6.1 Enterprise Financial Systems and Standards

China's Ministry of Finance (MOF) has formulated and promulgated the *Financial Principles for Enterprises* as well as financial systems to be adopted by different trades. The rules also apply to foreign-invested enterprises (FIEs). Financial systems cover the following aspects: revenue and expenditure, asset management, cost management, criteria and approval procedures for expenditure, foreign currency management, internal control, and audit. This chapter will focus on the regulations governing FIEs' financial registration, establishment of financial accounting department, investment capital, scope and uses of expenses, liquidation, and advance recovery of investment by the foreign investor.

6.1.1 Financial Registration

An FIE should apply to the financial authority for financial registration within 30 days after submission of application for business registration or change of registration details. To apply for financial registration, an enterprise should complete the *Financial Registration Form for Foreign-invested Enterprises*, supported by the following documents: approval certificate for establishment of an enterprise; feasibility study report and its approval document; FIE contract (agreement), articles of association (copy) and their respective approval documents; business licence (copy); and information on the FIE's financial management system and related rules formulated in accordance with the relevant state regulations.

An FIE should submit its financial accounting statements and status report of its financial position to the competent financial or administrative authority and local tax office on a regular basis. The format, content and schedule for submission should follow the relevant stipulations by MOF. Annual financial statements and liquidation reports should be accompanied by an auditor's report prepared by Chinese certified public accountants (CPAs).

6.1.2 Establishment of Financial Accounting Department

FIEs should establish a financial accounting department in the place where it is located, to be manned by qualified financial and accounting personnel responsible for handling financial and accounting matters in accordance with the law. (MOF has strict management guidelines regarding the qualifications of financial and accounting personnel.)

6.1.3 Investment Capital

To establish an enterprise, a certain amount of capital is required as stipulated in the relevant regulations and application for business registration at the industry and commerce administration departments is also necessary.

(a) Forms of Investment

Investors may make contribution to the registered capital of an enterprise in cash, in kind, or in intangible assets. Investors making contribution in kind and in intangible assets must provide proof of ownership and right of disposal, or other proof of their validity as required by law. Investors are not allowed to contribute leased assets or collateral assets.

Investors making contribution in intangible assets (excluding land-use rights) should provide asset appraisal or valuation reports. In general, the value of the contribution may not exceed 20% of the total registered capital of the enterprise.

If foreign investors are making contribution in cash, it should be in foreign currencies. However, profits in renminbi made from investment in other FIEs within the Chinese territory may be used as contribution in cash.

When the full amount of registered capital has been paid up, the FIE should appoint a Chinese CPA to compile a capital verification report.

(b) Investment Recovery

In general, during the operation period of the enterprise, investors are not allowed to withdraw their share capital by any means except through transfer of business as provided by law.

For Sino-foreign contractual joint ventures (JVs) whose contract stipulates that all the fixed assets should be handed over to the Chinese party upon expiry of the JV, provisions can be made in the JV contract that the foreign party may recover its investment during the term of the JV. However, the foreign party should still be jointly responsible for the JV's liabilities in accordance with the relevant laws and regulations as well as the provisions of the contract. Any pre-tax investment recovery should be reported to the competent financial authority for examination and approval.

(c) Sources and Uses of Capital Reserve

The sources of an enterprise's capital reserve include: the balance from investors' capital contribution in excess of the prescribed amount of registered capital; the balance resulting from the different conversion/exchange rates used in the assets account and the paid-up capital account; income in the form of donations.

The designated uses of an enterprise's capital reserve include: in the event of heavy losses where the un-allocated profits of the previous year, the reserve funds and development funds of the enterprise are inadequate to make up for the shortfall, the board of directors may pass a resolution authorising the use of such funds in making up for the losses; upon the board of directors' decision and completion of the relevant procedures, the funds may be used to increase the capitalisation of the enterprise.

6.1.4 Income Management and Profit Distribution

(a) Income

Revenue from the sale of goods should be recognized when all of the following conditions have been satisfied:

- The enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
- The enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- The economic benefits associated with the transaction will flow to the enterprise; and
- The relevant amount of revenue and costs can be measured reliably.

In the case of a cooperative JV using product sharing as the income distribution method, the investors are considered to have realised their income when they have received their share of the products. The amount of such income is calculated as per the sale price of the products sold to a third party or as per the prevailing market price.

Except otherwise stated in the contract or articles of association, the sale price of an enterprise's export products (or merchandise) should be ascertained by adding reasonable charges and profit margins to the costs if such products (or merchandise) are not directly sold by the enterprise.

(b) Profit Distribution

- Order of priority for profit distribution

  Enterprises should pay income tax on the profits they earn in accordance with the law. After-tax profits should be distributed in the following order of priority:

  (i) Paying all kinds of fines such as breach-of-contract fines, late charges, late interest charges and other penalties;

(ii) Making up for previous years' losses;
(iii) Contributing to reserve funds, enterprise development funds, staff incentives and welfare funds;
(iv) Profit distribution to investors.

- Principles of profit distribution to investors

  Equity JVs should distribute profits according to the actual proportion of capital contribution by the respective investors; cooperative JVs should follow the terms as stated in their contracts; whereas foreign enterprises should do so according to their articles of association.

  Investors failing to honour their contractual obligations in terms of capital contribution as stipulated in state regulations or other provisions in the contract will not be eligible for profit distribution.

- Conversion of profit in renminbi and profit repatriation

  Unless otherwise stated in the contract or articles of association, profit to be distributed in cash is on principle in the currency of the income from the enterprise's operation. Investors may convert their profit in renminbi into foreign currencies but have to be responsible for the possible profit and/or losses in currency exchange.

  Foreign investors may remit their profit overseas, or they may reinvest it in China.

(c) Reserve Fund, Enterprise Development Fund, Staff Incentive and Welfare Fund

The ratios of contribution to reserve funds, enterprise development funds, staff incentives and welfare funds are determined by the board of directors. Among these, reserve funds must account for at least 10% of an enterprise's after-tax profits. When the reserve funds reach 50% of the enterprise's registered capital, further contribution is not required. It is not mandatory for an enterprise to set aside an enterprise development fund.

Reserve funds are intended primarily to make up for an enterprise's operating losses. Development funds are usually used for expanding the enterprise's scale of production or operation; and upon approval by the original approval authority, such funds may also be used to increase investment. Staff incentives and welfare funds are earmarked for ad hoc incentive programmes and collective benefits such as subsidies for the purchase, construction, maintenance and repair of staff housing.

6.1.5 Liquidation

(a) Liquidators and Their Responsibilities

Upon dissolution of an enterprise in accordance with the contract, articles of association or due to other reasons, a liquidation committee should be formed within 15 days. In general, the liquidation committee should consist of directors of the enterprise and representatives of the creditors. Chinese CPAs or lawyers may also be hired to sit on the committee. If deemed necessary, the competent financial authority may send its staff to supervise the work of the committee. If the enterprise declares bankrupt, the case should be filed with the people's court for bankruptcy proceedings.

After the liquidation committee announces the liquidation of the enterprise, it will inform the creditors who will declare the outstanding debts owed to them within a specified period. The committee will then draw up a liquidation plan, prepare balance sheets and other financial statements, assets lists, debts and liabilities lists, and give its opinions to the board of directors on asset disposal. Upon approval by the board of directors, the liquidation plan will be filed with the competent financial and administrative authorities for the record and implementation.

(b) Liquidation Assets and Valuation

Liquidation assets include all the properties of the enterprise at the time of announcing the liquidation and the assets acquired during the liquidation period. However, three types of assets are excluded: first, the balance in the staff incentives and welfare funds and housing funds for mainland workers, and all properties and facilities purchased or constructed with such funds; second, the balance in the enterprise's insurance and other benefits for its mainland workers; third, the balance in the enterprise's trade union funds and the properties purchased or constructed with such funds.

Liquidated assets shall be appraised in accordance with the following rules:

- In accordance with the related stipulation of contract or article of association, if available;
- If there is no related stipulation of contract or article of association, price of liquidated assets should be determined through negotiation between Chinese and foreign investors, and the result shall be submitted to related government agencies for approval;
- If there is no related stipulation of contract or article of association, and Chinese and foreign invstores cannot reach an agreement, the price of liquidated assets shall be determined by liquidation committee by referring to opinions of appraisers, andthe result shall be submitted to related government agencies for approval; or
- In accordance with ruling of court or arbitration result, if available.

(c) Debt Repayment Responsibility

Enterprises with legal entity status in China (that is, limited liability companies and joint stock limited companies) should repay their debts with all the companies' registered assets. For enterprises without the status of a legal entity, the investors involved should bear unlimited liability for debt repayment and other related liabilities.

In a Sino-foreign cooperative JV where it is stipulated in the contract that the foreign party can recover its investment with priority during the term of the cooperation and that all the fixed assets will be handed over to the Chinese party upon expiry of the JV, both the Chinese and foreign parties should be jointly liable for debt repayment in the event of liquidation.

(d) Order of Priority in Debt Repayment

After all liquidation expenses are paid up, debts will be repaid in the following order of priority:

(i) Overdue workers' wages and labour insurance fees;
(ii) Overdue national taxes;
(iii) Overdue debts.

(e) Distribution of Residual Assets

In a liquidation exercise, after deducting all the debts and losses, the residual assets will be used to cover undistributed profits, capital surplus, other funds and the liquidation expenses. After all these deductions, the balance that exceeds the amount of the paid-up capital is the net liquidation proceeds, which will be deemed as profit and, as such, subject to income tax. The residual after-tax assets will be distributed to investors according to the following order of priority:

For equity JVs, distribution would be made according to the actual proportion of capital contribution of the respective investors. For cooperative JVs, distribution would follow the terms stated in their contracts and articles of association. For foreign enterprises, distribution would be made according to their articles of association.

(f) Cancellation of Financial Registration

When the liquidation process is complete, the liquidator will present a liquidation report accompanied by an income and expenditure statement for the liquidation period, and a verification report by a Chinese CPA, to the competent financial authority, and proceed with cancellation of the financial registration of the enterprise.