A Study on Financial Reporting Standards and Accounting Quality—Evidence from China

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Abstract. According to institutional theorists, the forms and business models of corporation are mainly shaped by factors such as politics, regulations, social norms and cultures. This paper examines how the International Financial Reporting Standards (IFRS) and institutional environment influence the accounting quality, in response to the threat of political extraction in China. We took mainland China as an example instead in our study, following the accounting quality definition of Barth et al. [2], we found that the developments of Chinese government performance audit are conspicuously different by region; to reflect such differences, we elaborated our research by dividing mainland China into 31 categories (provinces or cities). We set 2003-2010 as the time horizon for this study. After testing the Regression model, our empirical research achieved two conclusions: 1) IFRS adoption in China should significantly improve the accounting quality, and 2) IFRS and institutional environment should synthetically influence the quality of accounting as well.

1. Introduction

Due to the different legislation system, tax regulation, political and economic environment, the accounting systems are varies across countries. Recently, many important changes in the accounting standards around the world, the most obvious is to adopt international accounting standards (International Financial Reporting Standards, IFRSs), and will be in a world of a single era of financial accounting standards. IFRS have now become the most popular reporting standards languages around the world as numerous listed-companies from many countries have voluntarily adopted the standards over the last decades. International accounting literatures provide evidences that accounting quality has economic consequences, such as reduce the cost of capital and open new opportunities for diversification and improved investment returns [2,7], efficiency of capital allocation, and international capital mobility [4]. On February 15, 2006, the Ministry of Finance of the People’s ROC (China), Parliament passed a regulation that requiring all firms listed on stock exchanges of China member mandatory adoption IFRS when preparing their financial statements for fiscal years beginning on or after January 1, 2007. Widespread application of IFRS will result in a significant change in the business environment.

Despite the rapid growth and development of China’s economy in the past three decades, legal institutions and economic environment in China are still far from ideal [12]. The weak enforcement of property rights has given chances to rampant rent-seeking activities by government bureaucrats, as highlighted by numerous academic studies in recent years. In particular, firms owned by private entrepreneurs are more likely to be the subject of political extraction than state-owned enterprises. This problem is exacerbated by the variation in legal institutions across different provinces in China. This motivates us to systematically examine the implication of political extraction on firms’ corporate policies. The question we address is

1 In 2001, The IASB (International Accounting Standards Board) succeeded the IASC (International Accounting Standards Committee) and assumed its standard-setting responsibilities from the IASC to harmonize the financial reporting practices to reduce diversity and facilitate cross-listings and cross-border investment.
whether application of IFRS is associated with higher accounting quality than application of local domestic standards. Furthermore, we also investigate whether institution environment that after apply IFRS reveal more timely loss recognition, and higher value relevance than application of domestic standards.

2. Institutional Background, Literature Review and Hypothesis Development

The Chinese stock market also was organized by the central government as a means to transform its socialist planned economy into a market economy. In order to prevent the mass privatization of state-owned enterprise (SOE) and maintain their dominant role, ownership structure is divided into state-owned shares, institutional shares, employee shares, A shares, B shares, H shares, and other shares. The majority of shares is still controlled by the state and institutional shareholders, and the shares are non-tradable. Such a highly concentrated ownership structure determines the unique characteristics of the agency problem in Chinese corporations; in addition, it has become one of the key corporate governance problems in China [11]. When ownership is concentrated in the hands of a few controlling ownerships, as is the case in most countries around the world, the nature of the agency problem turns into conflicts between the controlling and minority shareholders. The majority shareholders for most listed SOE, are state agencies that lack experience in monitoring and controlling public corporations. Consequently, these controlling shareholders are likely to proscribe the minority shareholders because the undersized shareholdings of outside shareholders provide them with limited power to effectively monitor the controlling shareholders [3, 5-6]. Securities regulations are less rigorous than in many Anglo-American countries. Investors, financial analysts, and government officials are often uncertain about the real meanings and the true enforceability of regulatory codes and decrees. In addition, the audit market in China is not mature. Because of SOEs’ lack of demand for international auditors, small local auditors’ superior local knowledge, and SOEs’ collusion incentives [10].

Accounting is closed linked with the economic and political environments. Existing a variety of parties, according to their economic benefit, are interested in the development of accounting standards. As a matter of facts, institutional theory has come to be regarded as a dominant theoretical perspective in organizational theory research. Accounting in real cannot be isolated from the social processes operating in and around organization. Accounting as a social and institutional practice has come to view the phenomenon of accounting as a symbol of legitimacy. Adopting IFRS appears to reduce information asymmetry between managers and stockholders. Previous literature finds a reduction of information asymmetry as evidenced by lower earnings management, lower costs of capital, and lower forecast errors. We examine each of these economic consequences below. Barth et al. [2] suggest that accounting quality could be improved with elimination of alternative accounting methods that are less reflective of firms’ performance and are used by managers to manage earnings. They compare earnings management for firms that voluntarily switch to IFRS with firms that use domestic accounting standards. They find that after IFRS adoption, firms have higher variance of changes in net income, a higher ratio of variance of changes in net income to variance of changes in cash flows, higher correlation between accruals and cash flows, lower frequency of small positive net income, and higher frequency of large losses. Barth et al. [2] also investigate the value relevance of earnings by comparing the R-squared from two regressions: 1) price regressed on book value and earnings; and 2) earnings regressed on positive and negative returns. They find that R-squared increases after IAS adoption, providing evidence of greater value relevance for IFRS earnings.

Based on the above arguments, we propose the following research hypothesis:

H1: There is a positive association among mandatory adoption IFRS, institution environment and the income smoothing.

H2: There is a positive association among mandatory adoption IFRS, institution environment and the value relevance.

3. Source of Data and Variables Description

Our data comprises of provincial-level institutional indices and firm-level corporate governance as well as financial attributes. We collect firm-level financial data and the ultimate controlling shareholder data of state-controlled and entrepreneur-controlled Chinese firms that are listed on the Shanghai or Shenzhen Stock Exchange from the Taiwan Economic
Journal (TEJ) Finance database for the 2005 to 2008 periods are selected for the study. As prior research, accounting quality is proxied by income smoothing and value relevance. Higher accounting quality is expected to reveal less income smoothing and higher value relevance of earnings and equity book value (Barth et al., [2]). To detect a change in accounting quality attributable to changes in accounting standards rather than changes in incentives, we include controls associated with firms’ voluntary accounting decisions such as growth, leverage, size, cash flow and so on as Barth et al. [2]. The two research model is as following:

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\begin{align*}
\text{Smooth}_{it} &= \beta_0 + \beta_1 IFRS_{it} + \beta_2 \text{Inst}_{it} + \beta_3 IFRS \times \text{Inst}_{it} + \beta_4 \text{Issue}_{it} + \beta_5 CF_{it} + \beta_6 \text{Lev}_{it} \\
&+ \beta_7 \text{ROA}_{it} + \beta_8 \text{Loss}_{it} + \beta_9 \text{Second}_{it} + \beta_{10} \text{Large}_{it} + \beta_{11} \text{Size}_{it} + \beta_{12} \text{Big10}_{it} + \varepsilon_{it}
\end{align*}
\]

\[
\begin{align*}
\text{Price}_{it} &= \beta_0 + \beta_1 IFRS_{it} + \beta_2 \text{Inst}_{it} + \beta_3 IFRS \times \text{Inst}_{it} + \beta_4 \text{Issue}_{it} + \beta_5 CF_{it} + \beta_6 \text{Lev}_{it} \\
&+ \beta_7 \text{ROA}_{it} + \beta_8 \text{Loss}_{it} + \beta_9 \text{Second}_{it} + \beta_{10} \text{Large}_{it} + \beta_{11} \text{Size}_{it} + \beta_{12} \text{Big10}_{it} + \varepsilon_{it}
\end{align*}
\]

where for firm i in year t, Smooth is net income increment deflate by beginning assets; Price is the year-end market price; Inst is the provinces or cities score where the home office of the listed company registered. Reissue is the incremental amount of the outstanding common stock; CF is the cash flow from operating activities scaled by total assets; Lev is total liabilities divided by shareholders’ equity; ROA is the ratio of return on assets; Loss is the prior year’s operating, 1 if operating loss, otherwise 0, a dummy variable; Second indicate that if the company has issues H-share or others DR, also a dummy variable; Large is the largest stockholder, 1 if exist, 0 otherwise; Size is the natural logarithm of total assets; Big10 is a dummy variable taking the value of 1 when the firm’s auditor is one of the Big 10 accounting firms, that is, international Big 4 plus the top 6 local audits firms and 0 otherwise.

3. Empirical Results and Discussions

The empirical results show that earnings smoothing is associated with IFRS and the institutional environment, IFRS coefficient of 0.004 and 1% significance level, and expected the same as [1], the results that China will adoption the IFRS after the guidelines can improve the volatility of the surplus earnings smoothing phenomenon has improved to support the hypothesis of this study. The institutional environment (INST) coefficient of -0.005, 1% significance level, although contrary to the expected direction of the study, regardless of the institutional environment is good or bad, earnings smoothing is very serious, does not support hypothesis 1. Morck, Yeung and Yu [8] found that emerging capital markets, corporate level information content is very low in the 40 sample countries, the severity of China's capital market ranks second. The inference may be due to local institutional environment in China are not fairly perfect. The variable of IFRS \times INST coefficient -0.004, 10% significance level, this article is expected the opposite, but the coefficient is smaller than the INST, on behalf of IFRSs into earnings smoothing has also affected due to new accounting standards adoption, the effect of its influence local institutional environment, so the coefficient is still negative, empirical results support the hypothesis.

In summary, the empirical study reveals significantly higher quality in reported accounting measures after the mandatory adoption of substantially IFRS-convergent accounting standards in China with decreased earnings smoothing and increased value relevance to stock price. The findings also empirically confirm previous researchers’ argument that IFRS can be relevant to countries like China where economic and social environments and accounting needs become similar to those of advanced economies [9].

4. Conclusions

In summary, the empirical study reveals significantly higher quality in reported accounting measures after the mandatory adoption of substantially IFRS-convergent accounting standards in China with decreased earnings smoothing and increased value relevance to stock price and return. We found that the developments of Chinese government performance audit are conspicuously different by region; to reflect such differences; we elaborated our research by dividing mainland China into 31 categories (provinces or cities). We set 2003-2010 as the
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