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Jnl. of International Accounting, Auditing & Taxation 12 (2003) 121–130

Journal of International Accounting Auditing & Taxation

The association between legal regime and the value-relevance of accounting information: a Japan–U.K. comparison

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Abstract

Prior research has shown that there is an association between the legal regime of a firm's country of domicile and the value-relevance of its accounting information. However, it is still unclear whether it is the difference in the properties of accounting information ("the supply effect"), or alternatively, if it is the difference in the way the investors in certain jurisdictions interpret and apply that information ("the demand effect") that is mainly driving this phenomenon. Since the observed pattern in value-relevance is less likely to be observed in a particular capital market that belongs to a single legal regime (where the demand effect is assumed to be constant) in case the demand effect is mainly driving the association, I test for a marginal impact of the supply effect in a single capital market setting. Using U.S. stock price data, I find that the accounting numbers of U.K. firms, prepared under U.K. GAAP, are more value-relevant than those of Japanese firms, reported under Japanese GAAP. This result lends support to the supply hypothesis and suggests that the legal regime does have a marginal impact on the value-relevance of the accounting information.

Keywords: ADR (American Depository Receipt); Cross listing; Code law; Common law; Value-relevance

1. Introduction

Ali and Hwang (2000) have shown that country-specific factors such as the legal origin of a firm affect the value-relevance of its accounting information. They document that the value-relevance of accounting information is lower in code law countries where private-sector

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1061-9518/$ – see front matter
doi:10.1016/j.intaccaudtax.2003.08.004

bodies are less actively involved in the accounting standard setting process compared to common law countries. They interpret this finding as being consistent with the premise that the government standard setters of the code law countries tend to establish financial accounting rules more to satisfy regulatory needs, such as computing taxes or demonstrating compliance with the national government policies and macroeconomic plans, rather than to provide useful information to investors.

Pownall and Schipper (1999) note that one of the limitations of the research design commonly used in these value-relevance studies (i.e., where foreign stock returns are regressed on foreign accounting variable(s)) such as the one found in Ali and Hwang (2000) is that it does not enable one to distinguish the effects of standards on the properties of accounting information from the effects of interpretation and/or application of such accounting information. This result occurs because the statistical association between stock price and accounting numbers can be driven by either the properties of accounting information (i.e., the accounting number(s) that appear as the independent variable(s)) or the users' interpretation/application of that information (i.e., stock price that appears as the dependent variable).

Econometrically, the association between stock price and accounting information will increase when (1) price becomes more informative (i.e., as price contains less noise); and/or when (2) earnings quality increases (i.e., as earnings contain less measurement errors). In this paper, I posit that price becomes more informative when investors' interpretation/application of accounting information is more rigorous and that earnings quality is higher in common law countries than in code law countries.

While it is plausible that a difference in the legal environment leads to a difference in the properties of accounting information, it is also possible that the users (i.e., investors) in different legal environments with differing levels of capital market development have different levels of skill for analyzing the accounting information. For example, La Porta, Lopez-De-Silanes, Shleifer and Vishney (1997) report that common law countries tend to have more highly developed capital markets relative to code law counties. To the extent that investors in the more highly developed capital markets are on average more sophisticated users of accounting reports, one may, therefore, observe a systematic difference in the value-relevance even if there is no material difference in the properties of the accounting information.

As a result, some readers question the validity of conclusions drawn by those studies and ask if the properties of accounting data matter at all in the observed difference in value-relevance. The main objective of this study is to shed some light on this issue by isolating the effects of the "supply effect" on the observed value-relevance difference (i.e., a difference in the properties of accounting information stemming from differences in the regulatory environment) from the "demand effect" (i.e., different levels of sophistication in using accounting data on the investors' side).

One of the ways of disentangling the two potential explanations for the observed differences in the value-relevance is to standardize the institutional setting (such as legal regime) in which investors use the accounting information by examining how the accounting information is valued in a single institutional setting. Under this *ceteris paribus* condition, I expect that the difference in the value-relevance of accounting information prepared under two different reporting standards should be observed in a single capital market (where the inter-