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## Techniques in PRC Accounting (Cooking the Books, Chinese style)

In our March 2009 edition of Ferriers Focus Asia, we discussed some of the issues in relation to fraud that frequently occurs in Hong Kong and the People's Republic of China ("PRC").

The PRC is generally viewed as a country that does not adhere to international accounting policies and guidelines. Many PRC companies falsify their records to establish a successful operating environment or reduce the burden from corporate income tax or business tax. The accounting industry is generally aware that some companies in the PRC prepare two (or more) versions of accounting records, one for auditing, and one for tax purposes. In this edition of FFA, we share with you some techniques and examples undertaken in the PRC to manipulate accounting records, or "cooking the books", Chinese style.



In the PRC, accounting records for tax purposes are generally recorded using the cash based approach. In Western countries this approach is referred to as the "cash" basis of accounting as opposed to the more commonly accepted "accrual" basis. The cash based approach is widely used by many companies in the PRC to protect themselves from a potential cash flow imbalance as a result of the timing difference between the collection of sales proceeds and the payment to suppliers and the government for value-added tax ("VAT"). The creation of another set of accounting books and records may be undertaken to minimise the potential tax impact as well as reporting good results. Like some Western companies, PRC enterprises have their own methods to manipulate their company's financial position.

The PRC government has been working hard to

promulgate a set of internationally recognised accounting standards, consistent with those of the United States and Hong Kong. The main reason behind the introduction of the new rules is to address the concerns of investors about the unusual business practices of PRC companies, in particular manipulation of accounting records thereby allowing companies in the PRC to be more comparable to other international companies.

### Revenue recognition

Revenue is one of the easiest figures in accounting records for a company to manipulate. Revenue can be manipulated in a number of ways, such as inflating sales performance by the early recognition of sales transactions, or deferring invoicing to reduce VAT exposure. In the following paragraphs, we describe some techniques for revenue manipulation.



### Issued goods or despatch of goods

Issued goods (or despatched goods) are those goods that have physically left the company's warehouse and have been delivered to a customer's warehouse. Under normal circumstances these goods satisfy the accounting criteria of "revenue recognition", which is an accounting standard that places certain conditions as to when a company may record revenue earned. Generally speaking, goods which have been delivered to the customer's warehouse and bear the customer's chop on the delivery note are considered as goods sold and ownership of the goods has been properly transferred to the customer.

In the PRC, it is not uncommon that goods physically delivered to a customer are not accompanied by a VAT sales invoice. This is because the vendor not only has the obligation to account for VAT payable in its accounting records at the time of delivery, but also incurs a liability to pay Output VAT to the Tax Bureau once the sales invoice is issued. It does not matter when the sales amount is expected to be settled by the customer. Therefore, the usual practice in the PRC is for a company to deliver goods to a customer at a given date and issue the sales invoice with VAT at a later date to avoid an immediate VAT obligation on the sales transaction. The vendor intends to issue a VAT sales invoice at the time of settlement, or as agreed with the customer. Alternatively, customers

might negotiate with the vendor to accept delivery of the goods, but not record the receipt of goods as purchases. The customer is prepared to accept the deferral of receipt of the VAT sales invoice as it increases inventory for operating activities and defers the cash settlement of the sales transaction and VAT. Accordingly, goods physically delivered to customers are still considered as inventory of the company (an asset) instead of goods sold (an expense) in their accounting records and the corresponding sales are not yet recorded. In this manner, the vendor is able to manipulate sales performance and VAT liabilities in order to manage cashflow whilst the customer is able to defer a payment obligation.

In this scenario, the warehouse records monitoring the delivery of goods are reliable for the purpose of demonstrating the inventory movement. The vendor would only tamper with the sales records in order to manipulate the sales results and minimise the risk of queries from auditors carrying out sampling checks on inventory during the physical inventory count. Instead of solely reviewing the sales invoices, a combination of tests on the timing of goods delivered and the timing of sales recognition, together with the consideration of delivery terms, would be a good approach in identifying unusual sales transactions.

### Manipulation of goods delivery

In contrast to the deferred recognition of sales transactions discussed above, early recognition of sales transactions is another accounting technique applied by companies in the PRC. This is particularly notable in those companies that are subsidiaries or representative offices of overseas companies, as these PRC companies are more concerned about their financial performance and achieving the group's financial targets than any exposure to VAT. We illustrate the arrangement in the following example.

Company A would like to deliver goods from its warehouse to Customer B. All associated documents, such as VAT sales invoices, delivery notes and packing lists are readily available at the time of delivery and are sent with the goods delivered. Customer B receives and accepts the goods at the time of delivery. As such, the sales transaction will immediately be recorded as a sale of Company A. It seems like a normal trade. In fact, Customer B has not yet placed a customer order to Company A. Company A itself arranges the delivery and records the sale in order to boost sales performance. It is even possible that the destination of the goods delivery might also be controlled by Company A itself.

The method also applies to consignment stock. Company A sets up an arrangement with Customer B by claiming the inventory held in Customer B's warehouse should be recognised on a consumption basis rather than on delivery terms, so that Customer B will not be charged at the time of accepting the goods (*In most cases, this practice is not in line with sales contract terms*). The quantities of inventory consumed by Customer B are agreed on a monthly basis between both parties as sales of consigned inventory. Company A then recognises the sales transaction to Customer B according to the agreed schedule generally prepared by Customer B. This practice is particularly good when Company A has to control the monthly sales performance in order to achieve sales targets.

This method of revenue manipulation however has the effect of distorting cash management. Hence, if a company's sales and accounts receivable keep growing, but aren't correspondingly reflected in the cash flow

statement, the reader should smell the oil burning in the wok. Another red flag is that there may or may not be a consignment sales contract established between the parties. Under normal trading circumstances it is sometimes possible to ascertain the ownership of goods delivered to the customer by checking on the party bearing the insurance costs on inventory loss.

### Invoicing arrangements

Companies in the PRC using deferred revenue techniques consequently incur too many expenses and reduced revenue, which may affect the bottom line if all the expenses are recorded in a timely manner. As such, companies prefer to defer receiving expense or purchase invoices. Conversely, some companies might need extra expenses to equalise an overstatement of revenue which may have been important to meet revenue targets as explained above. As such, Company A (with excessive purchase invoices) and Company B (with insufficient purchase invoices) would like to arrange a 'trading of invoices'. This is particularly common in company structures with undisclosed relationships. Since the purchase invoice has not been issued, Company A instructs its vendor to issue a purchase invoice to Company B instead of Company A itself. Company B will then arrange payment to settle with the vendor on behalf of Company A, which carried the original purchase invoice obligation. Such an invoicing arrangement also enhances equalisation of tax obligations and covers inappropriate accounting transactions.

Alternatively, companies in the PRC will also use a temporary account due from individuals to defer expenses as it is easier to lose the audit trail by dealing with individuals, compared to a temporary account with companies. Such an account is usually explained as a temporary loan account to employees. This classification is a good method for avoiding or deferring potential corporate income tax and business tax by manipulating the amounts spent by the individuals. To some extent, these types of invoicing arrangements are not easily identified in ordinary operational accounts until tests have been undertaken on the warehousing records and the purchasing documentation.



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## Fictitious invoices

The PRC Tax Bureau requires companies in the PRC to record VAT invoices for transactions undertaken in a timely manner. A company generating significant income with unexpectedly low costs is exposed to a higher tax obligation. In addition to the invoicing arrangement discussed above, the company may also be able to purchase fake VAT invoices at a very low cost to inflate the operating costs. Counterfeit VAT receipts often show false company addresses which when checked are sometimes located in barren wasteland, housing estates or even garbage heaps. Over 200 people a year are executed in the PRC for VAT tax fraud. The PRC's biggest ever tax fraud involved the non-payment of VAT to the tune of Yuan 32.3 billion.

Companies in the PRC are generally not able to identify whether an invoice is fake based on its content, however the Tax Bureau in the PRC offers an online recognition tool (e.g. Shanghai Tax Bureau's website <http://www.csj.sh.gov.cn/wsbs/ptfp/login.jsp>) for companies to verify the validity of VAT invoices. However, it is not an efficient procedure for undertaking a check on a large volume of transactions.

## Conclusion

Changing the mindset of the way people do businesses in the PRC is a long term project, particularly given the "cash" concept that has been engraved in the heart of the PRC people for thousands of years. The PRC government is working to formalise the accounting rules and change the impression held by Western society in respect of the veracity of PRC financial reporting. The PRC will become more internationally recognised and comparable when enterprise reporting shifts from the current cash based focus. More importantly, it will be a big milestone if enterprises in the PRC can move away from the concept of having two (or more) sets of accounting records.



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