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# Value-relevance of Earnings and Book Value Over the Institutional Transition in China: The Suitability of Fair Value Accounting in This Emerging Market<sup>☆</sup>

Xiaohui Qu<sup>b,\*</sup>, Guohua Zhang<sup>a,\*</sup>,<sup>1</sup>

<sup>a</sup> Institute for Financial and Accounting Studies, Xiamen University, Xiamen, Fujian 361005, China

<sup>b</sup> School of Management, Xiamen University, Xiamen, Fujian 361005, China

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## Abstract

This paper investigates the value-relevance of earnings and book value over 20 years of institutional transition in China, from 1991 to 2010, and explores the suitability of Fair Value Accounting (FVA) in the emerging capital market. In contrast to findings in the mature market, we find that the combined value-relevance of earnings and book value of listed firms in China has significantly increased with the improvement of accounting regulations and the development of market mechanisms. The incremental value-relevance of earnings keeps steady and shows a tendency to slightly decrease. Meanwhile, the incremental value-relevance of book value has significantly increased. We have not found evidence that FVA contributes to the improvement of value-relevance of earnings and book value due to IFRS convergence and the consequent application of FVA. © 2015 University of Illinois. All rights reserved.

*JEL classification:* M41

*Keywords:* Value-relevance; Earnings and book value; Fair value suitability; Emerging market; Institutional transition

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\* Corresponding authors. Tel.: +86 592 2180 580, +86 592 2181 172.

*E-mail addresses:* [xhqu@xmu.edu.cn](mailto:xhqu@xmu.edu.cn) (X. Qu), [ghzhang2006@163.com](mailto:ghzhang2006@163.com) (G. Zhang).

<sup>1</sup> The author is also a full time professor at the Center for Accounting Studies, Harbin University of Commerce, Harbin, China.

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## 1. Introduction

This paper is motivated by the wide convergence of IFRS around the world, and the recent concerns and debates on the economic consequence of Fair Value Accounting (FVA) adoption, especially the suitability of FVA when implemented in emerging economies. It is known that modern FVA originated from mature markets and has been widely adopted in IFRS. However, the debate on the adaptability of FVA implementation around the world has not stopped. Though FVA is shown to be superior over Historical Cost Accounting (HCA) (e.g., Barlev & Haddad, 2007; Barth, 1994; Barth and Clinch, 1996; Barth and Landsman, 1995; Carroll et al., 2003; Danbolt & Rees, 2008; Niu and Xu, 2009; So & Smith, 2009), it is also documented that FVA remains an impediment to the full adoption of IFRS in the EU and some other countries (Al-Khadash & Abdullatif, 2009; Jermakowicz & Gornik-Tomaszewski, 2006; Larson & Street, 2004; Peng & Bewley, 2010). The suitability of FVA in emerging economies is also questioned (Peng & Bewley, 2010), and empirical study (Al-Khadash & Abdullatif, 2009) reveals that FVA may distort income and mislead the users of financial statements in circumstances where the capital markets are inefficient and go through periods of uncertainty. Underdeveloped capital markets and different institutional settings are conceived to be the primary cause of the reluctance toward adoption of FVA (Cairns et al., 2011; Christensen & Nikolaev, 2013; Jermakowicz & Gornik-Tomaszewski, 2006). The quality and function of financial information may differ in different institutional settings. The empirical studies in mature markets suggest that there would be a loss in value-relevance over time (Collins et al., 1997; Elliott & Jacobson, 1991; Jenkins, 1994; Lev & Zarowin, 1999; Ramesh & Thiagarajan, 1995; Sever & Boisclair, 1990) because of periods including negative earnings or nonrecurring items (Basu, 1997; Elliott & Hanna, 1996). This might not be true in emerging markets, as accounting standards and elements of the institutional environment are constantly being improved to both correspond with and support the transition of the economies. The improved institutions and regulatory environment may eventually improve the quality of financial information and increase the value-relevance of financial reports.

The study by Filip and Raffournier (2010) reveals that the value-relevance of earnings in transitional economies differs from that in mature markets. This leads to our research inquiries: 1) In the institutional transition of emerging markets, has the value-relevance of financial reports been improved along with improvement of the institutional environment? 2) Together with the adoption of IFRS in emerging markets, has FVA contributed to the improvement of financial information and improved the value-relevance of earnings and book value? Because studies investigating the economic consequence of FVA in the context of a dynamic institutional transition are still limited, we try to answer the aforementioned questions. This paper contributes to literature by providing a dynamic test on the changes in the value-relevance of financial information over the recent institutional transition in China, and by providing a contextualized understanding of the economic consequences of implementing IFRS-converged accounting standards and the suitability of FVA implementation in the emerging market of China.

China's capital market was established in 1990 and has experienced important regulation changes, including accounting regulation changes, thereafter. FVA was introduced in 1998, discarded in 2000, and readopted in 2006 in the Chinese *Accounting Standards for Business*

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