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The Business Management Playbook for China

2019 edition

Takeaways

Fapiao Accounting will cost your business a lot of money in the long run.

Recognizing revenue and expenses based solely on available fapiaos leads to misleading financial reports and incorrectly reporting the business's tax liability. You won't realize the cost to your business until it's time to adjust your financial reports or you're caught in a tax audit.

Many external accountants charging high service fees still do Fapiao Accounting

This is the simplest way to meet a business clients compliance requirement and allows the service provider to maximize its margins. It's not until later down the road when the client realizes the negative effects of Fapiao Accounting.

Running your business efficiently in China requires you to adapt your process

China has a different set of rules than the rest of the world; not only laws and regulations. How well and experienced you are in dealing with the common hassles of doing business in China will reflect on the health of your business and your take-home profits.

Employees, partners and clients/vendors won't always behave as you expect them to

The people element of your business often presents the greatest learning curve for many foreign business owners. Familiarizing yourself with the common practices and behaviors is the best way to avoid any surprises.

Your business software won't always work well in China

Software implementation in China most often fails because western managers assume that the business and its employees can undergo rapid change. A step-by-step approach starting with the most critical controlling elements allows your Chinese business to adequately assimilate itself to the new software.

Compliance is more than just bookkeeping and tax filing

While you might be able to get away with paying RMB 2,000 a month in exchange for having your compliance taken care of, the cost to your business is higher than that. Good compliance ensures the integrity of your financial reports and helps you build trust with your employees and investors.

Don’t rely on your bookkeeper to do any value-added work

Accountants in China are overwhelmingly bookkeepers. The financial reports they provide are of little to no value for management decision making or in many cases are outright misleading. Financial planning and analysis requires someone who understands your business and adheres to the principle of accounting.

Fraud is preventable if you know what you’re doing

Having internal control mechanisms in place is especially important in China to ensure your business is operating as you intended it to. A clear set of well-designed internal procedures prevents your employees from exploiting your company or manipulating far away managers.

Tax planning maximizes your take-home profit

China has very business-friendly tax policies compared to many countries. Whether you sell to China or have a registered legal entity here, having the right business structure helps minimize your tax liability and maximize your take-home profit.

Taxes in China can be hard to get right

Fapiaos have an important role to play in China. If mishandled, they can lead to the business paying more taxes and hurting its cash flow by recognizing its tax liability early.

Shared CFO’s are a cost-effective way for foreign businesses to receive the help they need in China

A shared CFO is a senior accountant or business advisor who use the latest cloud technology software automation tools to provide high-level accounting and business advisory services to their clients. They come at a fraction of the price of a full-time CFO.

"There are many elements of doing business in China which are new to foreign businesses entering the market. This is one of the most comprehensive guides we have seen about doing business in China"

Brecht Timmermans
General Manager, BenCham

“Business finance and accounting have specificities that need to be taken into account for ensuring smooth, sound and profitable activity in China. The Business Management Playbook is very helpful for understanding the usual operational challenges when managing a business in China.”

Christine Miles
Foreign Senior Counsel,DHH Law Firm, Beijing
SME Working Group Coordinator, French Chamber of Commerce in China

“The Business Management Playbook is an outstanding synopsis of the rules to follow when conducting business in China. It highlights the different cultures, business ethics, and business climate that dictate the different ways to resolve problems and conflicts. A great outline and bible for those who manage affairs in China.”

Peter Pang
Chairman and Managing Partner, IPO PANG XINGPU Law Firm

"Our clients are often located overseas selling into China or have a small operation here. They have limited visibility of the practical challenges they face on the ground here in China and this is where the The Business Management Playbook becomes very valuable.”

Veli Ruismäki
Project Director, China Sage Consultants

“As a foreigner looking to start a business in china it is really hard to find a source that covers the things you need to consider or be aware of. This detailed guide goes a long way to help answer a lot of those questions when starting out.”

Mark Ternouth
Founder and Managing Director, Ternitabout Limited (UK)

EXECUTIVE SUMMARY

Doing business in China is going to require you to navigate new and unfamiliar challenges. There are many pitfalls unique to the Chinese business environment that create risks and financial losses that prevent foreign companies from effectively executing their strategy and maximizing profits.

Unfortunately, China's accounting service industry is predominantly shaped by conventional accountants who are mandated to meet only compliance requirements and not help businesses address the various China specific challenges they face. This results in many small businesses spending their valuable capital on services that are not helping them grow their business and increase their profits.

Cloud accounting software and other SaaS technologies are now enabling accountants to move beyond compliance services and provide CFO level services to small businesses.

The Business Management Playbook for China explains how small businesses can avoid the many pitfalls that cause businesses to fail and how they can get help with the challenges they will face operating a business in China.

HIGHLIGHTS

- **The No. 1 root cause of tax problems in China**
- **How to correctly handle fapiaos in your business process**
- **How to ensure success when working with Chinese clients / partners / employees**
- **How to successfully implement technology into your business in China**
- **What are shared CFO's and how can they help grow your business**

Table of Contents

Part 1

Part 2

Part 3

Part 4


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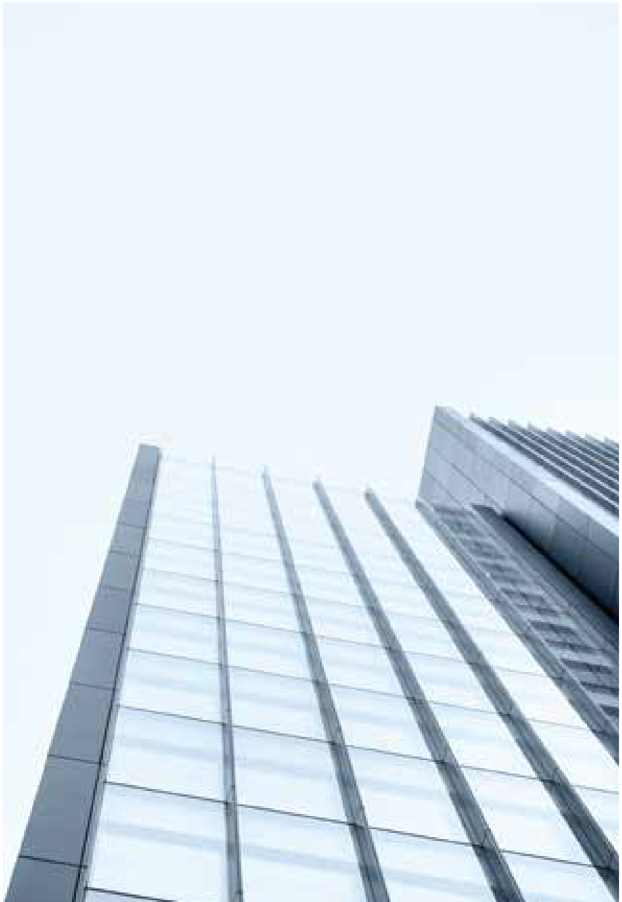
Part 1/ What You Should Know About Compliance Services in China

The assumption amongst foreign companies doing business in China is that statutory compliance requirements are complicated and very demanding. Many consent to paying high service fee's in exchange for their compliance requirements being met. Typically, this includes cashier services – making payments and issuing fapiao – and the conventional bookkeeping and tax filing services. The high service fee's being charged often lead to the misconception that the quality of service being delivered is high. Due to the nature of how compliance in China works, the infamous fapiao in particular, many of the service providers charging high service fees can be found using the same approach to meet their client's compliance requirements as their low-cost competitors.

Their approach to compliance leads to a variety of tax risks as well as operational risks, much of it stems from the method of bookkeeping used by the accountant and how fapiaos are handled. Like most countries, Chinese Generally Accepted Accounting Principle (GAAP) specify that transactions must be **accrued** in the period that they occur. However, the role of fapiao in the business environment has allowed a different practice to prevail in China.

Many accountants exist in **information isolation**; and as a result, they lack the visibility of a business's operations to understand the businesses and to accrue revenue and expenses correctly. They instead use a method called **Fapiao Accounting** to meet their clients' compliance requirements.



Accrual Accounting

Accrual accounting is an accounting method that records revenue and expenses when goods and services are actually delivered, regardless of when cash and fapiao are exchanged.

Fapiao

An official VAT tax invoice provided by a seller as proof of purchase of goods or services including their value and the amount of tax paid. It's also a warranty against tax evasion, unlike other countries where invoices serve as a tax receipt.

Fapiao Accounting

Are your books based solely on Fapiaos?

Fapiao Accounting refers to recognizing revenue and costs solely based on available fapiaos. Accountants do not record transaction until they issue an output fapiao or receive an input fapiao – and from there they generate the required financial statements and calculate a business' tax liability. This method of accounting is a bare-minimum approach to compliance and does not require the accountant to do much in terms of actually understanding the business.

Fapiao accounting exists because it is the simplest and cheapest way to meet tax compliance requirements in China. While technically illegal according to Chinese accounting law, this method is tolerated up until the point where it produces material inaccuracies in the financial reports, for which the business will be liable. The widespread nature of the problem and lack of effective enforcement methods available to tax authorities allows businesses to accumulate significant tax risk before it warrants the attention of the tax authorities. Nonetheless, many accountants prefer this method because it is the simplest way to meet their contractual obligations with their clients.

Inaccurate financial reports

Financial reports will only display transaction information for which fapiaos have been issued, excluding revenue or costs without fapiaos.

Tax Risk

Several of the common mistakes associated with fapiao accounting results in the business underpaying its taxes, which incurs fines & penalties up to 5 times the tax shortage or overpaying on its taxes due to duplicate or lost fapiaos. Serious cases of tax shortage can result in the business's credit rating being downgraded limiting its ability to seek financing and create operational constraints.

Cash flow problem

Reporting an output VAT without a matching input VAT fapiao results in the business paying VAT and CIT early and limiting the cash available for running the business.

Example Accrual Accounting

James operates a trading company in China and allows his clients flexible payment terms up to 30 days of receiving the goods. James should record his revenue in the same period in which the goods arrived at the client.

Example Fapiao Accounting

James ships his goods and expects to get paid by his client next month. The client pays him 30 days after the goods arrived and James asks his accountant to issue a fapiao. Upon issuing the fapiao, the accountant records the revenue on the financial reports.

Unknowingly, the accountant and James just illegally manipulated the businesses revenue and potentially delayed tax (VAT and CIT) payment by not accruing the revenue in the correct period.

Fapiao Accounting

Inaccurate Financial Reports

When an accountant performs bookkeeping on the basis of fapiao, the figures on the financial reports are often distorted for a certain period. Financial reports show when fapiao's were issued and not when the goods or services were delivered together with their associated costs as is required by accounting law in China.

Fapiaos are physical objects that need to be transferred between the business, its client, and the accountant. The physical fapiao must be printed by the supplier and sent to the client or the accountant directly. In case a fapiao is lost and needs to be reprinted, it's easy to see how an input fapiao can be delayed into a later accounting period.

Example

A business sells goods in March worth RMB 5,000 and receives the input fapiao worth RMB 4,000 in Jun. If the accountant performs bookkeeping on the basis of fapiaos, they will understate cost and over-state profit by RMB 4,000 in Q1.

When bookkeeping on the basis of fapiao, financial reports will inadvert-ently conceal the true profits earned by the business.

ACCRUAL BASED

	Mar	Jun
Revenue	5,000	0
Cost	4,000	0
Profit	1,000	0

FAPIAO BASED

	Mar	Jun
Revenue	5,000	0
Cost	0	4,000
Profit	5,000	-4,000

Fapiao Accounting

Tax Risks

An accountant who performs bookkeeping on the basis of fapiao will exclude any transactions for which a fapiao was never issued unless they are instructed to do otherwise by the business owner.

The business owner must pro-actively provide revenue figures for which a fapiao was never issued before they report to the tax authorities. Forgetting to do so can cause the accountant to under-report revenue which carries a financial penalty.

Penalties are subject to judgement of the tax authorities, but can range from:

- **0.5 - 5 times of tax shortage, in addition to the amount of tax shortage (based on tax amount and discretion of tax authority)**
- **0.05% interest rate per day on the tax overdue**
- **Imprisonment in serious cases**

Example

A business that sells goods worth 30,000 RMB of which 6,000 RMB are sold domestically without the need for fapiao and 4,000 RMB for export, will underreport its revenue by 10,000 RMB- also under reporting their VAT and CIT.

	FAPIAO BASED	GAAP BASED
Revenue	**20,000**	**30,000**
Revenue with Fapiao	20,000	20,000
Revenue without Fapiao		6000
Revenue for Export		4000
Cost	25,000	25,000
Profit	-5000	5000

Fapiao Accounting

Cash Flow Problems

In China, VAT payments make up anywhere from 0% to 13% of revenue, depending on how much input VAT can be deducted and the combination of goods and services offered by the company. When cash balances are low, making VAT payments earlier than is required can create significant cash shortage for the business.

Clients in China will always request a fapiao as early as possible as this helps them offset and decrease their own VAT payable. If when a fapiao should be issued is not clear, then it's easy to give in to clients demands and issue a fapiao upon request which can lead to cash flow problems for many small to medium-sized businesses.

Overpaying on your taxes

Not tracking which fapiaos have been issued can easily result in duplicate fapiaos. Even if your client only records one, issuing a fapiao twice results in double the tax liability!

Paying VAT early

Tax policy in China allows for VAT to be recognized at a later period for sales on credit and for pre-payments of goods. Businesses need to familiarize themselves with these laws in order to avoid paying VAT early.

Overpaying CIT

If a business is profitable, recording revenue without the associated costs will incur 25% CIT payable on that revenue. This tax paid needs to be claimed back in the form or future tax reductions or a refund. Tax refunds can be difficult procedures in many cases and should be avoided if at all possible.

Why Fapiao Accounting is Bad for Your Business
https://www.aepochadvisors.com/why-fapiao-accounting-is-bad-for-your-business/

Why Are the "Basic" Compliance Services so Expensive?

Service providers would like you to believe that higher service fees are indicative of a higher quality of service. However, the high prices charged by many service providers is more often indicative of inefficient practices and other overheads which provide little to no additional value for the client beyond meeting their statutory requirements. This is especially true when speaking about compliance services, which is increasingly being automated through the use of cloud-based software and Robotic Process Automation (RPA).

Inefficiency

Conventional accounting systems still widely use **manually intensive methods** of bookkeeping that involve many repetitive data handling tasks; such as manually entering data into an accounting system, extracting information from physical fapiaos, transferring data from one system to another. Accountants that have adopted the use of **cloud accounting software** and other automation tools can effectively reduce the time spent generating the necessary financial reports for a client by at least 50% while simultaneously increasing the accuracy and reducing the risk of human error.

Reluctance to change

To the surprise of many foreign business owners, the conventional accountant does not perform bookkeeping on the basis of accrual in China. This would require accountants to have visibility of your day-to-day operations to understand the nature of each transaction. Achieving this level of visibility would simply be too time-consuming and costly for the accountant using conventional accounting methods.

Language

English speaking support is an important requirement for many foreign businesses in China. However, the higher cost of qualified English-speaking staff is compounded by the inefficiency of accounting methods used.

"Foreign businesses are often subject to the same risks resulting from poor quality bookkeeping as their Chinese competitors paying significantly lower service fees."

Firm 1:

- Conventional Accounting systems
- Excel & manual data handling
- Email correspondence
- Low quality compliance service
- Purely fapiao accounting

Service Fee: **RMB 500 / month**

Firm 2:

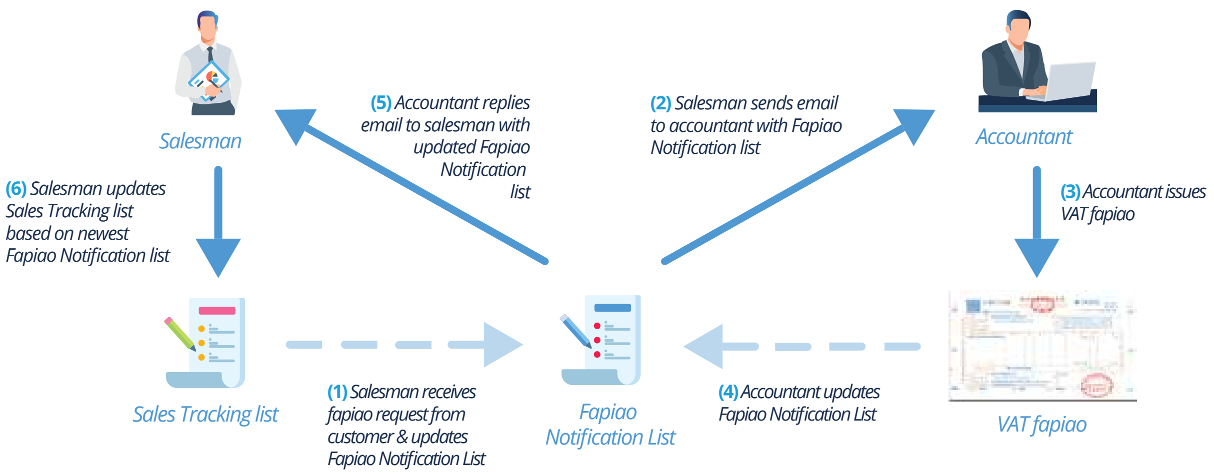
- Conventional Accounting systems
- Excel & Manual data handling
- Email correspondence
- Low quality compliance services
- Fapiao & Accrual accounting
- Basic English Speaking Staff

Service Fee: **RMB 5,000 / month**

CASE STUDY 1: Information Isolation

How you collaborate with your external accountant is a significant factor in both the price they charge you for their services and also the quality of those services. External accountants are often isolated from your communications unless specifically included in a courtesy copy of an email (Cc.) or informed directly about what's going on in your business. This kind of collaboration is very **inefficient** for both your employees and the service provider but also leads to many mistakes being made in your bookkeeping.

In July 2018, a trading company discovered that their tax filing system had been locked by the tax authorities. Upon contacting the tax officer, they discovered the amount of fapiao issued exceeded their reported revenue by RMB 190,000 for the month of June. They suspected that the business underpaid its VAT or was possibly issuing illegitimate fapiao (虚开发票) to their clients. During the period for which the tax filing and fapiao system was locked, the trading company was unable to collect RMB 8 million in revenue until they were again able to issue fapiao to their clients, significantly impacting their cash flow.

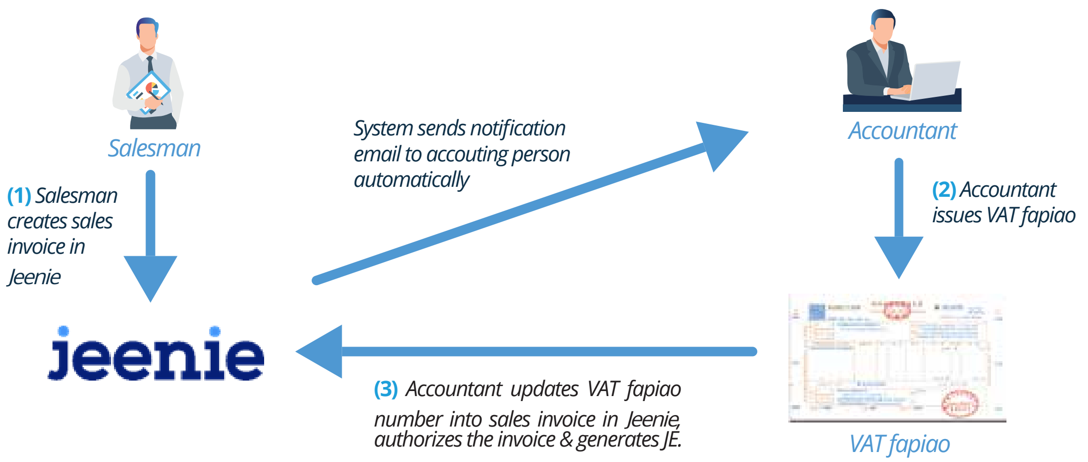


Problem:

The communication between the external accountant and the sales staff was based on spreadsheets and email correspondence. Over time, simple human error lead to the duplicate issuing of several fapiaos. Neither the accountant nor the sales regularly reconciled the amount of fapiaos issued with the revenue figures reported on the financial reports, allowing the accountant to issue duplicate fapiaos.

Solution:

Human error can be minimized with the help of software automation and reducing the amount of repetitive data handling by the accountant. The following process was later implemented to manage and reconcile fapiaos with sales records through cloud-based software to solve the problem of information isolation.



Part 2/ What Hassles are Brought by a Chinese Specific Business Environment?

Doing business in China is going to require you to navigate new and unfamiliar challenges. It is common to make mistakes and waste resources while the business owner is becoming familiar with the Chinese business environment. Some will even acknowledge they are still learning after more than a decade of doing business in China. It's important to be aware of the nuances of operating a business in China and a possess a willingness to forego what might be common sense back home.

Your success will likely depend on how well you are able to address the many challenges you will face in day-to-day operations. Most challenges will require you to examine the problem from three areas: Process, People & Technology.

Process

Structuring your day-to-day operations, the same way you would in a foreign country is unlikely to succeed. Firstly, your daily operations must account for the role Fapiao play in the business operations. To maintain a healthy cash position to run your business, it is important to know the different types of fapiao and learn how to manage each one properly. Secondly, finance should be involved in the business procedures for multiple reasons; e.g. budgeting not only to control the business cost but also for tax implications. You also need to make sure internal control policies adequately protect your business and are followed correctly within the organization. Chinese compliance requirements are inherently different making it easy for foreign businesses to make costly mistakes.

People

Doing business in China will inevitably require you to build relationships with clients, staff and business partners. Without extensive experience in China, it will be very difficult to predict the behavior of these people and ultimately make it difficult to build trusting relationships. However, knowing the common habits and behaviors that are most likely to negatively impact your business helps you get off on the right foot.

Technology

The ERP systems that enable you to run your business effectively back home may have varying degrees of success in China. You should ensure that software you choose for you Chinese business meets all the data collection and compliance requirement, can be efficiently adopted by your staff and you can receive the necessary support in China if required.

Process

How well does your business process work in China?

Your daily business operations have an underlying impact on your accounting and tax liability. Understanding the impact that daily operating decisions have on your bookkeeping and tax liability can help avoid the common mistakes that hurt a business's cash flow and increase its tax risks. How well and experienced you are in dealing with the common hassles of doing business in China will reflect on the health of your business and your take-home profit.

It helps to have a structured process for handling daily operations including;

- Fapiaos and sales/purchase contracts
- Data Management
- Day-to-day compliance

SMEs often do not realize that outsourcing statutory reporting and tax filings do not fulfill the full extent of their compliance requirements. Businesses are required to provide explanations to justify their activities, in which case they will be required to hand over additional supporting documentation and evidence to the tax authorities. This often requires the business to ensure that its procedures are correctly carried out and are producing the necessary documentation and records. A structured operating plan not only provides complete coverage of compliance requirements but also improves efficiency and profitability.

If unfamiliar with the Chinese business environment, this can be a real challenge. Accountants and financial professionals are the most reliable source of help when structuring a compliance plan that suits your day-to-day operations. Make sure that this person understands your business and has the visibility of your activity to make valuable suggestions about how to manage your business process.

CASE STUDY 2: Cash Flow & Tax Risks

In China, Fapiaos play an important role in the business process. They are often mistakenly interpreted as VAT invoices by foreign business managers which leads them to issue Fapiaos upon the request of the client. It's important to be informed about when fapiaos should be issued to avoid cash flow problems resulting from paying VAT earlier than is required.

Tip

Whenever the delivery of goods/services and payment for those goods/services **does not** occur in the same period (one calendar month), preferential tax treatment policies allow the business to delay recognizing their VAT liability. In order for you to effectively delay your VAT liability, the fapiao issuance terms must be included very careful in your contract. Speak to a financial advisor to help interpret the preferential tax law into your contracts.

In order to secure a sales contract, you extend a line of credit to your client allowing them to make full or partial payment within 30 days of delivery of goods or service. You then deliver fapiao together with your goods or service, as you normally do. Doing so would result in paying a 13% (goods) or 6% (service) VAT earlier than is required on top of the cost of the goods you just sold your client, hurting the business' cash flow.

- Payment within X number of days of issuing fapiao
- Fapiao will be issued within X days of shipment of goods

- Fapiao will be issued within X days of payment

China allows for the preferential tax treatment of the sale of goods or service on credit, allowing VAT liability to be recognized **upon the payment of those goods or services**. In order to take advantage of this preferential tax treatment, the business must include in their sales contract's specific terms regarding the exchange of the following three flows and make sure the arrangement/sequence of flows benefits the business' cash flow and tax liability;

1. **Fapiao flow – fapiao issuance date**
2. **Funds flow – payment date**
3. **Goods or Service flow – good or service delivery date**

When everything is on the negotiating table, it's important to know how specific contract terms impact your businesses cash flow in order to negotiate favorable tax terms for your business. When finalizing sales contracts with your clients, make sure to involve your financial controller or shared CFO to advise on the tax implications the three flows will have on your business.

CASE STUDY 3: Business Data Management

Compliance issues can go unnoticed when business owners and employees are consumed by the daily process of things. We fall into habits and cease to question our daily routines. What expatriate managers might be accustomed to doing in other countries – and is compliant in those countries – may not satisfy Chinese compliance requirements. It's therefore important to view daily procedures critically and ensure that your business is complying with the full scope of the requirements.

Tip

Ensuring that your business is compliant starts with your day to day operations. This includes collecting all the necessary data for your business to make use of all the tax savings available to businesses in China. Consult a financial advisor to understand what the requirements and the tools available to you to run your business in China efficiently.

During a periodic stock take, a food and beverage trading company in China noticed that there was significant inventory lost due to expiration or other reasons and decided to deduct the lost inventory from their revenue. To calculate the deduction, the external accountant used the following formula to report the expired inventory;

INVENTORY REDUCTION - INVENTORY SOLD = INVENTORY LOSS

Calculations without detailed records of inventory such as this are highly problematic and non-compliant accounting practice. The following year, the company received a notice from the tax bureau requiring the company to pay additional corporate income taxes because the supporting documents failed to justify the inventory loss, which significantly affected the cash flow and the profitability of the company.

Chinese Tax Law requires that deducting lost inventory from revenue should be supported by fundamental information to those write-offs including;

Breakdown of the lost inventory, including;
- **arrival date,**
- **manufacture date,**
- **expiration date,**
- **actual cost of goods**

Internal Approval documentation

External Verification Certificate per requests of the tax regulations

The external accountant deducted the expired inventory to the best of their ability without being involved in the warehouse management, resulting in the tax penalty. Unfortunately, this is not the full extent of the problems produced by poor financial control for inventory but also; inefficient inventory management, defective internal control, distorted financial statements, and incorrect performance assessment.

How to Handle an Inventory Write-Off & Product Wastage
https://www.aepochadvisors.com/inventory-write-off-china/

CASE STUDY 4: Budget Controls

China controls the amount that businesses can deduct within certain categories of business expenditure. Exceeding these limits will incur 25% corporate income tax at the end of the tax year during the annual tax return. This catches many businesses by surprise and can result in a large tax bill eating away at any profits the businesses might have earned.

Tip

Under Chinese tax regulations, different expense items have a deductible limit calculated on annual gross revenues or annual gross salary (see table below). To take full advantage of these deductions without exceeding the limit, businesses should keep track of their revenues and check whether the expense accounts are within the relative deductible limits **on a monthly basis,** instead of just before the annual CIT clearance at which point it becomes too late to adjust them. This requires a finance professional to plan in advance on how to best allocate expenses, actively monitor your expense accounts and execute routine control to help you plan future expenses and promptly alert you when you're about to exceed these limits.

Deduction Item	Deduction Base	Deduction % Limit	Transferable to next accounting period
Employee Benefits	Anual Gross Salary	14%	Non-transferable
Employee Union Fund	Anual Gross Salary	2%	Non-transferable
Employee Education	Anual Gross Salary	8%	Transferable
Business Hospitality (Entertainment etc)	Total Hospitality Expense Amount Limit: Annual Gross Revenue	60% 0.5%	Non-transferable Non-transferable
Marketing & Advertising	Annual Gross Revenue	15%	Transferable
Marketing & Advertising: Cosmetics, Pharmaceutical & Beverage Company	Annual Gross Revenue	30%	Transferable
Marketing & Advertising: Tobacco Company	Non-Deductible	0%	Non-transferable
Public Welfare Donation	Deductible: Donate to Public Welfare Social Organizations Limit: Annual Gross Profit	15%	Transferable for 3yrs

Company A has an annual gross revenue totaling RMB 100M. Last year, they recorded hospitality expenses of RMB 4.5M. Chinese tax law limits hospitality deductions to 0.5% of Annual Gross Revenue or 60% the amount (whichever is lower). Any amounts beyond these limits will become non-deductible and incur 25% corporate income tax for the company.

Therefore: (4.5M - 100M x 0.5%) x 25% = 4M x 25% = 1M RMB extra CIT payable!

Hospitality expenses are best reserved for sales activity and client hospitality. Unfortunately, external accountants, especially those who do **Fapiao Accounting**, often book meals fapiao as hospitality expenses disregarding the actual business purpose of the expenses. For example, those meals given to employees during overtimeare considered employee benefits as well as certain travel expenses are often mistakenly booked as hospitality expenses. This often leads to the business quickly exceeding their deductible limit. External accountants rarely care about the implications of exceeding such limits leading a large tax adjustment at year end and the business paying an additional 25% of Corporate Income Tax.

Expense Claims in China - Make Sure They're Tax Deductible
https://www.aepochadvisors.com/expense-claim-deductions/

People

Every industry and country has its own unique business norms which one must familiarize themselves with. Factors such as cultural differences, the difference in values, and established patterns of behavior are the most prominent reasons why foreign business owners have difficulties in China. When working with people, there are certain behaviors and practices you should be cautious of in order to save yourself some unnecessary hardship.

I. Business Partners

It's very common for local small businesses to maintain **two sets of financial books**; one for tax filing purposes known as the "external books"and another for management purposes known as the "internal books". This allows the business to conceal its revenue and avoid paying taxes or other liabilities to small shareholders.

Revenue Manipulation

Business owners or managers may attempt to reduce and conceal revenue as much as possible to avoid paying Value Added Tax and Corporate Income Tax. They request their client to pay by cash or pay to their private bank accounts, instead of the company bank accountin order to avoid having to report the business revenue.

Profit Manipulation

Purchasing fake input fapiaos in order to overstate the expense and understate the profit of the business, thus avoiding 25% corporate income tax.

Cash Transactions

Revenue which does not get recorded on the "external books" is used to pay suppliers and often used to pay employees, thus avoiding individual income tax (IIT) and statutory social security costs. Local suppliers encourage this behavior and offer discounts for foregoing a fapiao, as this allows them to conceal their own revenue and expenses.

These practices are not only illegal but also result in numerous negative outcomes for the business including:

- Wrongful evaluation of business performance conducted by business partners
- Heavy fines from tax authority if audited
- Downgraded credit level or even been blacklisted
- Revocation of business license in serious cases

CASE STUDY 5: Two Sets of Financial Books

Accountants are usually the ones who are called in reaction to unusual business activity by a local business partner or manager. In the case of a foreign investor, the activities of their Chinese business partner implicated them in tax evasion. Read the full case study below;

Risks of Working with your Clients & Vendors

Before signing any contract or making any legal commitments with a vendor or client, it is in your best interest to do some research regarding their legal and registration status in China. Failure to do so might land your business in trouble. Here are some of our suggestions:

Vendor's Legal Registration Status

Knowing your vendor's local registration status allows you to carry out more accurate price comparison taking into consideration that tax rates difference between small scale VAT payers (3%) and the normal VAT payers (6-13%). You must also know whether the vendor can provide the **VAT special fapiao**, which is deductible from your output VAT payable. A larger input VAT deduction (6-13%) means a lower tax cost for your business.

Credit Rating

Be sure to look up the vendors or clients credit rating from government official websites before entering into any business agreements with them. You will be able to see if they have been involved in any fraudulent activity in the past (such as issuing illegitimate fapiaos '虚开发票', or tax evasion) and make better decisions on the terms of your business arrangement.

Below are some official websites for your reference;

http://wenshu.court.gov.cn China Judicial Ruling Database

http://www.cninfo.com.cn/new/index Online Public Disclosure Database

http://www.gsxt.gov.cn/index.html National Enterprise Credit Information Publicity System

http://www.yibannashuiren.com General VAT taxpayer Inquiry

http://www.chinatax.gov.cn State Administration of Taxation

http://www.mof.gov.cn/index.htm Ministry of Finance

Risks of Managing your Chinese Employees

In China, it's especially important to protect the longevity of key intangible assets and prevent past employees from being able to engage in direct competition with the business once their tenure is over.

Contract Termination

When deciding to terminate the employment contract, you must be careful with your approach. Exiting employees may report your business to the tax authority or administrative authorities for "non-compliance" issues **with or without evidence** if they feel unhappy or unjust about the circumstances of the termination. This may trigger unwelcomed attention from the tax authorities and possibly a tax audit. Reducing this risk often requires you have professional staff handling employee relationships, and how to terminate contracts and implementing the right policies for your human resources.

Confidentiality and Non-competition

In addition to employment contracts, businesses must protect key assets to avoid labor disputes and damages/loss to the company. These can be separate confidentiality agreements or non-competition agreements only for employees who have access to important business information such as client databases and specific key knowledge.

Technology

Business Software & ERP Systems

Many foreign managers are obsessed with using an ERP system to precisely control their business and assume that the same ERP system that run successfully in their home country will deliver the same benefits for their China operation. In reality, this proves to be gravely incorrect and could even adversely affect working efficiency and increase operational costs if incorrectly carried out.

To help small businesses avoid falling into the same traps, we have highlighted three things to note regarding the use ERP systems in China and offer practical advice to help you adapt to China and achieve your goals.

Too much, Too quickly

In China, striving for perfection can cripple a company. The key to winning in this fast-changing market is embracing pragmatisms. Unlike in Western markets, that have long-time established rules and relatively predictable supply chain behaviors, maintaining competitiveness in today's Chinese marketplace businesses must be serving clients with incredible speed, extreme flexibility, in-depth local knowledge, and extensive connections.

Believing in having a perfect all-in-one ERP system that will solve all your business problems right away is shortsighted. You will encounter new problems every day, inside your company and out in the market. Instead of deploying a system complete with all the features, you should focus on addressing the 20% most problematic areas pertinent to your business, so that 80% of the most impactful issues are under control.

Your employees are not welcoming of the ERP system

How useful your ERP system is to you is contingent on the employees who use it on a day-to-day basis. Many employees in China rarely take your ERP system as seriously as you do and may not be ready for such transformations of their duties.

Many of your staff may lack the motivation, adequate skills, and professional attitude to use the system as instructed because often they do not understand the impact ERP tools have on their work performance and do not see the benefit it brings to the business. Naturally, they lose interests in understanding how the new systems and tools could help the company and their team perform better as a whole.

Therefore, a system that is too complex for them to follow from the beginning does not last long. Instead, begin with the overall objectives you want to achieve with the system, then develop a step-by-step approach when putting them into actions. Ensure proper implementation and training at each step before further developing your ERP system.

It is advised to designate one employee to take charge of your ERP system that supports various functions of the entire organization. The person assigned to this role should stand at a management level and take responsibilities to continually improve and optimize the system. This will ensure the system remains functioning coherently even when significant changes happen to the business.

Software as a Service

Traditional all-in-one business software, such as Kingdee, Yongyou, SAP or Microsoft Dynamics still dominate the ERP market in China. These systems are comprehensive and monolithic, rendering them impractical for the situation of running and managing a small business.

Software as a Service (SaaS) offers a light-weighted and lean solution for many small businesses and come at a fraction of the cost of incumbent ERP systems for both the licenses and the implementation. There are plenty of SaaS applications supporting different business functions out there to look at. For small businesses, they are more affordable, accessible and user-friendly.

Secondly, don't expect traditional ERP consultants to fully grasp the core of your businesses while they work for you, as they are software configuration experts but not professionals with financial and business expertise. If you aim to fundamentally enhance your company's internal control and management performance, get help from a professional business advisor (Shared CFO), who is knowledgeable in China practices. As SaaS applications are much simpler, your Shared CFO can help setup and implement such tools, where they make sure best practice and sound controlling procedures are realized into the systems.

"When changing business systems which employees work with, hesitation is normal. It is related to a loss of control and therefore a loss of competency. To overcome this, employee enabling should be a key focus of any implementation plan in China."

- Anne Babilon-Teubenbacher,
Senior Change Manager, CPC Consulting

Part 3/ Does Your Accounting Service Provider Add Value to Your Business?

A business with sound financial management will not only be more profitable but also easier to manage and better equipped to take on new challenges. The function of the financial departments goes beyond just accounting and bookkeeping to include ensuring the integrity of the business's functions internally and externally.

The mandate of a sound financial management function must include;
- Ensuring the day-to-day operations are compliant with relevant regulations
- Establishing internal control and managing operating risks
- Financial planning and analysis
- Tax strategy and planning

It's important that the financial function have the necessary visibility of business activity and get involved inside the day-to-day operations of the business in order for them to adequately perform their role. This enables the financial controller to prevent material losses before they occur. They will also provide more valuable management reports and help make important decisions that help the business achieve greater profitability.

However, small businesses normally choose to outsource the financial functions due to the cost of having a full-time dedicated finance professional. The case, however, is most conventional accountant normally only provide the basic bookkeeping and tax filing on the basis of fapiao or using uncorroborated data provided by the company. They never care about the company's profitability, cash flow status, cost saving or business efficiency.

Compliance

High quality compliance vs low level compliance

The standard accounting firm in China is only mandated to meet the statutory compliance requirement of a business, as opposed to helping increase the profitability of the business. They are encouraged to choose the simplest method of achieving their contractual obligations with little regards for the actual performance of the business. They are prone to creating additional tax risk, creating unreliable financial reports and stressing the cash flow of the business.

The actual accounting work often happens out of sight of the business. This makes it difficult for a business owner to judge the quality and reliability of the external accounting service provider until it results in material losses for the business.

Fapiao accounting

Fapiao accounting is one of the lowest quality methods of meeting a business's compliance requirements, carrying the greatest financial risks in the long run. Over time, the impact of low-quality compliance become more and more evident in the business's financial reports.

"Compliance is not just about meeting statutory requirements. It's also about ensuring the integrity of the business for its employees, shareholders and external stakeholders."

The benefits of high-quality compliance services go beyond avoiding fines and other financial penalties. High-quality compliance helps you:

- Ensure complete and accurate financial reports, fundamental to making conscious decisions about the direction of the business.

- Create systems and data that are clear and synchronized with the businesses requirement for documentation.

- Pursue best-practices and eliminate any redundant steps or potential risks from your operations.

- Building trust with your employees and shareholders, who will, in turn, create more opportunities for your business to grow.

CASE STUDY 6: Low Quality Compliance

This balance sheet below comes from a client that approached us in 2018. They were requested by the tax authority to submit the breakdown of the inventory at which time the business owner looked at the balance sheet and was shocked by several balance sheet items being far too large to reflect the reality of their business situation.

ASSETS	AMOUNT (in RMB)	LIABILITIES & EQUITY	AMOUNT (in RMB)
Fixed assets	150,123.87	Short term loans	900,000.00
Inventory (1)	**2,508,964.00**	Accounts payable	1,623,730.39
Accounts receivable	623,730.39	Tax payable	256,370.00
Other receivables (2)	**1,869,458.56**	**Received in advance (3)**	**3,869,458.56**
Cash	491,904.80	Accrued expenses	491,904.80
		Other payables (4)	**5,697,409.03**
		Share capital	200,000.00
		Retained earnings	-7,394,691.16
Total assets	**5,644,181.62**	**Total liabilities and equity**	**5,644,181.62**

The WFOE was set up in 2014 and for 4 years the accounting function was performed by a "Fapiao Accountant". Balance shown were as of Dec 31st, 2017. Average Annual Revenue is RMB 5M/year

The business owner then sought help from a professional financial advisor. The financial advisor then highlighted several high tax risk areas of the balance sheet for the following reason:

(1) Inventory: The balance represents 6 months of stock turnover, significantly higher than the industry average (1-2 months).

Cause: The accountant did not recognize revenue for sales without fapiao and therefore did not book the associated cost nor did they reduce inventory balance accordingly.

(2) Other receivables: The balance includes RMB 1.5 million funding to one of the local shareholders which has been outstanding for a few years and never received.

Cause: The accountant did not highlight and report the long outstanding receivable to the business owners.

(3) Received in advance: The balance includes RMB 3 million of revenue for which the VAT fapiaos were never issued.

Cause: The accountant did not recognize revenue for which a fapiao was not issued. Instead, they incorrectly booked the revenue on the balance sheet as "received in advance".

(4) Other payables: : The balance includes RMB 5 million of intercompany payables.

Cause: For funding the loss of the company, the company receives a total of 5 million RMB of funding from its overseas head office over the last four years, without registering it with the State Administration of Foreign Exchange (SAFE).

RESULT:

- Distorted and misleading financial reports (please refer to below details).

- High tax risks, including understated revenue, thus underreported VAT and CIT. Also, the long outstanding shareholder's loan would be treated as dividend and subject to IIT.

- Other risks such as legal risk, debt risk (e.g. the shareholder's loan pending in "other receivables") and foreign exchange risk (e.g. the overseas head office funding pending in "other payables").

The following adjustment demonstrates how misleading a balance sheet can be as a result of low-quality accounting services. The mistakes on the balance sheet have an equal impact on the Profit & Loss Statement **understating sales revenues by RMB 3 million and net profits by RMB 1 million!** Unfortunately, this is not an abnormal case. Low-quality accounting services creating material mistakes and mislead managers about the performance of the business, for which they will ultimately be accountable for.

ASSETS	Amount (in RMB)	Adjustment	Corrected Amount (in RMB)
Fixed assets	150,123.87		150,123.87
Inventory (1)	**2,508,964.00**	**-2,000,000.00**	508,964.00
Accounts receivable	623,730.39		623,730.39
Other receivables (2)	**1,869,458.56**	**-1,500,000.00**	**369,458.56**
Cash	491,904.80		491,904.80
Total Assets	**5,644,181.62**	**-3,500,000.00**	**2,144,181.62**

Liabilities & Equity	Amount (in RMB)	Adjustment	Corrected Amount (in RMB)
Short term loans	900,000.00		900,000.00
Accounts payable	1,623,730.39		**1,623,730.39**
Tax payable	256,370.00		256,370.00
Received in advanced (3)	**3,869,458.56**	**-3,000,000.00**	**869,458.56**
Accrued expenses	491,904.80		491,904.80
Other payable (4)	**5,697,409.03**	**-5,000,000.00**	697,409.03
Share capital	200,000.00		200,000.00
Retained earnings	-7,394,691.16	**4,500,000.00**	-2,894,691.16
Total Assets	**5,644,181.62**	**-3,500,000.00**	**2,144,181.62**

Financial Planning & Analysis

Being well versed on the details of your business' performance means you are better equipped to make informed decisions. Most business owners track key performance indicators for their key staff such as sales and marketing, but do they do so for their entire business?

Seeing how your business performance is trending helps you identify what is working and what's not.

Can you answer these questions about your business?

- How much working capital do I have to run my business?
- Should I be repaying my debt sooner or reinvest profits into my business?
- How are my current assets trending and what does this mean for my turnover?
- How liquid are my assets in case of emergency situations?
- What are gross profit margins and how scalable are they?
- What's the best way to finance my long-term goals?
- Could I recover from a disaster such as losing my largest client?
- Are my sales cyclical and how can I optimize my business for these cycles?

Tip

It's a good idea to track a few key ratios and figures which are important for your business and include them in monthly management reports.

There will come a time where your gut instinct on the health of your business is wrong or you find yourself unprepared to make an important decision. Understanding your business performance over time helps you accurately anticipate how your business performance is trending and helps you identify what is working and what isn't.

Your business data is only as valuable as the decisions you make with it. Therefore, key data about your business must be readily available to you when an opportunity presents itself. When you need a little bit more context about the health of your business to make an important decision, you might want to look at your own key performance indicators to help guide you in your decision making.

CASE STUDY 7: Misleading Financial Reports

A fast food restaurant chain has three business lines, sandwiches, pizzas and seafood lunch packs with a number of operations in several major cities in China. Each restaurant is performing differently; unfortunately, due to the very basic financial reports being produced by their external accountants, it is difficult for the boss to have an idea of how well each respective restaurant is operating, which city or line of business is more profitable causing the business owner a great deal of frustration.

Below is the basic financial report per business line which was manually produced by the external accountant using the excel spreadsheet:

Currency: in 000' RMB	Sandwiches	Pizza	Seafood Lunch Pack	Total
Revenue	1,800	1,700	1,000	4,500
Cost of food ingredients	1,050	988	584	2,622
Overheads:				
Rent	144	136	80	360
Utilities	24	23	13	60
Salaries	72	68	40	180
Total Costs:	1,290	1,215	717	3,222
Gross Margin	510	485	283	1,278
Gross Margin %	28.33%	28.55%	28.40%	28.40%

The issues here are as follows:

1. The cost of food ingredients was calculated by closing balance minus the opening balance, ignoring the losses from the expired foods and other possible scenarios. There is no accurate cost record of the food ingredients per category or per item so it's not possible for the accountant to come up with accurate cost calculations.

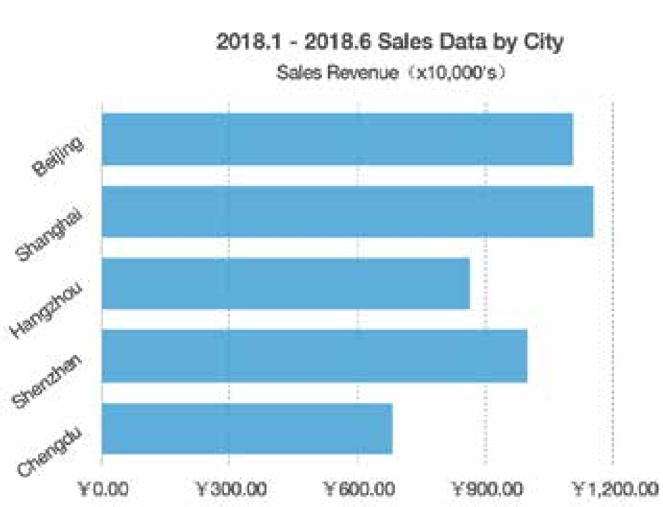
2. The bookkeeper is manually allocating overhead expenses according to the percentage of the revenue, which makes the margins of the different lines become very similar.

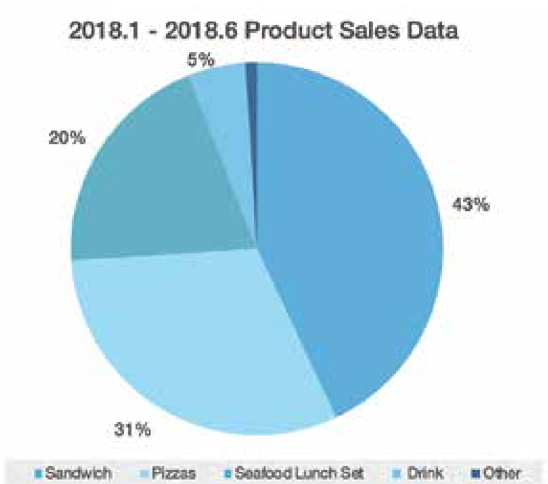
Several months after switching to a cloud inventory management system, the business and its management finally have an accurate overview of inventory records, allowing them to produce an accurate profit and loss analysis per business line. They then noticed that the first report was misleading and that one of the business lines "Seafood Lunch Pack" was actually operating in a loss. This realization led to the decision to introduce a new food choice to the menu and to discontinue the non profitable business line .

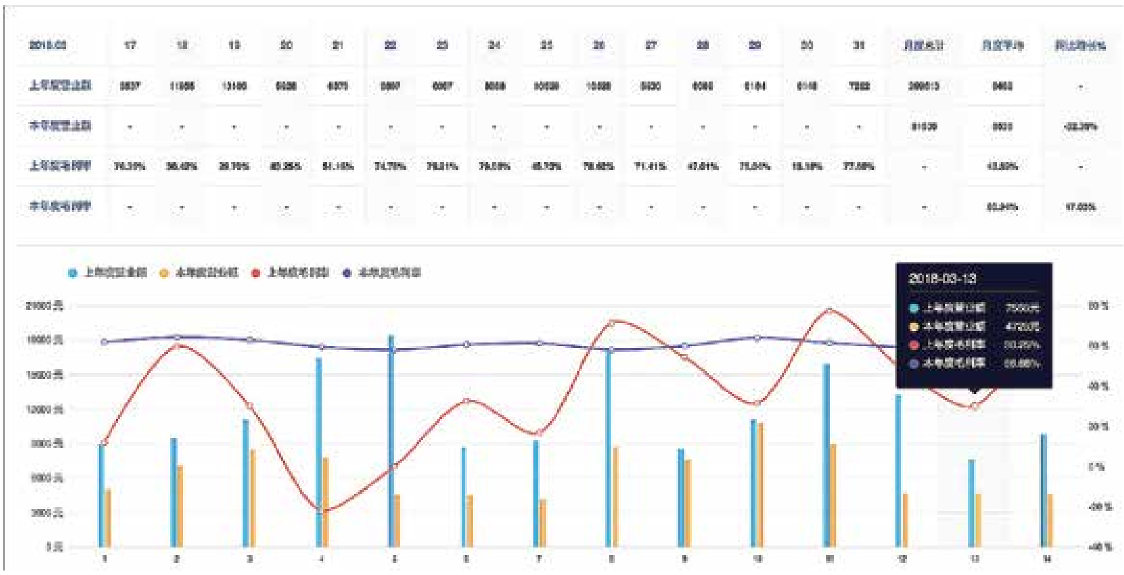
Currency: in 000' RMB	Sandwiches	Pizza	Seafood Lunch Pack	Total
Revenue	1,800	1,700	1,000	4,500
Cost of food ingredients	758	884	980	2,622
Overheads:				
Rent	144	136	80	360
Utilities	24	23	13	60
Salaries	72	68	40	180
Total Costs:	998	1,111	1,113	3,222
Gross Margin	802	59	-113	1,278
Gross Margin %	44.56%	34.68%	-11.33%	28.40%

Furthermore, the business owner now has a timely, multi-dimensional financial and business reports available to them at a moment's notice. These multi-dimensional financial reports support the business owner to analyze the sales and profitability per city, per business line, and even per restaurant.

More in-depth business analysis such as inventory movement, food expiration analysis, vendor's AP aging, member clients' visit behavior analysis, online sales trend etc. are now available to help the business owner maximize their profitability.







Internal Control

In order to ensure the reliability of the business process and achieve business goals, companies put in place internal control procedures to guide employees and management on daily operations. These guidelines add additional control mechanisms to the business process that helps avoid material loss of assets/resources and ensure the accuracy and reliability of financial reporting.

There are 5 key elements to design your internal control guidelines:

- **Approval:** To prevent fraudulent transactions, operations must be approved by designated persons inside the business.
- **Segregation of Duties:** Employees and management should have a clear separation of the four operational steps, namely; authorization, processing, recording, and review.
- **Documentation:** Transactions must be supported by proper documentation. This will also help track the transactionsin their entirety.
- **Reconciliation:** To ensure the accuracy of the records, transactions must be matched with the documentation involved.
- **Supervision:** One or more individual should be appointed to ensure that internal control procedures are functioning as intended.

Which are the most common internal control problem in China?

Theft (Money or Assets)

In China, theft of money or assets is a legitimate risk that needs to be controlled from. It is not unlikely that employees in **sales, purchasing, and cashier** roles within your business will at some point be offered personal incentives to influence their behavior in one way or another. Along with the conventional definition of theft, this can also include employees selling the same/similar products as your business to your clients or acting in a way that benefits the employee at the expense of the business

"Foreign businesses coming to China need to accept the fact that managing a business in China will be different. They need to pay close attention to internal control, especially for their sales and purchasing departments, who are often offered personal incentives in order to influence the business."

- Veli Ruismäki,
China Sage Consultants

Manipulation of Performance Metrics

- A salesperson who can directly access the sales system can move the sales recognition date between periods in order to maximize their KPI bonus.
- A local manager may manipulate the EBIDTA margin by controlling the contract signing date and invoicing date to maximize his/her performance bonus.
- A salesperson that can directly access the inventory system can move the sales recognition date to a later stage and move the cash received from clients to his/her personal pocket by reporting a fake stock report.

CASE STUDY 8: Report Manipulation

International companies with branches in China must circumvent local managers ability to provide false reports which would otherwise reveal unflattering details about their performance or possibly fraudulent behavior. To do this, the headquarters management must **independently** verify the local manager's reports, monitor the local manager's behavior and establish more than one line of reporting within the regional office.

Company X is a medical device supplier registered as a Chinese WFOE to sell into the Chinese market. Their sales contract offers a 1-year warranty period which gives customers the ability to request substitutions for any malfunctioning part free of charge.

Sales manager were responsible for receiving customer complaint and filling in warranty claim applications on behalf of the client. The application was then approved by the local general manager and the order sent to the overseas mother company.

After 3 years of operations in China, company X does a stock-take and ultimately finds RMB 2.5 million of inventory losses. The mother company initiated an investigation and discover that the local general manager colluded with the sales manager to defraud the business by exploiting the warranty policy. The sales manager filled out fake applications on behalf of customers which were then approved by the local general manager in order to obtain additional spare parts. The additional spare parts were then sold on the market for which the revenue went to the sales employee and the general manager's personal accounts.

Where these problems came from:

- An absence of a periodic stock take; A periodic stock-take would have discovered the illegal system well before reaching RMB 2.5 million in lost assets. Furthermore, such periodic control would have discouraged the whole system.

- No software was in place that allowed remote inventory control; the mother company did not have the ability to autonomously check individual inventory items.

- No segregation of duties between sales and customer support. By combining these functions, the sales team was able to defraud the company.

- Weak approval procedure that allowed the local manager and sale team to collude; the absence of a **designated financial controller** tasked with reporting directly to the overseas headquarter allowed the collusion to occur.

Tax Planning

Tax planning allows businesses to improve cash flow and save money without making significant changes to their products or services. There are many business-friendly tax incentives to enable businesses to succeed. Unfortunately, these can be very complicated leading to businesses not to take advantage of them altogether or make costly mistakes with their taxes.

Most business owners simply want the assurance of knowing that their tax compliance is properly taken care of. This neglects the benefits of adequate tax planning on the cash flow of the business and their overall cost of doing business. While it can be difficult for foreign businesses to grasp the tax policies and benefits available to them, a professional financial advisor can help businesses to begin reaping these benefits in a short amount of time.

Tax planning can be viewed in two phases:

1. Business set up tax planning
2. Daily tax planning activities

"Tax is a source of great anxiety for a lot of our clients. Everybody wants to avoid a nasty adjustement at the year end tax filing"

Business Registration Tax Planning

An important decision needs to be made before the business even gets started which is how to register your legal entity in China. This depends on several factors such as how many investors are involved, what the expected turnover is, and even who and where your clients are. How you register your business is an important element of the overall tax paid by your business and how profits are remunerated to the business owners.

Selection of city/district

The decision regarding the selection of the city/district should be taken based on two factors: the main one being different district have different preferential tax policies, thus, choosing the most suitable district for your business should be taken into consideration in order to receive preferential tax treatment and a favorable regulatory environment. Secondly, you must also consider the viability of the area in terms of cost metrics, work force, supply chain and logistics in the area.

Entity type

Choosing between limited or unlimited liability entity will not just determine your responsibility towards debts and liabilities but it will also impact the tax regulations you are subject to. Sole proprietorships and partnerships (unlimited liabilities) enterprises are exempt from Corporate Income Tax but will pay Individual Income Tax. The total tax burdens are much lower than the limited liability company due to their ability to apply a "deemed profit rate" for IIT calculations and their exemption from Corporate Income Tax. Unlimited liability enterprises can be created by one or more individuals, in which case all the partners are responsible for all debts of the business. Owners of limited liability companies are only liable for the debts and obligations of the organization to the extent of their capital contribution and the company is subject to Corporate Income Tax.

Tax payer status

During the business setup, you can apply for two types of taxpayer for VAT purpose: general taxpayer and small-scale taxpayer. In short, small scale taxpayers must have revenue equivalent or below RMB 5 million and can enjoy a reduced tax rate (3%) at the expense of not being able to deduct input VAT against output VAT. General tax payers are able to deduct their input VAT but apply an output VAT rate of 6% (services) to 13% (goods). Therefore, this choice should be made considering your sales forecast and how much the input VAT Special Fapiao that you expected to receive.

Other tax implications to consider;

- Whether to apply the "Actual profit", "Cost plus"or, the "Deemed profit" base during tax registration in order to minimize the companies tax liability.
- Group companies must decide whether to register a legal branch or subsidiary as an independent filing (独立核算) or non-independent filing (非独立核算) entity. The corporate income tax filing and calculation are also different for the two filing types.
- Whether it is possible to apply preferential tax policies for Micro- and Small-sized Enterprise (MSE).
- Whether it is possible to apply preferential tax policies for a "high-tech" company.

CASE STUDY 9: Registering a Legal Entity in China

Mr. Tong and Mr. Chan decided to register a legal entity together with expected revenues and profit totaling RMB 4.5 million and RMB 1 million respectively.

Given that their forecasted revenue was below RMB 5 million, they decided to apply the small-scale taxpayer policy allowing them to pay 3% VAT. Now, they have to choose between founding a limited liability company or a partnership enterprise (unlimited liability).

The tax implications of a limited liability company are as follows:

Limited Liability Company	Amount (in RMB)	Tax Rate
Revenues	4,500,000.00	
VAT	135,000.00	3%
Taxable income for CIT	1,000,000.00	
CIT	50,000.00	5%*
Profit after CIT	950,000.00	
IIT for Dividend	190,000.00	20%
Total tax paid (VAT + CIT + IIT)	375,000.00	**8.33%**

Net profit after taxation: RMB 760,000 (= 950,000 - 190,000)

*Businesses with taxable income below RMB 1 million apply a 5% CIT rate compared to the standard 25% CIT rate.

The limited liability company pays an effective tax rate of **8.33%** while a partnership enterprise pays only **3.93%!**

The tax implications of a partnership enterprise are as follows:

Sole proprietorship or partnership enterprise**	Amount (in RMB)	Tax Rate
Revenues	4,500,000.00	
VAT (20% refund from local government)	108,000.00	2.4%
Taxable income for CIT (Deemed profit rate applies 10%)***	450,000.00	10%
CIT (no CIT for unlimited liability companies)	-	0%
Profit after CIT	450,000.00	
IIT for Dividend****	69,000.00	6.9%
Total tax paid (VAT + IIT)	177,000.00	**3.93%**

Net profit after taxation: RMB 931,000 (= 1,000,000 - 69,000)

** Application of sole proprietorship or partnership enterprise subject to local regulation or restrictions for the foreign business owners.

***The deemed profit rate is between 10% and 40% (based on the business nature) determined by the Chinese tax authorities. The deemed profits apply for those taxpayers who do not keep accurate and complete books.

****The IIT rate is based on the following table

China Individual Income Tax Rate Table

- applicable for individual business

Level	Taxable Income (Annual)		Tax Rate	Quick Deduction Amount
1	-	30,000.00	5%	-
2	30,000.00	90,000.00	10%	1,500.00
3	90,000.00	300,000.00	20%	10,500.00
4	300,000.00	500,000.00	30%	40,500.00
5	500,000.00		35%	65,500.00

Daily Tax Planning Activities

Application of tax preferential policies and lowest tax rate

Different industries, business within a specific scale/scope, even certain transactions, can enjoy preferential tax policies. These policies can be hard to understand and more difficult to apply without the help of an experience financial processional with in-depth knowledge of applicable policies relevant to your business. An external accountant who provided the basic compliance services are unlikely to possess the required knowledge and skills to be able to provide access to these preferential tax policies.

Defer the timing of tax liabilities

SMEs often suffer from irregular cash flow, placing constraints on their business. Planning and delaying your tax payments allows businesses to enjoy more predictable tax payments and more cash available to run their business. Many preferential tax policies exist which allow businesses to delay VAT and CIT payments while remaining compliant with applicable regulations.

Contract review and negotiation

All transactions have tax implications. Sales, purchase, and employment contracts all contain important details which impact the tax liability for the business and the timing of when said liability shall arise. Businesses can request preferential tax terms in their contracts by default by involving a financial advisor to review and help structure the terms of the contract.

Budget control for deductible expenses

For certain categories of business expenditures, Chinese tax authorities established percentage limits that indicate the maximum amount of allowed business expenses. Daily planning of these figures is fundamental to take full advantage of the allowable expenses and avoid paying additional taxes.

Intercompany transaction

Companies with subsidiaries in China need to pay special attention to tax planning to avoid double taxation or Transfer Pricing (TP) investigation from the tax authorities in the countries which they operate. The most efficient approach will vary case by case on the applicable tax rates (VAT and CIT), profitability, TP filing regulations, business/transaction details of the overseas head office and it's China subsidiary. A finance expert will consider the regulations of the countries involved and advise how to arrange contracts so that price and contractual terms minimize the tax liability and the risk of a tax audit in both countries.

Handle the coordination and relationships with the local authorities

Every business has to communicate with the local authorities from time to time. In large companies, the finance director will take on this responsibility as he/she is the one who best understands the business, the financial data and its compliance status. However, within SMEs, this role is often left unfilled. Maintaining a continuous good relationship with local authorities can often help satisfy requests for additional information pre-audit and possibly avoid or minimize the tax penalty in case of a tax audit.

CASE STUDY 10: Year End Tax Adjustments

The table below shows a real tax adjustment which an external accountant processed during an annual Corporate Income Tax return. For compliance purpose, the accountant conducted a tax adjustment for all the expense items which exceeded the deductible limit and increased the taxable income accordingly, thus incurring an additional 25% corporate income tax on the adjusted amount.

In terms of compliance, the accountant fulfilled his/her contractual obligation by performing the tax adjustments once per year during the annual CIT return. However, this ended up costing the business a large sum of money.

Deduction item	Actual Costs/ Expenses in P&L	CIT Allowable Deductions	Taxable Income Adjustment
Employee Benefits	180,000	280,000	
Employee Union Fund	50,000	40,000	10,000
Employee Education	150,000	160,000	
Business Hospitality (Entertainment etc)	150,000	50,000	530,000
Advertising & Promotion	580,000	1,500,000	400,000
Expenses without qualified Fapiao	1,900,000	-	360,000
Expenses paid for staff's personal expenses (non-business related)	150,000	-	150,000
Inventory Loss without proper and complete supporting documentation	680,000	-	680,000
Tax Penalty and Interest	54,000	-	54,000
Management fee paid to Head office without "Service Contract" at "Arm Length Principle" (or without paying Withholding Tax)	800,000	-	800,000
	Total Taxable Income Adjustment:		2,984,000
Tax payable adjustment = 2,984,000 x 25% = 746,000	Additional Tax Payable (increase)		746,000

The table above demonstrates the impact that **daily tax planning** activities can have on the tax liabilities of a business. An external accountant will ensure your compliance, without considering the additional tax cost. Many of the adjustments in the P&L statement above can be avoided with the help of a finance expert **working INSIDE the business**, understand the business procedures to manage the day to day expenses control, thus avoiding the additional tax payable.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Part 4/ What Valuable Financial Services are Affordable for SMEs?

A shared CFO is your own part-time senior financial professional which costs you roughly the same as a single full-time junior financial employee. They bring a minimum of 10 years' experience working inside big multinational companies and provide the valuable financial services to help you succeed in China.

The average cost to an employer for someone in this position is around RMB 0.8–1.5 million per year, making a full-time CFO something only accessible to large corporations. New technologies are opening up new possibilities for CFO's to provide their services independently and shared amongst multiple SME clients as opposed to just a single large corporation. The cost to the business is roughly 25% to 30% that of the full-time CFO.

What is a Shared CFO exactly?

- A senior financial professional who used **Cloud-based Accounting and SaaS applications** to perform the role of CFO and provide high-end financial services more efficiently.

- Someone who intelligently uses technology to achieve visibility of the business process to remove any communication inefficiency and overcome the need to be on location at all times.

- Works with multiple SME clients, usually within a similar business scope or environment, as opposed to just a single large corporate client.

- Works independently without large corporate overhead allowing them to provide valuable financial services for a fraction of the price.

- Your personal senior financial professional to work as your sounding board, discussing practical solutions to the very real problems you may face when doing business in China.

"Growth in Shared CFO services is closely related to the increased sophistication of technologies in the accounting sector, enabling practices to seamlessly integrate with the software platforms used by clients.This allows practitioners to undertake work remotely and readily upload and download data between different computer systems."

- Erik Asgeirsson
President and CEO
CPA.com

When do You Need a Shared CFO?

A Shared CFO will ignite your business growth.

The benefits of having a senior financial professional by your side when making those important decisions is far reaching. The right time to consider an alternative to your conventional accounting and bookkeeping service provider is not **after** a major failure but **before**.

It's time to look for a Shared CFO if you:

- Are a business owner serious about growing your business and profits
- Recognize the need for strategic and financial skill set to meet the increasingly sophisticated demands doing business in China
- Not confident in or frustrated by the low quality services from conventianal accountant
- Cannot afford to employ a full-time CFO
- An ambitious business owner eager to scale up your business fast
- Want to make your life easierknowing that you have a professional to help make important decision

Quote from business owners:

"The best kept secret"

"My shared CFO has added at least RMB 2million to the sales price of my business"

"Now I spend more time working ON my business, not in the business."

"I'm enjoying the business much more now that I have everything under control"

"My sales have gone from RMB 20 million to RMB 30million in just 18 months"

Compliance
Ensure the Integrity of Your Business

Compliance goes beyond just scheduled tax filings and other statutory requirements. It's also about adhering to the principles of accounting and financial management to ensure that the business is generating accurate financial reports. A shared CFO get involved inside your business and helps you avoid the negative consequences of inadvertent non-compliance.

This will enable you to:

- Trust that financial reports reflect the true performance of your business
- Avoid fines and other penalties associated with non-compliance
- Relax knowing that your business is prepared to respond to complex financial questions and comply with an audit
- Maintain a high business Credit rating and build confidence with your employees and stakeholders

What can a shared CFO do for you?

- Audit existing financial reports and internal procedures and identify potential risks.
- Ensure that monthly statutory filing requirements are met on time.
- Ensure that year-end annual filings and adjustments are correct and submitted on time.
- Establish internal procedures for sales, purchasing and expense claims that meet the necessary compliance requirements.
- Ensure ongoing compliance by auditing the internal procedures and documentation.
- Setup systems for collecting the necessary supporting documentation and information collection for relevant business activities.
- Provide relevant interpretations of regulatory changes and how it may impact the business.
- Properly handle questions from the local tax authorities.
- Maintain the proper relationships with local authorities including tax bureaus, industrial and commercial bureaus, customs, SAFE etc.
- Establish systems to capture necessary business information for complying with the applicable tax policies and regulations.

Internal Control
Avoid Costly Mistakes

A shared CFO brings extensive financial controlling and risk management experience to your business. They will provide you with the support and guidance needed to develop a controlling procedure for your business that brings you more clarity and confidence when making important decisions.

This will enable you to:

- Bring more transparency to your business process
- Relax knowing that your business is operating as you intended it
- Identify any potential risks before they materialize
- Focus on growing your business

What can a shared CFO do for you?

- Analyze your existing business process and identify any internal and external risks.
- Help structure employee responsibilities and propose potential segregation of duties that reduce risk.
- Structure procedures and coordinate local resources to reduce the necessary management involvement in day-to-day operating tasks.
- Create approval procedures for handling various employee requests.
- Suggest areas that require management involvement and focus.
- Establish Key Performance Indicators (KPIs) and the methods of measuring performance.
- Monitor KPI data and compare it to the true performance of the business.
- Routine audits of various business functions.
- Independently monitor local management and communicate to the overseas senior management team about any abnormalities.

Financial Planning and Analysis

Keep Your Business on Track

A shared CFO will introduce completely new ways of looking at your business and help you discover a new way to grow your profits. They will ensure that your business is capturing relevant data about your business and help present that data in a way that is useful for management decision making.

This will enable you to:

- Better understand the true performance of business
- Better plan for your future goals and help you meet those goals
- Answer difficult decision such as "What is the true profitability of individual products of services?"
- Make important decisions more confidently

What can a shared CFO do for you?

- Identify important data that your business creates on a day-to-day basis.
- Suggest methods and tool to efficiently collect important business data.
- Identify your business' Key Performance Indicators (KPI).
- Establish methods of collecting and timely reporting of KPI for quick decision making.
- Produce monthly management reports containing the most important business data.
- Attend management meetings and provide context and interpretations of key business data.
- Establish reporting procedures to ensure all business units receive constructive feedback on their performance.
- Improve reporting efficiency so that important information for decision making is made readily available.
- Identify areas for improvement and provide valuable suggestions to improve profitability.
- Help set achievable business goals and generate necessary budgets to achieve those goals.
- Coordinate with various departments and reinforce budget controls.
- Improve the visibility of a business' expenditures and associated business costs.
- Educate management about the implication of certain decision on the financial performance of the business.

Cash Flow Management

Maximize the Cash Available to Grow Your Business

A shared CFO can help your business better understand its cash requirements and help protect you from potentially devastating events that could put you out of business. They will also help you maximize the cash available for you to pursue opportunities to grow your business. And when times are tough, they will help you manage your precious cash so that you can continue to operate.

This will enable you to:

- Better understand your business's cash requirements
- Identify future threats and challenges your business will face
- Explore all financial options available to achieve your goals
- Understand the root cause of cash flow fluctuations or problems

What can a shared CFO do for you?

- Calculate the break-even point for individual products or services.
- Calculate the cash requirements for projects and the expected period which the business will see a return on its investment.
- Forecast future cash flow and establish whether the business should cut cost or plan to increase sales.
- Identify ways to better manage current assets and liabilities to maintain sufficient cash flow.
- Explore ways to improve the efficiency of working capital in the short-medium term.
- Explore cut costing areas that minimizing the impact on the business ability to meet its goals.
- Shorten the sales and invoicing process to help you get paid faster.
- Defer payments when possible with consideration for important business relationships.
- Introduce new financing options applicable to the business in China.
- Evaluate financing options and suggesting most viable options for the business.

Tax Planning

Keep More of Your Profits

Many people think that tax planning is something only for large corporations. Small businesses are more vulnerable to large tax bills that can send them scrambling to hold on to any profits they might have made. A shared CFO brings tax planning and legal expertise affordable to small businesses that help them keep their hard-earned capital and avoid the nasty outcomes of an unexpected tax bill.

This will enable you to:

- Plan for future payments and avoid large tax adjustments
- Make use of all the tax incentives that are available to you
- Minimize the tax costs and maximize the profitability of the company
- Reduce your tax risk and avoid a tax audit

What can a shared CFO do for you?

- Examine existing business process to identify any preferential tax policies available to the business.
- Review whether transaction records are complete, sufficient and in accordance with the tax regulations.
- Review that internal and external approval documents are sufficient for tax deductions.
- Review balance sheet items and ensure there are no significant potential tax risks.
- Review internal policies such as travel policies, expatriates' expense reimbursement policies to ensure compliance and minimize the tax costs.
- Provide most cost-effective remuneration procedures for investors and employees.
- Review and provide optimal contract terms for the business's sales, purchase and employment contracts.
- Negotiate with tax authorities on behalf of the business when necessary.
- Plan an optimal tax exit-strategy for investors.
- Provide updates regarding the impact of recent regulatory on the business and its shareholders.
- Embed the tax planning strategy in daily operation and every business procedure.
- Coordinate the various departments and resources for the overall tax planning to ensure minimizing your tax costs.

SaaS Implementation

Get the Most Out of Your Software

Involving a shared CFO in your software solution brings a valuable cost vs benefit perspective to the software that drive your business. They help setup your software solutions so that your business runs smoothly and with minimum risks. They're also the ones who will still be there long after implementation is complete to ensure that everything is operating as intended.

This will enable you to:

- Make informed decisions about which software is most suitable for your business.
- Configure your business solutions to meet your internal and external requirements.
- Make informed decisions based on the available budget and the most essential functions.
- See results faster by following a realistic plan given your unique business situation.

What can a shared CFO do for you?

- Requirement study of business process and data collection.
- Construct software implementation plan and timelines.
- Budgeting for implementation and ongoing maintenance costs.
- Business blueprinting built on connected SAAS applications integration.
- Defining a list of master data.
- System setup and configuration.
- Conduct end users training to ensure the system is successfully adopted.
- Conduct regular system audits to ensure the integrity of business data being created.
- New user training during job transitions and handover.
- Preparation of historical data and migration (if applicable).
- Intensive monitoring during the system go-live period.
- Ongoing support.

Abbreviations :

VAT – Value Added Tax
CIT – Corporate Income Tax
IIT – Individual Income Tax
GAAP – Generally Accepted Accounting Principle
SMEs – Small and Middle sized Enterprises
MSEs – Micro and Small sized Enterprises
SAFE – State Administration of Foreign Exchange
SaaS - Software as a Service
EBIDTA – Earning before Interest, Depreciation, Taxation and Amortization

Aepoch Advisors is a cloud accounting and advisory practice servicing foreign businesses in China.

We take care of your compliance, setup software solutions and help oversee financial side of your business. You are freed to focus on exploring the amazing business opportunities in China.

Our clients love our service as we help them navigate a variety of intricacies of doing business in China, so that they can streamline operations, mitigate risks and maximize profits.

Book a free workshop to introduce your business and requirements. We can offer you immediate advices in addressing critical issues and problems. Contact us at hello@aepochadvisors.com for more information.

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