

Mainland audit issues Q&As - value-added tax

The Questions and Answers (Q&As) below are developed by the Working Group on Mainland Audit Issues of the HKSA Auditing and Assurance Standards Committee (AASC) to raise practising members' awareness of the common audit issues that may be encountered by auditors in the audits of the financial statements of Mainland enterprises that are prepared under HKGAAP framework. They should be read in the light of Statements of Auditing Standards.

This set of Q&As addresses some of the common issues relating to value-added tax (VAT) in the Mainland, including some useful background information about VAT, the more common questions to be considered in the planning process and the practical procedures that may be applied by the auditors in ascertaining the amount of input VAT. VAT is a complicated area and the Working Group will seek to address other common issues on the subject in future Q&As.

The Working Group welcomes your comments and feedback, which should be sent to commentletters@hksa.org.hk, for the attention of Stephen Chan, Technical Director (Ethics & Assurance) & Head of Standards & Technical Department Coordination.

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Q1: What background information on VAT is useful to auditors in auditing the financial statements of Mainland enterprises?

A1: VAT is a kind of turnover tax levied on the value added in the course of importation, production, distribution and retailing of goods. The general tax rate is 17% but necessities such as agricultural and utility items are taxed at 13%. Export goods are exempted from VAT.

VAT is the major source of fiscal revenue for the Government of the People's Republic of China. The Provisional Regulations of the People's Republic of China on Value-added Tax (中華人民共和國增值稅暫行條例) which is currently effective in the Mainland was promulgated by the State Council in December 1993 and came into effect in January 1994.

VAT invoices (增值稅專用發票) are issued by the seller to the buyer upon the sale of goods for the purpose of calculating the output VAT payable/ input VAT creditable for the seller/ buyer. The collection of VAT is based on invoicing control and VAT invoices are the irreplaceable documents required for the crediting of input VAT.

VAT registration is required for an enterprise to qualify as an ordinary VAT taxpayer (增值稅一般納稅人) which can issue VAT invoices. The registration procedures are as follows:

- I. The enterprise must submit a written application together with the following documents:
 - a) Tax registration certificate;
 - b) Business licence;
 - c) Certificates issued by the relevant Finance Bureaus held by in-house personnel of Finance function (從事財會工作人員持有由財政部門核發之會計證);
 - d) Ownership or lease agreements on real estates for registered office and places of production /operation;
 - e) Relevant contracts (e.g joint venture agreement) and articles of association;

- f) Evidence on opening of bank account for tax payment; and
 - g) Other relevant documents requested by the tax authorities.
- II. The tax authorities will then conduct a preliminary examination on the application report and relevant documents submitted. On approval of the application, an Application Recognition Form of VAT General Taxpayer (增值稅一般納稅人認定申請書) will be issued to the enterprise. The form will further request the completion of the following information:
- a) Date of commencement of business;
 - b) Scope, mode and address of operations;
 - c) Book-keeping conditions to assess the ability to accurately report on output and input tax figures; and
 - d) Organisation structure of personnel in Finance function.
- III. The enterprise has to complete the Application Recognition Form of VAT General Taxpayer and pass it to the tax authorities with the above documents for final examination.

VAT is calculated and the amount payable is the difference between the output VAT collected on sales less the input VAT paid on purchases/expenses. It is payable on a monthly basis and a taxpayer has to pay within ten days after each month end. Special rules are in place however in respect of the refund of input VAT for exporters.

Under Guoshuifa (國稅發) [1993] No.157, it is illegal to issue a VAT invoice where no taxable transaction has actually occurred.

In accordance with Guoshuifa [1997] No.134, fraudulent VAT invoices are defined as those issued by a party other than the seller or in a location other than the selling place.

Pursuant to Guoshuifa [2000] No.187, even though there is a genuine business transaction, the buyer is not allowed to claim any input VAT credit on the VAT invoice obtained from the seller via improper channel. In addition, a buyer in good faith will only have the previously claimed input VAT disallowed in this respect without any penalty or surcharge if the following criteria are satisfied:

- There is no tax evasion on the part of the buyer and no evidence suggesting that the buyer is aware of the case in which the seller has obtained the invoices via improper channels.
- The invoices: (a) are issued by the seller in the province it resides; (b) bear the name of the seller with its official chop; (c) state the quantity and price of goods; and (d) have all shown details matching with the actual transactions.

If the tax bureau alleges that a taxpayer has used improper VAT invoices and the taxpayer fails to prove that it is a good faith buyer, penalty and surcharge could be imposed. It is the taxpayer who bears the burden of proof in any tax dispute or investigation.

Anti-forgery measures on VAT invoices are currently being developed by the Mainland tax authorities. The “Golden Tax Project” (金稅工程) is being developed to aim at the installation of a nationwide computer network to match input VAT claims against the corresponding output. On its completion, taxpayers and tax officials can verify the invoices received via their own anti-fraud invoicing control machines (terminal port of the Golden Tax System) while the tax authorities can monitor all VAT invoices issued throughout the Mainland.

In accordance with Guoshuifa [2000] No.183, all VAT taxpayers must issue computerised invoices under the VAT Anti-forgery Tax Control System (增值稅防偽稅控系統) instead of hand-written ones by the end of 2002 to facilitate the implementation. However, it is being noted that hand-written invoices are still prevalent in some remote regions at present.

More than Rmb1 billion is expected to be spent over the next five years to further integrate around eight software platforms across a countrywide network. The whole system is expected to complete by 2010.

Q2: *What are the more common questions that auditors ask in obtaining an understanding of the accounting and internal control systems for VAT administration in audit planning and developing an appropriate audit approach?*

A2: Some of the more common questions are:

a) VAT registration

- Has the company performed proper registration as a VAT taxpayer?
- Has the company obtained approval from the relevant local tax bureaus if it sells in other Mainland locations?

b) VAT accounting system

- What are the main control procedures over the invoicing system?
- Does the company have a separate VAT accounting system which complies with the VAT Accounting Treatment Regulations (增值稅會計處理規則)?
- Is there a nominated person responsible for the VAT accounting records?
- Does the company keep a register of VAT invoices and are those invoices kept in a safe place to which only designated people have access?
- Who is responsible for checking the validity of input VAT invoices and has the staff been trained to do so?

c) VAT returns

- Are all returns submitted on time and accepted?
- Is input VAT related to domestic sales segregated from input VAT related to export sales in the returns and how?
- Has any non-recoverable input VAT been identified?
- Has the tax bureau made any adjustments on the returns?

d) Others

- Are there any sales made below market values?
- Are there any deemed sales for VAT purposes (e.g. transfer of goods between branches or offices)?
- Do the figures for output and input VAT appear reasonable with taxable sales and purchases?
- Has the company been ever subject to VAT investigation by the local tax bureau? If yes, what was the result?
- Are there proper accounting treatment and disclosure on VAT balances?

Q3: *What are the practical procedures that auditors can apply to ascertain the amount of input VAT recoverable, and in particular the authenticity of VAT invoices?*

A3: Currently, buyers have to submit VAT invoices to the tax bureau for certification within 90 days after receipt. The certification process involves number-matching and is the condition for valid input VAT claims at present. However, the credit claims can still be disallowed if the conditions mentioned in Q1 are not satisfied in subsequent tax investigations, if any.

Telephone hotlines are available in the relevant local tax bureaus for checking the authenticity of VAT invoices. This service is provided in every region throughout the Mainland. The phone numbers can be found in the respective websites of the relevant tax bureaus. For instance, the hotline for Beijing is 010-16881688 and those for Shanghai and Shenzhen are 021-54679568 and 755-123661 respectively.

However, verbal confirmation cannot replace the above formal certification process to make the claims effective. This is often used as a preliminary check on receipt of invoices of material amounts.

All input VAT invoices have to go through the certification process set out above to make any subsequent claims effective. The actual payment of a claim would involve a two-stage approval process: (i) the approval of the amount of a claim; and (ii) the approval of the payment of the claim. Payment of a claim does not automatically follow the approval of the amount of the claim and auditors should be aware of this process.

In addition to making reviews on any history of failed VAT claims and the related reasons, auditors can perform analytical procedures to assess the reasonableness of input VAT, which should be the product of applicable tax rate and purchases in ideal situations. Discrepancies may arise if there is timing difference between the receipt of goods and invoices. Attention should be paid to proper accruals on VAT when sales are recognised.

Guoshuifa [2002] No.7 and No.11 stipulate the details for export refunds. There is a non-creditable/non-refundable portion in those input VAT claims ("NCNR VAT").

NCNR VAT is determined as equal to (VAT rate – VAT refund rate) X (FOB value of exports – value of bonded imported raw materials). The range of the difference between VAT rate and VAT refund rate is around 4% to 6% and this irrecoverable item should be expensed in the income statement. This applies to most trading goods and is a nationwide requirement.