Have investors benefited from China's IFRS convergence?

A SUMMARY OF ACCA RESEARCH REPORT NO 31

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Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

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This paper summarises and puts into context the findings of a 2013 ACCA report on research into IFRS convergence in China.

ABOUT THE REPORT

Does IFRS Convergence Affect Financial Reporting Quality in China?, ACCA research report no 131, by Dr Edward Lee, Professor Martin Walker and Dr Colin Zeng, February 2013.

This report looks into the way the substantial convergence between Chinese Accounting Standards (CAS) and IFRS in recent years has improved the usefulness of accounting earnings for investors. The findings strongly suggest that IFRS convergence is helping China achieve more balanced, equitable and sustainable growth led by the private sector.

The full report is available from the ACCA website at: www.accaglobal.com/en/technical-activities/technical-library/financial-reporting.html

Background to the research

The research behind this report was commissioned by ACCA in late 2011 as part of an initiative to examine the impact of International Financial Reporting Standards (IFRS) on the global economy.

The research contributes to a series of reports published by ACCA on the subject, which together make a strong case for global standards:

- *Mandating IFRS: Its Impact on the Cost of Equity Capital in Europe* (Lee et al. 2008)
- *Towards Greater Convergence* (ACCA 2011b)
- *IFRS in the US: The Investor's Perspective* (ACCA 2012b).

All the above research shares a common understanding: that investors are the primary users of company accounts and that informing their decisions is one of the key purposes of financial disclosures. Yet investor opinion is not generally seen by policymakers as a reference point against which to prioritise issues, nor does it drive an agenda for continuous improvement in transparency or measures to meet the needs of shareholders (ACCA and Grant Thornton 2012). ACCA's work on IFRS aims, among other things, to rebalance the debate by placing the needs of investors at its heart.

In China, ACCA's research has consistently documented the increasing sophistication of national exchanges and investors. ACCA has most recently worked with Deloitte (ACCA 2010) and the Shanghai Stock Exchange (ACCA 2011a) to understand preparers' and investors' perceptions of and expectations from narrative reporting, and highlighted the need for better disclosures of matters relating to risk, internal controls and governance. ACCA research has also examined investors' and finance professionals' roles in driving the greening of the Chinese economy (ACCA 2012a) and noted the potential for investors to drive disclosure and transparency in the supply chain.

As a global accountancy body, ACCA strongly supports the move to one system of worldwide accounting standards, as urged by the G20 in their summit meetings since the global financial crisis of 2008–9. ACCA believes that the business environment stands to benefit from the enhanced comparability and transparency this will introduce, but this process hinges on successful convergence between national and global standards in key economies such as China.

WHAT IS VALUE RELEVANCE?

If reported accounting figures provide information to investors about the value of a company, one would expect such figures to be correlated with the company's share price. In practice, this correlation is never perfect, because reported figures are fuzzy signals: part information, and part 'noise'. Accounting noise comes from many sources: one-off events; accounting rules; intangible assets; calculation errors; more timely information not included in the accounts; or intentional manipulation by management.

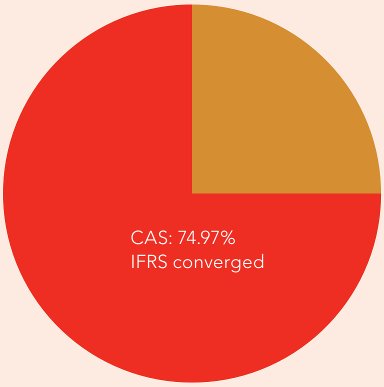
When published figures are noisy, investors have to make adjustments to them, or assume that companies with noisier accounts are riskier than they look. Both reactions weaken the link between reported figures and the company's share price. Value-relevance studies take advantage of this in order to estimate how useful the accounts are to investors, and whether they have become more useful over time.

Another way of doing this is to estimate the cost of capital for listed firms, which is very attractive because it allows researchers to assign a precise monetary 'value' to improved disclosures. Lee et al. (2008) took this approach in discussing the European experience. The researchers have avoided this approach for the current report, because conventional measures of the cost of capital rely on the assumptions of the Capital Asset Pricing Model (CAPM), which have been discredited in the last few years. Moreover, the implied costs of capital measures used in the 2008 report are not widely available for a Chinese sample because Chinese firms have a limited analyst following.

China's IFRS convergence – a natural experiment

In 2007, China adopted a new set of Chinese Accounting Standards (CAS), which the International Accounting Standards Board (IASB) believes to be 'substantially converged' with IFRS. As of early 2010, CAS were about three-quarters of the way towards full agreement with IFRS (Qu and Zhang 2010), and convergence continues.

Figure 1: IFRS converged



Source: Qu and Zhang (2010)

In *Does IFRS Convergence Affect Financial Reporting Quality in China?* (Lee et al. 2013), the researchers look at how the value relevance of accounting earnings among China's listed firms changed following the introduction of IFRS-converged CAS in 2007. The report is based on a sample of 10,017 firm-year observations of Chinese firms listed on either the Shanghai or Shenzhen stock exchange between 2003 and 2009.

To ensure that their findings were truly the result of IFRS convergence, and not other changes to the Chinese economy or capital markets, the researchers took advantage of a very fortunate feature of China's convergence path: the fact that many companies were already reporting to an IFRS-converged standard even before 2007.

Companies can issue two types of share in China. Most issue 'A' shares, denominated in RMB, which are intended for domestic investors. A large minority also issue 'B' shares, denominated in US or Hong Kong dollars (in Shanghai and Shenzhen respectively), which are mostly intended for foreign investors. Since 2001, 'B' share issuers have been required to accompany their published accounts with IFRS reconciliations.

This policy created a natural experiment. The issuers of A and B shares were similar to the treatment and control groups in a controlled experiment – they have been subject to the same influences in almost every way, apart from reporting requirements. Changes to the value relevance of reporting after 2003 can be calculated for both the 'treatment' and the 'control' group. Any changes that are significantly more pronounced among issuers of 'A' shares than issuers of 'B' shares can be attributed to IFRS convergence.

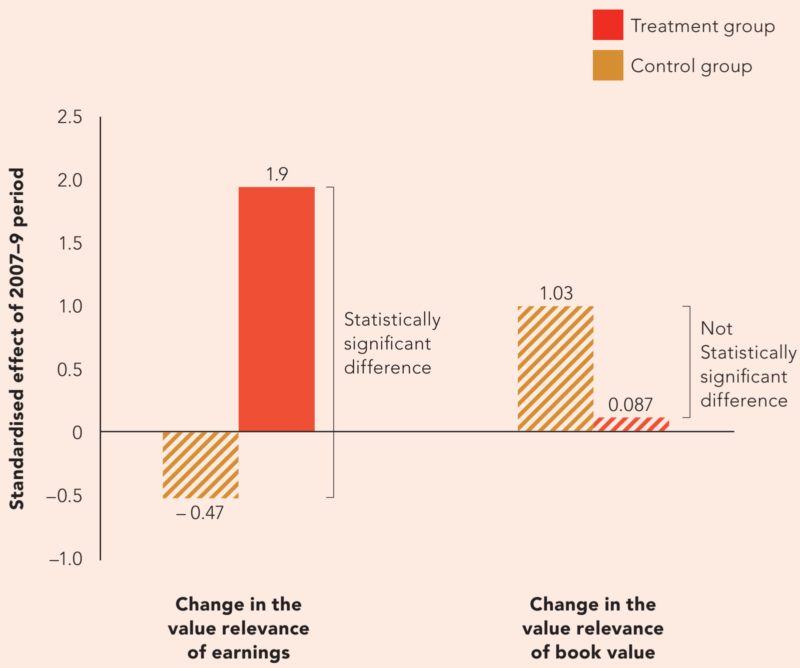
The results, part 1: assessing the experiment

The report shows that both reported earnings and book values of Chinese companies were value-relevant to some extent under the old CAS: investors took them into account when valuing the companies.

In addition, however, earnings became significantly more value-relevant under IFRS-converged CAS only in the treatment group: the A-share issuers that did not have to make IFRS-converged disclosures before 2007 (see Figure 2). In the control group (B-share issuers that had to make IFRS-converged disclosures even before 2007), earnings remained about as informative as they were previously. This analysis shows no significant changes to the value relevance of book values after 2007 in either the control or the treatment group, or any significant difference between the two.

This means that investors in Chinese firms have found earnings more informative since IFRS convergence and this change is hard to attribute to any factor other than convergence itself; and since the control group are A-share issuers, the implication is that it is mostly Chinese, not foreign, investors who saw the rise in the value-relevance of reported earnings.

Figure 2: Isolating the effect of IFRS convergence on value relevance



Note: The shaded columns indicate estimates that are not statistically significant.

The results, part 2: incentives and institutions

Having established the overall effect of IFRS convergence on the value-relevance of earnings, the researchers then focused on the treatment group of A-share issuers in order to understand which companies started producing more informative accounts after convergence, and why.

Much previous research on the impact of IFRS, including Lee et al. (2008), shows that IFRS convergence has been more beneficial in countries with more developed stock markets and better institutional frameworks than in countries without these attributes. This is something of a paradox. Moreover, if it is true, then most emerging markets should see few benefits from IFRS convergence. Why, then, has convergence yielded such clear benefits in China?

The researchers explain this paradox as being the result of companies' incentives. Some companies can better afford to alienate investors than can others. In emerging markets such as China, the overall effect of IFRS convergence will tend to average out the reactions of companies with good incentives and those of companies with poor incentives.

The researchers broke this central hypothesis down into several more specific hypotheses, which they tested among the companies in the treatment group (A-share issuers). They found that the value relevance of earnings improved among firms with the following very specific characteristics.

MANUFACTURERS

Manufacturers, who make up 50% of all market capitalisation in China, improved their disclosures more upon convergence than did other companies. The researchers anticipated this finding, because companies in the sector compete more intensely than others for equity capital.

COMPANIES IN LESS DEVELOPED CHINESE REGIONS

The researchers expected that companies in less developed regions would be more constrained in their access to finance and would therefore make more of an effort to improve disclosures post-convergence. This hypothesis was consistently confirmed, despite the fact that the researchers tried multiple definitions of 'less developed' regions (by level of government decentralisation, quality of the legal environment, credit market development and geography).

COMPANIES WITH WEAKER TIES TO GOVERNMENT

The researchers expected that a) the more a company is accountable to government as opposed to investors and b) the more a company relies on government funding, the less attention it would pay to the information needs of equity investors. These hypotheses were confirmed, as the value relevance of accounts increased most after convergence among privately owned firms, and marginally more among local government-owned companies than central government-owned ones. The benefit of convergence was greater among companies receiving less government subsidy.

FOREIGN-OWNED COMPANIES

The researchers anticipated that the scrutiny of foreign investors would encourage Chinese companies to provide more accurate disclosures. This was proved right: foreign-owned companies saw a greater increase in the value relevance of their earnings after convergence.

STOCK EXCHANGE DE-LISTING RULES

The researchers tested one last hypothesis, which was related to the rules governing Chinese listings. In China, stock exchanges impose de-listing rules intended to protect investors, according to which underperforming companies are de-listed. Under the rules in force during the 2003–9 period, companies making consistent losses for three years were de-listed. The researchers reasoned that these rules must create strong incentives for management in companies at risk to manipulate earnings in order to avoid de-listing.

This hypothesis was confirmed: companies facing a low risk of de-listing saw the value-relevance of earnings improve after IFRS convergence, while those at risk of de-listing saw no improvement. This divide is probably set to widen as, in December 2012, both the Shenzhen and Shanghai Stock Exchanges enacted new de-listing rules that are stricter than the ones in force during the 2003–9 period.

THE INSTITUTIONAL FRAMEWORK: SOME BACKGROUND INFORMATION

Figures 3–6 summarise China's performance by comparing the institutional framework of its capital markets with those of other advanced and emerging economies, as assessed by the World Economic Forum (WEF 2013).

Figure 3: WEF assessments of minority shareholder protection (scored from 1 to 7)

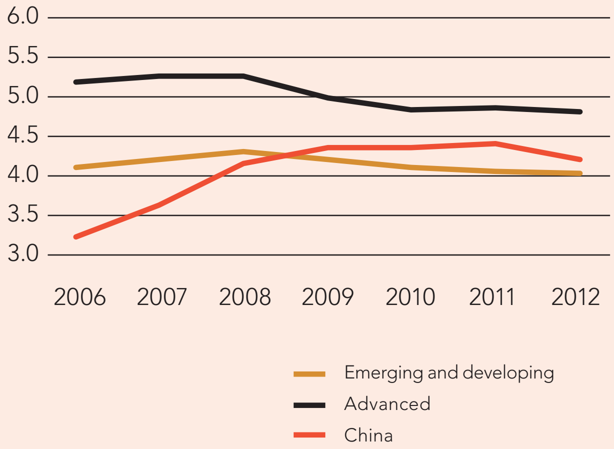


Figure 5: WEF assessments of security exchanges regulation (scored from 1 to 7)

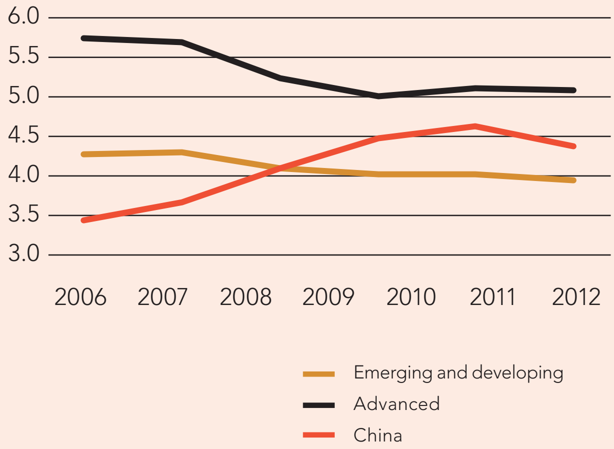


Figure 4: WEF assessments of investor protection (scored from 1 to 10)

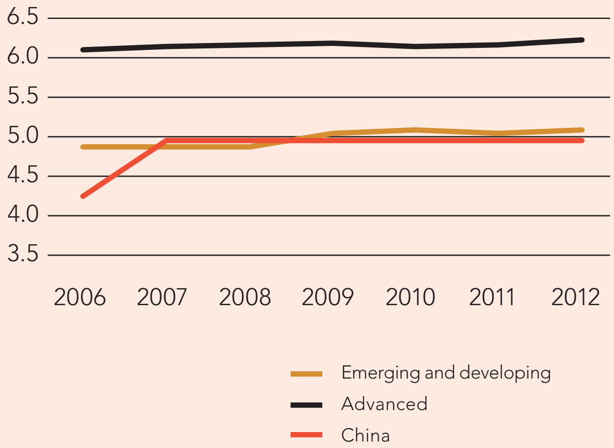
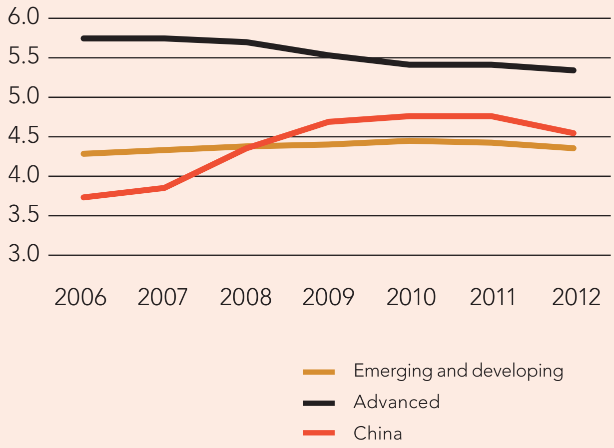


Figure 6: WEF assessments of auditing and accounting standards (scored from 1 to 7)



Conclusions

The report is a timely reminder of the value of global reporting standards. Its findings suggest that the introduction of IFRS-converged CAS (China Accounting Standards) has benefited the Chinese economy by making reported earnings more informative and useful to investors.

This relationship depends, however, on the extent to which listed firms have sufficient incentives to give an accurate account of themselves. High-quality disclosures are a particularly valuable tool for manufacturers, which face fierce competition for equity funding. Companies that cannot rely on government funding have improved their disclosures more than others; so have companies in less-developed parts of China, and those with foreign shareholders.

This means that IFRS convergence has helped China achieve more balanced, equitable and sustainable growth as well as to integrate further into the global economy. It also means that, as the institutional environment of Chinese stock exchanges continues to develop, the benefits of IFRS convergence will grow.

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