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The valuation properties of earnings and book values reported under IAS, domestic GAAP and U.S. GAAP: Evidence from China, Hong Kong, Japan, Korea and Singapore

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ABSTRACT

This paper examines whether earnings or book value is the dominant valuation accounting measure for companies reporting under alternative accounting standards — International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS), U.S. Generally Accepted Accounting Principles (U.S. GAAP) or domestic accounting standards of China, Hong Kong, Japan, Korea and Singapore. Our sample consists of domestic firms in the five Asian countries and firms from these countries cross-listed in the United States as American Depositary Receipts (ADRs) from 2002 to 2011. For domestic firms, book value is more informative than earnings for firms from Hong Kong, Singapore, China, Japan and Korea during 2002–2011 although their accounting standards are influenced by different systems. For the ADR sample, book value is more informative than earnings for U.S. GAAP reporters and reconcilers during 2002–2007. However, earnings are more informative than book value for U.S. GAAP reconcilers from China. After 2007, ADRs in our sample from Hong Kong, Japan and Korea continued to file under U.S. GAAP. Some ADRs from China filed under U.S. GAAP and some filed under IFRS. Earnings are more informative than book value for IFRS users; however, book value has higher incremental value relevance than earnings for U.S. GAAP users. We contribute to prior research by providing evidence on the valuation properties based on accounting measures reported under different GAAPs for the Asian countries.

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1. Introduction

This paper examines the valuation properties of earnings and book values reported by companies under alternative accounting standards — International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS), U.S. Generally Accepted Accounting Principles (U.S. GAAP) and domestic accounting standards of the five Asian countries of China, Hong Kong, Japan, Korea and Singapore. Ashbaugh and Olsson (2002) find that *Earnings* is the dominant accounting measure for valuation for cross-listed firms reporting under IAS, but Residual Income is the dominant accounting measure for valuation for cross-listed firms reporting under U.S. GAAP. Their sample consists of 26 non-U.S./non-U.K. firms that traded on International Stock Exchange Automated Quotations (SEAQ) in London. We obtain a broader sample consisting of domestic firms in the five Asian countries and firms from these countries cross-listed in the United States as American Depositary Receipts (ADRs) from 2002 to 2011. The objective of this paper is to examine whether earnings or book value is the dominant valuation accounting measure in these countries with different accounting practices.

We use the models in Collins, Maydew, and Weiss (1997) to calculate incremental value relevance of earnings and book value. The firms in the domestic sample prepare their financial reports in accordance with domestic accounting standards, while the ADRs in the cross-listing sample report under or reconcile to U.S. GAAP during 2002–2007. After 2007, cross-listing firms can choose to file their reports using IFRS or U.S. GAAP (Securities & Exchange Commission, 2008). This offers us an opportunity to compare the valuation usefulness of accounting numbers reported under IFRS, U.S. GAAP and domestic accounting standards for these Asian countries.

Our study is of interest for the following reasons: the rapid growth of Asian capital markets, differences in accounting practices with convergence towards IFRS, and an increase in the number of firms cross-listing in the U.S. market. First, the rapid growth of the Asian economies during the 1990s and 2000s has generated great interest among U.S. investors in the securities of Asian-based companies. Hong Kong and Singapore were ranked as the second and the fourth largest economies

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in Asia in terms of market capitalization (Stock Exchange of Hong Kong 1999).[4] Japan is a developed market with a large market capitalization (Hoyer-Ellefsen, 2004). China's state-owned enterprises have been increasingly successful in raising capital (Zhang, 1998). Korea is one of the newly industrialized Asian economies, and had the highest GDP of the four newly industrialized Asian economies.[5] A country that opens up its capital market is more likely to use IFRS to increase access and attract foreign investors (Hope, Jin, & Kang, 2006).

Second, these Asian countries provide an opportunity to examine differences in their accounting practices on the valuation properties of accounting numbers. The accounting systems in Hong Kong and Singapore are highly influenced by the U.K. standards because they were under British rule for many years. These two countries were one of the first to implement International Financial Reporting Standards (IFRS) (Deloitte & Touche, 2008).[6] On the other hand, Korea's accounting practice is strongly influenced by tax law (Graham & King, 2000; Jang & Lee, 1997). Early adoption of IFRS was allowed for listed companies with the exception of financial institutions in 2009 and the full adoption of IFRS has been required since December 2011 (European Commission, 2011). Japanese accounting developments have been controlled by the government to serve economic expansion and tax collection (Shiba & Shiba, 1997). Japanese public companies are allowed to voluntarily use IFRS in 2010 (Deloitte & Touche, 2012), but the mandatory adoption has not yet been finalized. China revised regulations in 1998 to harmonize accounting practices with international practices. A new set of Chinese accounting standards that substantially converge to IFRS has been introduced in selected companies in 2007 (Ding & Su, 2008). As of 2010, standards and interpretations issued by IASB have been implemented in China; however, there are differences relating to alternative treatments and certain modifications which reflect China's unique circumstances (The European Commission's Report, dated July, 2011).

Finally, many firms in these countries also cross-list on foreign stock exchanges, especially the U.S. stock market, to gain access to foreign capital.[7] Cross-listing firms subject themselves to increased enforcement by the SEC, a more demanding litigation environment and increased level of disclosure (Lang, Lins, & Miller, 2003). Before the fiscal year ended November 15, 2007, the ADRs were required to reconcile to or report under U.S. GAAP for cross-listing in the United States. Our study further provides evidence on the cross-country comparability of financial reporting under U.S. GAAP, IAS/IFRS and domestic GAAP. As of 2010, full IFRS is applicable in Hong Kong, is partly adopted in Singapore, is permitted in Korea and Japan, and is substantially convergent in China (Deloitte & Touche, 2012).

For domestic firms in our sample, book value and earnings perform well in explaining market capitalization; book value is more informative than earnings. Similar results are obtained for firms from Hong Kong, Singapore, China, Japan and Korea during 2002–2011 although their accounting standards are influenced by different systems. For the ADR sample, book value is more informative than earnings for U.S. GAAP reporters and reconcilers during 2002–2007. However, earnings are more informative than book value for U.S. GAAP reconcilers from China. After 2007, ADRs can choose to file under U.S. GAAP or IFRS. ADRs in our sample from Hong Kong, Japan and Korea continued to file under U.S. GAAP. We did not find filings for ADRs from Singapore. Some ADRs from China filed under U.S. GAAP and some filed under IFRS. Our results show that earnings are more informative than book value for IFRS users, consistent with Ashbaugh and Olsson (2002). However, book value has higher incremental value relevance than earnings for U.S. GAAP users, consistent with Collins, Pincus, and Xie (1999) who find that the value relevance of earnings has declined over time, having been replaced by an increased value relevance of book value. We contribute to prior research (e.g. Ashbaugh & Olsson, 2002; Collins et al., 1999; Francis & Schipper, 1999) by providing evidence on the valuation properties based on accounting measures reported under different GAAPs for the Asian countries.

2. Prior research

2.1. Accounting standards in selected Asian countries

Hong Kong and Singapore are significantly influenced by the common law accounting system from the United Kingdom, and the more recent influence of IAS (Ball, Robin, & Wu, 2003). Accounting standards in Hong Kong have complied in material respects with the applicable IAS since 1992 (Price Waterhouse Information Guide, 1991 and 1995). In 2005, Hong Kong adopted national standards that are identical to IFRS for all listed companies; the World Bank's Report on the Observance of Standards and Codes for Hong Kong, China dated October 2009 (page 15) http://www.worldbank.org/ifa/rosc.html states that full IFRS is applicable in Hong Kong. Singapore has aligned the Singapore Statements of Accounting Standards (SAS) with the IAS since 1994 (Teoh & Ng, 1997).[8] Singapore has adopted most IFRS as the Singapore equivalent of IFRS but has made changes to the recognition and measurement principles in several IFRS (Deloitte & Touche, 2012). Singapore Financial Reporting Standards were to fully converge with IFRS by 2012, but the full convergence has not yet occurred as planned (Deloitte & Touche, 2012).

Japanese and Korean accounting was regulated by Commercial Code and Tax Law (Graham & King, 2000; Higgins, 2002; Jang & Lee, 1997; Shiba & Shiba, 1997). The Commercial Code is primarily concerned with the protection of creditors and is biased towards conservatism in accounting practices. Tax Law influences the adoption of accounting methods.[9] Japanese accounting standards are set in the public sector unlike international accounting standards that are developed by an independent standard-setting body (Mande & Ortman, 2002).[10] The accounting system in Korea was based on the Japanese accounting system and was not very transparent. The Chinese accounting system was strongly influenced by the Soviet system of accounting (Graham & Li, 1997; Zhou, 1988). After the 1980s, China developed a socialist-market economy, where capitalism and enterprises operate under the state oversight process.[11] Accounting principles have undergone

[4] The market capitalization of Hong Kong increased more than seven times from US $83,386 million to US$608,159 million during 1990–1999. Similarly, the Singapore capital market had an increase in market capitalization of more than nine times from US$21,124 million to US$192,983 million (Stock Exchange of Hong Kong 1999).

[5] The others three countries include Taiwan, Hong Kong and Singapore; source: IMF World Economic Outlook database 2004 http://www.imf.org/external/pubs/ft/weo/2004/02/data/dbcselm.cfm?G=203.

[6] International Accounting Standards (IAS) were issued by International Accounting Standard Committee (IASC) that was established in 1973. In 2001, IASC was renamed to International Accounting Standard Board (IASB), an independent standard-setting body. International Financial Reporting Standards (IFRS) are developed through the due process by IASB (IASB web site, http://www.iasb.org). In this study, we use IAS and IFRS interchangeably.

[7] As of December 2007, the market value of non-U.S. listed companies is approximately $11.4 trillion, 42% of total market value of the NYSE and the increased value from emerging countries is larger than from developed countries (Foote & Jie, 2008).

[8] The Disclosure and Accounting Standards Committee (DSAC) and the Singapore Minister of Finance recommended that Singapore adopt IAS. As of December 31, 1994, all standards issued by the IASC have been adopted by Singapore, except for three IAS. The exceptions are IAS 15 "Information reflecting the effects of changing prices", IAS 29 "Financial reporting in hyperinflationary economics" and IAS 30 "Disclosure in the financial statement of banks and similar financial institutions" (Teoh & Ng, 1997).

[9] Japanese GAAP requires conformity between financial and tax reporting (Ali & Hwang, 2000). Korea does not capitalize goodwill, and asset revaluations are amortized to equity according to schedules mandated by tax law (Graham & King, 2000).

[10] The Business Accounting Deliberation Council (BADC), an advisory body to the Ministry of Finance (MOF), sets accounting standards in Japan. A private body, Japanese Institute of CPAs, plays a role in the implementation of Japanese GAAP (Mande & Ortman, 2002).

[11] In China, all foreign-owned businesses and joint ventures must be approved by the state (Graham & Li, 1997). Land is generally not sold but leased for 50 years by the state (Smith & Brauchli, 1995). Exchange is monitored and controlled through official state bank channels (Graham & Carley, 1995).