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Research Note

Changes in the value relevance of accounting information over time: Evidence from the emerging market of China

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ABSTRACT

We investigate the changes in the value relevance of accounting information among Chinese firms over the past two decades, during which accounting reforms are launched to provide decision makers with increased disclosure and higher quality financial information. We also investigate the factors that differentiate firms showing significant value relevance improvement from firms showing little improvement. We find increases in the value relevance of some financial variables and decreases in others, which suggests that accounting numbers help to explain the pricing process of stock shares although at different levels. In addition, we find that value relevance improvements are more pronounced for smaller firms, firms with lower growth rates, and those with greater asset tangibility. We also document that value relevance improvements are generally lower in an exuberant stock market. These results have implications for a variety of information users and policy makers in emerging countries which are reforming their accounting systems.

1. Introduction

This paper investigates the changes in the value relevance of accounting information among Chinese firms over the past two decades. Value relevance is defined as the informativeness of financial statements. The higher the value relevance, the more financial statements can be relied upon to make investment decisions and thus the greater the association between financial statement items and firm stock-share prices or returns (Francis and Schipper, 1999; Sami and Zhou, 2004). The purpose of this paper is to provide greater insight into changes in value relevance and the factors that influence value relevance against a background of accounting reforms in a broad sense, rather than charting the causal relationship between accounting reforms and the value relevance of accounting information.[1]

Our study is primarily motivated by the unique environment of the Chinese emerging market, in which accounting standards, regulations, and practices have experienced revolutionary change over the past two decades.[2] Another motivation comes from the mixed results documented in the literature on the value relevance of accounting information based on U.S. data. For instance, whereas some studies find increases in the value relevance of accounting information over time (Collins et al.,

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[1] We owe thanks to an anonymous reviewer for addressing these issues.

[2] We use a broad definition of accounting and regulatory reforms that goes beyond the introduction of new accounting standards, rules, and regulations by themselves. This broad definition considers implementation issues such as (1) changes in auditing standards, profession, and practice; (2) changes in human capital, in particular the qualifications of accounting personnel; and (3) reforms in the judiciary system and administrative sanctions on the management of public companies and their auditors.

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1997; Landsman and Maydew, 2002), others show that value relevance has in fact been decreasing over time (Lev, 1989; Brown et al., 1999) or changes are in different directions when different accounting items are used (Francis and Schipper, 1999). To shed light on this issue, we use the emerging market of China as an experimental setting, where the majority of publicly listed firms are traditional manufacturing and merchandising firms and where the role of new-economy firms is more limited than in developed markets.

We address the topic by studying two research questions. The first is whether, with the accounting and regulatory reforms that have occurred in China in the past two decades, the value relevance of financial information has increased for investors. Our principal measure of value relevance is the change in the ability of the key accounting variables, such as assets, liabilities, and earnings, to explain stock returns and market value. Given the accounting and regulatory reforms of the past two decades, we expect the power of the key accounting variables to explain stock returns and market value to improve over time. The second issue that we investigate is whether factors such as firm size, growth, monitoring by long-term debt holders, cross-listing, state-ownership, and auditor characteristics affect changes in the value relevance of financial information. We use changes in the absolute value of the residuals from four evaluation models to measure improvements in the value relevance of accounting information.

Consistent with the literature, we find that earnings level and earnings changes are positively associated with the pricing process in most years. Interestingly, the balance sheet relation does not behave as predicted until after 2002, when total assets are positively and liabilities negatively associated with firm value. Further analysis using the lagged book value of equity as an alternative deflator rather than outstanding shares indicates that the unexpected signs in the earlier years may be the result of dramatic changes in outstanding shares.

To test the changes in value relevance at different stages of the accounting and regulatory reforms, we group the regressions into three periods. In all cases, the regressions for the later period are closer to the true models than those for the earlier periods. Overall, the results suggest that the accounting numbers do help to explain the pricing process of stock shares in the emerging market of China, which is consistent with earlier studies (e.g., Sami and Zhou, 2004).

We do not find evidence that the value relevance of the models changes uniformly in the same fashion over time. On the contrary, we find that the value relevance of the balance sheet relation increases whereas that of the book value and earnings relation decreases over the period studied. Moreover, we do not find a significant change in the pattern of the value relevance of the earnings relation and the accruals and cash flow relation. This result is consistent with the notion that the usefulness of specific accounting information varies with its necessity at different stages of economic development. Finally, using the change in the absolute value of the residual as a measure of improvements in value relevance, we find that smaller firms, firms with lower growth rates, and those with greater asset tangibility experience more pronounced value relevance improvements. Moreover, the value relevance of accounting information is generally lower when the stock market is more optimistic.

The remainder of this paper is organized as follows. Section 2 discusses the background of financial disclosure practice and the institutional setting. A literature review and research questions are presented in Section 3. Section 4 discusses the sample, variables, and empirical method. Section 5 discusses the results and the empirical analyses. Finally, Section 6 presents our conclusions.

2. Background

In 1992, China implemented the Accounting Standards for Business Enterprises, which represented the first step in a series of accounting and regulatory reforms in the world's fastest growing economy. The reforms transformed the Chinese accounting system from a Soviet-style central-planning-oriented system to one that aimed to harmonize with international practices. In the period since 1992, improvements in accounting standards have necessitated the parallel development of auditing standards that are, in various ways, modeled after the standards promulgated by the International Federation of Accountants.

Accounting reforms in China went through three stages (Chen et al., 2002). The first stage was from 1992 to 1997, during which all listed A-share firms were required to follow the *Experimental Accounting System for Joint Stock Limited Enterprises* and the *Accounting Standard for Business Enterprises* issued in 1992 by the Ministry of Finance (MOF), and the accounting regulations issued by the Chinese Securities Regulatory Commission (CSRC).

The second stage was from 1998 to 2000, characterized by the adoption of the *Accounting System for Joint Stock Limited Enterprises* in 1998. During this period, A-share firms were required to follow the *Chinese Accounting Standards* (CAS) issued by the MOF and the *Accounting Law* issued by the State Council in 1995. Financial statements were also more commonly audited by independent auditors during this stage.

The third stage of development spanned 2001–2008, and was characterized by greater convergence with international practices.[3] The MOF also issued the *Accounting System for Business Enterprise* (2001), which represented a further step toward

[3] There have been several other reforms in the Chinese accounting standards in recent years. On December 6th, 2007, the China Accounting Standards Committee (CASC) and the Hong Kong Institute of Certified Public Accountants (HKICPA) issued a joint declaration on mainland Chinese standards convergence. A separate declaration was also issued relating to auditing standards. China has also tried to converge with the IFRS, but with a focus on the convergence process rather than direct adoption. See *China affirms commitment to converge with IFRSs*, a press release issued by the IASB on February 15, 2006 (http://www.ifrs.org/News/Announcements+and+Speeches/China+affirms+commitment+to+converge+with+IFRSs.htm).