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Does Convergence of Accounting Standards Lead to the Convergence of Accounting Practices? A Study from China

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Abstract

In this empirical study we examine whether China's efforts to converge domestic accounting standards with International Financial Reporting Standards (IFRS) over the past 15 years have resulted in the successful convergence of Chinese listed firms. This study is unique in that we evaluate convergence of firms' accounting practices from three perspectives: (1) the level of compliance with Chinese GAAP and IFRS, (2) the consistency of accounting choices under Chinese GAAP and IFRS, and (3) identification of significant differences in the net incomes produced under Chinese GAAP and IFRS (earnings gap).

Using the 1999 and 2002 annual reports of 79 Chinese listed firms we find improvement in both compliance with IFRS and in the consistency of the accounting methods used in annual reports prepared under Chinese GAAP and IFRS. We also find a reduction in the earnings gap from 1999 to 2002. However, interestingly we observed that Chinese listed firms' compliance with IFRS is significantly lower than their compliance with Chinese GAAP. Overall we believe that our findings suggest that in China the convergence of accounting standards has been a conduit to the convergence of accounting practices.

Keywords: Accounting convergence; Accounting regulations in China; Capital markets in China; Emerging markets

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1. Introduction

The primary objective of the International Accounting Standard Board (IASB) is to develop a single set of high quality accounting standards for use in global financial reporting. To this end, the IASB and its predecessor have issued 41 International Accounting Standards (IAS) and seven International Financial Reporting Standards (IFRS).[1] As an integral part of its objective the IASB promotes the convergence of national accounting standards and IFRS. The IASB's efforts have resulted in the adoption of IFRS by a considerable number of countries. Among the 99 countries that have either adopted or permitted the use of IFRS for domestic listed companies as of August 2005, 80% are from emerging capital markets (Deloitte & Touche, 2005). Along with the IASB's success, however, there is concern that the convergence of accounting standards may not lead to the convergence of accounting practices if firms do not comply with the standards (Street, Gray, & Bryant, 1999; Street & Bryant, 2000). This concern is accentuated in emerging market economies that may not have the accountants, auditors, and regulators to support compliance. As pointed out by Eccher and Healy, the standards developed by the IASB are "primarily based on those for countries with highly developed capital markets… It is questionable whether such standards are also optimal for developing and transitional economies that lack the infrastructure for monitoring managers' financial reporting decisions" (p. 1).

In this empirical study we use China — as a case of an emerging market economy — to examine whether its efforts to converge domestic standards with IFRS over the last 15 years have been successful, i.e., do Chinese listed firms' accounting practices converge with IFRS? China provides a clear opportunity to evaluate the convergence debate. Since 1992, China has issued four sets of accounting regulations (1992, 1998, 2001, and 2006); each replaced the previous one and was considered to be in greater conformity with IFRS (Chen et al., 2002; Pacter & Yuen, 2001; IASB, 2006). It has been noted in the literature and by the IASB that impressive progress has been made toward the convergence of Chinese accounting standards with IFRS (IASB, 2005; Xiang, 1998). However, Chen, Gul, and Su (1999) and Chen et al. (2002) find that there is a significant difference in both 1992 and 1998 between Chinese GAAP and IFRS-based net incomes of Chinese listed firms. Our study extends Chen et al. (2002) by evaluating the level of and the improvement in the convergence of Chinese listed firms' accounting practices with IFRS since promulgation of the 2001 Chinese GAAP.

In addition, this study contributes to the literature by evaluating the convergence of accounting practices using three evaluation methods: (1) the level of a firm's compliance with accounting regulations, (2) the consistency of firms' accounting choices under two sets of accounting regulations, and (3) whether the net incomes produced by the same firm under different sets of accounting standards are comparable. Each of these methods evaluates different aspects of convergence. No previous study has integrated these three approaches, most likely due to the difficulty in obtaining suitable sample firms. We are able to study these evaluation methods because of China's unique market segmentation which

[1] To simplify the presentation, we use the term IFRS to refer to both International Financial Reporting Standards issued by the IASB and IAS issued by the IASB's predecessor, the International Accounting Standards Committee (IASC).