中國稅務及投資顧問有限公司
China Tax & Investment Consultants Ltd

PRC Accounting Standards

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Development of PRC accounting standards

1. Old PRC Accounting Standards, issued by PRC Ministry of Finance between 1997 and 2001
2. New PRC Accounting Standards (38 standards), issued by MOF on 15th Feb 2006 and effective on 1st Jan 2007

Scope of applications

1. New accounting standards (listed companies; non-listed companies encouraged to adopt the new rules)
2. Old accounting standards (non- listed companies)

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Legal Framework for Accounting

1. PRC Company Law, revised on 27th Oct 2005
2. PRC Securities Law, revised on 27th Oct 2005
3. Administrative Measure relating to Share Structure Reform for Listed Companies, Document No. (2005) 86
4. Revised M&A Rules, 8th Sept 2006 by PRC Ministries and Institutions directly under the PRC State Council
5. Bankruptcy Law, 1st June 2007
6. Reg. for the Administration of Future Trading 16-3-2007

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Adoption of fair value principle in new PRC accounting standards (examples)

1. Non-monetary asset swap (No. 7)
2. Business combination (No. 20)
3. Investment property (No. 3)
4. Debt restructuring (No. 12)

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Recognition and measurement criteria

	Old standards	New standards
1.	Cost principle	Move to accounting attributes
2.	Matching principle	Dropped
3.	Accrual principle	Accepted as the base of accounting, measurement, and reporting
4.	Division of revenue and capital expenditure	Dropped
5.	Prudence	Prudence
6.	N/A	Substance over form

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Comparison with IAS and IFRS (IA)

	IAS	PRC New standards
1.	Objectivity	Objectivity
2.	Relevance	Relevance
3.	Clarity	Clarity
4.	Comparability	Comparability
5.	Substance over form	Substance over form
6.	Materiality	Materiality
7.	Prudence	Prudence

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Comparison with IAS and IFRS (IB)

	IAS	PRC New standards
8.	Timeliness	Timeliness
9.	Reliability	
10.	Neutrality	
11.	Integrity	

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Comparison with IAS and IFRS (II)

	PRC AS	IFRS/IAS
Financial Instrument: Recognition and measurement	No. 22	IAS No. 39
Transfer of Financial Assets	No. 23	IAS No. 39
Hedging	No. 24	IAS No. 39
Financial Instrument: presentation and disclosure	No. 37	IAS No. 32 IFRS No. 7

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Comparison with IAS and IFRS (II)

	PRC AS	IAS
Consolidated F/S	No. 33	No. 27
Investment in Sub.	No. 2	No. 27
Investment in Asso.	No. 2	No. 28
Interest in JV	No. 2	No. 31

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Impact on financial statements

Increasing the earnings

- Debt re-structuring (No.12): adopting FV principle
- Non-monetary asset swap (No.7): adopting FV principle

Decreasing the earnings

- Share-based payment (No. 11) (Scope: payment to employee for service received only)

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Impact on financial statements

New standards that may increase or decrease earnings

1. Inventory (No. 1)
2. Financial instruments: recognition and measurement (No. 22)
3. Hedging (No. 24)
4. Long-term investment (No. 2)

Ironing out fluctuation in earnings

1. Consolidated financial statement (No. 33) (defining subsidiary)

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PRC Accounting Standards relating to M&A Transactions

1. Business Combination PRC AS (No. 20)

IFRS (No. 3)

- All business combinations are acquisitions.

- A business combination occurs when an entity acquires the net assets that constitute a business <Direct acquisition>, or acquires equity interests of one or more other entities and obtains control over the entity or entities. <Indirect acquisition>

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PRC definition

➢ The PRC AS No. 20 does not give a definition on business combination.

➢ The PRC Company Law and tax rule give similar definition to that in the IFRS and IAS.

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Legal form of direct acquisition

Net asset taken over

1. Acquisition by absorption
2. Acquisition by merger

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Legal issues under direct acquisition (Art. 174, Co Law)

1. Take over assets & assume liabilities (net assets) of target company
2. Target company ceases to exist
3. Notify creditors (10 days)
4. Public notice (30 days)

No requirement for liquidation procedure

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Acquisition under common control

➢ The difference between the NBV of the asset acquired and the NBV of the consideration (or the face value of equity issued) shall be taken to capital reserves. Relevant expenses are charged to income statement.

Acquisition not under common control

➢ The difference between FV and BV of net asset given up shall be taken to I/S.
➢ The difference between the cost of acquisition and FV of identifiable assets of the acquired entity shall be treated as good will or charged to I/S (if negative).

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Direct Acquisition – corporate identity no longer exists

Consideration	Benefits received
➢Cash ➢Assets & liab. assumed ➢Equity issued	➢Net assets (assets taken over & liabilities assumed)
At BV/FV	At BV/FV

Q: If A Ltd issues 1 million shares (par value RMB1 each) at RMB10 to acquire net assets of B Ltd with BV at 8 million (FV being 10 million), what is the accounting treatment assuming that they are under control?

A: Difference between par value of shares issued and BV of net assets in Sub-b (2 million) is adjusted in capital reserve.

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Indirect Acquisition – parent-sub. co. structure emerges

Consideration	Benefits received
➢ Cash; ➢ Assets; or ➢ Equity issued	➢ B Ltd's Equity interest in C Ltd

Q: A Ltd transfers intangible assets to B Ltd for its 100% equity interests in C Ltd. The FV of C's net assets is 10 million. The BV and FV of A's assets are stated at 8 million and 11 million respectively.

A: In A's book, the profit on assets disposal is 3million (FV-BV), and the GW arising from acquisition is 1 million (11-10).

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Notes about Business Combination

1. Accounting profit/loss is not equal to tax profit/loss.
2. Assets can be stated at BV or FV depending whether or not there is common control before and after the acquisition.
3. Business acquisition can be an asset deal or an equity deal. In an asset deal, the assets and liabilities of the acquired entity survive the acquisition.

Comparison between IFRS No. 3 and PRC AS No. 20

1. PRC AS provides for "business combination under common control".
2. Different accounting treatment for "biz combination under common control" and "biz combination not under common control".
3. Different accounting treatments on expenses relating to the biz combination.

[1] Difference between accounting and tax rules
Consideration exchanged

Forms of consideration

1. Cash
2. Non-cash assets (at BV or FV)
3. Equity instrument given up or issued (at Co level or shareholder level)
4. Combination of (1), (2), and (3)

[2] Difference between accounting and tax rules
Equity deal : general and special treatment

Acctg treatment	Tax rule	Remarks
(1) FV	Taxable	Equity given up / disposal
(2A) FV	At cost, non-taxable	Parent-sub on consolidation Equity acquired
(2B) BV	At cost, non-taxable	Tax exempt re-organization SAT doc. GSF (1997) No. 71; Or no change in ultimate ownership SAT doc GSHF (1997) No. 207

Other examples for the differences

- GW arising on biz combination is amortized in 10 year or less, SAT document Guo Shui Fa (1997) No. 71
- Under PRC accounting rule, GW arising is not amortized. Rather it is subject to test for impairment at B/S date under PRC AS No.8 <Impairment of Assets>.

Points to note in Business Acquisition

Foreign investor who acquires equity interest owned by Chinese party in JV (or domestic Chinese Co) is subject to following legal restrictions:

1. Restricted category as per "Catalog for Guiding Foreign Investment in Industry"?
2. State owned assets? Acquisition must be approved by SASAC.
3. Target company listed? Approval from CSRC is needed.
4. Non cash consideration? Turnover taxes (VAT and BT).

2. Long-term investment PRC AS (No.2)

Initial recognition

- Type 1: Acquisition in a business combination
- Type 2: Acquisition in other cases (not a business combination)

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[I] Initial recognition in biz combination (type 1)

- Whether or not common control exists before and after acquisition?

- If yes, the difference between the NBV of the consideration paid (or equity shares issued) and NBV of the assets acquired shall be adjusted in capital reserve.

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If not,

- Difference between net BV of assets given up and the FV of the assets given up shall be taken to income statement.
- Difference between cost of investment and FV of the identifiable net asset acquired shall be treated as goodwill or loss, as per business combination (No. 20).

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Illustration

At 2006.3.1, A Ltd transfers a piece of equipment to B Ltd for B's 70% equity interest in C Ltd. The fair value of the identifiable net asset for C Ltd is 3 million. Below are particulars of the equipment:

1. Costs 5 million
2. Accumulated depreciation 1.8 million
3. Fair value is 2.8 million
4. Relevant legal fee 0.03 million

- Cost of acquisition = fair value of assets given up
  = 2.8 + 0.03 = 2.83

- Profit on equipment disposal

= FV of assets given up – NBV of the assets given up
= 2.8 – (5 – 1.8) = - 0.4

- Good will = cost of acquisition – fair value of net assets acquired

= 2.83 – (3 x 70%) = 0.73

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Dr. Disposal of asset	3.20	
Dr. Accum. Depreciation	1.80	
Cr. Fixed asset		5.00

Dr. Long term investment	2.10	
Dr. Goodwill	0.73	
Dr. I/S (loss on disposal)	0.40	
Cr. Asset disposal		3.20
Cr. Bank		0.03
	8.23	8.23

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[II] Acquisition other than in business combination (Type 2)

Rules of initial recognition

1. Cash
2. Equity issued (FV)
3. Contribution from investors (Agreed terms)
4. Non-monetary asset swap (No. 7)
5. Debt re-structuring (No. 12)

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Comparison with IFRS No. 3

1. IFRS: The difference between the cost of long-term investment and the proportion of the FV in the identifiable net assets of the associated companies, shall be treated as goodwill.

2. The PRC AS No. 2 does not recognize the goodwill under the same circumstances, and does not adjust the initial cost of long-term investment.

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Comparison with old standards

1. Short-term investment and long-term bonds are taken out from the old version.

2. Short-term investment is reclassified as "financial asset at FV through profit & loss" under PRC AS (No. 22) Financial Instruments: recognition and measurement;

3. Long-term bonds are reclassified as "investment held to maturity" under PRC AS (No. 22).

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Accounting methods

1. Cost method – investment in subsidiary; but equity accounting method on consolidation
2. Equity accounting method – Jointly controlled entity or entity under significant influence

Asset impairment

1. Under the cost method, the impairment follows provisions in PRC AS No. 22 Financial instrument-recognition and measurement
2. Otherwise, the impairment follows provisions in PRC AS No. 8: assets impairment.

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Difference between accounting and tax rules

1. Under the equity accounting method: recognition of after-tax earnings in invested company at different point of time

2. Cost of investment may not be equal to the tax cost; the acquisition of equity interest in business combination

3. The consideration is settled in non-cash assets

4. PRC Tax rules do not recognize impairment loss

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3. Debt restructuring (PRC AS No. 12)

Comparison with IFRS

- No corresponding standards in IFRS (except for few comments in IFRS No. 39 Financial Instrument: Recognition and measurement)

Development of PRC AS No. 12

- 1998.06.12 FV
- 2001.01.01 BV (profit to reserve; loss to I/S)
- 2006.02.15 FV

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Condition for application

- Creditors' Concession
- Borrowing entity in financial difficulty

Legal forms of debt restructuring

- Court order; or
- Agreement with creditors

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Ways of implementation

1. Cash payment
2. Conversion of debt into equity
3. Amending the terms of debts
4. A combination of the above

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B Ltd owed A Ltd 1,000,000 for goods bought 6 months ago. B Ltd cannot redeem the note, bearing interest at 6% p.a., payable to A Ltd on 2006.7.1. After negotiation, A agreed to accept B's share in full settlement. Below are the particulars of the shares (ignoring stamp tax):

- Par value 1.00
- No. of shares 100,000
- Market value each share 9.60
- Interest for 6 months: 30,000 = 1,000,000 x 6% x 6/12

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Dr	Investment (9.6 x 100,000)	960,000	
Dr	I/S – non business loss	70,000	
Cr	Bills receivable		1,030,000

Loss on debt restructuring in A's book
= reduction in principle + interest not yet received
= 40,000 + 30,000
= 70,000

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Points to consider in a debt to equity conversion

1. Legal restrictions?
- Check Catalog on Guiding Foreign Investment in Industry

2. Turnover taxes?
- Non-cash assets as consideration

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4. Non-monetary asset swap PRC AS (No. 7)

Scope

1. Non-monetary assets swap PRC AS (No. 7) and Employee benefits PRC AS (No. 9) is under scope of IAS (No. 19) Employee benefits.

2. Asset swap in business combination: PRC AS (No. 20) business combination shall apply.

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Book value vs. fair value method

1. If following conditions are met, parties to the transaction should use FV method: (i) the transaction has a commercial substance * ; (ii) the value of asset acquired or given up should be reliably measurable. The difference between the BV and FV of the assets given up is taken to I/S. (* meaning different cash flow patterns)

2. If above conditions are not met, BV of assets given up shall be used as cost of assets acquired. No profit or loss is recognized.

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Main contents

1. Transaction not involving compensation.
2. Transaction for which one pays the compensation to make up the differences in value exchanged.
3. Transaction for which one receives the compensation for the differences in value exchanged.

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Comparison with PRC tax rules

- PRC tax rules treat the asset swap (or exchange) as two separate transactions:

(i) the disposal of assets at FV and profits realized are taxable; and

(ii) the acquisition of the other asset at FV.

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A Ltd exchanged a piece of equipment for a vehicle with B Ltd. Particulars of the swap are below:

	A's Equipment	B's Vehicle
Book cost	500,000	350,000
Dep'n	200,000	30,000
NBV	300,000	320,000
Asset impairment	0	10,000
Fair Value	350,000	300,000
Compensation	-50,000	+50,000
Transportation	20,000	
Turnover tax	19,250	16,500

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The payment received to FV of asset given up is: 50,000 / 350,000 x 100%=14.29%. That is less than 25% and should be classified as non-monetary asset transfer.

In A's books of accounts

Dr	Fixed assets – vehicle	339,250 *	
Dr	Bank – receipt of compensation	50,000	
Cr	Disposal of equipment		389,250
Dr	Disposal of equipment	50,000	
Cr	Profit on asset swap		50,000

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Cost of vehicle
= FV equipment – compensation rec'd + transportation + taxes
= 350,000 - 50,000 + 20,000 +19,250
= 339,250*

* Cost of asset acquired (vehicle) = FV of assets given up (equipment)

Disposal of fixed asset account
= net book value + transportation + tax + profit
= 300,000 + 20,000 + 19,250 + 50,000
= 389,250

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In B's books

Cost of equipment = FV of vehicle given up + comp. + tax
= 300,000+50,000+16,500
= 366,500

Loss on asset given up = FV – (NBV – impairment)
= 300,000 - (350,000 - 30,000 - 10,000)
= -10,000

Dr	Equipment	366,500	
Dr	Impairment	10,000	
Dr	Depreciation	30,000	
Dr	Loss on asset swap	10,000	
Cr	Fixed asset (vehicle)		350,000
Cr	Bank (50,000+16,500)		66,500

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5. Income tax

Main contents

1. Adopting concept of tax base on assets and liabilities
2. Temporary difference arises between carrying amount of assets / liabilities and tax base.
3. Temporary differences: taxable and deductible temporary differences
4. Recognition and measurement of current and deferred tax expenses
5. Presentation: reconciliation of accounting profit & tax expenses, and separate disclosure of current and deferred taxes in financial statement.

Application rules

1. Separate calculations are performed to determine current tax and deferred tax.
2. Current tax is recognition of tax payable to (or refundable by) tax authorities in current period.
3. Deferred tax reflects the future tax consequences of items recognized in the B/S at period end.
4. Movements (changes) in deferred tax balances are recognized in I/S, in equity, or as adjustment to GW arising on biz acquisition.

Examples for deferred tax liabilities/assets arising

1. Revaluation of assets or Impairment of assets.
2. Different depreciation rates between accounting and tax rules.
3. The adoption of equity accounting for Investment in JV, associated companies.
4. In business acquisition, the adoption of FV to assets acquired without change in tax base.
5. Loss not recognized previously by the acquired entity in business acquisition.
6. Additional assets/liabilities recognized on business acquisition. (i.e. intangible previously not recognized)

Illustration 1

H Ltd acquires S Ltd, which only has two properties. Both properties are depreciated at the same rate for accounting & tax purposes. Carrying amount of properties are stated at cost. The properties are for own use by H Ltd after acquisition.

Net assets S Ltd.	BV	FV	Tax base	Temp. diff	Tax rate	Tax liab.
Property A	100	130	100	30	30%	9
Property B	150	140	150	-10	30%	-3
Intangibles		50	0	50	30%	15
	250	320	250	70		21
Deferred tax on acq'n		-21				
Identifiable net assets acq'd		299				
Goodwill		51				
Consideration		350				

Consolidation	H Ltd.	S Ltd.	Conso. Adj	Consolidated Acct
Investment in S	350		-350	0
Properties		270		270
Intangibles			50	50
Goodwill			51	51
Deferred tax			-21	-21
Net assets	350	270		350
	-350	-270	270	-350
Capital	-350	-270	0	-350

Illustration 2

Z Ltd issues a convertible note with face value of $10,000 that matures in 3 years. No coupon interest is payable. Using a discount rate of 9%, the PV of the note is $7,722. The liability component is $7,722 and the equity component is $2,278 that is recognized in equity. Show the accounting treatments:

	Dr	Cr
Cash	Dr 10,000	
Convertible note payable		Cr 7,722
Capital reserve		Cr 2,278
Capital reserve	Dr 683	
Deferred tax liability at 30%		Cr 683

Computation of deferred tax liabilities at year ends

	Yr 0	Yr 1	Yr 2	Yr 3
	$	$	$	$
Liability				
Opening		7722	8417	9174
Imputed interest at 9%		695	757	826
Closing	7722	8417	9174	10000
Defered tax liability				
Convertible note	7722	8417	9174	10000
Tax base	10000	10000	10000	10000
Temporary difference	2278	1583	826	0
Deferred tax liability at 30%	683	475	248	0
Charge (Cr) to I/S		-208	-227	-248

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Movements in I/S and B/S over the life of the note

	Yr 0	Yr 1	Yr 2	Yr 3
Income Statement				
Interest expenses		695	757	826
Deferred tax (Credit)		-208	-227	-248
Balance Sheet (extracts)				
Deferred taxation	683	475	248	0
Convertible note	7722	8417	9174	10000
Capital reserve (2278-683)	1595	1595	1595	1595
	$\boxed{10000}$			

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6. Revenue (PRC AS No. 14)

Scope: revenue arising from

1. Sales of goods
2. Rendering of services
3. The use of entity assets by other party that yield interest, royalties and dividends

➢ Rental income is included in Accounting for Lease

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Sale of goods

1. Seller has transferred to buyer significant risks and reward of ownership of the goods.
2. Entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
3. Amount of revenue can be measured reliably.
4. Probable that economic benefits associated with transaction will flow to the entity.
5. Costs incurred or to be incurred in respect of the transaction can be measured reliably.

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Comparison with old version issued on 1998

Scope

Following have been removed from the exclusion list:
1. Gain from swap of non-monetary assets
2. Income derived from future contracts
3. Profits derived from debt restructuring

Compared with old standard: "cost incurred or to be incurred should be measurable" has been added to new version.

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Comparison with PRC tax rules

1. Accounting and income tax rule: accrual principle adopted and no divergence observed
2. Scope of sales under VAT regulations > scope of sales under accounting rules (deemed sales provision)
3. Scope of VAT includes certain services subject to BT in a mixed sale transaction
4. Accounting and VAT rule: difference in recognition and measurement

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Illustration

A Ltd sold goods to B Ltd for $100,000 on 27th December 20X3. Cost of goods is $52,000. VAT rate is 17% and income tax rate is 30%. B Ltd returned the goods on 9th January 20X4. BOD did not approve financial statement at that date.

1.	Prior year adjustment – I/S	-100,000	Account receivable	-117,000
	VAT payable 17%	-17,000		
2.	Prior year adjustment – I/S	52,000	Inventory	52,000
3.	Prior year adjustment – I/S	14,400	Note: (100,000-52,000) x 30%	
	Income tax payable	-14,400		
4.	Prior year adjustment – I/S	33,600	Note: (100,000-52,000) x (1-30%)	
	Retained profits	-33,600		

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Balance Sheet Extracts at 20X3.12.31

Retained profits	-33,600	Inventory	52,000
VAT payable	-17,000	Account receivable	-117,000
Income tax payable	-14,400		
	-65,000		-65,000

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Financial statement, income tax and VAT returns (assuming income for year 20X3 and first quarter of 20X4 is 3,000,000 and 1,000,000 respectively.)

	I/S	IT Returns	VAT Returns
Income 20X3	3.0	3.0	3.0
Goods returned	-0.1	-0.1	
Income 20X4	1.0	1.0	1.0
Goods returned			-0.1
20X3 and 20X4	3.9	3.9	3.9*

* Note: Input VAT on purchase had been included in 20X3.

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Comparison with tax rules

1. Example for different recognition rules: as illustrated
2. Example for different rules of measurement

Example: different measurement rule

Q: A product costing 100 is for sale under “buy one get one free” promotion. How VAT is computed?

A: $100x2 x 17%=34 (if structured as quantity disc’t); $200x50% x 17%=17 (if structured as price disc’t)

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Comparison with legal rules

1. PRC contract law (title for goods passes upon delivery in general)
2. Administrative measures on tax invoices:
(i) Scope - tax invoices not issued for deemed sales;
(ii) Timing - tax invoices issued upon receipt of payment

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7. Investment Property (No. 3)

Scope of investment property

Including the following:

- (a) land use rights let out for rental income
- (b) land use right held to be transferred after appreciation
- (c) building structures let out for rental income

Excluding property for self-use, and property for sales

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Investment Property

Rental income

- ➢ accounting for leases

Initial recognition

- ➢ At cost; including taxes and relevant expenses

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Investment Property

1. Measurement after acquisition

- ➢ Cost model – depreciation
- ➢ FV model – valuation at period end through I/S

2. For cost model

Building – Accounting for fixed assets (AS No. 4)

Land use right – Accounting for intangibles (AS No. 6)

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