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Value relevance of accounting information: Evidence from an emerging market

Tamer Elshandidy *

Department of Accounting and Finance, University of Bristol, 8 Woodland Road, Bristol BS8 1TN, United Kingdom
Department of Accounting and Finance, University of Helwan, Egypt

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ABSTRACT

Without making any distinction of the applicable accounting standards, this paper investigates, firstly, the value relevance of accounting information from 1999 to 2012 in different segments of the Chinese stock market. This investigation includes A-shares, prepared under Chinese Accounting Standards (CAS) for domestic firms; B-shares, prepared under either the International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS) for both domestic and overseas firms; and H-shares prepared under either the IAS or Hong Kong GAAP for Hong Kong and overseas firms. Then, the paper examines whether or not the converged IFRS with CAS, applicable from 2007 onwards, is more value relevant when compared with prior to the 2007's standards (CAS, IAS, Hong Kong GAAP for A-share, B-share, and H-share markets, respectively). Based on 34,020 firm-year observations and after controlling for industry- and year-fixed effects, the findings suggest that accounting information is value relevant with A- and B-share markets, while it is partially relevant with the H-share market. The paper finds that the converged IFRS with CAS is more value relevant in A-shares and B-shares and it is partially more value relevant with the H-share market. These findings have implications for both policymakers and investors since they provide further empirical evidence for the current policy procedure which harmonizes local GAAP with IFRS.

1. Introduction

Over the past decades, considerable attention has been paid to examining whether or not accounting information, prepared under either the International Accounting Standards (IAS) or the International Financial Reporting Standards (IFRS), has value relevance. Also, there is on-going debate on whether or not a notional accounting GAAP has more value relevance than IFRS. Prior literature on value relevance in China does not provide an extensive answer to these concerns since, over a limited period of time (between mostly a five-year period as in Lin & Chen, 2005; Liu & Liu, 2007; or even less as in Abdel-Khalik et al., 1999; Chen & Wang, 2004; Liu, Yao, Hu, & Liu, 2011), it concentrates on one or two types of sharers (A-shares as in Haw, Qi, & Wu, 1999; Bao & Chow, 1999; Chen & Wang, 2004; A-shares and B-shares as in Abdel-Khalik, Wong, & Wu, 1999; Chen, Chen, & Su, 2001). Over a period of 14 years, this paper considers all firms with A-shares, listed on either the Shanghai or Shenzhen stoke markets, and all firms with H-shares listed on the Hong Kong stock market. Hitherto, compared to previous studies, this paper is one of the largest scaled data sets and, therefore, answers a call from previous literature such as in Lin and Chen (2005).

The Chinese context offers quite unique characteristics which are the reasons for this paper. Chen and Wang (2004) explained that, in China, the capital market had grown quickly and developed more segments. These refer to the independent capital market segments, created by different kinds of ownership structure, and a funding practice which, within the Chinese context, has three distinct main segments. These are A-shares (traded by domestic investors); B-shares (traded widely by foreign investors); and H-shares (traded by Hong Kong investors).

Increasingly, attention is being paid to the extent to which accounting information, prepared under accounting regulations, is successful in meeting those investors' demands. Since 2007, all listed firms are required to provide their accounting information under a new set of Chinese accounting standards; these are seen largely to be more convergent to IAS or IFRS. Over a period of 14 years, this paper addresses whether or not accounting information has value relevance, and, then, tries to break the time period by distinguishing between the period prior to and post 2007. To that end, this paper utilizes the price model, a modified Ohlson model, and, then, expands that model to include the interaction between the period prior to and after 2007.

Accounting information can be regarded as a product of accounting systems which relies on rules and/or standards (e.g., Core, Guay, &

* Tel.: +44 117 331 0915; fax: +44 117 331 7391.
E-mail address: Tamer.Elashandidy@bristol.ac.uk.

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Buskirk, 2003). Accordingly, most investors make their decisions based on accounting numbers. Whether or not the accounting information is linked to investors' decisions becomes an imminent empirical issue to be considered. In China, given the fact that there are several different stock markets, any one company may prepare more than one financial report. There may be different levels of disclosure standards if they need to be issued stocks in more than one market. The consequences of the variations in this decision-making reflect the different accounting standards. One related question might be: how does the market reflect these different accounting standards?

Therefore, under different Chinese stock market segments, this paper examines whether or not the accounting numbers have value relevance. Also, it explores whether or not converged IFRS with CAS, was adopted mandatorily by all listed firms amongst all markets from 2007, has higher value relevance when compared to the old set of accounting standards which were applicable prior to 2007.

After holding not only industry- and year-fixed effects but also the impact of institutional characteristics, as proxied by ownership structure, the paper finds that, within both A-share and B-share markets over those 14 years, the variations, in both a firm's market value and its stock prices, are correlated significantly and positively to those changes in its reported earnings and the book value of its equity. Within the H-share market, those variations are attributable partly to accounting information (namely reported earnings rather than book value of equity). Previous results were given over the whole period of the study without observing the impact of the type of applicable accounting standards. Once this has been made, the results suggest that, within A-share and B-share markets, accounting information, based on the converged IFRS with CAS, is likely to be significantly more value relevant than the one observed for accounting information based on CAS and either IAS or IFRS.

This paper contributes to the literature on value relevance by offering a large-scaled study. It examines empirically not only the impact of accounting information on stock prices but also the impact on market value amongst three distinctive markets including A-shares, B-shares, and H-shares. Unlike most previous research (e.g., Lin & Chen, 2005; Liu & Liu, 2007) which did not validate their results against the fact that those results could be driven by firm specific and/or industry specific effects. Such research did not examine whether or not the value relevance was conditional to some underlying institutional characteristics such as ownership structure. This paper contributes, also, to the literature by questioning the extent to which the convergence, between local accounting standards and IFRS, is an effective way to improve the quality of a country's accounting system, and, then as a result, increasing the value relevance of accounting information. In this regard, this paper's empirical evidence should be of interest to investors and policymakers not only in China but also to those in other emerging markets.

2. Regulatory background

The Shanghai stock market was established in the late 1990s and the Shenzhen stock exchange was opened in early 1991. Firms, listed on those two markets, are authorized to issue A-shares for domestic investors and, therefore, their values are exhibited in Renminbi (RMB). Those firms are able, also, to issue B-shares to foreign investors. In such cases, normally, values are given in US dollars in the Shanghai market and in Hong Kong dollars in the Shenzhen market. Firms, listed on the Hong Kong stock market, are authorized to issue H-shares to local or foreigner investors, and therefore, all values are given in US or Hong Kong dollars. The segmented capital stock market shows how the differences in communication, trading rules and transfer of information in the different exchange markets. Even between homogeneous products, this can lead to some differentiation of performance in both market pricing and risk. Although the Chinese stock markets lack a long, developed history, for several reasons, there remains a special segmental situation in the Chinese stock market; this can be seen in the differences in companies' stock prices and performance after being issued in A-shares, B-shares or H-shares.[1] In comparison with other capital segmental markets, there are noteworthy Chinese characteristics. For instance, Hietala (1989) found that, usually, domestic stock prices are lower than in the foreign market. However, for companies with a dual listing, the price of overseas foreign shares is much lower than the price of A-shares issued by the same company. Fernald and Rogers (2002) investigated the discount phenomenon of foreign shares. From the extent of listed companies' disclosure of financial information, the differences, between these methods of preparation, might lead to those numbers having different value relevance in the Chinese stock market.

A-shares and B-shares are two main types of public shares issued in mainland China. In order to explore the value relevance of A-shares and B-shares, this paper starts with the applications of the prepared and audited accounting principles. These are the CAS, accepted for the A-share market, and the IAS, accepted for B-share markets. Moreover, the recent trend in A-shares has moved generally towards using IAS to replace the domestic GAAP (Fung, Lee, & Leung, 2000). The difference between A-shares and B-shares is that the former is issued only to domestic firms and uses RMB as the key exchange currency while, before 2001, B-shares, issued in U.S. dollar denominations, were not open to Chinese residents. Both A-shares and B-shares in the same companies transferred equal rights in terms of ownership (Fung et al., 2000). Once these markets were established, investors and policymakers demanded a need for relevant accounting information and, therefore, many reforms emerged to ensure that the accounting system fitted with investors' needs (Chen & Wang, 2004). For instance, for experimental listed firms, the accounting regulations were established in 1992 in order to become more reflective of an equity-oriented market rather than a traditional fund-based market. In 1998, through issuing accounting regulations, those regulations were revised to become closer to IAS. Also, these became a recognizable success in harmonizing Chinese regulations with IAS (Chen et al., 2001).

In 2006, in order to adapt to the requirements of a globalized economy, the Chinese Ministry of Finance issued officially a new set of accounting standards, namely, the IFRS converged with CAS. The new accounting standards include one common standard and 38 specific standards. Also, the supporting enterprise application guidelines constitute China's new accounting standard system (Chen & Wang, 2004) since, from 2007 onwards, all listed firms, in all markets, are required to follow those standards. One problem, for the new standards system, is accounting information reaching the next milestone on the path to the adoption of IFRS (Barniv, 2009). For instance, these are the enlargement of the scope and content of the consolidated financial statements and reclassifying the financial tools (Cheung, Jiang, & Tan, 2010).

3. Relevant previous research

The first research question, which this paper seeks to answer, is whether or not, in the different segments of the Chinese stock market, accounting information has value relevance to investors. In order to identify whether or not accounting information has value relevance, this should be assigned to the way by which accounting information drives the variations in the market indicators. Within the Chinese context, previous literature on value relevance (see Appendix A for an intensive review) was based on different approaches and offered mixed results on the value relevance of accounting information based on local or International Accounting Standards amongst and across A-share, B-share, and H-share markets.

[1] The related information about this section is all provided in the websites of the Shanghai stock exchange (SHSE) (http://www.sse.com.cn); the Shenzhen stock exchange (SZSE) (http://www.szse.cn); and the Hong Kong stock exchange (HKSE) (http://hkex.com.hk).