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Value relevance of international accounting standards harmonization: Evidence from A- and B-share markets in China

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Abstract

Applying both the price-levels model and the lagged-price-deflated returns model, we investigated the incremental value relevance of the reconciliation of accounts from the Chinese Accounting Standards (CAS) to the International Accounting Standards (IAS) by those Chinese listed companies that have simultaneously issued A-shares and B-shares. In addition, we examined the usefulness of accounting numbers (earnings and book values) and their value relevance to the A- and B-share markets in China. The study finds that earnings and book values of owners' equity determined under CAS are more relevant accounting information for the purpose of determining the prices of A- and B-shares. The CAS-based earnings changes were reflected in stock returns in the B-share market, while the CAS-based earnings were closely associated with stock returns in the A-share market. However, the study found that the reconciliation of earnings and book values from CAS to IAS basis is partially value-relevant, mainly to stock prices in the B-share market, while the earnings reconciliation is generally not value-added to stock returns in either the A- or the B-share market. The study results suggest that accounting numbers based on domestic accounting standards, in contrast to IAS, are more value-relevant in the Chinese stock market at present.

Keywords: Value relevance; International accounting harmonization; Chinese stock market; Chinese accounting

1. Introduction

Stock companies reappeared in the Chinese economy in the late 1980s. Two stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), were established in late 1990 and early 1991, respectively, followed by a rapid expansion of capital market

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in the country since then (Mookerjee & Yu, 1999; Fung, Lee, & Leung, 2000; Chen & Thomas, 2003). Nonetheless, the Chinese stock market is still far from standardized with respect to its regulatory framework. In particular, financial reporting and information disclosure is underdeveloped compared with the standards in most industrialized countries. A major problem lies in the lack of transparent and reliable accounting information to assist investors and other market participants to effectively make decisions (Chan & Rotenberg, 1999; Aharony, Lee, & Wong. 2000). In the absence of a sound regulatory system, some Chinese listed companies have released unreliable or even fraudulent information to the market (Chen, Lee, Rui, Firth, & Gao, 2002). Concerns have been raised on the quality of accounting and reporting practices in China, owing to the increasing exposures of accounting scandals in the listed companies in recent years (Chen & Thomas, 2003).[1]

As a result of the increasing public demand for improving the relevance and reliability of corporate disclosure, it has become widely accepted that the Chinese accounting system, which was developed to serve the government's centralized planning and control over the economy, should be overhauled and internationally accepted accounting standards and practices should be adopted (Ge & Lin, 1993; Mills & Cao, 1996; Lin & Chen, 1999). The internationalization of Chinese accounting is driven by a rapid progress of economic restructuring towards a market-oriented economy and the government's intention of attracting more foreign capital. In particular, following China's official entry to the World Trade Organization (WTO) in late 2001, the Chinese economy has become increasingly integrated with world markets. This development, again, calls for the harmonization of Chinese accounting standards (CAS) and practices with the internationally accepted norms since accounting serves as the language of business.

The International Accounting Standards (IAS) promulgated by the International Accounting Standards Board (IASB)[2] are widely regarded as the internationally accepted rule of accounting practice, and the need to adopt it in China has been gradually recognized (Winkle, Huss, & Chen, 1994; Xiao & Pan, 1997; Lin, Chen, & Tang, 2001). In fact, since the mid 1980s, the Chinese accounting system has been undergoing continuing reforms aimed at creating a set of accounting standards to replace the original rule-based accounting regulations (Davidson, Gelardi, & Li, 1996; Lin & Chen, 2000). At the same time as the *Accounting Standards for Business Enterprises* (ASBE) was introduced in 1993, the Chinese government also formulated the *Accounting Regulation for Companies Adopting Share-Capital Systems* (amended in 1998), which applies exclusively to listed companies. Since 1997 the government has further promulgated several transaction-based *Practical Accounting Standards* (PASs). These new accounting standards or regulations are modeled on the IAS, although a substantial gap remains between the Chinese accounting standards and IAS (Xiao & Pan, 1997; Chen, Gul, & Su, 1999; Lin et al., 2001).[3]

[1] Among them, "Ying-guan-xia," "Oriental Electronic Co.," and "Zhen Bai Weng" are particularly notorious cases, which have caused substantial losses to investors and attracted widespread criticisms of the existing accounting and reporting practices of listed companies in China.

[2] IASB was called the International Accounting Standards Committee (IASC) before 2002. Thereafter, the 'International Accounting Standards' have been retitled to 'International Financial Reporting Standards (IFRSs).

[3] For instance, Chen et al. (1999) reported, on average, earnings determined by CAS were 20–30% higher than the IAS amounts. After restating to IAS-based earnings, about 15% of the B-share companies changed from reporting profits to losses, suggesting the difference between CAS and IAS was substantial. They identified 12 major items contributing to the differences in the reported incomes, which were attributable mainly to three areas; 1) varied standard requirements in CAS and IAS, 2) effects of specific government policy such as mandatory consolidation of the original 'dual rate' system of foreign exchange and subsidies for employee housing, and 3) difference in the judgement (application of the 'conservatism' convention in particular) made by domestic auditors and the 'Big 5' who applied CAS and IAS, respectively, in auditing Chinese listed companies.