

# Is accounting information value-relevant in the emerging Chinese stock market?

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## Abstract

This study examines empirically whether domestic investors in the Chinese stock market perceive accounting information based on Chinese GAAP to be value-relevant. The study is motivated by the market-based value-relevance literature in the U.S. and by the recent developments of accounting and stock markets in China. Using a sample of all listed firms in the Shanghai and Shenzhen Stock Exchanges from 1991 to 1998 with available data, we obtain evidence of value-relevance in China based on a return and a price model. Specifically, we address three research questions. First, we document that accounting information is value-relevant in the Chinese market according to both the pooled cross-section and time-series regressions or the year-by-year regressions. Second, we further examine whether value-relevance in China changes in a predictable manner with respect to four factors including positive vs. negative earnings, firm size, earnings persistence, and liquidity of stock. Third, this study examines two competing explanations about the value-relevance of accounting information between A-share and AB-share companies and finds that investors place more weight on accounting information in A-share companies. Collectively, in this study, we report evidence consistent with the notion that accounting information is value-relevant to investors in the Chinese market despite the young age of the market and the perception of inadequate accounting and financial reporting in China. © 2001 Elsevier Science Inc. All rights reserved.

*Keywords:* Value-relevance; Chinese accounting; Chinese stock market

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## 1. Introduction

This study empirically investigates the value-relevance of accounting information in the emerging Chinese stock market. The study is motivated by recent developments in both

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research and practice. From the perspective of information economics, accounting and financial reporting play a vital role in an efficient capital market. Major accounting standard-setting bodies such as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Committee (IASC) have adopted this investor oriented information usefulness perspective and specifically stated that the primary purpose of accounting is to meet the needs of capital markets (FASB, 1978; IASC, 1994). Consequently, it is not surprising that an important objective of the Chinese accounting reform is to improve the usefulness of financial reporting in the stock market (Winkle et al., 1994; Xiang, 1998; Chen et al., 1999).

Since Ball and Brown (1968), accounting researchers have produced numerous studies documenting the association between accounting earnings and stock returns. More recently, studies about the value-relevance of accounting information have been expanded to include both balance sheet measures of assets and liabilities and income statement measures of earnings thanks to the Ohlson model (Ohlson, 1995). While earlier studies focused on the U.S. market, more recent research has investigated the value-relevance of accounting information in non-U.S. markets because of increasing emphasis on the role of accounting information in global markets (e.g., Alford et al., 1993; Amir et al., 1993; Harris et al., 1994; Barth & Clinch, 1996; Chan & Seow, 1996; Graham & King, 1998).

The current study extends this line of inquiry into the emerging Chinese stock market. Because of the unique institutional setting of the Chinese market, the results of this study have implications for both theory and practice in China and beyond. The study starts with a test of general value-relevance of accounting information in the Chinese stock market. This test is necessary not only because there is a lack of convincing evidence on the value-relevance of accounting information in China beyond anecdotal stories of how Chinese accounting is inadequate, but also because there exist identifiable, conflicting reasons for and against finding value-relevance in the Chinese market.

There are discernible factors suggesting that accounting information may not be as value-relevant in the Chinese market as in a mature market. First, Chinese accounting systems and regulations were traditionally not market-oriented. Most listed companies were state-owned before going public and the purpose of their accounting was not to provide useful information to investors but to facilitate centralized state planning and control. Although the Chinese government issued a separate accounting standard for listed companies as early as in 1992, there have been numerous unresolved issues in implementing a shareholder-oriented accounting system. Consequently, the value of accounting information in the Chinese market has been questioned in the literature (Curran, 1994; Aharony et al., 2000; Haw et al., 1998). Second, the reliability of accounting information in China has been a source of concern. Independent auditing is relatively a new phenomenon in China. While it is true that financial statements of listed companies must be audited by CPAs, the quality of audits in China has been generally perceived low (Aharony et al., 2000). A relatively weak monitoring role by outside auditors may contribute to a lack of confidence in and less use of financial statements. Finally, compared to a mature market such as the U.S. market, the Chinese market lacks a sufficient level of corporate governance such as independent outside directors, audit committee, and competition in the managerial labor market, which weakens investors' confidence in their use of accounting information.

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