits include: What information does the company have about its fixed assets? How far have they depreciated? What is the nature of these assets? All this information will be pulled directly from the fixed assets module of the tech-powered accounting software and displayed on a fixed assets list.

At the very least, going digital results in most documentations being accessible online, saving auditors and executives from rifling through filing cabinets at the financial year-end. For companies that haven't adopted the finance and accounting technology, they are well advised to think about it for the next year or plan for in the near future. Newer tech-enabled accounting solutions are no longer prohibitively expensive or difficult to use. For companies that use an accounting service provider and don't have highly complex requirements in terms of processing or reporting, flexible platforms now exist, whose access are part of the services provided by accounting providers to smaller firms, sometimes with only minimal upfront setup fees.

Summary: Getting the most out of the annual audit

An effective audit is beneficial to a company's management and development in the long run. To purse audit effectiveness, close collaboration between the auditor and the auditee is needed.

From the companies' perspective, by conducting necessary self-checking, preparing needed accounting and tax documentations, analyzing core finance issues, and preparing for auditors' inquiries in various aspects, they can not only help to minimize the disruption of the annual audit on their business operations, but also enable a more comprehensive audit that can help senior management gauge the efficiency of the financial workings of their company.

In addition, to get the most out of the annual audit, companies are suggested to take the chance to improve their internal control and review related-party transactions. Especially for smaller companies that don't have a designated team to handle the matters and don't have separate internal control reviews and transfer pricing assessments, it is well advised to integrate these value-added reviews into the annual audit process.

Annual Compliance Requirements in China: What Do Companies Need to Know

Author: Qian Zhou

With the scope and punishments of China's social credit system being further clarified in 2021, legal and regulatory compliance has become more important than ever. More attention should be addressed to the annual compliance procedures as mandated by various governmental departments.

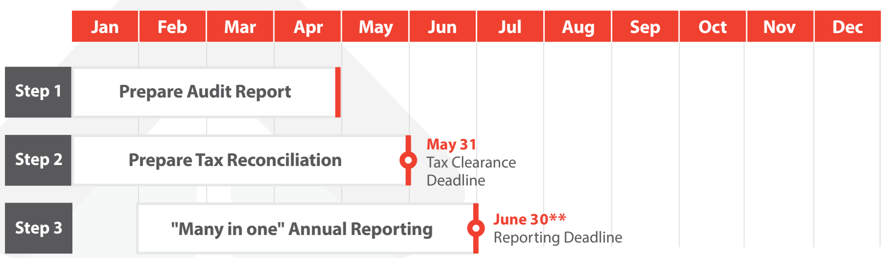
Foreign invested enterprises (FIEs) and representative offices (ROs) in China are required to produce an annual audit report, conduct annual tax reconciliation, and report to relevant government bureaus in charge, though the detailed procedures and requirements are different. Failure to carry out these procedures properly or on time may result in extra expenses, penalties, downgrading of the credit of the business, or even revocation of business licenses.

In this article of China Briefing Magazine, we will walk investors through the annual compliance requirements for FIEs and ROs in China and highlight the latest updates and trends.

Annual compliance procedures for FIE

For FIEs, regardless of wholly foreign-owned enterprises (WFOE) or joint ventures (JV), the annual compliance requirements start after the end of the fiscal year (December 31 as China follows the calendar year) and usually takes place until the end of June.

Annual Compliance Timeline*



**Subject to regional variation*

***A postponement of the deadline might happen. Please refer to the official notice posted by the authority in charge.*

Step 1: Prepare an annual audit report

The annual compliance procedures start from the annual audit of the business. Though the preliminary audit can start as early as November or December, the annual audit report must be prepared after the end of the fiscal year to include data from the past whole year. And to proceed with the annual tax filing in May, the audit report should be completed before the end of April.

The annual audit report for FIEs generally consists of a balance sheet, an income statement, a cash flow statement, a statement of change in equity, and a supplementary statement of financial indicators. To ensure that FIEs meet Chinese financial and accounting standards, the annual audit report should be conducted by qualified accounting firms and signed by two Certified Public Accountants (CPAs) registered in China.

Despite a requirement by the PRC Company Law, in some cities, companies may not be required to submit the annual audit report to the local tax bureau. Rather, they may only need to disclose whether they have done annual audit during annual reporting. Even so, companies are not suggested to take the chance. They are still advised to conduct their audit on a yearly basis for the reasons we explained in the first article.

In the case where an annual report is required, the requirements for the report may vary by region. For instance, in Shanghai, companies must include a taxable income adjustment sheet in the audit report, which is not a necessary supplement in Hangzhou, Beijing, or Shenzhen. Companies should stick to the local formalities.

Transfer pricing compliance

Transfer pricing concerns the prices charged between associated enterprises established in different tax jurisdictions for their intercompany transactions. Specifically, any party engaged in related-party transactions with other group entities is required to demonstrate that such transactions are conducted in a manner consistent with the "arm's length standard" – under which taxpayers should be able to demonstrate that they transact with related parties in a similar manner, under comparable conditions as they would with third parties.

It is quite common for FIEs in China to conduct the bulk of their transactions with affiliated companies overseas. For example, they may import from their foreign parent company and either sell the products domestically, or export products purchased from China to their overseas affiliates. These transactions can raise issues in transfer pricing and bring the foreign company into non-compliance with the Chinese tax bureau. The annual audit is a good chance to review such related-party transactions to assess whether they are in line with the arm's length principle and to avoid being challenged at the CIT reconciliation stage or be subject to a transfer pricing investigation by the tax bureau.

Moreover, according to relevant laws and regulations, enterprises reaching specific thresholds must prepare the master file within 12 months from the fiscal year end of the group's ultimate holding company, and prepare the local file and special file before June 30 of the year that follows the related-party transaction. Further, contemporaneous documentation may need to be provided to tax authorities within 30 days upon request. By reviewing the related-party transactions in the annual audit process, companies will know whether they have reached such thresholds and be better prepared to comply with the requirements.

*For more information see our issue of China Briefing Magazine titled "**How to Manage Transfer Pricing in China**" or for personal inquiries please email us at china@dezshira.com*

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Step 2: Conduct CIT reconciliation

The next step following the audit report is to conduct annual corporate income tax (CIT) reconciliation, which is also called annual CIT filing, before May 31 every year.

Although the State Taxation Administration (STA) oversees all kinds of tax, only CIT requires annual reconciliation to the tax bureau at company level.

In China, CIT is paid on a monthly or quarterly basis in accordance with the figures shown in the accounting books of the company – companies are required to file CIT returns within 15 days from the end of the month or quarter. However, due to discrepancies between China's accounting standards and tax laws, the actual CIT taxable income is usually different from the total profits shown in the accounting books.

As such, the STA requires companies to conduct annual CIT reconciliation within five months from the previous year's year-end to determine if all tax liabilities have been met, and whether the company needs to pay supplementary tax or apply for a tax reimbursement.

Generally, the Annual CIT Reconciliation Report must include adjustment sheets to bridge the discrepancies between tax laws and accounting standards among other documents. FIEs that conduct transactions with related parties should prepare an Annual Affiliated Transaction Report on transfer pricing issues as a supplementary document to the Annual CIT Reconciliation Report.

Moreover, FIEs in certain regions might be required to prepare another separate CIT audit report by meeting certain conditions, which also vary from city to city.

The CPA firm that prepares the financial audit report usually also has Certified Tax Agents (CTAs) to prepare audit report for CIT. In the case that the CPA firm does not have CTA qualification, companies must hire another CTA firm to do the report. The CTA firm will request an annual (financial) audit report as reference for CIT reconciliation.

In the current trend of digitalization and business reform, annual CIT reconciliation can be conducted through online channels, under which companies can conveniently submit relevant information in the appointed system. This is specially recommended in the context of the COVID-19 pandemic. However, if companies cannot make online CIT reconciliation due to certain circumstances, they can still go to the tax bureau in person to submit relevant materials as required.

The deadline for conducting annual CIT reconciliation is May 31 every year, but the investigation of the tax compliance could last to the end of the year, and companies should be prepared to provide supporting documents upon demand from the tax bureau. Besides, where companies are unable to conduct CIT reconciliation within the stipulated deadline due to a force majeure event, such as where the company was quarantined due to COVID-19 control measures, they may apply for an extension. But they must submit a report to the tax bureau immediately upon cessation of the force majeure event. The tax bureaus shall investigate the facts and approve accordingly.

Every year around March, depending on the location, the local tax bureau will issue annual guidance on CIT reconciliation. FIEs are suggested to keep an eye on the guidance for any potential changes regarding the requirements and procedures.

Note

All companies engaging in production and operation, including pilot production and operation, are required to go through this procedure, regardless of whether or not the company is under a tax deduction period, and whether or not the company makes profit. For companies maintaining branch offices in multiple locations and required to pay tax on a consolidated basis, there are special rules and requirements regarding CIT reconciliation procedures. Companies should pay special attention to the matter if they fall into this scope.

Step 3: "Many-in-one" annual reporting

The third step of annual compliance is to conduct annual reporting to multiple government bureaus before June 30 every year, to ensure that companies are compliant and that the information related to each department is updated.

Starting from 2020, the annual reporting to multiple governments can be done by submitting all relevant information at once through the National Credit Information Publicity system (www. gsxt.gov.cn). This is the so called "many-in-one" reporting.

Companies are no longer required to separately report to the local State Administration of Market Regulation (SAMR, which previously was called Administration of Industry and Commerce or AIC), the commerce bureau, the finance bureau, the tax bureau, the statistical bureau, and the foreign exchange bureau. The annual report submitted should cover at least the following information:

- Basic information of the enterprise, including the contact information, the existence status of the enterprise, the business scope, the licensing situation, the staffing and salary information, the social insurance contributions, the IP situation, etc.
- Investor profile, including information regarding the subscribed and paid in amount, time, ways of contribution, the actual controller of the investor, etc.
- The name and URL of the website of the enterprise and of its online shops.
- Equity change information of the equity transfer by the shareholders of a limited liability company.
- Information relating to any investment by the enterprise to establish companies or purchase equity rights.
- The balance sheet information of the enterprises, including total assets, total liabilities, total owner's equity, etc.
- Warranties and guarantees provided for other entities.
- Information regarding the operation of the enterprise, including total imports and exports, total revenue, income from the main business, operational cost and expenses, R&D expenses, total tax payment, gross profit, net profit, profit distribution, etc.
- Information regarding the credit and debt.
- Tax breaks information if the enterprise enjoys preferential treatment for importing equipment.
- Customs relevant information if the enterprise is subject to the administration of the customs.

Part of the information will be synced from the statistics maintained by other government bureaus, such as the social security bureau and tax bureau, automatically. Enterprises are required to prepare and submit other information online during the period between January 1 and June 30.

Legal consequences of failing to follow annual compliance requirements for FIEs

If the enterprise fails to submit the annual reporting information on time, it will be put into the Catalogue of Enterprises with Irregular Operations (Irregular Operations Catalogue), which is open to the public.

Besides, the enterprise will also be put into the Irregular Operations Catalogue if fraudulent information or serious concealment are discovered by authorities in the random check following the annual reporting.

If the enterprise is listed in this Catalogue for three years in a row, there will be more serious consequences – the enterprise will be put into the Catalogue of Enterprises with Illegal and Dishonest Behaviors, which serves as a black list for future operations and investments.

The legal representative and the general manager of the blacklisted enterprise will be banned from taking the legal representative or general manager role in other enterprises for three years, and the blacklisted enterprise will be at a disadvantageous position in bidding, government procurement, licensing application, obtaining land, as well as making new investment in the future.

FIEs are suggested to pay attention to the deadlines and requirements, or make timely correction where incompliance happen, to avoid serious consequences.

Annual Compliance Timeline for RO

Deadlines can vary depending on the locality of the enterprise

Annual compliance requirements for ROs

RO's annual compliance includes preparing an annual audit report, a tax reconciliation report, and then report to the local SAMR in charge. While the procedure looks like that applicable for FIEs, each step has different requirements and focus.

Step 1: Prepare annual audit report

While FIEs are only required to submit the audit report in limited scenarios, it is a mandatory requirement for an RO to do so. The annual audit report for ROs should be prepared by external licensed accounting firms and signed by two CPAs registered in China.

When doing the annual audit for ROs, auditors should pay special attention to the following factors:

- Bank statements, cash, staff, and IIT: The balance on the bank book should be the same as that stated in the bank statement. If not, a bank reconciliation should be prepared to verify the differences. The balance on the account should be the same as the cash contained in the cash box. The auditors will perform a cash count during their field work. Employment of staff must be registered in accordance with the relevant regulations (local employees registered with qualified dispatch agencies and valid work permits for expatriate staff), and IIT correctly assessed and filed.
- Expenses report: Expenses include rent, transportation, telephone, salary, office purchases, entertainment, audit fees, utilities, and dispatching service fees, regardless of whether these are paid from the RO or directly from its head office. Any expenses belonging to the fiscal year should be properly accrued with contracts or agreements as support. The total salary of the chief representative, whether paid offshore or locally, must be included in the expenses. If employees are involved in overseas social security plans, these payments must be included in the expenses report.
- Taxable income: According to relevant laws and regulations, ROs of foreign enterprises in mainland China must pay CIT on their deemed taxable income, as well as value-added tax (VAT) and consumption tax (CT) when it is applicable. The CIT liability will be assessed by the deemed profit method, cost-plus method, or actual revenue method. Among these three methods, the cost-plus method is the most used, since the other two methods require ROs to submit numerous supporting documents.

- Under the cost-plus method, the taxable income, that is, the deemed revenue, is calculated on the basis of the expenses:

DEEMED REVENUE= RO EXPENSES / (1 - DEEMED PROFIT RATE*)

**The deemed profit rate is decided by the tax bureau, and shall be no less than 15%.*

Step 2: Annual tax reconciliation

Like FIEs, ROs also need to submit the Annual Taxation Consolidation Report to the tax bureau by the end of May each year, though regional variations may exist. If the audited taxes due are found to be different from the taxes paid by the RO, the RO shall discuss the variation with the tax bureau.

For foreign companies that suspect this might occur, it is wise to hold preemptive discussions with tax advisors prior to audit submission. The annual tax reconciliation could be conducted through the online filing. Offline channels are also available if online filing is unsuccessful.

Step 3: Annual reporting to local branches of SAMR

ROs are required to submit an annual report between March 1 and June 30 every year providing information on the legal status and standing information of the foreign enterprise, ongoing business activities of the RO, and an audit report. As compared to FIEs, the reporting period starts later, and the audit report is mandatory in all circumstances.

During the annual reporting process, the following documents should be provided in paper or online:

- Annual report (the template will be distributed by local authorities around March);
- Business registration certificate;
- Audit report; and
- Proof of information on the legal status and standing of the headquarters overseas.

Legal consequences of failing to follow the annual compliance requirements for RO

Failing to submit the annual report on time may lead to additional penalties, ranging from RMB 10,000 to RMB 30,000. An RMB 20,000 to RMB 200,000 penalty might be given if the report includes fraudulent information. Failing to make corrections as required or fraud could lead to license revocation.

Tips on managing annual compliance requirements

Tip 1: Paying attention to the procedural changes and corresponding requirements

While the essential steps remain similar, in the context of China's business reform and opening up, the detailed procedures have been subject to frequent changes in recent years:

While the changes are designed to cut red tape in the long run, it increases compliance risks for enterprises in the short-term. Companies are suggested to pay special attention to the annual compliance updates, study the new requirements, and make necessary preparations to stay compliant.

Tip 2: Paying attention to the local variations

The detailed procedures and requirements of each step may vary from one place to another. It is not always right to assume the company is compliant by solely referring to the national laws and regulations. As mentioned in the early parts of the article, for example, FIEs in certain regions might be required to prepare another separate CIT audit report in the CIT reconciliation by meeting certain conditions, and these conditions also vary from city to city. Businesses are suggested to consult with a qualified service firm or contact the local government to avoid unnecessary misconduct in the annual compliance.

Tip 3: Using qualified third-party services

As there are many special details to pay attention to in the annual compliance process, it could be quite challenging and onerous for some companies to manage by themselves, especially those which do not have a strong internal financial team.

It is not uncommon to see companies getting penalized for unnecessary mistakes or negligence, with business credit being affected. Such companies are suggested to use professional third-party service firms rather than managing the matter internally.

To select qualified services, the below standards could be used as references:

- A service firm that can manage the whole annual compliance process is better than those which can only handle one or two steps of the procedures.
- A service firm that has branches in different cities and is familiar with local variances will be more suitable to provide services to FIEs that have multiple subsidiaries or branch offices in China.
- A service firm that is familiar with international accounting standards, such as IFRS and GAAP, and cando mapping or conversion among the standards, is more qualified in providing services to FIEs whose headquarters may have financial consolidation requirements.
- A service firm that can work in fluent English can have better communication with the senior management of the FIEs to make the annual compliance process smoother.

What are the Differences Between CAS and IFRS and How to Bridge Them?

Author: Qian Zhou

China has developed its own accounting rules referred to as the Chinese Accounting Standards (CAS) since 1992. Despite substantial convergence between CAS and the International Financial Reporting Standards (IFRS) that most western investors are used to, practical implementation and interpretation differences remain.

Knowing the difference between CAS and IFRS is of vital importance for Chinese subsidiaries that report under CAS and provide financial statement information to a parent entity that reports under IFRS or for foreign entities that report under IFRS and consolidate their Chinese subsidiaries.

In this chapter, we enumerate the main differences between CAS and IFRS, explain two methods on converting financial statements from CAS to IFRS, and offer tips and suggestions to companies on how to better manage the conversion.

What is CAS and IFRS?

The CAS framework, also known as Chinese Generally Accepted Accounting Principles (Chinese GAAP), is based on two standards:

- Accounting Standards for Business Enterprises (ASBEs); and
- Accounting Standards for Small Business Enterprises (ASSBEs).

The Ministry of Finance (MOF) released ASBEs in 2006 and brought them into effect in January 2007. It experienced several amendments in the following years. Currently, the ASBEs consist of one basic standard, 42 specific standards, and several application guides. Most foreign invested enterprises (FIEs) established in China generally adopt ASBEs for their accounting and financial reports.

Entering into force on January 1, 2013, the ASSBEs are the counterpart of ASBEs for SMEs, providing unified standards for small-size enterprises. The ASSBEs use the ASBEs as a reference but are more similar to tax laws in terms of their tax calculation methods, which simplify the process of making adjustments between accounting standards and tax rules. Small-scale enterprises can choose to adopt either the ASBEs or ASSBEs.

For the purpose of this article, the CAS we discuss mainly refers to ASBEs and other related accounting documents (that is, application guide, interpretations, expert working group opinions, etc.) and exclude ASSBEs.

IFRS is the most-used set of accounting standards globally, with 166 jurisdictions accepting it so far, including all of the nations in the European Union as well as Canada, India, Russia, South Korea, South Africa, and Chile. IFRS are issued by the International Accounting Standards Board (IASB). An older version of it was called International Accounting Standards (IAS), which was partly replaced by IFRS in 2001.

For the purpose of this article, by IFRS we mainly refer to IFRS standards and relevant interpretations, including IFRIC Interpretations, SIC Interpretations, and practice statements. IFRIC is the interpretative body of IASB. SIC Interpretations were previously issued by the Standard Interpretations Committee (SIC) and were subsequently endorsed by the IASB.

What are the major differences between CAS and IFRS?

Although CAS has substantially converged with IFRS, there are additional considerations due to the special circumstances in China. This leads to accounting treatments that are different from those derived from the principles and description in IFRS.

Besides, when IFRS updates are released, CAS do not implement them directly. Rather, MOF reviews the updates and decides whether they are suitable to be added into CAS. So, the adoption of the IFRS updates in CAS is either delayed or may not happen at all, which also lead to differences between CAS and IFRS.

Since it is hard to capture all the differences that exist between the two sets of standards, we will focus on differences that are commonly found in practice.

Differences in the presentation of financial statements

CAS and IFRS have multiple differences regarding the presentation of the financial statements. As a communication exercise, financial statements are intended to provide investors and other stakeholders with high quality, decision-useful financial information. The difference on this level is thus of special importance.

For example, CAS and IFRS are different in:

- **Accounting year:** CAS mandates that the accounting year must start on January 1 and end on December 31 of each year. While under IFRS, the accounting year is not specified and an entity can consistently prepare financial statements for a one-year period, such as the February 1 to January 31 of each year. The IFRS even allows the accounting year not to follow the full calendar year. For example, some entities prefer to report for a 52-week period for practical reasons, which is allowed by IFRS.
- **Presentation currency:** Chinese accounting laws require that a set of financial statements for statutory purposes must be presented in RMB. Foreign transactions must be converted to RMB in accordance with relevant accounting standard. There is no such requirement in IFRS in terms of presentation currency.
- **Title of the financial statements:** CAS and IFRS have different titles for the financial statements. For example, the "balance sheet" under CAS is called "statement of financial position" under IFRS, and the "income statement" under CAS is called "statement of profit or loss" under IFRS.
- **Income statement by nature or by function:** Expenses in an income statement are either classified by their nature or by their function. IFRS allow expenses to be presented by functions or by nature, while CAS only permit expenses to be presented by functions. On this aspect, IFRS allows greater flexibility. An income statement by nature is the one in which expenses are presented according to categories they are spent on, such as employee benefit, rent, utility, interest, etc. The expenses will not be further classified into their functions (that is, cost of sales, administrative, research and development, etc.). Instead, an income statement by function is when expenses are presented according to different functions they are spent on.
- **Classification of accounts:** A chart of accounts (COA) is an index of all the financial accounts in the general ledger of a company. It offers a digestible breakdown of all the financial transactions that a company conducted during a specific accounting period. On the COA level, CAS and IFRS are different in the classification of accounts. CAS classify accounts by function while IFRS classify accounts by function or by nature. For example, for bank charges, they are classified as "financial expenses" under CAS while they are included in the "administrative expenses" account under IFRS.

Why does the classification of accounts matter?

Different users desire different information regarding the breakdown of expenses. While management may be more concerned with the nature of the expenses, other users of the financial statements, such as donors, may find the expenses presented by function is more helpful for them to understand how the money is being used.

Differences in accounting treatment

With China committing to converge with IFRS, there are no big differences between CAS and IFRS on this aspect. Nevertheless, the accounting treatments of certain subjects, such as land, fair value measurement, and related party identification, etc., could be different due to local requirements.

For example, regarding the valuation methods for fixed assets, under the IFRS, one may choose to appraise fixed assets either using the cost model or applying the revaluation model. CAS, however, only allow fixed assets to be appraised based on their historical cost.

Differences in bookkeeping practices

Bookkeeping differences can be observed between CAS and IFRS in practice.

For certain subjects, CAS is more complex in bookkeeping. For example, under CAS, the VAT-related sub-accounts are further divided into input VAT, transfer-out of unpaid VAT, VAT deductions and exemptions, output VAT, transfer-out of input VAT, etc. Under IFRS, it might only be an account called VAT payable for bookkeeping.

Besides, CAS require a specific account name to be used when recording double entries. For example, for the two sub-accounts under lease liabilities, one is called lease payment (the undiscounted outstanding rental payment) and another one is called the unrecognized financing charges (the difference between the outstanding rental payment and its present value). There are no such requirements under IFRS.

Note

These rigid rules in CAS make it difficult for an IFRS user to understand the journal entries in China. Thus, it's better to invest in a competent accountant who understands both CAS and IFRS and is capable of converting the financial statements from CAS to IFRS for the headquarters' review.

Why it matters

For investors newly entering the China market, knowing the difference is helpful to them in understanding local accounting standards. Foreign stakeholders must understand how financial statements are made under CAS to evaluate the financial position and business performance of their Chinese investments.

For foreign entities that report under IFRS and consolidate their Chinese subsidiaries that report under CAS Standards, the information from the Chinese subsidiary needs to be carefully translated, mapped, and converted to fit into the overseas parent company's accounting books and policies. Knowing the differences the two is a prerequisite for being able to do so.

Moreover, for foreign entities that negotiate transaction terms with entities that report under CAS Standards (and vice versa), knowing the difference between CAS and IFRS enables them to respond quickly to analyzing and concluding deals. This is of vital importance under the current economic climate brought on by the COVID-19 pandemic, where global merger and acquisitions (M&A) are more active as companies reconfigure their operations, integrate new business segments, and prepare for the post-pandemic future.

How to bridge the differences between CAS and IFRS?

As to the conversion from one accounting standard to another, there is no universal method that fits for all. The conversion process must be tailor-made based on the specific circumstances and transaction nature of the entity.

A well-developed approach is key to the success of the conversion and helps entities to meet key deadlines. Besides, when designing the COA mapping for a specific entity, the accountant in charge of the conversion should pay attention to transactions where accounting treatments under CAS and IFRS are different.

Generally, the conversion can be divided into two phases. The first phase is more about difference analysis and preparation, while the second phase is about the implementation.

Phase one

Once the decision for conversion is taken up, the first step is to identify the differences between the CAS and IFRS, to conform the accounting policy and accounting mapping of the headquarter and the Chinese subsidiary, and to identify the data gaps.

This phase is crucial to the development of a structured conversion plan that covers the major issues and obstacles.

To be more specific, phase one can be divided into the following steps:

- Analyze the difference between CAS and IFRS on accounting treatment.
- Analyze the difference of accounting policies and accounting estimates between China subsidiary and headquarters.
- Analyze the differences between CAS and IFRS on report format.
- Analyze the difference between CAS and IFRS on disclosure requirements.
- Make a list of differences.
- Calculate variance and prepare adjusting entries to recognize different accounting treatment for transactions.

Phase two

Upon completion of the phase one assessment and having developed a list of differences for this specific conversion, the focus then shifts to the implementation phase. In phase two, related adjustments need to be quantified for the periods to be presented and the financial statements under the new accounting standards will be generated.

In practice, two set of methods might be applied. Method-2 is recommended.

Method-1:

- Import the most detailed account balance table under CAS in the accounting software into Excel as the initial figures.
- Post the adjusting entry to the corresponding account for the initial figures.
- Generate the CAS adjusted figures by integrating the initial figure with the adjusting entry.
- Analyze the sub-ledger account of the headquarters under IFRS that are corresponding to the sub-ledger account under CAS.
- Prepare reclassification adjustment for accounts.
- Post the reclassification entries to the corresponding accounts of the CAS adjusted figures.
- Add CAS adjusted figures and all reclassification entries to generate the final figures for sub-ledger accounts of headquarters under IFRS.
- Generate IFRS financial statements by summarizing the sub-ledger accounts of IFRS.
- If notes to statements are required, differences in the format of statements should be considered.
- Finally, recheck the difference list to ensure that all discrepancies have been accounted for and adjusted.

Method-2:

- Match sub-ledger accounts of the financial statements under CAS with headquarters' sub-ledger accounts of the financial statements under IFRS.
- Set up the formula link between sub-ledger accounts of the financial statements under CAS and the headquarters' sub-ledger accounts of the financial statements under IFRS.
- Post the adjusting entries to the corresponding sub-ledger accounts under CAS.
- Produce IFRS financial statements by summarizing the automatically generated sub-ledger accounts of IFRS.

Tips and suggestions

In the case where overseas headquarters under IFRS needs to consolidate their Chinese subsidiaries that report under CAS Standards, the headquarters are suggested to give as many instructions as possible. For example, headquarters are suggested to instruct how to make journal entries to convert fixed assets appraised by the historical cost model to those appraised by revaluation model.

Besides, the headquarters are suggested to plan ahead for the conversion. Especially for the data gaps, they should leave buffer time for the necessary processes. For example, if fair value assessment is expected to be involved in the conversion, the headquarter should allocate at least two weeks for it, as this assessment is conducted by third party professional valuers, which takes time.

Last but not the least, headquarters or Chinese subsidiaries are suggested to hire third party professionals who are familiar with both CAS and IFRS. They should be able to communicate with both the headquarter and the Chinese subsidiary effectively.