

# Peeling the Onion



Issue of Feb

Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

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## Happy New Year !!!

Spring Festival starts on 18th February, with Chinese New Years Eve being 17th. We would like to wish everyone Happy New Year and a healthy, happy and prosperous year of the Pig! Year 2007, or per Chinese calendar 4704, is Red Pig Year, otherwise known as Female Fire Pig year. People born in year of Pig are lucky, mild tempered, enjoy eating all of the time, love sleep and they worry very little. Red Pig Astrology Year actually starts on 4th February China time zone at 13.18, which is the official "start of spring", not on New Years Day, as commonly thought.



feature article

## Convergence of China GAAP to IAS

### New ASBE Issuance

On 15 February 2006, the Ministry of Finance of the People's Republic of China (the 'MoF') formally announced the issuance of the long awaited Accounting Standard for Business Enterprises ('ASBE'). The ASBE consists of the Basic ASBE and 38 Specific ASBEs. These standards, which will be applied effectively from 1 January 2007, will become mandatory for all listed Chinese enterprises. Other Chinese enterprises are also encouraged to apply these standards. The ASBE replaces the existing Chinese Accounting Standards (CASs) and an earlier version of the ASBE. The applicability of the CASs and the older version of the ASBE are not changed except for those entities required or electing to adopt the new ASBEs. The new ASBEs mark China's determination and effort to converge to IAS. They are substantially in line with IFRSs, except for certain modifications that reflect China's unique circumstances and environment.

Actually, the new ASBEs result from China's long-term struggle and progress to market economy. Since the stock market began, China has planned to replace the accounting model adopted under the planned economy by a set of standards that is more suitable for an evolving market economy. In 1992, China issued an Accounting System for Business Enterprises (ASBE), which is symbol beginning of accounting reform. Since then, China has issued 20 exposures and 16 specific accounting standards. In 2005, China issued 17 exposure drafts including Insurance Contract etc.

### Convergence to IAS

In the process of formulating its own accounting standards, China has always referred to IAS, so in many aspects CAS is consistent with IAS. Chinese Ministry of Finance has much contact with IASB to find the ways to diminish some essential differences with IFRS, such as the opinion of reliability of fair value etc. On November 8, 2005 Mr. Wang, secretary of Chinese Accounting Standards Committee, signed a joint declaration with Sir David Tweedie, Chairman of the IASB, which marked the Chinese effort to converge to IAS. The number of adjustments required to convert the financial report prepared

under CAS to an IAS report has reduced over the years. As a result of the accounting reform over the recent years, China has almost now harmonized with IAS.

On the other hand, globalized markets require a common language and convergence to IAS. To promote the convergence to IAS, IASB has encouraging their countries to enlarge the range of IFRS or harmonize their national GAAP with IAS, rather than simply replace them. However there are no voices from developing countries in IASB, partly because capital markets in developing countries are limited and the quality of information is lower. This provides a good opportunity for China to cooperate with IASB and to persuade IASB to consider the characteristics associated with developing countries. Such a role could assist IASB in their understanding and their applicability and effectiveness of accounting regulations IAS. It is also probable that China might seek to take a seat on the IASB.

### **Difference between CAS and IAS**

Although the new ABSE shows more convergence to IAS, there are still some differences between CAS and IAS.

First of all, the accounting policies of certain economic activities prescribed under CAS are designed to focus on truthfulness and prudence, since the environment of market economy is not mature enough in China. For example, to prevent listed companies from polishing their financial statements through non-monetary transactions, China has issued Accounting Standard for Non-monetary Transactions, which prescribes the respective accounting treatment of non-monetary transactions involving exchange of similar and dissimilar assets. There is not a similar standard in IAS.

Secondly, China prefers historical cost to fair value as a measurement. But IAS 39 and IAS 40 include financial assets and investment property in the realm of fair value, which are the main part of assets in listed companies. It is rather difficult to acquire the information of fair value in China, because the capital market is relatively small and other commodity markets also need further improvement.

Thirdly, sometimes the same activities may have different effects on current profit. For example, the profit of annual financial report of Bank of Communications in 2004 based on CAS was 0.9 billion Yuan, which was only 57% of that reported in their prospectus based on IAS. The most prominent difference between them was the transfer of a non-performance loan to China Cinda Asset Management Corporation, which increased profit by 1.2 billion Yuan according to IAS.

Finally, most stakeholders of Chinese listed firms do not care much about public accounting information, due to questions on accuracy and transparency. From the perspectives of performance evaluation and supervision, laws and regulations in China have paid too much attention to net income, so it is not easy to replace it with comprehensive income as per IAS.

### **Conclusion**

Confirming with the global capital market, China should provide high quality, transparent and comparable information in capital markets. Chinese standard setting bodies should provide specific problems and suggest solutions directly to IASB to converge with IAS actively.

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## **Revision to the Chinese VAT Export Refund**

In China, companies are required to pay Value Added Tax ( "VAT" ) on goods purchased locally in China. If those goods are subsequently exported, the exporter could apply for a refund of the VAT paid. The export VAT refund rates are varied depending on the types of goods exported, in which VAT could be refunded fully, partially or even with no refund at all.

On 14 September 2006, the Ministry of Finance, the National Development and Reform Commission, the Ministry of Commerce, the General Administration of Customs and State Administration of Taxation jointly announced that China has further reduced the export VAT refund rates for certain items, which would lead to further increases in the absolute costs for exporters in China. These newly announced revision of VAT export refund rates have come into effect on 15 September 2006.

## **The revision**

The revision in the export VAT export refund rates could be categorized into the following three categories (by product groups): (a) products where export VAT refunds have been abolished; (b) products where export VAT refund rates have been reduced; and (c) products where export VAT refund rates have been revised upwards.

### **Abolishment of VAT export refund**

1. All non-metallic products (except salt and cement) listed in Article 25 of import and export Tariff Regulation, coal, natural gas, olefin, bitumen, silicon, arsenic, stone materials, non-ferrous metals as well as certain scrap materials.
2. Metallic ceramic, 25 types of pesticide and their intermediary products, certain finished products of leather, lead-acid battery and mercuric oxide battery.
3. Thin fleece of goat, charcoal, crosstie, cork products, certain processed primary wood products.

### **Decrease in VAT export refund rates**

1. Refund rate for steel products under 142-tariff heading has been reduced from 11% to 8%
2. Refund rate for ceramic products, certain finished products of leather and glass products has been reduced from 13% to either 11% or 8%.
3. Refund rate for certain non-ferrous metallic materials has been reduced from 13% to either 5%, 8% or 11%.
4. Refund rate for textile, furnishings, plastic, lighter, and specific wood products has been reduced from 13% to 11%.
5. Refund rate for non-mechanically propelled vehicles and certain component parts has been reduced from 17% to 13%.

### **Increase of VAT export refund rates**

1. The refund rate for significant technical equipments, certain IT products, and bio-medical products as well as certain “encouraged” high-tech products has been increased from 13% to 17%.
2. The refund rate for selected processed products made from agricultural products has been increased from 5% or 11% to 13%.

## **Rationale**

Apart from attempting to address the issues of high consumption and high pollution in China, Chinese high favorable balance of trade also contributed to the revision of VAT export refund rate. The General Administration of Customs has announced that based on the trading data of August 2006, another record high trade surplus of US\$18.8 billion was recorded in August 2006. This is the 28<sup>th</sup> consecutive month where favorable balance of trade was recorded.

Facing with the continuing high favorable balance of trade that attracted critics from various parties, Mr. Bo Xilai, the Minister of the Ministry of Commerce, has indicated that China has been considering various ways to reduce the high favorable balance of trade. The recently announced revision of VAT export refund rates may be considered as one of China’s efforts in addressing this issue.

## **Conclusion**

In conclusion, this revision represents another structural change to the VAT export refund policy of China. The Chinese government will be using it to direct and monitor economic activities.

The revision has raised the VAT cost for businesses exporting “high energy consumption and high polluting” products while eliminating or reducing the VAT cost on the exportation of goods that fall under the “high technology and other encouraged industries” . At the same time, it is also hope that the revision could reduce the pressure on an upward revision of the Renminbi.

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## Challenges and Opportunities Coexist

Analysis on newly issued foreign banks regulation “PRC Foreign Bank Regulation”

Since the first foreign bank representative office was established in Beijing in 1979, China has begun her involvement in world economy in a more extensive way. In fulfilling one of her commitments when joining World Trade Organization (WTO) in 2001, China has issued a landmark ruling allowing foreign banks to offer a full range of services to local customers on 11 November 2006.

### Background: A review of foreign banks developments in China

#### 1. Branches and Representative Office (RO) of Foreign Banks

During the past decade, the number of RO of foreign banks in mainland China reached its peak in 1997, which was about 550. Subsequently, the number of RO has decreased and it was kept at around 220 in recent years. The number of branches of foreign banks in mainland China is relatively stable, around 150 over the past 10 years.

#### 2. Geography segmentation

These branches and RO are normally located at coastal cities and metropolitans. Shanghai, particularly due to its extraordinary characteristics, such as government policy, industrial basis, financial position and infrastructures, becomes the most attractive city for foreign banks. However, it is now a trend for these foreign banks to extend their business away from coastal cities, especially to central and western regions, which are equipped with preferential policies.

#### 3. Operating strategies

These foreign banks have adopted different strategies in China, which include:

- a) Target at multi-functional business, including both wholesale banking and personal banking, such as HSBC, Standard Chartered Bank, etc;
- b) Cooperate with foreign investment enterprises, particularly clients of their headquarter, such as Japanese banks; and
- c) Specialized in a particular industry.

### Latest development: The newly issued regulation

1. Foreign banks shall operate RMB business in China, without any geography or customer restriction.

#### 2. Policies:

##### a) Registered capital

For banks wholly owned by foreign entity and those established through joint venture, their minimum registered capital

shall be RMB 1 billion or the equivalent exchangeable currencies.

b) Business scope

Once authorized by China Banking Regulatory Commission (CBRC), foreign banks shall be allowed to take deposits from public, offering short-term, middle-term and long-term loans, both in RMB and foreign currencies. Authorized branches of foreign banks shall operate partial or complete foreign currencies business and certain RMB business.

c) Supervisory measures

Foreign banks shall be supervised and regulated by CBRC. Based upon its assessment of the operating risks of foreign banks, CBRC could take certain actions, such as suspending part of foreign banks' services and demanding a replacement of senior management personnel.

d) Restrictions

Foreign banks that are found not complying with regulations in respect of deposit and borrowing rates could be penalized by China Banking Regulatory Commission.

3. Foreign banks could set up a separate entity, or simply just branches and RO in China depending on their own business needs.

4. Consistent treatments between domestic and foreign banks

Since foreign banks are now operating on the same platform with those domestic banks in terms of business scope and customer base, they therefore subject to the same regulatory framework.

## Challenges

### 1. Foreign banks

a) Since they are new participants in RMB services, how to position themselves in market place and be accepted widely by customers is a key to their success in China market.

b) Localization is another challenge to these foreign banks. China is totally different from any other part of the world. Foreign banks still have a long way to go in getting accustomed to China banking regulation system, legal system and economic environment.

c) The big four state-owned banks are their main rivals. The big four have large network of branches that have given them greater access to consumers across China. For example, the number of branches established by each of the big four domestic banks is ranging from 11,000 to 55,000. Whereas for foreign banks, they are normally operating no more than 30 branches in China (for each foreign bank).

d) Apart from competition from domestic banks, foreign banks are also facing stiff competition among themselves. Foreign banks like HSBC, CITIBANK, and Standard Chartered Bank which have long penetrated into China market are likely to compete against each other for market share in this new RMB business.

### 2. Domestic banks

a) Facing fierce competition from foreign banks could be the toughest challenge to domestic banks for a long time. The primary reasons are due to shortage of capital and high level of non-performing loan (NPL), which reduces the competitiveness of these domestic banks.

b) The existing segmentation and rigorous regulations in banking industry have boosted specialization of domestic banks, which could hinder their future development. Taking commercial banks for an instance, generally their target market is state-owned enterprises, some of which could be operating unsatisfactorily. Consequently, NPL in those banks increases and resulting in a vicious circle as more loans may be needed by these SOE. On the contrary, foreign banks usually are multi-functional. Their services spread to not only traditional business, but also cover investment and securities business. This reduces their operating risks by not relying on a single segment of the market and increases their overall competitiveness.

c) Human resource issue could be another challenge to domestic banks. Generally foreign banks seem to be able to attract the talents from the banking industry. Accordingly, how to retain talented and experienced personnel in those domestic banks are becoming a critical issue that needs to be resolved.

## Opportunities

### 1. Foreign banks

a) Worldwide reputation, international background, innovation and brand name are foreign banks' greatest assets. More and more individuals are looking for personalized and customer-friendly services, as well as a broader range of services, which are the strength of foreign banks.

b) The good relationship with multinationals paves their way in China. Based upon their long established partnership, more and more foreign enterprises located in mainland China are anticipated to switch their RMB business to foreign banks.

c) China with her more than 1.3 billion population and continuing economic growth would give foreign banks endless business opportunities.

### 2. Domestic banks

a) As foreign banks begin to offer RMB services, this could encourage domestic banks to explore new market niche.

b) To attract and maintain royalty customers, domestic banks have to look for ways to improve their productivity, efficiency and competitiveness.

## Conclusion

Foreign bank headquarters have shown tremendous interests in China market. As mentioned before, huge consumer market and continuing economic growth encourage more and more foreign banks to set up separate entities, branches or RO in China.

The domestic banks seem to take every opportunity to strengthen themselves in anticipation of a stiff competition ahead, including raising additional capital through initial public offering (IPO) in China and/or abroad.

However, whatever the effects of this new regulation may have over the domestic and foreign banks in China, the consumers are most likely to benefit from additional alternatives and increased competition in the banking industry for RMB business.

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