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Accounting Quality in the Accounting System of China

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«Da Venezia ho ricevuto gli insegnamenti
più preziosi della vita;
da Venezia sembra di uscirmene adesso
come accresciuto dopo un lavoro ...»

A. Modigliani

A mia madre, a mio padre, ad Andrea,
la prima cosa bella.

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前言 中国会计素质

中国经济的快速发展影响了其他经济体系，中国企业现在被认为是全球经济领域的重要参与者。。本文的目的是了解中国会计信息环境，主要集中在中国财务报表的会计信息素质。由于中国市场不成熟，由于中国的社会经济环境，中国会计据说是提供低质量的会计信息。鉴于中国经济快速增长，中国会计正在变得越来越重要。因此，改进会计信息很重要。这个假设似乎是合法的，因为会计用户对财务信息的需求不断增长，所以中国大陆应该提供更高的准确性，可比性和透明度。本文的第一部分重点是中国会计制度在这几年中所面临所发生的变化。我将从中国会计的重大变化开始。特别是从中国会计准则的发展到中国普遍接受的会计准则的采用。中国普遍接受的标准(New Chinese GAAP)符合国际财务报告准则(IFRS)。据文献分析，1992年，1998年，2001年和2006年，中国会计融合过程分为四个主要阶段，分别为财政部颁布的四项会计准则。第一次会计改革是在1992年进行的。1992年，“中国会计准则”的主要目的是为了通过建立中国会计核算概念框架，实现遵循社会主义市场，以满足统一会计核算和统一会计信息质量的需要。1998年至2000年期间的第二阶段趋同是1998年“公认会计原则”的颁布，其目的是取代以往1992年的“公认会计准则”。中国财政部提供了十个具体的中国会计准则（也称为CAS）。在第三阶段，2001年，财政部发布“企业会计制度”，以取代1998年发行的会计制度，也得益于世行提供的资金。2001年，得益于世行提供的资金的帮助，财政部发布了“企业会计制度”，2001年的ASBE由十六个CAS组成。

2006年2月15日，中国财政部发布了这套变成一套新，自2007年1月1日起在中国证券交易所上市的公司被采纳为强制性。财政部发布新“中国公认会计原则”，制定了国际财务报告准则可比较的中国企业会计准则制度，由“基本准则”，38项具体标准和实施指引组成。

2006年2月15日，中国财政部发布了新“中国公认会计准则”，自2007年1月1日起在中国证券交易所上市的公司强制性采纳。中国财政部根据国际财务报告准则制定了中国企业会计准则制度，由“基本准则”，38项具体标准和实施指引组成。当然，与国际财务报告准则的统一改变了会计信息环境，影响了会计信息素质。本节的最后部分反映了在ASBE强制性采用强制性执行ASBE之后发生的进一步的情况发展。首先，我们应该提到了中国财政部于2009年9月2日发布的“中国

企业会计准则继续全面融合国际财务报告准则”。旨在宣布中国将继续努力，继续融合。本文件的重点是达到中国新一届 GAAP 与国际财务报告准则全面趋同的最终目标 20。12 年 4 月，CASC 出具了“关于进一步改革新股发行制度的指导意见”（CASC 2012）。本文件旨在减少行政干预，完善股份有限公司股份发行基本规则，上市交易；加强市场参与者正确发挥作用；通过股价推动公司价值的可靠反映；实现中小企业平衡协调发展，保护投资者的权益。2012 年 5 月，CASC 出具了“关于进一步提高公开发行公司财务信息披露质量问题的意见”。本文件已经颁布实施“关于进一步改革新股发行制度的指导意见”中概述的重大要求。本文件的目的是进一步提高进行首次公开招股（IPO）的公司的财务信息素质，提高报表透明度，同时旨在促进所有市场参与者在发行新股时履行职责。2012 年 9 月，中国证券监督管理委员会公布了“公开发行证券公司信息披露内容和年度报告格式”，“年度报告格式”修订标准。本修订标准的目的（修订标准的目的）是提高中国会计准则的透明度，使中国财务报告更有效。中国证监会还出具了第一号和第二号“上市公司监管指引”，以简化和实现正确的披露要求。2012 年 12 月，中国证券监督管理委员会决定进行特别检查，其目的是推动基于信息披露的新股发行改革，提高会计信息质量。这些检查是根据市申请进行审查的公司进行的。在检查期间，会计师事务所被要求对潜在发行人进行财务会计信息的自查，并提交自查报告。2014 年，中国财政部发布了三项新的 ASBE（CAS 39 公允价值计量，CAS 40 联合安排，CAS 41 其他实体权益披露）（毕马威，2014 年），修订了 5 项准则，它发了几个草稿，它们正在与国际财务报告准则不断融合（AOSSG，2016）。

2015 年 11 月 24 日，财政部和国际财务报告准则基金会在受托人最后一次会议期间在北京签署了联合声明。在此次联合声明中，国际财务报告准则和中国财政部重申其新中国公认会计准则与国际财务报告准则全面趋同的目标，加强合作继续。他们签署了这份新的联合声明，是继 2005 年第一份联合声明取得的重大成果之后是 2005 年第一份联合声明以后取得的重大成果。他们突出强调了中国新一届会计准则与国际财务报告准则大幅融合的重点，强调使用这些新标准明显提高了中国财务报告的质量和透明度。本文的第二部分重点是会计质量。根据会计文献，我们可以肯定，会计质量对经济影响很大，因为高质量的信息可以真实反映企业的现状，最终提高投资效率和决策过程。财务会计素质的核心概念是，一些

会计信息比其他会计信息更可靠。然而，会计文献提供了财务会计素质的不同定义，但是从相关性，忠实的代表性和可比性等基本定性特征来考虑会计素质。会计文献只提供了财务会计素质的不同定义，而我们应该从相关性，忠实的代表性和可比性等基本定性特征来考虑会计素质。相关性是指信息在决策过程中具有价值意义，具有预测价值。忠实的陈述是指一个事实，一个信息应该消息应该代表它旨在表示的内容，应该是中立的，没有错误。相反，可以指的是为了让用户在替代方案之间进行选择，如果一个信息有可比性，则信息是有用的。以下部分将重点介绍 IAS 下的会计信息是否与较高的会计素质相关联。在本第二章的最后一部分中，将从积极理论会计 (Watts, Zimmermann, 1978 年) 开始，对会计素质确定的主要方法进行分析，这可以被看作是第一种强调机会主义选择的方法以财务会计法核算。在下一节中，将提供对本年度制定会计素质主要方法的文献综述。第一种方法描述的是基于权责发生制的方法。按权责发生制核算，收入与现金收益无关，无偿支付费用。

因此，一个实体的经营性现金流量应该从其应计收入和支出中得出，不超过应计利润之前或之后的一个操作周期。换句话说，假设财务交易和事件的结果在转换为现金之前在财务报表中转载。应计质量方法侧重于实体的现金流量权责发生程度的不确定程度。综合来看，实体的应计项目与实体的经营周期中的现金流量之间的等值变化越大，实体的应计素质越低，因此实体的会计素质越低。所描述的第二种方法是基于特定应计项目的方法。这意味着这些研究是基于有一些具体的财务报表项可能被操纵的假设。

分析研究的第三分支是基于频率分布。在这种方法中，通过预定的基准检测收益管理。例如，如果给定的公司将获得超过预设标准的盈利的竞争激励，结果是，在管理它们之后分配收益将比较少可疑，与稍微低于或特别高于固定门槛。第三部分和最后一部分分析了中国的会计信息质量。

可以说，独特的中国社会经济环境在某种程度上可能会影响中国会计制度在与国际财务报告准则大幅度融合后取得的进步。中国会计准则会导致会计质量低下的主要原因将得到总结。导致财务报告素质低的原因有很多，例如：经济和制度因素；国有上市公司所有权；政府对资本市场的控制；市场机构薄弱；有限的产权保护；政治关系的重要性和缺乏独立审计师。那么重点将放在新中国会计准则与国际财务报告准则的大幅度趋同之间是否增加了中国的会计素质。有很多研究研究了分

析了这种关系，结果是混合的。事实上，有研究认为，有可能说中国财务报表的整体质量在价值相关性，报告收益，及时性和可预测性方面有显著提高，而在其他方面，据说 IFRS 与中国标准之间的融合过程在理论上比实践更多。最后一节将重点介绍中国会计财务报告素质的主要研究。

Introduction

China and its fast economic development have affected every other economy, and Chinese companies are now considered as important players on a global basis.

The purpose of this work is understanding how is Chinese accounting information environment, mainly focusing on the accounting information quality in Chinese financial statements. This assumption seems legit because of the growing demand from accounting users for financial informations that shall provide a higher level of accuracy, comparability and transparency in mainland China. The first part of this work focuses on the changes that Chinese accounting system has faced during the years. The starting point are the significant changes that Chinese accounting has faced, such as the passage from Old PRC GAAP to New PRC GAAP, that can be considered as substantially converged with IFRS. On 15th February 2006, Chinese Ministry of Finance issued this new set of accounting standards, and their adoption became mandatory since the 1st January 2007 for companies listed on Chinese Stock Exchange. The issuance of the NEW PRC GAAP by MOF produced IFRS comparable Chinese ASBE system, that are composed by Basic Standard, 38 specific standards and an implementation guidance. Of course, the harmonisation with IFRS has changed the accounting information environment, and, as a consequence, has influenced also the accounting information quality. The final part of this section reflects the further developments that took place after the ASBE's mandatory adoption. First of all, it is fundamental to mention the «Roadmap for Continuing and Full Convergence of the Chinese Accounting Standards for Business Enterprises with the International Financial Reporting Standards» issued by Chinese MOF on 2nd September 2009. It aims to declare that China would have played all its efforts to continue the convergence process. The main point of this document is the final goal to reach a full convergence of Chinese New PRC GAAP with IFRS. Secondly, on April 2012 the CASC issued the “Guiding Opinions on Further Reforming the Issue System of New Shares” (CASC 2012). This document aims to reduce the administrative interventions, improving the basic rules for share issues of joint stock limited companies and listing and trading of their shares; enhancing market participants to properly play their roles; promote a reliable reflection of the value of a company through its share prices; realise a the balanced, coordinated development of both primary and secondary markets and to protect rights and interests of investors. On May 2012, the CASC has issued the “Opinions on Issues concerning Further Improving the Quality of Financial Information Disclosure by Companies Undertaking an Initial Public Offering”.

This document has been issued to implement the significant requirements outlined in the “Guiding Opinions on Further Reforming the Issue System of New Shares”.

The aim of this document is to further improve the quality of financial information for companies undertaking an initial public offering (IPO), increase reporting transparency and aims also to promote the fulfilment duties of all market participants while issuing new shares. In September 2012, the CSRC released the revised standard “No.2 for Contents and Formats of Information Disclosure by Companies Publicly Offering Securities —Contents and Formats of Annual Reports”. The aim of this revised standard is to enhance the transparency of Chinese Accounting practices and to make Chinese financial reports more effective. The CSRC also issued the No.1 and No.2 “Regulatory Guidelines for Listed Companies, in order to simplify and fulfil the correct disclosure requirements.

In December 2012, the CSRC decided to launch ad hoc inspections, with the precise aim of promoting a new share offering reform based on information disclosure and to enhance the quality of accounting information. These inspections were made on the financials of companies whose IPO applications were put under review.

During these inspections, accounting firms were asked to carry out a self-examination of the financial and accounting information in terms of prospective issuers and then submit the self examination reports. In 2014, Chinese MOF has issued three new ASBEs (CAS 39 Fair Value Measurement, CAS 40 Joint Arrangements, CAS 41 Disclosure of Interests in Other Entities) (KPMG, 2014) and revised five of them, and issued several Exposure Drafts in 2015 and 2016, which are in continuing convergence with IFRS (AOSSG, 2016).

The latests further development occurred on 24 November 2015, when the MOF and the IFRS Foundation signed a joint statement in Beijing, because of the Trustee’s final meeting. In this late Joint Statement, IFRS and Chinese MOF reaffirmed their goal of full convergence between New PRC GAAP and IFRS, enhancing the continuation of their cooperation. They signed this new Joint Statement as a consequence of the great results achieved after the first Joint Statement of 2005. In this meeting, they highlighted the fundamental point that Chinese New PRC GAAP are substantially converged with IFRS, emphasising the fact that the use of these new standards has noticeably improved the quality and the transparency in financial reporting in China.

The second part of this work focuses on accounting quality. According to accounting literature, it is possible to affirm that accounting quality has a great influence on economy,

because high quality information can truly reflect the current situation of a firm and, eventually, increase investments efficiency and decision making process.

The core concept of financial accounting quality is that some accounting information are more reliable than others. However, accounting literature provides different definitions of financial accounting quality, but they all consider accounting quality from its fundamental qualitative characteristics, such as relevance, faithful representation and comparability. Relevance refers to the fact that an information can be value relevant in the decision-making process and having a predictive value. Faithful representation is referred to the fact that an information shall represent what is aimed to represent and shall be neutral and free from errors. Comparability, instead, refers to the fact that in order to let users choose between alternatives, an information is useful if it can be compared.

In the last section of this second chapter, the main approaches in the determination of accounting quality will be analysed, starting from the Positive Theory Accounting (Watts, Zimmermann 1978), that can be seen as the first approach highlighting the opportunistic choices that can be made in financial accounting methods. In the following section a literature review of the main approaches of determining accounting quality developed during the years will be provided.

The first kind of approach described is the one based on accruals. According to accrual-basis accounting, revenues are recognised independently of cash collections, and expenses are recognised independently of cash payments.

Thus, an entity's operating cash flows is supposed to derive from its accrued revenues and expenses no further than one operating cycle before or after accrual.

In other words, the results of the financial transactions and events are reproduced in financial statements before the conversion to cash occurs. Accrual quality approaches focus on the degree of uncertainty in an entity's cash-flow-to-accrual correspondence. In synthesis, the more fluctuations there are in the equivalence between an entity's accruals and its cash flows in an entity's operating cycle, the lower the entity's accrual quality and, as a consequence, the lower the entity's accounting quality. The second type of approach described is the one based on specific accruals.

This means that these researches are based on the assumption that there are some specific financial statement items that are likely to be manipulated.

The third branch of studies analysed is based on frequency distribution.

In this kind of approach earnings management are detected through predetermined benchmarks. For example, if a given firm will receive a competitive incentive to reach earnings that surpass a prefixed standard, as a consequence, distributing earnings after

having managed them will be less suspicious, compared to the ones for earnings amounts that are slightly under or exceptionally above the fixed threshold.

The third and final part analyses the accounting information quality in China.

It can be said that the unique Chinese social and economic environment can, in some cases, interfere with the improvements achieved by the Chinese accounting system after the substantial convergence with IFRS. The main reasons that can lead to a low accounting quality in Chinese accounting will be overviewed.

There are a number of reasons that can lead to low financial reporting quality, for example: economic and institutional factors; state ownership of listed firms; government control of capital markets; weak market institutions; limited protection of property rights; the importance of political connection and the lack of independent auditors.

Then, the focus will be on whether the substantial convergence of the New PRC GAAP with IFRS has increased the accounting quality in China. There are a lot of studies in this field that have examined these kinds of relationships but their results are mixed. The last section of this work will focus on the main studies that have been conducted on the financial reporting quality in Chinese accounting.

Chapter 1: Accounting System in China

1.1 From the 1992 Old PRC GAAP to 1996

It is known that China is a developing country, and this implies the fact that its capital markets are relatively young. Chinese Accounting is a delicate matter, because China has a unique political, social and cultural condition. Accounting in China has always been a means in the hands of government. Thanks to the control it had on accounting, Chinese Government has been able to exert its massive control on society and economy.

As it is easy to guess, Chinese accounting has faced several transitional periods, that lead it to a substantial convergence with IFRS.

Thanks to the Open Door Policy, China had opened its doors to foreign investments. In this phase, Chinese economy underwent a revolutionary shift, in fact its economic system changed from a socialist-planned economy to a socialist-market economy. This economic reform had the main purpose of modernising China and integrating it with the international market. Since this new policy had attracted more and more foreign investments, it became necessary also to simplify the accounting practices. Before the Open Door Policy, Chinese Accounting system was based on Uniform Accounting Standards, also known as UAS. These UAS were standards developed specifically for each industry. However, the UAS were considered to be too different from Accounting International practices, so the MOF issued the Accounting Regulations for Share Enterprises, in 1985, that were considered much more similar to International accounting systems.

The greatest step forward made by Chinese Government's economic reform was in the 1990s, period in which there has been the opening of the Chinese Stock Exchange Market, in Shanghai (SHSE) in December 1990 and Shenzhen (SZSE), in June 1991. Firms that are listed on these two stock exchanges were able to issue two kind of shares: A shares and B shares. A-shares are denominated in Chinese Yuan and are predominantly traded by domestic investors. Initially, companies were only allowed to issue A shares, of course to domestic investors. Later, in order to attract foreign capital, B shares were introduced. B-shares are denominated in US dollars in Shanghai Stock Exchange and in Hong Kong dollars in Shenzhen Stock Exchange and are traded by international investors. Firms issuing A-shares should comply with Chinese GAAP while firms issuing B-shares should to comply with IFRS. There is also the case of firms issuing both A and B-shares, also

known as AB companies, in order to satisfy domestic and foreign investors (Peng and Smith, 2010). In this case, firms are required to prepare two sets of financial statements, one in compliance with IFRS and one in compliance with Chinese GAAP. Of course, after the introduction of these innovations in Chinese economy, a lot of questions arose, but the most important was about the fact that foreign investors in China had a lot of difficulties in the interpretation of the financial statements provided by Chinese companies. The above mentioned factors affecting Chinese economic policy lead to the need for a high-quality accounting system (Peng and Smith, 2010). In this way, Chinese economy shall reach an integration with the international market and attract foreign capital. According to literature, Chinese accounting convergence process can be divided in 4 main stages, according to the four accounting regulations issued by MOF respectively in 1992, 1998, 2001 and 2006.

The first stage is linked to another important event that occurred in those years. The Chinese MOF underwent a new project of developing two main principles, known as Accounting Standards for Business Enterprises, commonly called ASBE or Old PRC GAAP¹, in May 1992, and Financial Management Regulations for Business Enterprises, in November. These two set of principles became effective the 1st July 1993 and, according to MOF, these two documents shall be complementary. With this reform, accounting became a means that can be used also from external users, and not only from Chinese Government, this of course thanks to the opening of Chinese market to foreign investors.

The 1992 ASBE had the main purposes of fulfilling the need of complying with a socialist oriented market, uniforming accounting practices and granting accounting information quality by setting a new conceptual framework for Chinese accounting (Aiken and Lu, 1993). These standards can be applied by all Chinese companies, with no distinction of industry. The 1992 Standards were composed by 10 chapters, each of them dealt with a specific matter:

1. General Rules
2. Basic Principles
3. Asset
4. Liability
5. Equity
6. Revenue

¹ From 1992 to 2006, Chinese Standards can be called Old PRC GAAP, ASBE or CAS, there is no difference between these three ways of calling them.

7. Expenses
8. Profit
9. Financial Statements
10. Other Regulations

The 1992 Standard also comprehended four main sections. In the first section, composed of the first chapter, it is possible to find four macro accounting principles that were accepted internationally: going concern, accounting period, monetary measurement and accounting entity. The second section was based on the second chapter, and was composed of 12 general principles: Objectivity, Relevance, Comparability, Timeliness, Consistency, Understandability, Accrual Basis, Matching Principle, Conservatism, Historical Cost, Separation of revenue and capital expenditure and Materiality. In the second section it is possible to find the delineation of a conceptual framework, giving a great importance to accounting information quality.² The third section, that included the following six chapters, dealt with Accounting Elements, that are: asset, liability, equity, revenue, expenses and profit. The last section, chapter 9 and 10, lined up the financial statements that Chinese companies have to issue: Balance Sheet, Profit and Loss Statement and Statement of change in financial position. Companies are also required to disclose Supplementary statements and notes and Statement of Financial Affairs.

As said before, together with ASBE, MOF also issued a Financial Management Regulations for Business Enterprises. The main purpose of the Regulation was to standardise the principles issued in the ASBE, in order to make them easily applied by companies. The 1992 Regulation was made up of 46 articles organised in 12 chapters. However, the 1992 Chinese Accounting Reform was considered as a turning point for China, but, this set of Standards and its relative Regulation had to face several problems. First of all, the aim of this reform was to renew Accounting in China, but Chinese Accounting, since its beginnings, has always been too fragmented. It was hard to accomplish the aim of the reform. Furthermore, there was an overlapping between the content of these two documents, diminishing their effectiveness.

After the issuance of the ASBE, in that same year, the MOF issued 14 transitory standards for State Owned Enterprises. These were industry specific rules. The MOF also affirmed that they were transitory because a new set of 30 detailed standards would soon be issued (Xian, 1998). These 30 new standards, thanks to a 3 million dollars financial support of

² See paragraph 2.1.

World Bank, marked the beginning of a three-year collaboration between MOF, Accounting Affairs Bureau (AAB) and Accounting Standard Setting Core Group. Deloitte Touche Tohmatsu, one of the Big Six at that time, was appointed as the consultant of this project, together with Chinese Accountants. This project took place between 1994 and 1996. By March 1996, the MOF issued 30 standards applicable to all Chinese industries called Practical Accounting Standards (PAS). Compared to the 1992 ASBE, these principles were much more accurate. We can say that the 1992 GAAP were composed of the Experimental Accounting System for Joint Stock Limited Enterprises and the Accounting Standards for Business Enterprises, that is commonly called ASBE.

1.2 From the Old PRC GAAP to the New PRC GAAP: from 1998 reform to 2006 mandatory adoption of the New PRC GAAP.

In this section, all the remaining steps that lead to the convergence of Chinese Accounting Standards with IFRS will be overviewed.

The second stage of convergence, that took place between 1998 and 2000, was marked by the issuance of 1998 GAAP, with the aim of replacing the previous 1992 GAAP. In this phase, the Accounting System for Joint Stock Limited Enterprises was issued. Ten specific Chinese Accounting Standards (also known as CAS) were provided by Chinese MOF. In this same period the MOF also established the China Accounting Standards Committee, also known as CASC. This Committee had a central role in the convergence process, because its main focuses are the planning, structuring and development of the accounting standards; it also provided a selection of accounting policies and helped in the implementation of accounting standards. Before becoming effective, the Accounting Department of MOF should submit new standards' exposure drafts to CASC, in order to receive their comment and potential approval (ROSC, 2009).

The third stage of development, from 2001 to 2006, was linked to the fact that China made great efforts in the unification of accounting practices, also because it wanted to get admission in the World Trade Organisation (WTO)³. In fact, in 2001 the MOF issued the Accounting System for Business Enterprises, in order to replace the one issued in 1998, also thanks to the funds provided by the World Bank. The 2001 ASBE were composed by sixteen CAS⁴: six of them were new Specific Accounting Standards (Intangible Assets, Borrowing Costs, Leases, Interim Reporting, Inventories and Fixed Assets). Furthermore,

³ China joined WTO in 2001.

⁴ These sixteen CAS can also be called Old PRC GAAP.

five of the ten already existing standards were revised (in specific the ones about Cash Flow Statement, Debt Restructuring, Revenue Investments, Changes in Accounting Policies and Estimates and Correction of Accounting Errors) and 5 standards remained unchanged. After the 2001 reform another important change was introduced. Companies issuing A shares (denominated in Chinese Yuan) kept applying the Chinese GAAP, while companies issuing B shares started to issue two financial statements, one in compliance with Chinese GAAP and one in compliance with IFRS. This can be considered as a great step towards harmonisation with IFRS. Moreover, in 2003, the CASC was reorganised. It now comprehended 26 members that were appointed by the MOF and was organised in three professional committees: Professional Committee on Accounting Theory, Professional Committee on Accounting Standards and Professional Committee on Accounting for Government and Non-profit Organisations. From 2005, the MOF also organised several training programs with the main purpose of strengthening the understanding of the newly issued CAS. Several Accounting organisation took part in these training programs: National Accounting Institutes (NAI), The Institute of Certified Public Accountants (CICPA) and The China Accounting Securities Regulatory Commission (CSCR). These training programs were addressed mainly to listed companies and statutory regulators. We can conclude that this third phase, thanks to the desire that China had to joint the WTO, concretely contributed to the building of the basis for the following convergence phase. In this stage, Chinese accounting became more and more comparable with IFRS, lessening the difficulties for foreign shareholders.

The forth and final stage of the convergence started when, between the 7th and 8th November 2005, the CASC and IASB signed a joint statement for the convergence of ASBE/PRC GAAP and IFRS. China's Vice Minister of Finance and Secretary-General of CASC, Wang Jun, and the IASB Chairman, David Tweedie took part to the meeting⁵. However, there were also others that took part to the November meeting. From the Chinese side, Liu Yuting, CASC's member and Director-General of the Accounting Regulatory Department of the Chinese MOF, together with the key figures of the Accounting Standards Setters Team gave their contribution in this agreement. From the IASB side, also three IASB members took part in the agreement, Warren McGregor, Patricia O'Malley and Tatsumi Yamada. Also two IASB Directors joined, Wayne Upton and Paul Pacter. This statement had three main points. The first point dealt with the importance of the convergence that Chinese accounting should reach with International

⁵ Joint Statement of the Secretary General of the CASC and the Chairman of the IASB, 7-8 November 2005, Beijing.

accounting, as a direct consequence of economic globalisation, by establishing a single set of high quality accounting standards. By doing so, there should be no difference between an enterprise's financial statements prepared under CAS and one prepared following IFRS. The second point highlights the fact that the New PRC GAAP were issued with the aim of convergence with IFRS. It is also stated that there are still some differences between the two accounting systems. These differences are limited and mainly refer to the reversal impairment of losses, disclosure of party relationship and transactions. The third and last point explains that IASB has pointed out several issues regarding Chinese Accounting but this is due to the fact that China has a unique condition and economic environment. The 15 February 2006, MOF issued this new ASBE system, with the main aim of being of high quality and comparable with IFRS. On 1st January 2007, the application of New PRC GAAP became mandatory and effective. This new system was composed by a Basic Standard, that had to set the basis for issues that are not included in other standards; 38 Specific Standards, 22 of them were newly issued while 16 of them were only revised; an Implementation Guidance, a guide that can serve as an explanation of every single Accounting Standard and provide information about how financial statement should be prepared. Even though these differences, the IASB can learn from this situation and provide high quality solutions. Moreover, on December 2007, the CASC signed a joint statement on the equivalence between New Chinese Accounting standards and Hong Kong Accounting Standards. The Accounting Standards convergence process represents a huge step forward for China and China's economic development. With the convergence process, it is possible to say that China has built the basis for the integration with the world's economy. The reduction of the differences in financial reporting system will incite foreign and eventually domestic investors, gaining several advantages thanks to its new condition. As said before, there is a reduction in terms of the differences, but there is still not a complete elimination of them.

Table 1: 2006 ASBE/New PRC GAAP

Standard Number	ASBE Basic Standard	New/Revised
1	Inventories	Revised
2	Long-Term Equity Investments	Revised
3	Investment Property	New
4	Fixed Assets	Revised
5	Biological Assets	New
6	Intangible Assets	Revised
7	Exchange of Non-Monetary Assets	Revised
8	Impairment of Assets	New
9	Employee Benefits	New
10	Enterprise Pension Funds	New
11	Share-Based Payment	New
12	Debt Restructuring	Revised
13	Contingencies	Revised
14	Revenue	Revised
15	Construction Contracts	Revised
16	Government Grants	New
17	Borrowing Costs	Revised
18	Income Taxes	New
19	Foreign Currency Translation	New
20	Business Combinations	New
21	Leases	Revised
22	Financial Instruments: Recognition and Measurement	New
23	Transfer of Financial Assets	New
24	Hedging	New
25	Direct Insurance Contracts	New
26	Reinsurance Contracts	New

Standard Number	ASBE Basic Standard	New/Revised
27	Extraction of Oil and natural gas	New
28	Changes in Accounting Policies and Estimates and Correction of Error	Revised
29	Events after the Balance Sheet Date	Revised
30	Presentation of Financial Statement	New
31	Statement of Cash Flows	Revised
32	Interim Financial Reporting	Revised
33	Consolidated Financial Statement	New
34	Earnings per share	New
35	Segment Reporting	New
36	Related Party Disclosures	Revised
37	Financial Instruments: Presentation and Disclosures	New
38	First time adoption of Accounting Standards for Business Enterprises	New

Source: KPMG, 2014.

1.3 Chinese accounting harmonisation: further developments

After the mandatory adoption of New PRC GAAP, on 1st January 2007, its application has gradually expanded. This represented an important leap forward for Chinese Accounting and Chinese economy in general. This convergence process is also the result of the call from G20 and the Financial Stability Board (FSB), that sought the establishment of a single set of high quality accounting standards (ROSC, 2009). After the convergence process began, China has made his best to make a smooth transition from the Old to the New Accounting Standards. However, there have been a series of documents, issued after 2007, that can attest the status of Chinese accounting standard after the turning point of 2007.

First of all, we should mention the «Roadmap for Continuing and Full Convergence of the Chinese Accounting Standards for Business Enterprises with the International Financial Reporting Standards» published by Chinese MOF, on 2nd September 2009. This Roadmap has the aim to declare that China would have played all its efforts to

continue the convergence process. It was published in compliance with G20/FSB recommendations. It can be divided in 3 main areas of interest. The main point of this document is the final goal to reach a full convergence between Chinese New PRC GAAP and IFRS. China recognised the constant efforts made by IASB during the past years and also the brilliant results achieved. In order to reach the final goal, CASC and IASB here said that they have set up a proactive working mechanism, that requires two technical meetings a year, in order to get a detailed analysis of what happened and what will happen in the Chinese Accounting future. Chinese MOF also founded the Asian-Oceanian Standard Setters Group (AOSSG), an association of Asian-Oceanian accounting standard-setters. The purpose of the group is to discuss issues and share experiences on the adoption of IFRS and to give a significant contribution to the development of a high-quality set of global accounting standards and encouraging the adoption of IFRSs in the China. Its main objectives are:

- The promotion of the adoption and convergence process with IFRSs by jurisdictions in the region
- The promotion a coherent application of IFRS
- The regulation of the inputs from the region to the technical activities organised by IASB
- To team up Governments and Regulators and other regional and internal organisation with the aim of ameliorating the quality of financial reporting.

The second part focuses on the commitment between ASBE and IFRS to eliminate the few differences that still exist between the two accounting standards systems. The third and last part of the Roadmap schedules the main projects for the continuing and full convergence of ASBE and IFRS. IASB, in the Roadmap of 2009, expressed its desire of accomplishing its main projects by 2011. This same year is here considered as the target year for the continuing and full convergence project. We can eventually say that this Roadmap is fundamental in understanding which are the steps that came after the first convergence process' step.

On April 2012, the CASC issued the “Guiding Opinions on Further Reforming the Issue System of New Shares” (CASC 2012). The major points of this reform are based on:

- The reduction of administrative interventions over the last two years, with the aim of improving the basic rules for share issues of joint stock limited companies and listing and trading of their shares;
- To enhance market participants to properly play their roles;

- The promotion of a reliable reflection of the value of a company through its share prices;
- The realisation of a the balanced, coordinated development of both primary and the secondary markets;
- The protection of rights and interests of investors.

In the first section of the document, called “Improving rules, clarifying responsibilities and strengthening true, accurate, sufficient and complete information disclosure”, it is said that information disclosure system needs further developments. Another requirement is the reduction of the reliance on the regulatory authority's judgments on the profitability of companies that will later be listed. This point can be achieved only through the amendment and improvement of rules. Information disclosure requirements shall also be improved. Another crucial point that CSRC highlighted was the quality of information disclosure, because it should be raised from several points of views. Issuers and intermediaries shall perform their duties in compliance with laws, regulations and rules and may not disguise poor business performance of applicants. They shall state matters in accordance with laws, regulations and rules, in compliance also with the fundamental principles of good faith and professionalism. Issuers are responsible for information disclosure, thus they must adhere to the rule of conduct of good faith. Their fundamental duties and responsibilities are to provide accounting information users with reliable and complete financial accounting informations. Sponsors shall adhere to business rules and industry standards by acting in good faith, and fulfilling their duties. They shall conduct due diligence regarding the information disclosed by issuers and enhance issuers to provide complete and unbiased disclosure of basic information and risk factors, conducting necessary verifications of the professional judgements issued by other intermediaries. Accounting firms shall set up review and quality control rules. Certified public accountants shall respect their code of practice and shall apply quality control rules, ensuring the expected execution of important audit procedures, such as risk assessment, maintaining a rational professional skepticism and sensitivity to suspect financial information, preventing frauds, earnings management and other acts concerning the management. Accounting firms and certified public accountants shall provide audit reports, review reports or other assurance reports in compliance with their rules. Another important point in this document expresses the fundamental concept that a better quality of financial information disclosure can be reached only if all of the issuers and controllers respect their duties and only if any form of disguising information is absolutely

prohibited. Issuers shall set up a precise corporate governance structure, improve internal control rules, and set up a strategy for the protection of rights and interests of shareholders, especially minority shareholders. The fourth section of the document concerns the required regulations and punishment in case of violation or misconduct. In this section it is possible to understand how CRSC has worked to limit the occurrence of financial disclosure violations. In fact, it made several efforts to suppress false financial disclosure. For violations in the process of new share issues, such as financial frauds, profit manipulation and false disclosures, the relevant self-regulatory organisations shall take self-regulatory measures in accordance with their rules, while the CSRC shall be responsible of taking measures, such as regulatory measures or administrative punishment against the legal representative, financial chief and other relevant personnel of a company and the relevant personnel of an intermediary in accordance with law. Those suspected of any crime shall be transferred to the judicial authorities for criminal investigation. Where there are any expressed provisions of law or regulation, a heavier punishment shall be imposed in accordance with law. Where there are no clear provisions of law or regulation, further improvement shall be made.

On May 2012, the CASC has issued the “Opinions on Issues concerning Further Improving the Quality of Financial Information Disclosure by Companies Undertaking an Initial Public Offering” (CASC, 2012). This document has been issued to implement the significant requirements outlined in the “Guiding Opinions on Further Reforming the Issue System of New Shares”. The aim of this document is to further improve the quality of financial information for companies undertaking an initial public offering (IPO), increase reporting transparency and aims also to promote the fulfilment duties of all market participants while issuing new shares.

The first section called “All market participants shall diligently perform their respective duties to effectively improve the quality of financial information disclosure”. Financial information is fundamental for issuers that should issue a financial prospectus. According to share issue supervision, however, some problems have been found from several points of view with respect to the quality of financial information disclosure. In particular, financial information disclosed by some issuers lack of relevance or completeness, or some issuers adjust accounting policies, avoid important issues, or disguise financial statements, to the extent that some issuers are suspected of presenting false business performances or manipulating earnings. Through this document, the CRSC wanted to remember to issuers, accounting firms and other market participants that a great attention should be paid to resolve the existing problems in terms of financial disclosure, with the

final aim of improving the overall quality of financial information disclosure by companies undertaking an initial public offering. Who is responsible for issuing financial reports shall also bear the accounting responsibility for financial reports he or she issues and should also bear the disclosure responsibility for the financial information disclosed. An issuer should apply the provisions outlined in the Accounting Law and in the Accounting Standards for Business Enterprises to ensure the standardisation of the basic accounting work, to prepare accurate and reliable financial accounting reports composed by authentic and complete financial accounting information and assure the authenticity, accuracy and integrity of the financial information disclosed in a prospectus. The controlling shareholder or controller of any issuer shall not allow or help an issuer to falsify financial data, manipulate earnings or intentionally omit the disclosure of any important financial information thanks to their status. An accounting firm and its certified public accountants shall issue audit reports, examination reports or other assurance reports. An accounting firm should also further improve the quality control system and strengthen internal management. An accounting firm and its signatory certified public accountants shall effectively fulfil quality control procedures and maintain their independency during their practice, avoiding being involved in any specific accounting treatment or preparation of financial reports for an issuer.

In September 2012, the CSRC released the revised standard “No.2 for Contents and Formats of Information Disclosure by Companies Publicly Offering Securities — Contents and Formats of Annual Reports”. This is another evidence of the fact that CSRC, after the convergence process, has made great efforts in improving the quality of financial disclosure and the overall information environment in China. The aim of this revised standard is to enhance the transparency of Chinese Accounting practices and to make Chinese financial reports more effective. The CSRC also issued the “No.1 and No.2 Regulatory Guidelines for Listed Companies”, in order to simplify and fulfil the correct disclosure requirements.

In December 2012, the CSRC decided to launch ad hoc inspections, with the precise aim of promoting the new share offering reform based on information disclosure and to enhance the quality of accounting information. These inspections were made on the financials of companies who IPO applications were put under review. During these inspections, accounting firms were asked to carry out a self-examination of the financial and accounting information in terms of prospective issuers and then submit the self examination reports.

Based on all these further developments that occurred throughout the years, the convergence process continued, in fact, in 2014, the Chinese MOF have issued three new ASBEs (CAS 39 Fair Value Measurement, CAS 40 Joint Arrangements, CAS 41 Disclosure of Interests in Other Entities) (KPMG, 2014) and revised five of them⁶, and issued several Exposure Drafts in 2015 and 2016, which are in continuing convergence with IFRS (AOSSG, 2016).

One further development occurred on 24 November 2015, when the MOF and the IFRS Foundation signed a joint statement in Beijing, on the occasion of the Trustee's final meeting. In this late Joint Statement, IFRS and Chinese MOF reaffirmed their goal of full convergence between New PRC GAAP and IFRS, enhancing the continuation of their cooperation. They signed this new Joint Statement as a consequence of the great results achieved after the first Joint Statement of 2005. In this meeting, they highlighted the fundamental point that Chinese New PRC GAAP are substantially converged with IFRS, emphasising the fact that the use of these new standards has noticeably improved the quality and the transparency in financial reporting in China. Both participants of the meeting highlighted the importance of the international support for reaching the goal of one single high quality set of accounting standards, that complies with the G20 fixed objectives. This statement has been signed exactly ten years later the first one, lots of progresses has been made but they still want to enhance the cooperation for future developments, by reaffirming the objective of full convergence. In order to fulfil their expectations, they also decided to establish a joint working group, with the aim of exploring and enhancing the use of IFRS in China.

⁶ By now, Chinese ASBE are composed of 41 Standards

Chapter 2: Accounting Quality

2.1 The definition of accounting quality

In the past few years, the concept of accounting quality has been the subject of several economic and accounting studies, this because there are a lot of studies that aim to find a measure of it and because it is considered to be decisive in the corporate governance processes and can affect the correct functioning of financial markets and companies. There are a number of factors that can lead to say that there is a lack of accounting quality. The aim of the studies made in this field mainly focus on how it is possible to prevent and avoid low financial reporting quality. We should now identify what accounting quality means and the feature that an information should have in order to be considered of high quality. The term accounting quality has lots of definitions, there is no single and generally accepted definition of this phenomena. The reason why there are different definitions is due to the fact that depends on the purpose for with a given financial information is used and by who is used.

De Angelo (De Angelo, 1981) provided one of the first definition of accounting quality, that has been used in setting several frameworks. Here, accounting quality is a feature that is linked to some characteristic of the auditor:

$$P = (A \cap B) = P(B | A) P(A)$$

where:

P=joint probability

A= event A

B= event B

\cap = indicator of joint probability

$|$ =indicator of conditional probability

Accounting quality is the joint (\cap) probability (P) that a reviewer finds an error or irregularity in the client's accounting system (A) and reveals it (B).

With this definition, it is assumed that the probability of finding an error is given and positive, admitting the existence of auditing errors.

Another definition of accounting quality has been provided by both IAS and FASB conceptual frameworks, this because in order to be considered of high quality, financial statements shall fulfil the objective of financial statements and are required to have some qualitative criteria. (IAS 2006).

Which are the objectives of financial statements?

According to the IASB's Conceptual Framework, the first objective of financial reporting is to produce informations that will be useful for present and potential investors or creditors, in order to help them in their investments, credit and resource allocation decision making process. Given this assumption, financial information shall help investors and creditors to assess the real timing, the real amounts and the real certainty or uncertainty of that given business entity's future cash flows and inflows. This is fundamental in the assessment of the entity's capacity to create net cash inflows and, as a consequence, to generate returns to investors and creditors.

Who are the users of financial reports?

Another important factor that should be highlighted is the fact that financial reporting is not end in itself, it is an instrument by which is possible to help the wide users of these information in their decision making process.

Equity investors shall benefit from financial reporting because, thanks to it, they can understand if a business entity can eventually create net cash inflows and how this ability to create value can affect the prices of equity interests. Equity investors' focus is on the amounts, timing and uncertainty of these cash flows.

Creditors are the ones that lend/provide capital or other assets to a business entity who is in need of them. Present and potential creditors are interested in amounts, timing and uncertainty of these cash flows because a business entity is a means thanks to which they can gain interests and repayment of borrowings.

Suppliers, unlike the first two users, do not provide capital, but material resources of services. Financial reporting can help them to understand if the business entity they refer to can pay when due.

Employees can use financial reporting to deepen their understanding of the real condition of their employer, in terms of stability and profitability. By understanding the employer's real information, they can also understand if the employer can pay wages and grant other benefits. Customers may use financial reporting informations to assess if a given business entity can continue to provide services or goods. Governments and their regulatory bodies and tax authorities shall be in the need of financial information because they are interested in understanding whether resources are allocated in a correct way.

The IAS Conceptual Framework for Financial Reporting also provides the qualitative characteristics of decision-useful financial reporting information. In this section, the qualitative characteristics are classified in more and less useful ones. Users of financial reporting shall consider this classification during the decision making process and that the user that read these information shall know how to read them.

According to the Framework, the quality of financial reporting information is divided in relevance, faithful representation, comparability and understandability. To these four qualities we shall add two main limits, such as materiality and benefits that justify costs. These two constraints are linked together because each of them explains why in certain circumstances, some informations are included or excluded in financial reports.

Relevance refers to the intrinsic quality of information that makes it useful in case of making an investment, credit or in case of resources allocations. We can say that an information is relevant when it can help its users in forecasting the eventual effect of past, present and future transactions that may occur. There are three other fundamental concepts linked to relevance:

- *Predictive value* refers to the assumption that an item of financial reporting can be a means in a prediction process. By affirming so, does not mean that the financial item itself is a forecast, but we say that financial users (investors, creditors etc.) may refer to past information of a given business entity with the purpose of understanding and predicting how future can be. If users do not have access to past information, they will have no grounds for predictions about future. For instance, past or current financial positions of business entities are used to predict its future position and eventual performance and other financial reporting items, such as future dividends, salaries payment and interests. There is one point that shall be highlighted. As said before, information relevance is linked to predictive value but this does not mean that a relevant information has the main purpose of being predictive. A predictive value information is always not part of a series of information in which the following number in the series can be predicted observing the other numbers in that series.
- *Confirmatory value* refers to the concept that a financial item can confirm or correct previous or present evaluations. If an information confirms a previous prediction, this means that this information has increased the possibility that results will comply with the one expected, diminishing uncertainties. In case an information has changed the expectations, this means that it has changed the list of possible outcomes. Generally speaking, saying that a financial item that has

confirmatory value means that it can affect the extent to which a user has confidence in previous expectations. Predictive and confirmatory value are interconnected, if an information has predictive value, it also has confirmatory value.

- *Timeliness* concerns the aspect that an information shall be available in time in order to be useful for users in their decision making process, before it loses its possibility to influence users. This means knowing the right information in the right moment. For example, if an information is accessible after the decision time has passed, it will lose its ability of influencing financial users in their decisions and eventual valuations.

Faithful Representation refers to the concept that in order to be useful in investment, credit and eventual other decisions, a financial reporting item should faithfully represent the real economic condition it is willing to represent. The term economic condition refers to the phenomena that are included in financial reports, such as economic resources and obligations, transactions and other circumstances that can potentially change them. In previous Frameworks (IASB 1989), it is possible to find the concept of substance over form, but it is thought to be redundant, because, of course, a faithful representative financial reporting information can not be compatible with an information that subordinates substance over form. In order to faithfully represent an economic condition, an information shall be accurate and certain, if these features are not comprehended in the information, this will lessen the degree of faithful representation of that financial information.

An information that faithfully represents economic circumstances should also be:

- *Verifiable*: to faithfully represent the economic phenomena that it is willing to represent, an information should be verifiable by users. If an information is verifiable, users themselves will know that an information reflects the reality. Verifiability also implies that the information shall represent an economic condition without any error or bias and also that the verification method implied in the process shall be without errors and bias. As already said, an economic information shall lose its faithful representation feature because of errors in methodology or because of errors in the application process. Errors of methodology refer to the errors that may occur in case the measurement method used can not be able to produce a faithful representative information, for example if it omits some fundamental amounts, leading to an underestimation of amounts.

Errors of application concern the errors that may occur if a measurement method is used wrongly. This kind of errors can be intentional or unintentional. An information can be directly or indirectly verifiable. Direct verification means that a financial item is verified itself, for example by observing marketable securities and their relative price. Direct verification is most useful, because it is able to eliminate both error and bias. We can talk about indirect verification if, in order to accomplish the verification process, it is necessary to check inputs and recalculate outputs.

- *Neutrality* concerns the absence of bias in the achievement of an intended outcome or to cause a particular behaviour. This aspect is fundamental for faithful representation, because biased financial reports do not represent a real economic phenomena, and in this case we can talk of conservatism. Of course, neutrality does not refer to a kind of useless information, without the ability of influencing decisions and behaviour, but to a reliable information and free from bias.
- *Completeness* refers to the necessity of disclosing all the needed informations in financial reports, with the aim of faithfully represent an economic phenomena. For example, if in a statement of profit or loss some revenues are omitted, this would lead to an unfaithful representation of both items and totals.

Comparability is always described together with the concept of *consistency*. However, both these concepts have the purpose of accentuating the usefulness of financial information in the decision making process. The first aspect, comparability, refers to the intrinsic feature of financial information that can lead users to highlight similarities and differences between two set of economic circumstances. It does not refer to an individual information, but it refers to the quality of the interrelations lying between more information. Consistency concerns the use of the same accounting policies and practices either in the range of a single entity by period to period or in the range of a given period across several entities. In other words, we can say that comparability is the objective and consistency is the means used to achieve the purpose.

The last fundamental point highlighted in the IASB's Framework is *understandability*. The concept of understandability requires that the users of financial information should have knowledge of business and economic environment. Understandability refers to the quality of the information that enables its users to understand its meaning. An information is understandable if can be classified, characterised and it is presented in a clear and

complete manner. Of course, if an information lacks of understandability, it loses its possibility of influencing users' decisions.

As already said, in addition to these fundamental qualitative features of financial reporting information, we also have to mention two interrelated constraints on financial reporting (IASB, 2006), *materiality* and *benefits and costs*. These two constraints are useful because can help to understand why, in come cases, an information is included in financial reports, and in some other cases it is omitted.

We can talk about *materiality* if an information's omission or misrepresentation can influence the resources allocation decision making process. When talking about materiality, we should also consider that it depends also on the nature and amount of the given item judged in case of omission or misrepresentation. Materiality is not considered a fundamental qualitative feature of financial information but, for example, if an information faithfully represent a particular circumstance, of course, it will be necessary to valuate if it is a material information. The second and last constraint is related to *benefits and costs*. The benefits deriving from financial reporting information shall be a means of justification of the costs beard to provide and to use them. Among the benefits deriving from financial statements, it is important to mention a better functioning of capital markets, that can lead in a more efficient availability and pricing for consumers. The costs should be divided among direct and indirect costs. The direct one includes the cost that should be beard in order to gather and process informations, the indirect one refers to the cost deriving from litigations. However, these definitions have been included in 2006 Discussion Paper (IASB, 2006), while in 2015 Exposure Draft Conceptual Framework for Financial Reporting (IASB, 2015), the last update published by IASB, things are different. What is different is the structure of these qualitative features. The main difference that should be highlighted is that the qualitative characteristics of financial informations are divided in fundamental and enhancing qualitative characteristics.

The fundamental qualitative characteristics are Relevance and Faithful Representation. Here Relevance is described like in the 2006 Exposure Draft, but what is changed is that its definition is now linked to Materiality, that, in 2006 Exposure Draft, was considered a constraint to financial reporting. Materiality is here defined as «an entity specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report» (IASB, 2015). In the latest version of the Framework it is possible to find that relevance is linked to the concept of measurement uncertainty. Measurement uncertainty is seen as a factor that

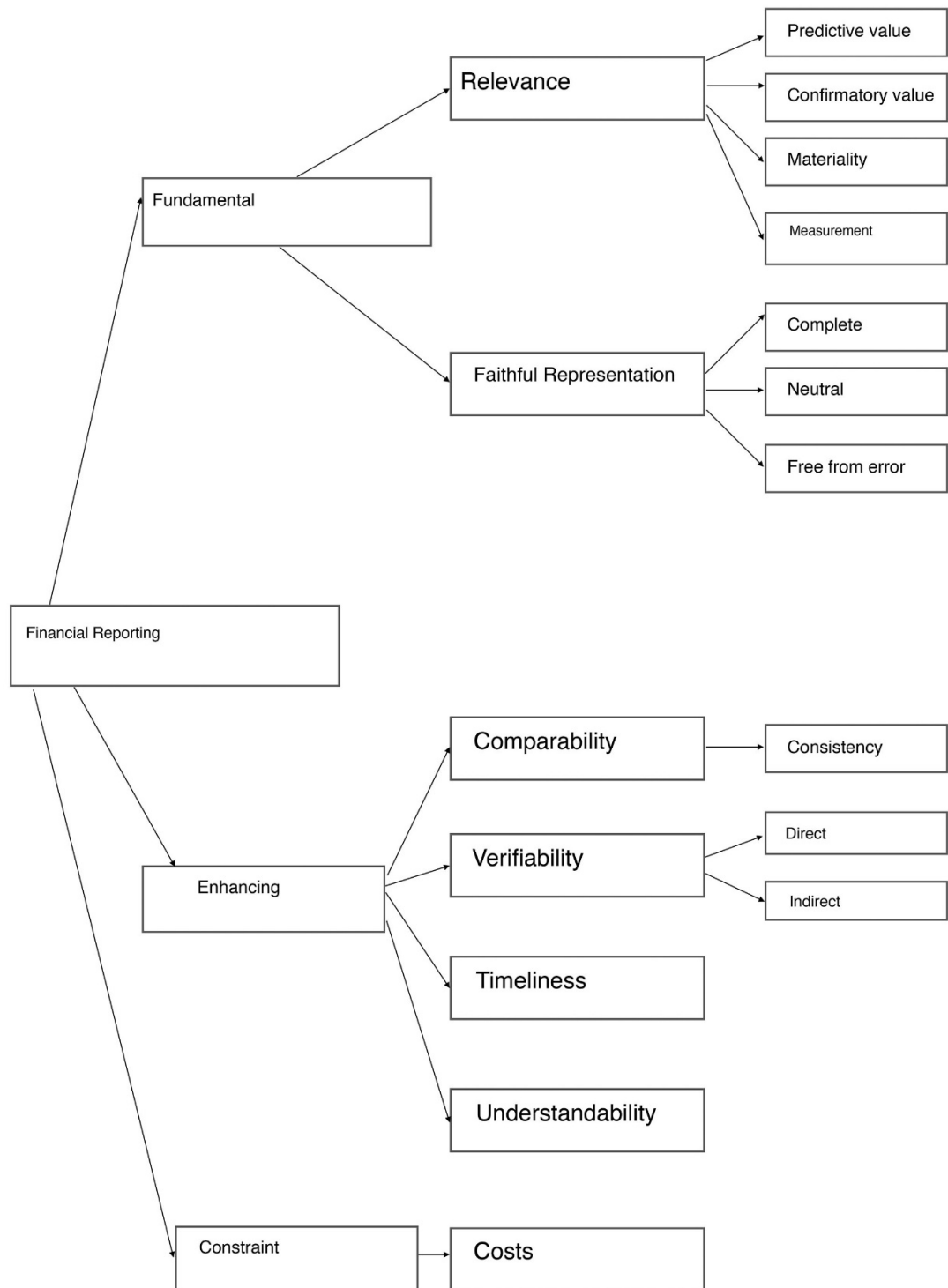
arises when an asset or a liability can not be measured directly, so it is necessary to estimate it. Estimates are fundamental in financial reporting, they shall be accurately described, in order to avoid the lessening of information relevance. An estimate can be considered relevant even if it has a high degree of measurement uncertainty. Of course, if an estimate has a low degree of measurement uncertainty, it will be much more relevant compared to one that has a high degree of measurement uncertainty.

Faithful representation is substantially described as before, but now it has three requirements. In order to be faithfully represented, an information shall have three features: complete, neutral and free from error.

The enhancing qualities are the ones that enhance the usefulness of information, that is already relevant and faithfully represented.

The major changes that can be highlighted in this second divisions are that timeliness is now part of this section, so this means that it is not related to relevance, as in the 2006 Exposure Draft. The last difference that should be highlighted is that now there is only one constraint, cost, because as said before, materiality is now linked to materiality (IASB, 2015).

Chart 1:Source: author.



2.2 Literature review of Accounting quality determination approaches

It is possible to say that the value of financial accounting is given by its quality. As already said in the previous section, the core concept of accounting quality is that some accounting information is better than other accounting information, in terms of effectiveness of the information it purports to communicate. It is not surprising that accounting quality is fundamental to participants in the financial reporting supply chain. Accounting quality has been measured through several approaches, there is a rich literature regarding this matter. We can first say that there are three main approaches for the measurement of accounting quality: accruals approach, specific accruals approach and frequency distribution approach. The first section of this study focuses on the Positive Theory Accounting developed by Watts and Zimmerman, which is the first concrete attempt of measuring accounting quality. Then the three different kinds of measurement approaches will be described, by examining the relative literature.

2.2.1 A milestone in the accounting research: Positive Theory Accounting (Watts and Zimmerman, 1978)

This section starts from Watts and Zimmerman study on Positive Theory Accounting because it is considered as a milestone in this field and also because it is one of the first approaches in these matters.

Watts and Zimmerman (1978) developed the Positive Theory of Accounting, which means analysing deeply the factors that can influence management's behaviour in terms of accounting standards, which are said to have an impact also on corporate lobbying on accounting standards. In fact, certain aspects are said to influence firms cashflows and are alternatively affected by accounting standards. In particular, these factors are taxes, regulation, management compensation plans, bookkeeping costs, and political costs. All of these factors are combined into a model which aims to demonstrate that large firms with reduced earnings, after a change in accounting standards, are favourable to the change while all the other firms are not in favour for the change, if the additional bookkeeping costs cover the cost of lobbying. They here defined the accounting standards as the result of a complex interaction among numerous agents, that employ resources to

set the basis for the accounting standards⁷. Here, Watts and Zimmermann want to build a positive theory on how accounting standards are determined, in order to deepen their understanding on the origins of the pressures affecting the accounting standard-setting process, how can various accounting standards impact on distinct groups of individuals and the allocation of resources, and the reason that leads various groups to employ resources to affect the standard-setting process. This work is seen as an expansion on Watts initial work (1974, 1977), now paying attention on the costs and benefits resulting from accounting standards which fall naturally to managements, thus helping in the understanding of the incentives that lobbies may have on accounting standards according merely to self-interest. It is even possible to assume that management's self-interest on accounting standards comply with that of the shareholders. They expressed their conviction that management has a fundamental role in the determination of standards⁸. Thus, a positive theory of standard-setting means understanding management's incentives. They then introduced the factors that are believed to be affecting managements' welfare and, their decision to consume resources trying to affect the standard setting process. In this study, Watts and Zimmermann also provided a model that includes all these factors, which is later tested using the positions taken by corporations regarding the FASB's Discussion Memorandum on General Price Level Adjustments (GPLA).

Watts and Zimmermann (1978) here assume that individuals act to maximise their own utility. As a direct consequence, management lobbies on accounting standards are also based on self-interest. As already said, they are convinced that management's self-interest on accounting standards is similar with the one of the shareholders. As a consequence, assuming that there is a similarity between management's and shareholders' self interest with no further investigation can lead to the exclusion of some relevant predictive variables that should be part of the model. In fact, they decided to analyse the two positions without the congruence assumption. The purpose of the examination is to identify factors which can act like predictors of lobbying behaviour. They postulate that management's utility is a positive function of the expected compensation in future periods and a negative function of the dispersion of future compensation. What should be understood is how can accounting standards affect management's wealth? Management's

⁷ Agencies of the Federal government (Securities and Exchange Commission and Treasury Department), state regulatory commissions, public accountants, quasi-public accounting standard-setting boards (the Committee on Accounting Procedures (CAP), the Accounting Principles Board (APB), and the Financial Accounting Standards Board (FASB)), and corporate managements.

⁸ "Management is central to any discussion of financial reporting, whether at the statutory or regulatory level, or at the level of official pronouncements of accounting bodies (Moonitz, 1974)."

total profit deriving from a firm comprehends wages, incentive compensation (for instance cash bonuses and stock or stock options).

Watts and Zimmermann (1978) in their analysis distinguished between mechanisms which benefit management's wealth:

- increases in share price (i.e., stock and stock options are more valuable)
- increases in incentive cash bonuses.

The selection of accounting standards can affect both these forms of compensation indirectly through: taxes, regulatory procedures if the firm is regulated, political costs, information production costs; while the selection of accounting standards can directly affect both these forms of compensation indirectly only through management compensation plans. The indirect factors can benefit managerial wealth because they are able to increase cashflows and share price. The indirect factor, management compensation, can increase managerial wealth because it is able to modify the terms of the incentive compensation. The selection of accounting standards can indirectly affect both these forms of compensation:

- Taxes: because tax laws are not directly related to financial accounting standards, but only in case of the last-in-first-out (LIFO) method. The adoption of a specific procedure for financial accounting does not help in reducing the occurrence of that given procedure in future Internal Revenue codes, and will increase the chance of adoption. Given the fact that management guesses a proposed financial accounting procedure to influence future tax laws, their lobbying behaviour is affected by the related tax law effects.
- Regulation: because the great majority of public utility commissions rate-setting formulas are based on accounting determined costs. Issuing a new accounting standard that reduces an utility's reported income can give management an alibi to ask for increased rates. The utility commission can decide to grant an increase depends on whether there are groups opposed to the rate increase, like consumers, because they are able to exert political pressure on the commission. Resulting from an accounting standard change, utilities have an incentive to support that change and they have incentives to deny accounting standards changes' if a rate decrease is likely to be consequential.
- Political Costs refers to the power to impact wealth distribution between various groups, which is very significant for the corporate sector. In fact, it seems that certain groups of voters receive an incentive to lobby for the nationalisation, expropriation, break-up or regulation of an industry or corporation. As a

consequence, elected officials may think that this is an incentive to enhance such actions. As an answer to these potential government intrusions, corporations take advantage of several devices, like social responsibility campaigns through the media, government lobbying and identification of accounting procedures that reduce reported earnings. We can conclude that the significance of the political costs, however, is mainly related to a firm's size.

- Information Production refers to the costs of practices like bookkeeping. In fact, we should consider that variations in accounting procedures are not costless to firms because they can imply an increase in terms of disclosure or can require corporations to change accounting methods, increasing a firms' bookkeeping costs.

The selection of accounting standards can indirectly affect both this forms of compensation:

- Management Compensation Plans refers to the fact that the main component of management compensation is incentive plan income, and it is also necessary to consider that these plans are tied to the accounting income. Accounting standards changes which implies an increase in the firm's reported earnings would then lead to a greater incentive income, but this will then lessen firm's cashflows and share prices. As long as a manager discloses a value of the after tax incentive income greater than the one representing the decline in each manager's portfolio, it is easy to expect that management will favour these kind of accounting changes. However, this implies that shareholders and non manager directors are not against accounting change or would not adjust the compensation plans for the change in earnings. As a consequence, the increased cashflows deriving from political costs, regulatory process and tax effects of an accounting change postulate that politicians/bureaucrats do not fully adjust for the change.

A fundamental assumption in Watts and Zimmermann's study assesses that shareholders and non managing directors have greater incentive to adjust and control increases in reported earnings consequent to changes in accounting standards rather than the ones of politicians and bureaucrats. However, shareholders, non managing directors, or politicians can adjust firms' accounting numbers in order to obtain a change in accounting standards, to the extent that the marginal cost of the adjustment is equal to the marginal deriving benefits. For instance, outside directors may have incentives to modify bonus compensation plans because of a change in accounting standards, but if these directors do not modify the plans, management compensation will increase while share price will

sharply decrease. However, shareholders and non managing directors' deriving benefits from the modification of compensation plans are immediate and direct, given an efficient capital market for equity claims. There is a greater likelihood that a given accounting standard change will result in increased tax, regulatory, and political benefits than that the same change will result in increased management compensation. For a given accounting standard change, managers should expect their own shareholders and outside directors to make a more complete adjustment than politicians.

According to this background, Watts and Zimmermann guess that managers are more likely to have greater incentives to choose accounting standards reporting lower earnings hereby increasing cashflows, firm value, and their welfare due to tax, political, and regulatory considerations rather than choosing accounting standards which report higher earnings and, hereby, increasing their incentive compensation. Nevertheless, this prediction is restricted to firms regulated or subject to political pressure. In fact, in small, unregulated firms, they guess that managers receive incentives to adopt accounting standards reporting higher earnings, if the foreseen incentive compensation gain is greater than the inevitable expected tax consequences. Finally, management is also expected to pay a great attention to how accounting standard can affect a firm's bookkeeping costs. Both indirect and direct factors are now combined together to develop a model of corporate lobbying standards. Given a proposed accounting standard, management's position is related both on the a firm's size, because it has an effect on the magnitude of the political costs, and is also related to whether the consequent increases or decreases in a firm's reported earnings the accounting standard may cause.

To conclude, Watts and Zimmermann (1978) in their study questioned why firms would employ resources with the aim of influencing the determination of accounting standards. A plausible answer to this question is related to the government intervention argument, which means that firms having subscribed a contract with governments, both directly through regulation (public utility commissions, Interstate Commerce Commission, Civil Aeronautics Board, etc.) or procurement, and indirectly through possible governmental intervention (antitrust, price controls, etc.), can influence their future cash flows by dampening government's action by reporting lower net incomes. The fundamental factor illustrating managerial voting preference on General Price Level Accounting is firm size because larger firms are more likely to lean toward GPLA (if earnings decline). This point is consistent with the fact that larger firms are easier subjected to governmental interference and, thus, have more to lose compared to smaller corporations.

The fact that there are costs generated by government intervention is likely to have more significant consequences on a firm's decisions than just its lobbying behaviour on financial accounting standards. As a consequence, a firm is expected to manage its reported earnings, but also to modify its investment-production decisions in case the potential costs of government interference are high. For instance, government intervention costs may influence a firm to choose less hazardous investments, thus avoiding high returns which can increase the occurrence of government intervention. The results tend to confirm the hypothesis that the decline in systematic risk as firm size rises and as government intervention costs increases.

However, after 1978 study, Watt and Zimmermann, published another study the following year (1979). This study is considered to be not very productive by the authors themselves but ten years later, (1990) they published another research which can be seen as a review and as a critic to their first work, which they defined controversial. In this paper, they said that 1978 study gave its contribution in terms of developing the concept of positive accounting theory. In this paper, they aim to improve the link between theory and practice, lessening calculation errors and developing a model which recognises that both direct and indirect variables are endogenous in the regression.

2.2.2 Accounting quality determination approaches based on accruals

The first approach that is analysed in this section is the one that measures accounting quality through accrual quality (AQ) approach. According to accrual-basis accounting, revenues are recognised independently of cash collections, and expenses are recognised independently of cash payments. Thus, an entity's operating cash flows is supposed to derive from its accrued revenues and expenses no further than one operating cycle before or after accrual. In other words, the results of the financial transactions and events are reproduced in financial statements before the conversion to cash occurs. Accrual quality approaches focus on the degree of uncertainty in an entity's cash-flow-to-accrual correspondence. In synthesis, the more fluctuations there are in the equivalence between an entity's accruals and its cash flows in an entity's operating cycle, the lower the entity's Accrual Quality and as a consequence the lower the entity's accounting quality. What is important to underline is that, in accounting quality measurement, accrual models are easy to manage compared to profit and cash flows. In fact, managers who want to make a firm's financial report higher earnings, will surely try to reach this goal thanks to strategies that may act on accruals in terms of amounts and time, considering the fact that

they cannot interfere in cash flows. Given the assumption that the distinction between accrual basis and cash basis concerns time, thus no difference can be found in a firm's accruals and cash, considering the total operating period of the firm (Jones, 1991). Beneish (2001) outlined the main reasons to focus on accrual based approaches:

- Accruals one of GAAP's results, if an earning is going to be managed, it will be accrued on the accrual side of the profit, thus not on cash side;
- Focusing on accruals lessens the occurrence of the problems related to the measuring of the distinct accounting policy preferences that have an impact on profit;
- In case earnings management is a non evident part of the accruals, pointing out the outcome of earnings management on disclosed profit is unlikely from the position of investors.

Concerning accruals, there are two main distinctions that should be highlighted. The first distinction is between short and long term accruals (Teoh, Welch, and Wong, 1998). Another important distinction that should be mentioned, refers to how is their position in terms of the control of the management. This separation is the one between discretionary and non discretionary accruals. The short term and discretionary accruals are the centre of the great majority of studies on earnings management. Discretionary accruals, that are also known abnormal accruals or unexpected accruals, are defined as non-obligatory expenses that are yet to occur but are recorded in the accounting book.

In fact, if managers are willing to modify accounting numbers, they will surely focus on financial events recorded in a discretionary way or can be omitted. On the other hand, non discretionary accruals, also called normal accruals, are defined as obligatory expenses that has yet to occur but are already recorded in account books.

The first model that will analysed is the one of Healy (Healy, 1985). This paper analysis is based on bonus contracts, gaining a more exhaustive definition of their accounting incentive impacts. It has been defined as a too simplistic study, in terms of estimating discretionary accruals, so for this reason it gained a lot of critics (Young, 1999). The test findings can be summarised as follows:

- (1) Managers' accrual policies are linked to income-reporting incentives of their bonus contracts.
- (2) Managers' changes in accounting procedures are linked with the adoption or variation of their bonus plan.

Healy (1985) Model is one of the first model in this field and it assesses that earnings management occurs in every period. In this study, Healy developed the hypothesis that managers who are in the position to receive bonus schemes according to a firm's performance are likely to raise the bonus schemes they are supposed to receive and then manage earnings. The theory is tested using actual parameters and definitions of bonus contracts for a sample of 94 companies. In this study it is stated that a firm's earnings include cash flows deriving from operations, both non discretionary and discretionary accruals. The accounting transactions related to non discretionary accruals and cash flows ordinarily must be completed in a manner which complies with regulations while discretionary accruals can be recorded in compliance with the policies and manners settled by managers. In this research what is assumed is that, in a specified frame, managers are likely to act upon earnings amount by periods by managing discretionary accruals. Watts (1977) and Watts and Zimmerman (1978)⁹ stated that bonus schemes are a fertile soil for managers to choose accounting procedures and accruals to increase the present value of their bonuses. This paper can be seen as a completion of the positive theory accounting Watts and Zimmerman developed, because it provides a more complete view of the accounting incentives that may derive from bonus schemes. The key starting concept here is that a current year discretionary accruals are part of last year's total accruals. In Healy's approach, discretionary accruals are predicted to equal zero. It is here postulated that a firm whose discretionary accrual amount is different from zero is applying earnings management, while a firm whose discretionary accruals amount is less than zero is increasing its profits, and finally a firm whose discretionary accruals are major than zero decrease profits. Furthermore, in this paper it is also stated that due to restrictions linked to legislation and restrictions caused by independent external audit, in case a company has increased its profits in a certain period of time, a contrasting policy would later be sought. If this is the case, it is postulated that the total amount of earnings management applications equals zero while the managers are in charge.

Healy (1985) pointed out three consequent situation that may derive from the assumption that managers, while they are in charge, are likely to choose discretionary accruals for the current and following two periods:

1. In the first situation analysed, a manager can choose discretionary accruals with the aim of decreasing profit. There are two deriving possibilities this first situation. Firstly, there can be the case in which profit before discretionary accruals is major

⁹ See paragraph 2.1

than the profit target decided for the bonus scheme, also called lower bound. Given this case, a manager cannot surpass the bonus scheme applying profit management, thus will not receive the bonus scheme. As a consequence, the manager will choose a strategy to lessen the discretionary accruals. The second possible case is when the profit before discretionary accruals, in period t , is between the discretionary accrual bound and the bonus scheme one. Given this case, a manager is able to decide either to diminish or to increase discretionary accruals. According to manager's decision, there are two possible outcomes. If a manager decides to increase discretionary accruals, he/she will receive bonus scheme for that current period but not the one expected for the next period. If the manager decides to lessen discretionary accruals, he/she will optimise the bonus scheme expected for next period but he/she will not receive the one expected for the current period. To conclude this point, it is evident that it is all in manager's hands, whether to reach the bonus in the current period and not in the following one and vice versa.

2. In the second situation analysed, a manager can choose discretionary accruals with the aim of increasing profit. If this is the case, it is foreseeable that a manager knows that it is possible to surpass the fixed lower bound in order to get the bonus scheme, but it is not simple to surpass the upper bound.
3. In the third situation analysed, the manager can choose discretionary accruals with the aim of diminishing profits. If this is the case, it is foreseeable that a manager knows that it is impossible to surpass the upper bound in order to get the bonus scheme, thus the manager, in the current period, will use discretionary accruals, that were addressed to diminish profit, with the aim of increasing next period's bonus scheme.

Healy (1985) developed this model for assessing the amount of Total accruals, including both discretionary and non-discretionary accruals ($ACC_t = NA_t + DA_t$), and given by the difference between reported accounting earnings and cash flows from operations. To conclude, it is possible to say that bonus schemes are considered as a means that managers can use to choose accounting procedures and accruals to optimise the amount of the bonus they are supposed to receive. As a consequence of this statement, schemes are effectively a mean which is capable of influencing managerial accrual and accounting choices, this because there is a link between accruals and managers' reported income incentives in bonus contracts. Findings in Healy (1985) study comply with the statement that managers prefer to choose income-decreasing accruals if their bonus plan upper or lower bounds

are binding, while they would prefer income-increasing accruals in case they are not binding. Findings which compared accruals for firms whose bonus plans comprehend and omit an upper bound support the assumption that if cash flows remain stable, accruals are expected to be lower for company-years having binding bonus plan upper bounds rather than for company-years without upper bound. Tests also suggest that the great majority of voluntary changes in accounting procedures are reported in the years consequent to the adoption or to changes of a bonus plan. Therefore, managers are not likely to change accounting processes to lessen earnings if the bonus plan upper or lower bounds are binding.

The second approach examined is the one made by De Angelo (1986). In this study, De Angelo developed the hypothesis that managers are likely to apply earnings management with the aim of modifying stocks in order to make them look less valuable, while publicly traded companies are brought to the non-public private company status with management buyout. In her study, she selected data regarding 64 companies that submitted a management buyout of public shareholder in NYSE (New York Stock Exchange) and AMEX (American Stock Exchange), taking as a sample period the years between 1973 and 1982. Among these 64 sample firms, 26 were listed on the NYSE while the remaining 38 were listed on AMEX. However, from the data selected, there is no proper evidence that managers regularly selected accruals with the aim of minimising the reported income of publicly owned firms in the period previous to the buyout.

The test she made in order to assess how earnings management is pursued has been developed taking total accruals as a fixed criterion in the period before the buyout. In fact, what De Angelo made is to estimate the differences in total accruals, postulating that the would be zero in case of no earnings management. We should consider that De Angelo's approach is deemed to be a modified version of the Healy's approach (1985), because no estimation period has been used in the test, except for the non discretionary accruals, for which only the previous year is considered. Another shared characteristic between the two approaches is that, in both cases, total accruals from the estimation period serve as a proxy for the predicted non discretionary accruals. In both approaches it is possible to provide an accurate calculation of non discretionary accruals, in case non discretionary accruals remain stable throughout time while discretionary accruals equal zero in the estimation period. On the other hand, in case non discretionary accruals are subjected to changes throughout time, both Healy (1985) and De Angelo (1986) will not be able to provide accurate measurements. It is licit to ask which model should be used, in terms of greater accuracy. The answer to this question depends on which kind of time series

produces the non discretionary accruals. Healy Model (1985) would be the best choice if non discretionary accruals are subjected to a constant a white noise process.

The third study in the accrual based approaches is the one made by Jones (1991). Her aim was to prove if firms would be advantaged by import relief, such as tariff increases or quota reductions, which can be seen as an effort to decrease earnings by means of earnings management, while during import relief investigations are made by the United States International Trade Commission (also known as ITC). The evident use of accounting numbers in import relief regulation constitute incentives for managers to modify earnings, with the aim of increasing the rate of possibility to gain an import relief or to maximise the relief. Differently from other researches on earnings management, in which generally conditions in which all contracting parties may receive an incentive to manage accounting numbers are examined, in Jones (1991) import relief investigations are seen as an unconventional reason for applying earnings management, that has not been analysed in previously provided studies on this matter. First of all, we should explain what import relief is. It can be defined as:

“A wealth transfer from a group of diffuse losers (consumers) to a group of concentrated winners (all other contracting parties of domestic producers receiving import relief).^{10c}”

What she argued is that that consumers do not pay a great attention to earnings management in the same way losers, this is mainly due to the fact that a consumer's loss is smaller and they have different interests from the ones of the contracting parties. Moreover, regulators have a minimum incentive to take account for managers' earnings manipulations, given the fact that their ultimate advantage for these kind of adjustments is not direct rather than in other situations.

To conclude, it is necessary to express the point that this research wants to observe how accounting numbers can be used in federal government program as a means for wealth transfers, such as import relief. Given this context, the discretionary component of total accruals is more effective, mainly because the ITC focuses on earnings before taxes, which comprehends the impact of all the accrual accounts, and, as a result, managers are inclined to employ different accruals to minimise reported earnings. Regarding non discretionary accruals, it is possible to say that they are here determined thanks to firm's specialised predictions. The model set up in this study can be intended as an extension of

¹⁰ JONES, J.J, «Earnings Management During Import Relief Investigations.», Journal of Accounting Research, vol.29 (2), 1991, pp. 194.

the ones used in similar studies. In specific, time-series models are suggested in the estimation of total non discretionary accruals, while cross-sectional tests are suggested in the estimation of earnings management. However, the consequent findings of these tests support the hypothesis that managers are likely to minimise earnings thanks to earnings management being applied while import relief investigations are ongoing.

In this model what is tried to be understood is if companies that want to benefit from import support are more likely to apply earnings management applications or not, with the aim of minimising their earnings, while ITC auditing period. With this strategy, managers have more possibilities to get the import relief they pursue or they are able to maximise the sum of the relief granted.

The main hypothesis in Jones (1991) is that:

“Managers of domestic producers that would benefit from import protection make accounting choices that reduce reported earnings during ITC investigation periods as compared to non investigation periods.¹¹”

The empirical tests might not support the earnings management hypothesis for several reasons. First, managers may believe the ITC adjusts for their discretionary accounting choices, reducing their incentives to use accounting choices to manage earnings. Interviews conducted at the ITC indicate that the ITC does not adjust for accounting choices, and most of the information that the ITC uses in its injury determination is publicly available; therefore, managers should be aware of the ITC's practices. Second, financial performance of the affected firms may be so bad that managers do not need to use accounting choices to manage earnings. If the amount of injury found by the ITC impacts the amount of relief granted, then firms will still have an incentive to manage earnings. Third, managers may rely on cost allocations rather than accruals to manage earnings for the product line investigated by the ITC. Cost allocations can be used by managers to shift revenues and expenses between the product line being investigated by the ITC and other product lines. Finally, the power of the tests may not be sufficient to detect managers' income-decreasing accounting choices. The sample selection procedures and empirical tests described in subsequent sections are designed to mitigate as many of these limitations as possible. Jones (1991) in this study limited the samples to import relief investigations requiring the ITC to provide an injury determination, such as

¹¹ JONES, J.J, «Earnings Management During Import Relief Investigations.», *Journal of Accounting Research*, vol.29 (2), 1991, pp. 200.

antidumping, countervailing duty, and general escape clause investigations. Another limitation related to the samples concerns the fact that she selected only investigations referring to a broad product line. This limitation is due to the fact that earnings management referring to small product lines may not be linked to the consolidated financial statement data in the empirical tests. However, it should be considered that there are a number of ways to apply earnings management, for instance through the use of accruals, modifications in accounting methods, and alterations in capital structure. In this research, total accruals are considered as the source of earnings management. Concretely, in this paper discretionary accruals are employed as a parameter of managers' earnings management in import relief investigations periods. Jones (1991) decided to use total accruals to detect earnings management, rather than using a single specific accrual (McNichols and Wilson, 1988)¹² because total accruals are able to include a larger section of managers' intervention. Findings in this study support the hypothesis that managers are likely to issue income decreasing accruals in the period of relief investigations. Discretionary accruals are the ones that succeed in the aim of decreasing the income while there are these ITC investigations. The models she developed, compared to previous studies, are a step forward in the measurement of discretionary total accruals. In particular, what is important here is that time-series have been used to evaluate total non discretionary accruals, while cross-sectional tests have been used for the measurement of discretionary accruals. To conclude, it is possible to say that the ITC may take advantage of the findings provided by Jones (1991).

The next study based on accruals is the one developed by Dechow and Dichev (2002). This approach is totally different from the previous ones, based on the calculation of abnormal accruals. What is new in this approach is that it is based on the assumption that accruals are able to variate the way cash flows are recognised in time, given the fact that modified earnings can provide an accurate measurement of a firm's economic performance. What they argue is that the quality of earnings and accruals is linked to the accuracy in estimating accrual errors. What they extracted from their research is an approach whose aim is to measure accruals quality in terms of residuals for firm-specific minimisation of changes on past, present and future working capital. In simpler words, Dechow and Dichev (2002) both measured accruals' quality considering their eventual conversion in cash the following year. Before describing, their approaches, it is important to precise the sample data they have selected. Their data are taken from Compustat files

¹² See paragraph 2.4.

and cover a sample period of twelve years, from 1987 to 1999. This choice is not casual, but it is due to the fact that they wanted accurate values of operating cash flows and accruals. To provide a calculation of accrual quality, Dechow and Dichev (2002) used this “firm-level time-series regression”. In other words, they measured accruals quality in terms of changes in working capital, because it is known that they will be converted in cash in one time. Their main findings can be divided in two main empirical applications: first of all, Dechow and Dichev (2002) proved the relation between accruals quality and economic fundamentals. What they evidenced is that accrual quality is greater in large businesses, stating that firms size is directly proportional to accrual’s quality, while is negatively related to the magnitude of accruals, the duration of the operating cycle, to earnings, cash flows and to the deviation of sales. Moreover they proved that accruals quality and earnings persistence are negatively liked, meaning that firms having low accrual quality own more accruals that will not be converted in cash, meaning that their earnings are fluctuating. For these kind of firms, the accrual section of their current earnings cannot be used to foresee their future earnings, evidencing a low earnings persistence.

The next approach, the one of McNichols (2002), is a critic to the previous one, Dechow and Dichev (2002). What she criticises is that, in their approach, Dechow and Dichev (2002) did not provide an accurate distinction between discretionary and non discretionary accruals, like in Jones (1991), and pointed out that this distinction is fundamental in the development of an approach. In addition, she also mentioned the fact that in Jones (1991), working capital accruals are only affected by the change in the current year’s sales, while the variations relative to the previous year and to the following ones are not considered. As a consequence, I can be said that McNichols (2002) evaluates this approach as not sufficient for the evaluation of accrual quality, due to the fact that there is past and following years that are not evaluated in the analysis. As a consequence, her aim is to create an approach which miles the one made by Jones (1991) and the one made by Dechow and Dichev (2002), with the aim of providing a new approach which has a greater explanatory value and with less errors.

McNichols (2002) evidenced the fact that measurement errors in Dechow and Dichev (2002) may interfere with basic variables affecting accruals. As a direct consequence, the inclusion of earnings variable to Dechow and Dichev (2002) approach is effective in terms of minimising errors in cash flow values. In his study, McNichols (2002) evidenced that both previous approaches were developed erroneously, due to the fact that sales and cash flows are interrelated. Another finding that is evidenced is that error terms have a

strong relation with the variables from the other approaches. As a consequence, the fact that these variables are correlated more to the error term than to the intervention is evidence of the assumption that some accruals, that were expected to contain interventions according to Jones (1991), in fact do not contain any intervention.

Larcker and Richardson (2004) examined the connection between fees paid to auditors for audit or non-audit services and the accrual measures choice, considering a large sample of firms. This relation can be a significant contribute to the debate on accounting profession and the applicability of granting non-audit services by accounting firms. According to findings in previous literature, there are three main economic explanations to say that the findings were quite inconsistent. First of all, corporate governance was not mentioned, analysing only the auditor, which is just one of a number of mechanisms devoted to the mitigation of agency problems in firms. Omitting corporate governance in researches means providing an incomplete analysis, and, as a direct consequence, providing an erroneous determination of earnings quality. Secondly, there are several methods to evaluate the financial links between auditor and client. According to previous literature (Frankel, Johnson, and Nelson, 2002), the focus was on the terms of non-audit services, such as ratio of non-audit fees to total fees. Nevertheless, the sum of fees paid by a client to the auditor are a possible measure to assess the extent to which the auditor depends on the client (DeAngelo, (1981); Reynolds and Francis, (2001); Chung and Kallapur, (2003). Finally, there are several approaches which are devoted to the description of the relationship between audit fees and earnings quality, considering a large sample of firms. For instance, the relevance of the auditor's observing role should be related to the resistance of the client's governance structure. Thus, employing a single regression model throughout several samples, that are composed of distinct models, is not likely to gather an accurate evaluation of the relationship between fees paid to the auditor, comprehending both audit and non audit fees and accrual selection.

To develop their approach, they used a sample of 5,815 firm-years reporting data, from Standard & Poor, concerning both audit and non-audit fees paid between 2000 and 2001. To minimise the effect of significantly small enterprises and auditors, they applied a restriction to their sample, limiting their sample to clients of the Big 5 and Grant Thornton and BDO Seidman, by doing so reducing the sample by 355 observations.

Larcker and Richardson (2004) are interested in is finding the unforeseeable element of total accruals. In literature, there are several examples of identification of abnormal/discretionary accruals, which are unforeseeable (Jones, 1991). Total accruals are receded on variables expected to change in correlation with normal accruals. There are two kind

of approaches, one following a time series approach and another one providing a cross-section for each industry (Becker et al.,1998). Both approaches have their limitations. What Larcker and Richardson (2004) did is to incorporate, between the undefended variables, also current operating cash flows. Their approach has been developed using firms taken from Compustat having information to determine an appraisal of total accruals, between 1988 to 2001. In compliance with prior researches, there is just, but limited, little confirmation of the positive relationship between fees paid to auditors and the calculation of accruals, taking as a sample a large portion of firms. Another positive association that has been found is between fees paid to the auditor and unforeseeable accruals, but just in case the fees are assessed through the ratio of non-audit fees to the sum of fees paid to the auditor. Using an alternative measurement of fees paid to auditors, which is able to assess the financial extent to which a client is dependent to an auditor, they found out that there is a negative relation between auditor independence and earnings quality. The portion of firms which showed to have the highest negative association are the ones that report: low market capitalisation, high growth chances, lack of independent boards of directors, low institutional holdings, and high insider holdings. If these are the cases, auditors are considered to be fundamental in the governance role of limiting the selection of abnormal accrual.

As for prior studies, also this research presents some limitations. First of all, this study comprehends some endogenous variables, such as auditor choice, purchase of non-audit services, and the governance structure. However, in this study, they bypassed this feature, and, as a direct consequence, their results are subjected to a series of problems related to this kind of variables. Secondly, they just analysed data based from 2000 and 2001, so is not possible to generalise their findings to different periods. Finally, like in prior researches, accrual measurement is used as an evidence of earnings management operated by managers. Measures of unforeseeable accruals are scrutinised because of their erroneous classification of foreseeable accruals as unforeseeable. Consequently, if payments to auditors and measures of unexpected accruals are associated, it could be caused by errors in the measurement of unexpected accruals, thus is not an evidence of managerial inadequate behaviour.

Francis, LaFond, Olsson, and Schipper (2005) approach is based on both modified Jones approach and Dechow and Dichev approach. Their objective is to distinguish between total or current accruals in normal and abnormal components. In their research, accruals quality is seen as the residual deriving from regressions associating current accruals to cash flows. Their findings demonstrate that poorer accrual quality is connected with larger

costs of debt and equity. Francis et al. (2005) also provided a separation between accruals quality linked to economic fundamentals and the one given by management choices, which is called discretionary accruals quality. Although both of them can impact the cost of capital, the former one's effects are more significant than the latter's one. In this study, the focus is on the connection between accruals quality and the costs of debt and equity capital, taking a significant number of samples between 1970–2001. This approach gave two main contributions. First of all, they found out that firms having low accruals quality are likely to have greater costs of capital, compared to firms having high accruals quality. Secondly, they tried to assess whether the components of accruals quality, accruals reflecting economic fundamentals and the discretionary factors may have separate cost of capital effects. It is suggested that, discretionary accruals are likely to comprehend opportunism, which increases the risks related to information, and performance assessment, that lessens the risk associated with information. They discovered that the quality of accruals related to economic fundamentals present greater costs of capital effects compared to discretionary accruals quality. In their research, Francis et al. (2005) used Dechow and Dichev's (2002) approach as the basis for the measurement of accruals quality, because this approach provides a correlation between working capital accruals, related to the present period, and operating cash flows, related to past, present and future periods. They decided to integrate this prior approach with the one developed by McNichols (2002), comprising also the changes in revenues and property, plant and equipment (PPE). They decided to centre on the measurement of accrual component of earnings because data on cash flows is given by earnings, in compliance with the findings in Dechow (1994), where current earnings can serve to determine future cash flow. Another reason of their choice refers to the fact that accruals quality is the best driver for information risk about cash flows. For this reason, they decided to use Dechow and Dichev (2002) approach to determine accruals quality, because it is based on the concept that accruals quality is affected by errors in the measurement of accruals, giving no importance to management intent. However, it is important to consider that there is a limitation to Dechow and Dichev's approach, which refers to the fact that only current accruals are comprehended. As a consequence, to lessen the effects of this limitation, Jones (1991) approach is used in terms of proxies for quality of accruals that focus on the value of abnormal accruals. To sum up, their accruals quality measurement approach is a cross-sectional Dechow and Dichev approach, with the PPE and change in revenues used in the modified Jones model. Francis et al. (2005) found out that the lower-quality accruals are, the higher the costs of debt. In addition, accruals quality "loads as a separate

factor in explaining variation in excess returns when added to both one- and three-factor asset-pricing regressions¹³”. Their findings also comply with the assumption that the two separate approaches to determine the discretionary part of accruals quality helped in understanding that discretionary accruals quality and economic fundamental based accruals quality have identical costs of capital effects. This finding supports the hypothesis that the discretionary component of accruals quality has a lower pricing effect, compared to the accruals quality based on economic fundamentals. Conclusively, their evidences are in favour of the hypothesis that capital market consequences of the distinction in accruals quality are caused by accruals quality proxies for information risk, which cannot be changed.

The last study comprehended in this section is the one made by Barth, Landsman and Lang (Barth et al., 2008). Their focus is the juxtaposition between the features of the accounting amounts of firms applying IAS and a series of companies that do not apply IAS. The reason for this comparison is to assess of the compliance with IAS is combined with a higher accounting quality and lower equity cost of capital. Their findings evidenced that companies complying with IAS exhibit lower earnings management, greater timely loss recognition, and greater accounting amounts’ value relevance compared to companies the comply with domestic accounting standards. Companies that follow IAS are said to show greater change in net income, greater variances of the change in net income and cash flows. Moreover, they have a reduced negative relation between accruals and cash flows, and a reduced occurrence of small positive net income. In general, firms following IAS show higher accounting quality compared to when they applied the domestic GAAPs. No consistent evidence has been found on the hypothesis that the compliance with IAS causes lower cost of capital. In general, thank to Barth et al., it is possible to say that the appliance of IAS causes a consequent improvement in accounting information quality. The sample of companies they analysed is composed of 1,885 firm year observations related to 319 firms using IAS between 1994 and 2003. They decided to begin their sample period because they fixed a minimum of four years before the adoption period of IAS. IAS firms samples are provided by Worldscope while financial and accounting data are provided byDataStream.

In compliance with prior research, also Barth et al. decided to distinguish accounting quality in earnings management, timely loss recognition, and value relevance. What they

¹³ FRANCIS, J. F., LAFOND, R., OLSSON, P., SCHIPPER, K. (2005), « The market pricing of accruals quality», *Journal of accounting and economics*, vol. 39(2), 2005, pp.323.

expected is that high quality earnings are likely to have low earnings management, but greater timely loss recognition, value relevance.

According to earnings management, we can say that it is divided in two main parts: earnings smoothing and managing towards positive earnings. What they guess is that firms using IAS have less manageable earnings compared to firms using domestic GAAP earnings, due to the fact that IAS clearly reduces managers to report earnings that do not faithfully show a firm's economic status. Concerning earnings smoothing, like in prior researches, they guess that firms that have a low rate of earnings smoothing as a consequence have greater earnings variability. In their view, firms using IAS are likely to have variable earnings compared to those using domestic GAAP. Barth et al. also hypothesised that firms having lower earnings smoothing will have a greater negative correlation between accruals and cash flows. Due to the fact that accruals reverse over time, there is a negative relation between accruals and cash flows. As a consequence, they expect that IAS firms will have a minimised negative accruals and cash flows relation compared to firms that do not use IAS.

According to the second feature related to earnings management, managing towards positive earnings, we can say that this practice is commonly used to manage earnings. The core concept of this aspect concerns the fact that it is preferred to exhibit low positive earnings rather than completely negative ones. As a consequence, they foresee that IAS would have low positive earnings compared to non IAS firms, and with a lower occurrence. In the second measure of accounting quality, timely loss recognition, higher quality earnings are expected and a greater frequency of significant losses. This feature is linked to earnings smoothing. This means that if earnings smoothing is applied, large losses are not likely to occur. As a consequence, they expect that IAS firms are likely to have frequent compared to non IAS firms.

According to value relevance, higher quality earnings are commonly associated with stock prices and earnings and equity book value, due to the fact that high quality earnings can perfectly show a company's economic condition (Barth, Beaver, and Landsman, 2001). There are two main points that should be highlighted. Firstly, earnings of high quality result from the compliance with accounting standards are expected to recognise amounts that truly represent a firm's condition. Secondly, opportunistic managerial discretion is less likely to occur in high quality earnings. Ewert and Wagenhofer (2005) united these features, which are an evidence of the fact that accounting standards are able to reduce the occurrence of opportunistic discretion result in accounting earnings having

greater value relevance. Thus, Barth et al. guess that IAS firms have a greater value relevance of earnings and equity book value rather than non IAS firms.

Barth et al., in order to test the above mentioned hypothesis, made a comparison of IAS firms and of non IAS firms, taking as a sample period the period after that IAS firms decided to use IFRS. By doing so, they are able to prove if IAS firms have a higher accounting quality compared to the non IFRS firm. However, it should be considered that IAS and NIAS firms¹⁴ may show differences in accounting quality in the post-adoption period, due to the pre-adoption period. To test this hypothesis, firms' accounting quality is analysed also in the pre-adoption period. Moreover, they also wanted to prove that IAS firm gained a greater accounting quality. To test so, they also compared IAS firms' accounting quality in both pre and post adoption period.

We predict that IAS firms have higher quality accounting amounts in the post-adoption period than they do in the pre-adoption period. Finally, findings in Land and Lang (2002) suggest that accounting quality may be improving worldwide. It also is possible that changes in general economic factors, including enforcement and attestation, could account for improvement in accounting quality for IAS firms. Finally, to see if IAS firms' accounting quality is also subject to other changes, changes in accounting quality for IAS firms, in both pre and post period, and the one of non IAS firms are compared. What is guessed is that the increase in accounting quality will be greater in IAS firms.

In their study, Bart et al. developed three distinct measurement for earnings management, timely loss recognition and value relevance. In the first one, like in Lang, Raedy, and Wilson (2006), ΔNI is measured through the changes in net income scaled by total assets. If there is even a low variance in net income, this means that there has been an earnings smoothing but we should consider that net income can be influenced by several factors that are not linked to the application of earnings management, such as firm's incentives to adopt IAS. However, the model they developed tried to lessen the impact of these effects. Having seen the fundamentals in this approach, it is possible to conclude saying that Barth et al. (2008) made three different kind of accounting quality comparisons. The first one is devoted to the comparison of the accounting quality in IAS and non IAS firms in the period immediately after the IAS firms started to comply with IFRS. The second juxtaposition concerns the accounting quality in firms applying IAS in the period before and after the adoption and finally, the third concerns the variations in accounting quality in IAS firms and non IAS ones in the period between the one preceding and following

¹⁴ Companies non-applying IFRS.

the one in which the IAS firms adopted IAS. In general, it is possible to say that complying with IFRS means also that there will be an improvement in terms of accounting information quality. In specific, firms applying IAS have a limited occurrence of earnings smoothing and a greater value relevance and timely loss recognition. According to the findings related to the pre adoption period, we can say that the difference reported in IAS and NIAS firms before the adoption period are not useful to explain the differences in the post adoption one, which are relevant. Finally, we can say that the changes for IAS and NIAS firms and it is evident that the changes in IAS firms, related to both periods, are greater than the changes in non IAS firms in the post adoption period.

2.2.3 Accounting quality determination approaches based on specific accruals

In this section, the focus shifts on the approaches based on specific accruals. This means that these researches are based on the assumption that there are some specific financial statement items that are likely to be manipulated. In the development of this approaches, researchers like McNichols and Wilson (1988) or Beneish (1997), attempted to prove the earnings management implications through a specific accrual account. There are some advantages in the use of specific accruals as an approach to determine earnings management. First of all, thanks to their knowledge about Accounting principles, researchers can build a prediction on the main factors that are likely to impact accruals. Secondly, discretionary accruals are also used in the sectors that suit them better in terms of quality of that given firm. Finally, there is the possibility to assess the correlation of private accrual account and explanatory variables (McNichols, 2000). Having seen the relative advantages, we should also consider the disadvantages of this approach. First of all, an evident obstacle is the problem in determining which is the specific accrual implied to manage earnings, because it should be considered that a number of accruals can be used for this goal. Secondly, this approach requires more institutional information and data compared to total accrual approaches, increasing the costs for this approaches. Finally, companies applying earnings management through a specific accrual account are said to be less than the ones applying it through total accruals.

First study in this field is the one by McNichols and Wilson (1988). Their aim is to prove that earnings are managed by managers through the use of a single accrual, the provision for bad debts. They choose this specific accrual because net accounts receivable are expected to depict future achievements. They said that what is different in their study is not only the use of a single accrual, but also the fact that they refer to GAAP to build their

accrual proxies. However, this approach demonstrates to have two compromises: the first is related to the non discretionary part of the discretionary proxy, this because then the discretionary part cannot be accurate in the detection of the variation of discretionary accruals and as a consequence the consequential measurements are useless. The second compromise is related to the fact that if the discretionary accrual represents only a part of the discretionary section of income, it is likely that it can erroneously detect earnings management in case other components have been used. Their findings comply with the assumption that the bad debt's discretionary component is able to decrease the income of firms reporting exceptionally low or high income. They developed two main hypothesis. The first one refers to the fact that firms tend to opt to use accruals to reduce the diversity of reported earnings. For instance, if income is high, income reducing accruals are expected to be used. The second one refers to the hypothesis developed by Healy (1986), in which managers having lower bounds compensation plans are likely to maximise the discretionary expense to increase the probability of having the lower bound in the following period. According to data, they selected firms having receivables that are a fundamental category of total accruals and having a provision for bad debts that is related to earning. By doing so, they selected a number of ratios, related to receivables, from Compustat 1986. Among them, they selected three main industry groups: 37 companies from the publishers industry, 29 firms from business services industry and 50 firms from non durable wholesalers industry, in total 116 companies. To conclude, it is possible to say that the introduction of this proxy has helped in the reduction of the bias compared to the other proxies used in previous studies. This proxy is important because it has also helped to demonstrate that income reducing accruals are used in order to manage earnings in case income is too high or low.

The next paper analysed is the one of Beneish (1999). This paper gave a great contribution to literature because it pointed out the basis for earning manipulation, such as distinguishing the features of earnings management and, more important, it developed a model to understand if manipulation has been applied. This model differs from the previous ones because it has been developed to detect earnings manipulation and to assess the factors that may lead to a company to apply these practices. Findings showed that there is an underlying relationship between the occurrence of earnings management and financial statement items. Another feature that contributes to this research's importance is because it also helped in understanding if a financial statement is manipulated or not. According to data, we can say that Beneish took a sample of 74 firms that are said to manage earnings and all the COMPUSTAT firms matched by two-digit SIC for which

data are available, in the decade between 1982-1992. He said that managers who manipulate earnings are likely to record fake, unearned, or unfaithful revenues, recording untrue inventories, or improperly capitalised costs. Findings in this study support the hypothesis that manipulation are more likely to occur when unusual increases in receivables, depreciated gross margins, low asset quality, increase in sales growth or in accruals occur. Given the fact that there is no absolute study on earnings management, he based his assumptions on the principle that it that can help in the selection of the explanatory variables related to financial statement data. First of all, firms earning management are more likely to occur if a firm has no expectation for the future. Secondly, like in Healy (1985) and Jones (1991), he had considered variables related to cash flows and accruals. Finally, he has also used variables from Watts and Zimmerman (1986) positive theory research, that guess that there are incentives for earnings management based on contracts. Moreover, the model includes also eight variables. Out of eight, seven of them has been pointed out as indices for this study, because they are able to evidence the misinterpretation that are consequential to manipulation, thanks to a comparison of the financial statement measures in the year of the manipulation.

1. Days Sales in Receivables Index (DSRI):

DSRI is the ratio of days sales in receivable in the first year where earnings management is revealed, year t , to the related measurement in year $t-1$. This variable aims to measure if the receivables and revenues are in or not in balance for two consecutive years. If a significant increase in DSRI occurs, this means that there has been a modification in the credit policy to enhance sales due to an increase in competition, but non proportionate increases in receivables in sales can also be the consequence of revenue inflation. For this reason, a great increase in DSRI can be associated with the possibility of overstatement of revenues and earnings.

2. Gross Margin Index (GMI):

GMI is ratio of the gross margin, in year $t-1$, compared to the one in year t . If the value of GMI is major than 1, this is an evidence of the fact that GM has declined, which is a completely negative aspects for firms because it evidences no future prospects. As a consequence, having no future prospects may leas companies to manipulate earnings. In fact, Beneish (1999) predicted a positive relation between GMI and the occurrence of earnings manipulation.

3. Asset Quality Index (AQI):

Asset quality can be defined as the ratio of non-current assets, other than property plant and equipment to total assets. What it gauges is the average of total assets that imply

uncertain future benefits. AQI is the ratio of asset quality in year t , relative to asset quality in year $t-1$. If AQI is greater than 1, this means that a firm has increased its engagement in cost deferral. As a consequence, he predicted that there will be a positive relationship between AQI and the likelihood of earnings management.

4. Sales Growth Index (SGI):

SGI is the proportion of sales in year t to sales in year $t-1$. Growth itself does not presuppose manipulation, but growing firms are seen as more likely to involve in financial statement frauds due to the fact that financial position and capital needs exert pressure on managers to reach their earnings targets. Moreover, if firms that are growing have to cope with stock price losses, this may lead firms to apply earnings manipulation. As a consequence, a positive correlation between SGI and the occurrence of earnings manipulation is predicted.

5. Depreciation Index (DEPI):

DEPI is the average rate of depreciation in year $t-1$ compared to the related rate but in year t . If the value of DEPI exceeds 1, this means that assets' depreciation rate is not growing, and this may lead companies to increase estimates of assets. As a consequence, also for this variable, a positive relation between DEPI and the occurrence of managing earnings.

6. Sales General and Administrative Expenses Index (SGAI):

SGAI is defined as the ratio of SGA to sales in year t compared to the measure in year $t-1$. SGA and the probability of manipulation are expected to have a positive correlation.

7. Leverage Index (LVGI):

LVGI is the ratio of total debt to total assets in year t pertinent to the relative ratio in year $t-1$. If LVGI is major than 1, this means that there will be an increase in terms of leverage. Given the assumption that leverage is arbitrary, LVGI unquestioningly gauges errors in leverage forecasts.

8. Total Accruals to Total Assets (TATA):

Total accruals are given by the in working capital accounts' changes except for cash less depreciation. This variable has been used to test if cash carries reported earnings, if higher positive accruals (less cash) can be related to a greater occurrence of manipulation. All these variables reflect year-to-year changes and can be an obstacle in case the denominator value is low. This paper bases its assumption on firms that clearly stated to have manipulated earnings. As it is easy to guess, earnings manipulation and financial statement data are fundamental for accounting researchers and professionals, because it data may not be useful and reliable. However, given the fact that financial statement data

can be manipulated, it is also necessary to highlight that these modification can also derive from another reason. For instance, modifications can derive from material acquisition in a specific period. There are some limitations in Beneish (1999). Firstly, this model has been developed with publicly traded companies, so it is not reliable for privately traded companies. Secondly, here the earnings management considered refer to overstatement, so there is no evidence of firms that may apply earnings management through earnings minimisation.

The last study analysed is the one of McNichols (2000). This paper discusses the compromises deriving from the three kind of approaches developed to evaluate earnings management: total accrual approach, specific accruals approach and frequency distribution of earnings. A key concept she evidenced concerns the fact that procedures for total accruals studies lack to consider the researches on incentives to manage accruals and do not consider how accruals work. Findings show that the first type of models do not include the fact that long-term earnings growth can also be untrue and can cause erroneous inferences on how earnings management is applied. In particular, she guessed that companies with higher expectations in terms of earnings are said to possess higher accruals compared to having a low expectation in terms of earnings. She found out that, in this kind of studies, it is fundamental to control the predicted earnings through the first kind of approaches, such as the aggregate accruals one. The benefits of using the specific accruals approach are related to the fact that they can help in understanding easily the non discretionary component, because researchers can use the accounting principles to comprehend what principles should be excluded in case there is no occurrence of earnings management. The third and last type of approach, frequency distribution approach, is beneficial because of the fact that it allows the researcher to make a reliable prevision on the occurrence of earnings that are not caused by the non discretionary part of earnings. We can say that the purpose of this research is to understand the occurrence of the impulse of modifying earnings and to provide a real measure for earnings management. In this approaches review, she said that Jones approach (1991) and its modified version (1995) are not suitable to assess the earnings management occurrence in several occasions that may be useful for accountants.

2.2.4 Accounting quality determination approaches based on frequency distribution

In this last section, the main studies developed on accounting quality determination based on frequency distribution will be overviewed. In this kind of approach, earnings

management is detected through predetermined benchmarks. For example, if a given firm will receive a competitive incentive to reach earnings that surpass a prefixed standard, as a consequence, distributing earnings after having managed them will be less suspicious, compared to the ones for earnings amounts that are slightly under or exceptionally above the fixed threshold. McNichols (2000), in her overview on frequency distribution models, said that:

[...]The power of their approach comes from the specificity of their predictions regarding which group of firms will manage earnings, rather than from a better measure of discretion over earnings. These studies measure discretion over earnings as the behaviour of earnings after management, which no doubt includes discretionary and non discretionary components. However, it seems implausible that the behaviour of the non discretionary component of earnings could explain such large differences in the narrow intervals around their hypothesised earnings targets. Stated differently, measurement error in their proxy for discretionary behaviour seems unlikely to be correlated with their partitioning variable¹⁵.

Having understood the fundamentals of this kind of approach, the Burgstahler and Dichev (1997) approach will now be analysed. They highlighted the point that firms want to show that they are successful by demonstrating that they are in a perpetual status of earning, even if it is the case of relatively small earnings. As a consequence, although a company has reported a loss, it may choose to manage earnings to avoid losing advantages. In this research it is also shown that the occurrence of small earnings decreases and small losses are quite low in the regions of the distributions, while, on the other hand, there is a great occurrence of small earnings and small positive earnings are exceptionally significant. This paper comprehends data from 1976 to 1994 from Compustat databases. Earnings management that aims to obstacle earnings minimisation is likely to be evident in cross-sectional distributions of earnings variation, in terms of exceptionally low occurrence of small earnings reduction and exceptionally high occurrence of small earnings maximisation. Moreover, management of earnings made to obstacle losses will be evident in terms of minimal frequency of small losses and exceptional occurrence of small but positive earnings. To test these assumptions, they developed two main hypothesis. The first one states that earnings are managed to prevent earnings minimisation, while the other one states that earnings management is employed to reduce losses. Evidences from this paper demonstrate that earnings minimisation and losses are easily managed, to the extent that between 8% to 12% of firms having small pre-managed earnings reduction may later report increased earnings. Between 30% to

¹⁵ MCNICHOLS, M. F., «Research design issues in earnings management studies. », *Journal of Accounting and Public Policy*, vol. 19(4–5), 2000, pp. 336.

44% of firms having negative pre-managed earnings may then report positive earnings. According to earnings management to reduce losses, Burgstahler and Dichev (1997) contributed to literature proving that there are two components of earnings, such as cash flow from operations and changes in working capital, that are commonly employed in earnings management. To support this assumption, they provided two theories. The first one concerns the costs in transactions with stakeholders, while the second one concerns prospect theory, that record sudden increase in benefits around zero changes in earnings and zero rate of earnings. The first theory is based on two distinct assumptions. The first one is related to the fact that data concerning earnings are able to impact the terms of a transaction between a company and shareholders, to the extent that the terms of a transaction will be beneficial for firms reporting high earnings. The second one concerns the fact that storing, retrieving, and processing information means bearing a high price, to the extent that stakeholders assume the terms of transactions relying on research based cutoffs with no changes in earnings. In general, given these two assumptions, it is possible to say that firms who have faced an earnings decrease are likely to bear higher costs in transactions with stakeholders. As a consequence, these two assumptions are seen as an incentive to obstacle earnings reduction.

Then the research by DeGeorge et al (1999) will be analysed. As already said, earnings are a fundamental component in decision making process for investments. As a consequence, investors may have an incentive in managing earnings. In their model, they developed three main thresholds that may be responsible of causing specific kind of earnings management and they are said to be ordered according to their importance. The first threshold is related to the fact that it is better to report positive earnings, rather than negative ones. The second one is related to the improvements related to the previous year and then meeting the market's forecasts. Earning management is defined thanks to Schipper (1989) as it is defined as the attempt that managers have to influence earnings for external audience. The way they accomplish this goal is through the income shifting between periods. However, we should consider that their approach considers the interaction among executives but there is no determination of the components through which they can manage earnings. They selected 5387 firms that had disclosed partial or complete data between 1974 and 1996. According to their findings, firstly we can say that they found out that earnings that are just short of the threshold are likely to be managed upwards. Secondly, both earnings that are far upwards or downwards from the fixed threshold are controlled in order to make them suitable.

Chapter 3: Accounting Quality in China

3.1 The reasons of low accounting quality in China

After the description of the various approaches for the determination of accounting quality, it is now time to deepen the focus on Chinese situation. Why can we assume that in China there is a low accounting quality? What factors can lead us to say that?

Accounting, as is easy to guess, is affected by its environment, and of course environment includes the culture of the country in which it operates. Hofstede (1980) developed a model of culture, and he described it as the collective programming of the mind and its is a factor capable to distinguish the members of a given human group from another. His study focused on over 100,000 IBM employees in 39 countries, Hofstede (1984). By doing so, he defined 4 main dimensions of culture

1. Individualism versus collectivism. Individualism highlights the preference of the individuals to take care of themselves and their immediate families only. The fundamental issue addressed by this dimension is the degree of interdependence that a society can maintains among individuals.
2. Large versus small power distance. Power distance is the extent to which the members of a given society can deal with the fact that power, in institutions and organisations, is not distributed equally. In societies characterised by a large power distance, people will better accept a hierarchical order, in which everybody has a place. The fundamental point highlighted in this dimension is the ability of society in handling inequalities among its members.
3. Strong versus weak uncertainty avoidance. Uncertainty avoidance refers to the degree to which the members of a society can bare uncertainty and ambiguity. Strong uncertainty avoidance societies have rigid codes of belief and behaviour and do not tolerate deviant persons and ideas, while in weak uncertainty avoidance societies, there is no rigid code and a greater acceptance of deviance. The fundamental point in this dimension is how a society can deal with the fact that future is unpredictable and there are two approaches to deal with it, trying to control future or let nature make its course.

4. Masculinity versus femininity. Masculinity highlights the societal preference for achievement, heroism and material success, while femininity draw attention to the preference for relationships, modesty, care for the weak and quality of life.

Later, in 1991 and 2010, two dimensions were added:

5. Long-Term Orientation versus Short Term Normative Orientation. This new dimension is based on Michael Harris Bond's research, supported by Hofstede, who conducted an additional international study among students with a survey instrument that was developed together with Chinese professors. This dimension, based on Confucian thinking, highlights the need that every society has to maintain some links with its past while dealing with present and future. Societies who report a low score on this dimension, for example, favour the conservation of traditions and norms while facing societal change with mistrust. A society with a high score in this dimension demonstrate to have a more pragmatic approach, encouraging efforts in modern education, because this can be a way to be prepared for the future.
6. Indulgence versus Restraint. This dimension was added according to Michael Minkov's analysis of the World Values Survey data for 93 countries. We can say that a society is indulgent if it allows free gratification of basic and natural human drives related to enjoying life and having fun while restraint means a society that abolishes any form gratification of needs, regulating it by means of strict social rules.

Hofstede has also provided a specific cultural dimension analysis for each country. If we refer to the Chinese society description throughout the Hofstede analysis, we can have a better understanding of the factors that can affect Chinese society.

According to the first dimension, Power Distance, China sits in the higher rankings in this index. Its score is 80. This means that Chinese society believes that inequalities amongst people are acceptable. There is no way of defending themselves from the power abuse of superiors, authorities have the power to influence individuals. People should not have aspirations that exceed their status.

Concerning Individualism vs. Collectivism, Chinese score is 20, so this evidences that Chinese society favours collectivism, and by doing so, people are used to act in the interests of the group. As far as the third dimension is concerned, China is a Masculine society, reaching a score of 66. Success is the main driver for society. In order to reach success, many Chinese will sacrifice family and leisure priorities to work. China has a low score on Uncertainty Avoidance, 30. Chinese are comfortable with the unfamiliar

and they can easily adapt themselves. China has a high Long Term Orientation score (87), which emphasises the fact that it has a very pragmatic culture. According to the last dimension, China is a Restrained society as can be seen in its low score of 24 in this dimension. Societies with a low score are more cynic and pessimistic.

After having provided a cultural background of Chinese society, it is now time to deepen our focus in understanding why Chinese market reports low financial quality information. One of the most important factors that should be considered when analysing accounting quality in China is the Chinese legal system. This is because this system has been built in the 1970's, during the Open Door Policy of Deng Xiaoping, but many rights and laws are not properly defined. For example, until 2005, China did not have the concept of property right. Another important Chinese legal system shortcoming is that there is a lack of legal protection for shareholders. An evidence of the absence of proper laws is the fact that companies are able to misstate their financial statements (Pistor, Xu, 2005), as a consequence of the fact that there is no shareholder's legal protection and because of regulation from officials, like CSRC has a limited possibility of regulation. As a direct consequence, the shortage of consistent enforcement of governmental regulations provides an inconsistent incentive for managers to act in compliance with rules (Shaoming et al., 2011). We should also consider that the transitional period that China had faced for the shift from a planned economy to a market oriented economy has given the opportunity to many companies to improve their economic performance by modifying their financial statements by creative accounting (Bai et al., 2008). Another important factor that may lead to say that there is a low financial reporting quality in China is the lack of education. This means that there are not so many trained accountants, causing a higher demand than supply for high quality accountants. As a direct consequence, non professional accountants should replace the professional ones that are lacking. Furthermore, the continuous changes that the Chinese legal and accounting system had faced caused a lot of difficulties for accountants and editors because they should follow and comply with all the new developments. Pressure is another driver for low financial quality information. Pressure is here interpreted as the anxiety experienced by managers to meet analysts' forecasts. Pressure is not only a question of concern, but can also be seen as an incentive to manage expectation, with the goal of lessening outside pressure on companies. Pressure can also come from stock markets and its relative regulators. Shanghai, Shenzhen and Hong Kong stock exchange have strict requirements and regulations that shall be respected by companies in order to reach the status of listed company. Moreover, Chinese stock markets also require a high annual performance and

disclosure requirements. The process of delisting is based on accounting numbers, if a company reports low financial number, it should pay the threat of delisting. This will cause, of course, a great pressure on companies year by year and a fake distribution of firm's information in China, in order to reach the required numbers. Another reason that can be considered as responsible of low quality financial statements is China's weak institutional environment. This is a controversial point because the institutional environment is weak concerning public laws, but it is extremely strong when dealing with interpersonal connections (*guanxi* in Chinese) (Yuan et al., 2009). An evidence of the political influence lies in managers decisions, in fact state-assigned managers were found to be more likely to transfer funds raised from public shareholders to the state in cash dividends, with the purpose of satisfying Chinese politicians (Fung, 2009). In the research conducted by Yuan et al. in 2009 they said that:

«We fill the void in the literature by demonstrating empirical evidence that state control affects the relationship between legal investor protection and ownership concentration. Specifically, we find that legal investor protection affects the ownership concentration of non-state-controlled firms, but not the state-controlled firms.¹⁶»

Another important research made in this field is the one made by Liu & Yung (Liu, Yung 2011), in which the impact of state ownership on earnings management is analysed. Contrary to one could imagine, state ownership is not the root of corporate inefficiency, in fact they found lower levels of earnings management among state-owned enterprises than private-owned firms in China. Moreover they found that:

«The fact that state enterprises have better earnings quality brings into question the conventional belief that state ownership is the root of all sorts of corporate inefficiency. One possible explanation for this surprising result is that the government might have served as a powerful external monitor guarding against managerial opportunism in state enterprises. Alternatively, the protection of state enterprises by the government might have reduced the pressure on managers to manipulate firm-specific information in state-owned firms».

The problem of companies ownership in China is crucial, because it can also lead to other internal problems whose result can affect the reporting quality. Given the fact that a Chinese company is, first of all, ruled by political institutions, means that the political achievements are much more important than the firm's own objectives. In this way, auditor's independence is mined by state ownership and relationships. We can eventually say that Chinese market, because of the deep influence that the Government exerts in

¹⁶Yuan Q., Wu S., Xu N., «State Control, Legal Investor Protection, and Ownership Concentration: Evidence from China », *Corporate Governance: An International Review*, 2009, 17(2), pp.176–192.

almost every field of Chinese economy and life, cannot be defined as a free market and it operates in an unfair environment. As an evidence of this fact, The Heritage Foundation has developed the Freedom Index, based on economic freedom¹⁷. According to 2017 ranking, China was ranked 111 on 180 countries, between the mostly unfree countries. The report states that:

«China's economy remains mostly unfree, and there is little momentum for reform. Despite a nominal openness to trade and investment, bureaucratic hurdles and resistance from vested interests in the state sector are substantial barriers to more dynamic economic development. Confronting a period of economic slowdown, the government has increased expansionary fiscal and monetary interventions. Deep-seated structural problems, including a state-controlled financial sector and regulatory inefficiency, have become more acute. Accumulating debt at various levels of the economy increases long-term risks. The legal system's vulnerability to political influence and Communist Party directives undercuts the rule of law and adds uncertainty to economic activity¹⁸».

If we examine China by looking at the four main areas in which the Economic Freedom Index is divided, we can find out that, according to Rule of Law (Property rights 48.3, Judicial Effectiveness 60.7, Government Integrity 41.6):

«The State owns all land, and protection of foreign intellectual property continues to erode. Xi Jinping's anticorruption campaign accelerated in 2016, but corruption remains endemic, and the leadership has rejected more fundamental reforms such as requiring public disclosure of assets by officials, creating genuinely independent oversight bodies, or lifting political constraints on journalists and law enforcement agencies».

The second area, Government Size, evidences a positive situation because all the indexes comprised in this area (such as Tax Burden, Government Spending and Fiscal Health) have a score that goes beyond 70. The third area, Regulatory Efficiency (Business Freedom 53.9, Labour Freedom 63.4, Monetary Freedom 71.8), highlights that:

«Elimination of the minimum capital requirement has made it easier to launch a new business, but the overall regulatory framework remains complex, arbitrary, and uneven. The labor regime continues to

¹⁷ The Freedom Index is an index that evaluates the overall economic freedom and it is calculated through the following twelve variables, grouped in four main broad areas: Rules of Law, that comprehends Property rights, Judicial Effectiveness, Government Integrity; Government Size, composed of Tax Burden, Government Spending, Fiscal Health; Regulatory Efficiency comprising of Business Freedom, Labour Freedom, Monetary Freedom; Market Openness, made up of Trade Freedom, Investment Freedom, Financial Freedom.

¹⁸ The Heritage Foundation, Miller T., Kim A. B., 2017 Index of Economic Freedom, Institute For Economic Freedom, Washington, 2017.

be repressive. The government props up numerous inefficient state-owned enterprises and funds a vast array of subsidies for manufactured exports, energy, agriculture, and consumer goods».

The last area, Market Openness (made up of Trade Freedom 73.6, Investment Freedom 20, Financial Freedom 20), in fact in the report it is emphasised that:

«Overall, trade is only moderately important to China's economy; the value of exports and imports taken together equals 41 percent of GDP. The average applied tariff rate is 3.2 percent. Numerous state-owned enterprises distort the economy, and the state maintains its tight grip on the financial system. The government controls almost all of China's banks, which are facing a rise in the number of nonperforming loans.»

As mentioned before, ownership structure in China should be considered as an obstacle to high accounting quality information. Yuan et al. (2009) stated that:

«In China, state-controlled firms represent the majority of listed firms (Claessens and Fan, 2002). As a code law and relationship-based economy of China, the state actually acts as a substitute for formal legal rules in protecting property rights. As the controlling shareholder of state-controlled firms, the state can use political power to enforce the contracts with other stakeholders and protect its own rights even in the case of a lower level of investor protection (Gourevitch and Shinn, 2005). Moreover, although there is a board of directors in every listed firm, the state still retains the authority to nominate top executives to the firms they control even with the enterprise reform, which increases the monitoring power of the shareholders to the top executives and mitigates the agency problems between shareholders and managers even though investors are poorly protected by legal rules. As a consequence, even though the legal protection of investors is poor, the state can use the political power it has to protect itself in performing property rights protection and monitoring top executives, rather than through the concentrated ownership mechanism¹⁹»

In China, there is no separation between ownership and management, in fact even in case of listed companies, there are a lot of owners. Who is in charge of the control of the management of a company also controls the vast majority of the company's shares. As a consequence, there is a lack of shares that flow in the market. To introduce the sixth point, we should remark that China has a two-tier governance structure, composed of Board of Directors and Supervisory Boards. The sixth point highlights the fact that the problem of China's corporate governance is the lack of independent board of directors and specialised committees in listed firms' environment (Schipani and Liu, 2001). Company law states that the shareholders' general meeting is in charge for the selection and

¹⁹ Yuan Q., Shinong W., Xu N., « State Control, Legal Investors Protection, and Ownership concentration: Evidence from China », *Corporate Governance Review*, 2009, vol.17 (2), pp 176-194.

removal of directors, but it does not define who should be responsible for nominating them. Schipani and Liu (2001) revealed that vast majority company officials were still nominated by government departments, instead of being appointed by the board of directors. Zhang (2000) also reported that in many company directors can only exert a symbolic influence and not a substantial one, as it is supposed to be. CSRC overhauled insider-controlled board structure by promulgating a regulation in August 2001 requiring each listed company to have at least one-third of the board to be independent directors by June 2003. CSRC's regulations require that independent directors must spend enough time on the companies they hold directorship; one person cannot hold more than 5 directorship positions concurrently. But according to a 1999 survey conducted by the OECD, the average percentage of independent directors on companies' board of directors was 62% in the U.S. Therefore, China needs to increase its percentage of independent directors. Another factor that we should focus on China's corporate governance is the weak supervisory board in listed firms (Schipani and Liu, 2001). In the Chinese system, companies complying with the country's Company Law have a two-tier board, this means that in addition to the board of directors, Chinese companies also have a supervisory board. This supervisory board has labor union, party, and major shareholder representation. However, it only has a vaguely defined monitoring role over the board of directors and managers.

It can be said that the supervisory board in China has no effective governance role, this because supervisors are not engaged in the selection of directors and managers and have no means of regulating them. In many companies, the supervisory board duplicates the authority of the board of directors but without corresponding and effective responsibilities. Even if there is the appointment of independent directors in the Board of Directors, they will bare hardships in dealing with objectivity towards the Board's resolution. As it can be guessed, the Board's member remain the only ones who can make decisions and benefit from self-serving opportunities. Transparency is another important factor that should be considered in Chinese economic environment. First of all, we should consider that there are two kind of transparencies. The first one refers to the Corruption Perception Index, that measures the extent to which corruption is believed to exist among politicians and officials. This index was developed by Transparency International, with the aim of advancing accountability, integrity and transparency. Transparency is here seen as:

« Transparency ensures that public officials, civil servants, managers, board members and business people act visibly and understandably, and report on their activities. And it means that

the general public can hold them to account. It is the surest way of guarding against corruption, and helps increase trust in the people and institutions on which our futures depend.»

China Corruption Perception Index in 40, on a scale of 0 to 100 and it is ranked 79/176 Countries. The second kind of transparency mentioned refers to accounting transparency. Accounting information transparency is crucial because it can influence the accomplishments of a company. A lot of researches has been made in this field. For example, Zhou and Chen (2008) analysed the influence that accounting information transparency has on industry level capital allocation. Their data comprehended A-shares listed companies on Shanghai and Shenzhen stock exchanges between 1999 and 2004. Their research came up with the assumption that accounting information transparency has a significant effect on resource allocation. This means that the more information is transparent, the better resources will be allocated (Zhou and Chen, 2008). Li (2009) contributed to the previous literature by observing 3600 A Shares listed companies from 2004 to 2006. The focus of his research is to investigate the influence that accounting information quality has on under and over investment of listed companies. He found out that high quality accounting informations can reduce risks and will improve capital allocation efficiency. Zhai et al. (2016) examined the relationship that lies between high accounting quality and investment choices, based on the governance function that accounting information has. This study shows that if we have high quality financial informations, there will be a high correlation of operative income growth between listed firms and its own industry. Furthermore, the link between accounting information quality and investment choices is more evident if the corporate governance environment is poor. As a direct consequence, high quality information has a fundamental governance role because it can lead managers to maximise their investment choices and attract shareholders. This study gave thee main contributions to literature. First of all, it gave empirical evidences of developing market. Secondly, as we can easily understand from the conclusions of this research, a transparent information environment is required to let accounting information play its role of helping in resource allocation and in capital investment choices (Zhai and Wang, 2016).

Another important Chinese phenomena that should be mentioned is the lack of audit independence in China and bad audit quality. A great part of Chinese CPAs lacks in international accounting practices knowledge, furthermore they are not sufficiently equipped with computer skills, as a consequence of a shortage of proper training. Besides, Chinese CPA firms have also several problems in their operations, because of a lack of proper supervision. As a consequence of these deficiencies, it is not hard to understand

that this can be a fertile field for fraud cases in the securities market. Managers are responsible for the production of fair financial information, while auditors are responsible for their audit report. Nevertheless Chinese CPA's role is not clearly defined. The unique field in which the CPA's legal liability is truly defined is in the decision making process of the People's Congress on the enforcement of the Company Law. Criminal charges could be enforced, if auditors are found to intentionally prepare false documents about asset valuation, capital verification, and examination that resulted in serious consequences. The punishment could call for imprisonment (up to five years) and fines that can reach 200,000 Yuan. There are several empirical studies in this field, and they found some unique auditing situations in China. For example, Abdel-Khalik et al.(1999) found out that independence and social acceptance of auditing in China appeared to have undergo a slow progress, because of the government's control over domestic CPA firms. DeFond et al. (2000) found that the increase in modified audit reports in recent years is followed by a consequential decline in audit market share among large audit firms. Xiao et al. (2000) described some distinctive features of Chinese audit market, like the lack of audit independence, the shortage of properly qualified auditors and a massive corruption environment. As said before, the studies in this field can be defined as controversial because some of the state that China's audit quality is low (Bai 2004, Michas 2011). Michas, in his paper investigated the country-level development of the audit profession in emerging markets and hypothesise whether development is associated with audit quality and auditor choice. Moreover he discovered that:

«What do I find? Results indicate that, after controlling for rule of law and investor protection, audit quality is higher in countries with more developed audit professions, but only for clients of Big Four auditors. This indicates that audit profession development in emerging market countries is an important determinant of audit quality for Big Four auditors in these countries, but not for non-Big Four auditors.²⁰ »

As it is possible to understand, audit quality depends on auditor's quality (Watts and Zimmerman, 1986). Since it is known that there is a shortage of independent auditors and Certified Public Accountants (CPA), Chinese MOF together with the Chinese Institute of Certified Public Accountants (CICPA) had promoted a series of training programs to improve the auditor's independence. Even though there has been these attempts to reduce this problems, China has to work hard to solve this problem.

Another crucial issue in China's corporate governance is the falsification and production of financial data by listed firms. Even if in theory Chinese laws on corporate governance

²⁰ MICHAS, P.N., «The Importance of Audit Profession Development in Emerging Market Countries», *The Accounting Review*, Vol. 86 (5), 2011, pp. 1731-1764.

appear to comply with international standard, in practice mandatory disclosure of company's information does not grant transparency, since the fact that investors are not sure about the truthfulness and reliability of company reports. Information disclosure in China, in many cases, has not been accurate and timely disclosed and sometimes investors had problems in understanding their contents. Doe and Chan (2002) cited a Ministry of Finance survey reported in the China Reform Daily on May 5 2001, that declared that approximately 98.7% of Chinese companies falsified their earnings in annual reports for the past accounting year. This is evidence of the fact that a company's management can take advantage of a high degree of autonomy, that is why sometimes it can go beyond the limits imposed by government and CSRC. As a direct consequence, some companies tend to hide their inefficiencies, as well as dubious dealings by passing over the mandatory disclosure requirements.

3.2 The influence of the convergence of Chinese accounting standards with IFRS on accounting quality

In this section, the main aim is to understand whether the convergence process of 2007 between IFRS and Chinese GAAP has made raised the quality of accounting information by examining the main studies in this field. The adoption of international accounting standards underwent several debates because it is common to think that complying with IFRS means increasing the quality of financial reporting and helping investors in their decision making (Daske, Hail, Leuz, Verdi, 2008). It is important to analyse the impact and relevance of IFRS in China because, as I already pointed out, China has a unique economic, political and institutional environment. These kinds of studies also help in understanding how non-English speaking countries can deal with the application of IFRS (Sunders 2009).

The first study examined is the one made by Liu, Yao et al. (Liu, Yao, Hu, Liu, 2011). This study contributes to literature by assessing whether IFRS are relevant to China and whether accounting quality has increased after the convergence process that took place in 2007. In this study, a great relevance is given to the potential improvements that can be found in earnings management and value relevance after the standards convergence process. Liu et al. selected Chinese firms that present annual and stock information availability in Compustat Global, taking as a sample period 2005 to 2008. In this study,

only A-shares companies are analysed²¹. The methodology used refers to the fact that accounting quality, is described through two main factors: earnings management and value relevance, taking as some prior studies as an example (Paananen, Lin, 2009). Earnings management, that is here defined as a «purposeful intervention in the external financial reporting process» (Schipper, 1989), also comprehends earnings smoothing, that can be seen as a particular form of earnings management that takes place when managers want to reduce the fluctuations that occur in their firms' net income. The findings of this study support the hypothesis that accounting information quality, in particular reported earnings, improved after the mandatory convergence between Chinese GAAP and IFRS. Through this study, it is possible to assess that the value relevance of reported earnings increased, while earnings smoothing substantially decreased after the convergence process. This supports the assumption that IFRS have ameliorated Chinese accounting situation because China is more and more similar to advanced economies. Furthermore, in compliance with Daske et al's (2008) findings, the improvement deriving from the IFRS adoption is expected to be greater for the adopters who had poorer quality as firms audited by Big Four before the standards change reported quality improvement to a smaller extent. The second study on the influence of IFRS convergence in China is the one made by Qu et al. (2012). This study's goal is to analyse if the convergence process of 2007 had improved the quality of accounting information for investors in Chinese A-share market. This because the convergence process between Chinese GAAP and IFRS is expected to have had a greater impact on companies issuing A-shares, listed on Chinese Stock Markets between 2004 and 2010. This study differs from the one made by Liu et al. (2011), because Liu et al.'s one only considered a testing time period that comprehended one year before and after the 2007 IFRS and Chinese GAAP process, furnishing an empirical evidence of the immediate reaction of the process. Differently from the prior study analysed, Qu et al. gave their contribution to literature by taking a longer sample period, in fact testing period comprehends 2004 to 2006 (pre IFRS period), from 2008 to 2010 (post IFRS period), because 2007 is seen as a transitional period. The aim of this study is to assess if the quality of information in Chinese A shares market has made some significant improvements, in particular assessing if earnings and book value of equity of Chinese listed companies has more value relevance in the post IFRS convergence period rather than in the pre adoption period. Qu et al. took as sample

²¹ The 870 companies selected for the study were from different industries, in particular: 66% manufacturing; 13% transportation, communication and utilities; 7% retail trade and wholesale; 5% services; 4% mining and construction; 2% agriculture; 3% public administration.

companies 309 Chinese A-shares listed companies by downloading the financial data of the sample companies thanks to CSMAR (Chinese Stock Market Accounting Research Database), providing a Multiple regression analysis. The financial data includes the revised version of their financial statements. The variables used in this study are:

- Market value per share (MV)
- Earning per share (EPS)
- Book value of equity per share (BVE)
- Leverage (LEV)
- Operating cash flow per share (CF)

In order to test if there has been a significant difference in the variable in the pre and post IFRS convergence period, the Wilcoxon test is used. This kind of test is fundamental to understand if the dissimilarities among the two groups are so significant that the use of Multiple regression test is needed in order to assess if the value relevance in the accounting information after the IFRS convergence process in China. Thanks to the Wilcoxon test evidenced the fact that there are significant differences in MV, EPS, LEV and CF but not in BVE, highlighting the fact that BVE is not because it does not have a linear issue. The third study made whose aim is to assess if the IFRS convergence had influenced financial reporting in China is the one made by Lee et al. (2013) with the collaboration of the Association of Chartered Certified Accountants, also known as ACCA. The main research question is, as already said, to assess if the IFRS and Chinese GAAP convergence process had improved Chinese reporting quality. In addition, Lee et al. wanted to testify if the impact of the convergence process has been influenced by Chinese political and socio economical factors. But what does this mean? This refers to the fact that accounting quality is not only linked to the accounting standards, because it is also determined by the possible incentives that a company may have in order to provide high quality financial informations. As a consequence, the more a company has external funds, the more it will be likely to have higher quality accounting informations. This study by Lee et al. is based on a sample of 10.017 firms year observation, including all Chinese industrial companies listed on Shanghai and Shenzhen stock exchange between 2003 and 2009. Differently from prior studies, the sample period is longer. The samples are organised in two groups:

- Treatment group: in which we can find A shares listed firms that should disclose financial statements in compliance with the convergence process between IFRS and CAS starting from 2007.

- Control group, composed of firms issuing both A and B shares, also known as dual listed companies. This means that this kind of companies should have provided accounting informations in compliance with IFRS even before the convergence process.

This division mainly serves as an indicator of the influence that the convergence process has had on companies, as a consequence if the shift has influenced the value relevance, this will be mainly visible in the treatment group rather than in the control group.

Lee et al. came up with seven main findings:

- It has been registered a significant increase in value relevance, but only for firms belonging to treatment group, that, of course, should comply with the new IFRS convergent Chinese GAAP. In control group, as expected, there has been no significant change.
- In the treatment group, the effect of the convergence between Chinese GAAP and IFRS is stronger for manufacturing firms, this because manufacturing industry is the industry that contributes most to Chinese economic growth and also because there is a great competition for external capital and firm in these field are expected to have greater incentives to have an efficient disclosure.
- Another important finding deals with the fact that the value relevance of reported earning is greater in firms located in less developed regions. This supports the hypothesis that this kind of firms have greater incentives to improve the quality of their financial reporting because it is harder for them to acquire foreign and external funds.
- The progresses made in value relevance of the reported earnings after the 2007 convergence process is less evident in firms that benefit from the Chinese Government control. This supports the hypothesis that these firms are not so motivated in ameliorating their financial statements because they already know they can count on the Chinese Government's support.
- The effect of IFRS and Chinese New PRC GAAP is more evident in firms that benefit from foreign ownership, because these firms provide the information need of their foreign investors.
- The improvements on accounting information quality deriving from the convergence process are lessened in Chinese listed firms in a situation of financial distress, as a consequence of the fact the new IFRS convergent Chinese standards are made in order to avoid delisting problem.

- The impact of the New Chinese GAAP is more evident in companies that cannot benefit from the Chinese Government's support, of course because they need to improve their financial reports as a consequence of the fact that the new accounting standards can attract foreign investors.

Lee et al.'s aim is also understand which are the institutional factors that may affect the Chinese convergence process. They evidenced six main areas that may be affected:

- Industry classification: in this part they expressed the fact that China's outstanding economic growth has contributed to build China's role in the global economy and as a leader in the manufacturing sector. This industry represents one-third of China's GDP and represent the 50% of Chinese stock market capitalisation. Because of Chinese importance in manufacturing sector, the competition for equity capital is greater among these firms and given the importance of China in this field, it is easy to guess that the convergence process has deeply affected this sector.
- Regional development: in this division, they wanted to highlight the fact that in China there are differences in the regional development. This means that China gave priority in the development of coastal regions, because of their desire of foreign trades. The development gap between coastal and inland regions, of course, influences the development of financial markets and promotes government's decentralisation. All of these factors influenced the financial reporting incentives. Moreover, there are empirical evidences, provided by Wang et al. (2008), in which it is highlighted the fact that the institutional development gaps are know to influence Chinese firms in their choice of auditors.
- State control: of course, it is not possible to avoid mentioning the fact that China is still subject to government's control and ownership over the great majority of Chinese listed firms. In fact, more or less the two-thirds of companies listed on Chinese stock exchanges in mainland China still have central or local controlling shareholders, that are affiliated with the government. Of course, Chinese government provides financial supports and other kind of business benefits. As it is easy to guess, state controlled companies are expected to comply mainly with Chinese government's political and social objectives rather than complying with foreign investors. As a consequence of this situation, we can conclude that the impact of the IFRS convergence process will be smaller on state controlled firms.

- Foreign ownership: Foreign investors that invest in China are often in a situation of information disadvantage, so that is why they ask for corporate transparency, much more than domestic investors. Another problem that should be considered is the fact that there is a common ignorance on Chinese culture and its background, so this implies that foreign investors' reliance on financial information increases. As a consequence, the improvements in financial statements' comparability and quality after the 2007 convergence process is expected to be a benefit for foreign investors, but not so much for domestic ones. After the convergence process, the financial statement can fulfil the needs of foreign investors. In terms of information accuracy.
- Delisting regulation: in order to benefit from the advantage of economic development and in order to assure that the equity capital is allocated to companies reporting good economic performance, it is mandatory in China that if there is a company that reports two consecutive years of losses, it will be classified as a specially treated firm. Being considered a specially treated firm means that if their daily price volatility exceeds 5%, their stock trading will be suspended. In addition, special treated firms cannot receive additional capital from the stock market. If, after two years of losses, the company presents an additional year of losses, it will be suspended by the stock exchange. After four consecutive years of losses, it will be completely delisted. Given this condition, companies are worried about the fact that a possible delisting situation may benefit from the flexibility provided by New IFRS convergent PRC GAAP to avoid reporting multiple losses. For this kind of firms, earnings quality can decrease complying with IFRS.
- State subsidy: even if Chinese capitalism now is becoming more and more market oriented, government subsidies still remain a mean of influence for Chinese economic development and it is seen as one of the most important source of finance for Chinese firms. Firms receiving this funds are expected to have less financial pressure and of course they will hardly rely on external capital markets for financial supplies. By the way, the advantages of the convergence between IFRS and Chinese GAAP are assumed to be greater for firms that receive low government subsidies, because of the fact that firms have a greater reliance on equity investors.

The main findings in this study evidenced that China had benefitted from the Chinese GAAP and IFRS convergence. In particular, thanks to this study it is understood that firms that having a greater request for foreign capital report a greater increase in value relevance of their accounting information, including firms located in more competitive sectors or that are in non developed regions, with less state control and foreign ownership. Given China's unique economic and social condition, several studies highlighted the point that it is difficult to assess whether China has taken advantage from IFRS, because these studies reported weak and controversial result. In this studies results are clear, some companies' value relevance increased. However, the benefit deriving from the convergence process is not homogeneous, because every firm has its own condition. In fact, IFRS convergence had increased the value relevance of firms that need to attract foreign capital. In this way, the convergence process can be useful to lessen that gap between companies benefitting from government subsidies. Another relevant study made in this same field is the one made by Kao and Wei (2014). This paper's aim is to study the underlying relationship between information asymmetry, ownership structure, pledge of directors and the quality of accounting information under different accounting standards. In this study A and B Chinese stock markets analysed, which apply China GAAP and IFRS. The aim is to discuss whether the use of IFRS can reduce negative effects deriving from information asymmetry, ownership structure, pledge of directors, and moreover a great importance is given in the promotion of accounting information quality. However, Kao and Wei (2014) until their study was published, there were no consistent empirical finding provided that affirmed that the adoption of IFRS produces higher information quality compared to other sets of accounting standards. In some studies (Leuz and Verrechia, 2000; Leuz, 2003; Leuz et al., 2003), it is argued that there is no existing difference between the information quality provided by different accounting standards. Leuz et al. are convinced that the selection of accounting standards is not so crucial, a uniform set of accounting standards is useless. Regarding the differences between Chinese GAAP and IFRS accounting information quality, this research aims also to measure the influence that information asymmetry and corporate governance may exert on accounting information quality. The main theories on financial accounting guess that a full disclosure of financial information is the best way to lessen information asymmetry. IFRS, as well, points out the necessity of transparency in financial statement. IFRS is said to assure a low information asymmetry and to ave a higher accounting quality. Another important aspect that is examined in this research is to assess if the adoption of IFRS, which is a synonym of granting a full disclosure of information, is able

to improve or tamper the equity restructure and the pledge that directors and supervisors have on shares. The main objective is to draw a comparison, in terms of accounting information quality, between the information gathered by IFRS system and China GAAP system, with the purpose of understanding which set of value can grant an higher accounting information quality, also in terms of reliability of information. We can say that Kao and Wei's aims can be summarised in four main points:

- The effects that Chinese GAAP and IFRS convergence may generate in accounting information quality.
- The role that information asymmetry plays in terms of accounting information quality complying with the IFRS system
- The influence that the shareholding structure may exert on IFRS accounting information .
- The effect that the commitment that shareholders and directors on shares can have on IFRS accounting information quality.

Kao and Wei organised their work into five main hypothesis. The first set of hypothesis concerns how IFRS adoption can improve the information disclosed in terms of relevance. Before pointing out the first set of hypothesis they had formulated, we should precise that relevance is here intended as a general feature that accounting information may have and it is composed of predictability, feedback and timeliness. The first set of analysis came up with five main hypothesis:

- Does the IFRS adoption grant a higher accounting information quality?
- Does the IFRS adoption has an higher predictability?
- Does the IFRS adoption generate a better feedback?
- Does IFRS information have a better timeliness?
- Does IFRS information faithfully represent what it purport to represent?

The second hypothesis deals with China and with its unique condition. It refers mainly to the fact that China is still developing its own set of accounting standards, so Kao and Wei guessed that IFRS adoption could enhance several aspects, such as transparency in financial reporting, lower information asymmetry and the quality of accounting information. The second part of their analysis is based on 5 assumptions:

- The IFRS adoption can lessen the negative effects that information asymmetry may have on accounting information quality.

- The IFRS adoption can attenuate the negative effects of information asymmetry on predictability value.
- The IFRS adoption can lessen the negative effects that information asymmetry has on feedback value.
- IFRS adoption can reduce the negative effects that information asymmetry has on timeliness.
- The IFRS adoption can reduce the negative effects that information asymmetry may have on faithful presentation.

Another crucial factor that is tested in this paper is that if the IFRS adoption can mitigate and lessen the negative effects deriving from state ownership, promoting a greater transparency and improving accounting information quality. In order to assess these factors, other five hypothesis have been drawn up:

- Can IFRS adoption lower the consequent effects of State-ownership on accounting information quality?
- Can IFRS adoption can reduce the possible negative effects of State-ownership on predictability?
- Can IFRS adoption can attenuate the negative effects of State-ownership on feedbacks.
- Can IFRS adoption can cut down State-ownership effects on timeliness.
- The IFRS adoption can lower the negative effects of State-ownership on faithfulness of the accounting representation.

Moreover, Kao and Wei wanted to prove that IFRS can better the quality of accounting information and can also mitigate the behaviour of earnings management. The hypothesis that they made in this field are:

- IFRS can lessen the effects deriving from ownership by senior managers on financial reporting quality.
- IFRS can reduce the effects of ownership by senior managers on predictability.
- IFRS adoption can lessen the negative effects of ownership by senior managers on feedbacks.
- The IFRS adoption can attenuate the negative effects of ownership by senior managers enhancing the timeliness of information.
- The IFRS adoption can help in the reduction of the negative effects caused by ownership on faithful presentation.

Thanks to the contribution that Beasley (1996) gave to literature, who sampled companies' reporting frauds in financial statements, it is possible to know that there is an underlying positive correlation between unethical financial reporting and the ownership by directors and/or supervisors. This means that the higher is the pressure exerted by the ownership of directors, the more likely are frauds in these companies' financial reporting, and as a consequence disclosing low accounting quality information. This paper guesses if the IFRS adoption would enhance transparency and a correct disclosure, diminishing the negative influence that major shareholders, directors and supervisors' ownership may cause. Therefore, the hypothesis are:

- IFRS can help in reducing the negative effects of ownership of major shareholders on accounting information quality.
- IFRS adoption can lessen the effects of ownership of major shareholders, directors and supervisors on predictability.
- IFRS adoption can limit the negative effects of blockholders, directors and supervisors' ownership on feedback.
- IFRS adoption can weaken the effects of blockholders, directors and supervisors' ownership on timeliness of information.
- IFRS adoption can diminish the consequent effects of ownership of blockholders, directors and supervisors' ownership on faithful presentation.

The last part concerns a common practice between directors and supervisors to borrow money by using company shares, so they are likely to have incentives to manage earnings. However, this paper aims to anticipate that IFRS purpose is to better accounting information quality by enhancing transparency of financial reporting in also in terms of limiting the negative effects of the commitment on supervisors and directors' shares. Hence, this paper aims to demonstrate that:

- IFRS adoption can limit the effects of the commitment that supervisors and directors' share have on accounting quality.
- IFRS adoption can limit the effects of the commitment that supervisors and directors' share have on predictability.
- IFRS adoption can limit the effects of the commitment that supervisors and directors' share have on feedbacks.
- IFRS adoption can limit the effects of the commitment that supervisors and directors' share have on timeliness of information.

- IFRS adoption can limit the effects of the commitment that supervisors and directors' share have on faithful representation.

Regarding data sources and sample selection implied in this research, 42 companies issuing both A shares and B shares on Shenzhen Stock Exchange and 44 companies issuing both shares on Shanghai Stock Exchange are examined. Given the fact that any of these companies provide observations on both A and B shares, this paper examines 172 companies data between 1999 and 2009. A total of 1,892 observation values have been sampled. Regarding faithful representation, there is a restriction in the research sample period, from 2002 to 2009, due to a lack of data acquisition. Hence, a total of 1,376 observation values have been established. The empirical data used is sourced from China Finance and economic database of TEJ, a database offered by Taiwan Economic Journal. As already said, this study aims to understand the effects of information asymmetry, ownership structure and commitment by directors and supervisors and shares on quality of accounting information under different sets of financial reporting standards. According to the literature that Kao and Wei had reviewed, there can be several factors influencing the accounting information quality. These may include: company size (Atiase, 1985); debt ratios (Dhaliwal et al., 1982); book/market multiple value; sales growth (Myers, 1977); payout ratio (Kasanen et al., 1996); auditing by Big 4 (Becker et al., 1998; Francis and Krishan, 1999; Francis et al., 1999); ownership by institutional investors (Rajgopal et al., 1999); return on equity (Freeman et al., 1982). This paper attempts to prove that there are some control variables that can influence the quality of accounting information, following a gradual regression. According to the empirical results, this paper includes a total of eight control variables, that are company size, debt ratios, book/market multiples, company losses, payout ratios, auditing by Big 4, ownership by institutional investors and finally return on equity. The first hypothesis included in the study aims to prove the accounting information quality between China GAAP and IFRS in distinct financial accounting standards. The second hypothesis made by Kao and Wei concerns the intrinsic ability of IFRS standards in enhancing the accounting information quality through the reduction of information asymmetry. As said before, ownership structures and directors and supervisors' commitment on shares are examined here as two corporate governance factors. The Ownership structure issue is here divided into three subcomponents, state ownership, ownership by senior managers and ownership by major shareholders, directors and supervisors in order to validate the third, fourth and fifth hypothesis by examining whether IFRS can lessen the negative effects of

state ownership, ownership by senior managers and ownership by major shareholders, directors and supervisors, focusing on the improvement of accounting information. The sixth and last hypothesis made by Kao and Wei assumes the IFRS adoption could limit the negative effects of directors and supervisors' commitment on shares and, instead enhance the quality of accounting information. The main findings of this empirical study suggest that the IFRS adoption can surely improve the accounting information quality in terms of predictability and timeliness. However, findings suggest that there are no relevant effects on faithful representation. Perhaps taxations hinder the adoption of IFRS so that accounting information cannot be faithfully presented. Moreover, as far as information asymmetry is concerned, it is suggested that it can eventually damage accounting information quality. Even if the IFRS adoption can help in reducing the consequent negative effects of information asymmetry on accounting information quality, the result are not relevant. According to the hypothesis that assumes that Chinese government's ownership, senior managers, major shareholders, directors and supervisors may have an adverse effect on accounting information quality is confirmed by the fact that a relative high percentage of holdings by major shareholders, directors and supervisors are likely to manage their earnings. IFRS adoption can limit the negative impacts of Chinese government, senior managers, major shareholders, directors and supervisors ownership. Moreover, it can enhance effectively the timeliness of accounting information. In addition, the IFRS adoption can control the influence of the pledge of shares by directors and supervisors while the deriving benefits of enhancing accounting information quality are not so relevant. This paper contributes in the examination of both reliability and relevance of accounting information. Thanks to the comparison made between the information quality under China GAAP and IFRS system, this paper wants to prove if, thanks to the IFRS adoption, it is possible to enhance and improve the accounting information quality. The findings concerning the effects of information asymmetry, ownership structures and pledge on shares owned by directors and supervisors on accounting information quality under the IFRS system show that IFRS is not an effective guarantee of quality. Their finding show that the accounting information quality is enhanced but not in a really significant way to have effects on the improvement of information asymmetry and on the limitation of the negative influence that may have on ownership exerted by the Chinese government and the pledge of shares by major shareholders, directors and supervisors. The only contribution that IFRS can give in the improvement of accounting information quality is to reduce the information asymmetry and enhance corporate governance, along with the IFRS adoption.

Another great contribution given to the literature is the study made by Rutledge et al.(2015). They wanted to assess the level of convergence between New PRC GAAP and IFRS after the convergence process of 2007, in terms of value relevance. The empirical models developed use data from dual-listed companies, on both mainland China's A-share exchange and Hong Kong's H-share, thus that must comply with IFRS. The findings show that the 2007 convergence process had given an important contribution in the elimination of several differences between the two accounting standards. In terms of value relevance, findings demonstrate that it increased under the New PRC GAAP throughout the sample period in this research, to the extent that the value relevance under the New PRC GAAP became even higher than the one under IFRS for the last two years. Even if there are several studies on this matter, none of them came up with a general assumption. Together with the rapid economic and institutional development in China, the MOF's aim is to improve the quality of Chinese accounting standards and financial reporting through the 2007 IFRS and Chinese GAAP convergence process. The current study made hypothesis on the promulgation of the new PRC GAAP. The main questions here are if it can reduce the differences in net income and net assets between PRC GAAP and IFRS. In specific, Rutledge et al. wanted to prove:

- Is there any significant difference in the net income before the Chinese GAAP and IFRs convergence process?
- No relevant difference in the reported net income has been reported in the post convergence period between PRC GAAP and IFRS.
- There is an important difference in the reported net assets between PRC GAAP and IFRS considering the pre-convergence period.
- There is no important difference in the reported net assets between PRC GAAP and IFRS in the post-convergence period.

Here it should be precised that, the pre convergence period is 2006, while the post convergence period means from 2007 onwards.

Continuing accounting reforms of PRC GAAP to converge with IFRS should improve the accounting and auditing functions, increase the amount and relevance of disclosure practices, and benefit investors in making decisions in the Chinese stock markets. Rutledge et al. guess that an increase in the value relevance of accounting information under PRC GAAP in China's A-share market is expected. On this matter, they hypothesise that:

- There has been an improvement in terms of value relevance of reported net income under PRC GAAP in mainland China's A-share market in the post convergence period, in specific between 2006 and 2011.
- There has been an improvement in terms of value relevance of reported net assets under PRC GAAP in mainland China's A-share market in the post convergence period, in specific between 2006 and 2011.

Companies issuing both A-shares in China's Shanghai stock exchange and H-shares in the Hong Kong stock exchange have to comply with two set of reporting standards. In fact, companies issuing A-shares in the mainland China stock exchange are required to comply with the New PRC GAAP. However, the situation is different for companies issuing H-shares in the Hong Kong stock exchange, because they must choose between IFRS or HKFRS for financial reporting. In general, IFRS is often said to grant a higher quality accounting information than PRC GAAP, and Big 4 firms are normally considered more professional and reliable than local accounting companies. In addition, compared to the Chinese stock markets, who are relatively young, while the Hong Kong one is relatively mature, granting a higher investors protection. Rutledge et al. highlighted the point that results of prior research are mixed, because in some studies IFRS is favoured while in some other favour Chinese domestic standards are favoured. Even if the New PRC GAAP has made significant step forward in the convergence with IFRS, Chinese MOF kept several exceptions to IFRS, because of Chinese unique business environment, as their objective is to establish a more adaptable set of accounting standards for Chinese companies. If Chinese companies are required to have a full adoption of IFRS, this may lead to negative impacts and can also lead to disclose biased financial information, because there can be self-interest in manipulating them. Given these conditions, we can hypothesise that New PRC GAAP is expected to produce more value relevant accounting information than IFRS for Chinese companies. Thus, the following hypothesis is made:

- New PRC GAAP is expected to provide more value relevant accounting information in mainland China's A-share market than IFRS in Hong Kong's H-share market.

The hypothesis test are applied to assess the harmonisation progress in China with the publication of New PRC GAAP, which is aimed to reach a substantial convergence with IFRS. A t-test has been used to test if there is a relevant difference between the reported net income for dual-listed companies using PRC GAAP for their A-shares in Chinese stock exchange and IFRS for their H-shares in the Hong Kong stock exchange, taking as a sample period the period from 2006 to 2011. Similar tests have been made to test

whether there is a relevant difference in reported amounts for net assets. The convergence process and the issuance of the New PRC GAAP in 2007 is expected to have reduced considerably the relevance of the differences between the amounts reported under PRC GAAP and IFRS, for both net income and net assets. They used a t-test to prove the existence of significant differences in net income and net assets between PRC GAAP and IFRS before and after the convergence progress between the two set of standards. Chinese companies listed both on mainland and Hong Kong stock exchange (also known as AH companies), so that apply both PRC GAAP and IFRS to prepare their financial statements are used as samples. Ruthledge et al. recognised the fact that there are several studies that sample AB-share companies, with the aim of proving that the convergence between PRC GAAP and IFRS is effective. On the other hand, because of an insufficient market regulation and because of a lack of understanding of IFRS by local accounting professions, the accounting information for the B-share stock exchange are non reliable and incomparable (Chen and Zhang 2010). Having used H-share companies to represent IFRS users is appropriate because of the fact that they are required to comply with the Hong Kong listing regulations. Moreover, most of their annual reports are audited by Big-4 accounting firms, that are known to have a deep understanding of IFRS and, as a consequence, are capable of granting highly reliable financial information. All the samples used are selected from the Hang Seng China AH Premium Index (AH Index), that is also used to calculate the spread between A-shares and H-shares of dual-listed Chinese companies. This index is composed of all Chinese companies listed on one of the Chinese mainland stock exchanges, Shanghai or Shenzhen stock exchange and the Hong Kong stock exchange. This because companies listed on mainland stock exchanges (SHSE or SZSE) are required to apply the New PRC GAAP to prepare their financial statements and are regulated by CSRC, while the Hong Kong Stock Exchange allows mainland issuers to choose between IFRS or HKFRS to prepare their financial statements. Further in the December 2010 the Hong Kong Stock Exchange regulations have been revised, in fact it is now possible for mainland companies to prepare their financial statements in compliance with New PRC GAAP instead of IFRS or HKFRS, with the aim of reducing the costs that dual listed companies should bear. In June 2012, there were 50 dual listed Chinese companies composing the AH-Index. Among them, 12 decided to adopt HKFRS while 10 decided to apply New PRC GAAP for their financial statements for the SEHK. 28 companies are left, but because of the different issuance dates and required disclosure years, the sample size varied in the observation period of 2006-2011. Consequently, there are 22 sample companies in 2006, 27 in 2007, and 28 sample

companies from 2008 onwards. According to data about net asset and net income from 2006 to 2011, they are available thanks to companies' annual reports and also thanks to Shanghai, Shenzhen and Hong Kong stock exchange websites. Secondary financial data used in this study were manually collected from companies' financial reports or from their relative stock exchange websites. The financial statements that are available online should comply with accounting standards and should have been audited by accounting firms in accordance with auditing standards to ensure high reliability and comparability. In order to prove the third and fourth hypothesis, a valuation model is used in order to assess and make a comparison between the value relevance of financial information under New PRC GAAP in the Chinese A-share market with that one under IFRS in the Hong Kong H-share market. The model used here is the Ohlson valuation model (1995), revealing how a firm's market value is associated with its book values of equity and earnings. In Rutledge et al.'s study market share prices from the last trading day of the fourth month of year $t+1$ (following the end of fiscal year t) are used because the China Securities Regulatory Commission (CSRC) establishes that all companies should publish their annual reports no later than four months after the end of the fiscal year. Share prices are here considered as dependent variables because their aim is to represent the information value relevance, and to assess the value relevance of accounting information under PRC GAAP and under IFRS. The samples of the study that are used to examine value relevance of information on the same base of companies used to prove the convergence between IFRS and Chinese GAAP. The sample companies comprehend all companies included in the AH-Index as of June 2012, so they must apply New PRC GAAP for financial reporting for Chinese stock exchange and IFRS for the Hong Kong stock exchange. Chinese market segmentation gives Chinese companies a unique opportunity to compare the value relevance of accounting information under PRC GAAP and IFRS through the analysis of financial statements of AH-share companies. As already said, t -tests have been used to test the convergence between New PRC GAAP and IFRS in terms of reported net income and net assets. According to their results, it is possible to say that there is a relevant negative difference between reported income under PRC GAAP and under IFRS for the year before the issuance of the New PRC GAAP. This means that the first hypothesis has been proved. On the other hand, no significant differences are detected between reported net income under the new PRC GAAP and IFRS subsequent to IFRS and New PRC GAAP convergence process. Thus, the analysis indicates that there is an effective convergence consequent to the mandatory adoption of the new PRC GAAP. This supports the second hypothesis, suggesting that the convergence process has

been able to effectively reduce the differences between PRC GAAP and IFRS. The following part aimed to show the results for the differences in net assets under the two different reporting standards. Results show that there is no relevant difference between reported net assets under PRC GAAP and under IFRS for any of the sample years. Rutledge et al. also tested the difference in the reported amounts under the two set of accounting standards. They also listed nine identifiable accounting issues that may cause the difference in net income and net assets of sampled companies, and they are ranked in terms of the number of affected companies for the latest fiscal year 2011. These factors are:

1. Safety Production Fund
2. Government Grants
3. Fixed Assets Revaluation and Depreciation
4. Business Combinations involving Enterprises under Common Control
5. Provision of Benefits (Post-retirement Benefits, Housing Benefits, etc.)
6. Land Use Rights
7. Circulation Right for Equity Separation Interest Capitalisation
8. Foreign Currency Translation
9. Others

However, out of nine, the first three of them can be considered as the most influential factors. Safety production fund is one of the three factors that contributed to differences between PRC GAAP and IFRS and it is possible to say that is the one that affected most the differences between the two sets of accounting standards. According to New PRC GAAP requirements, mining, construction, production of dangerous goods companies and the transport industry are required to make provisions for a safety production fund. This safety production fund is established according to the amount of a company's production or actual sales. Moreover, it is recognised in profit or loss with a subsequent increase in reserve. Such reserve is reduced for expenses incurred for safety production purposes or, when safety production related fixed assets are purchased, it is reduced by the purchased cost. These assets are not depreciated thereafter. However, no safety production fund is required under IFRS. However, Safety production expense is recognised in profit or loss when incurred. The annual provision of safety production fund smoothes the reported net income of financial statements, and as a consequence, it results directly in less net profit under PRC GAAP than IFRS. The second factor that may cause the differences between IFRS and New PRC GAAP refers to the government grants.

Before the issuance of the new Chinese accounting standards, these grants should be recognised in equity and the initial book value of the assets was charged to income statement over the useful life of the asset. From 2007 onwards, according to the New PRC GAAP regulations, government grants are generally marked as deferred income and then amortised to profit or loss over the related assets. IFRS, in the contrary, grants more flexibility than PRC GAAP. According to IAS 20 (IASB 2008b), two optional approaches are pointed out for the treatment of government grants related to assets. The first method is quite similar to the one pointed out by the New PRC GAAP, while the other one says that government grants are to be recognised as a deduction from the book value of the related asset. In terms of government grant, it is possible to say that New PRC GAAP and IFRS are not completely similar, however Chinese accounting reforms are in progress to reduce differences. However, in the annual reports of the sample companies, most of the government grants were received before New PRC GAAP was introduced. As a consequence, these grants were recorded in compliance with Old PRC GAAP, which means they were accounted as the relevant assets and credited as capital reserve. However, no consolidated financial statements were adjusted to make the financial report comply with New PRC GAAP. The different accounting treatment for this issue increases the differences in accounting of deferred income and the amount of depreciation expense. As a consequence, financial statements made in compliance with New PRC GAAP show lower net income and higher net assets, compared to those made under IFRS. The third and last relevant difference between New PRC GAAP and IFRS concerns the accounting measurements for property, plant and equipment, also called PPE. In China, because the state has the total ownership of land, companies can only purchase land-use rights, also called LUR. As a consequence, land is not comprehended in the PPE category, while LUR are accounted as intangible assets. The IAS that deals with this subject is IAS 16²². New PRC GAAP and IAS 16, however, present a common accounting measurement for the first recognition, but they differ in after-recognition measurement. According to both accounting standards, initial costs are generally capitalised. The difference in the after recognition method concern the fact that companies applying IFRS are free to choose between the cost method or a revaluation method while for companies complying with New PRC GAAP, only cost method for fixed assets is allowed. Given the prohibition to

²² IAS 16 *Property, Plant and Equipment* outlines the accounting treatment for most types of property, plant and equipment. Property, plant and equipment is initially measured at its cost, subsequently measured either using a cost or revaluation model, and depreciated so that its depreciable amount is allocated on a systematic basis over its useful life. Items of property, plant, and equipment should be recognised as assets when it is probable that the future economic benefits associated with the asset will flow to the entity, and the cost of the asset can be measured reliably.

use the revaluation model under New PRC GAAP, as a consequence there is no need to recognise a revalued amount in equity or income. The difference between the two after-recognition modes causes differences also in financial statements, bringing also a subsequent depreciation of expenses under both accounting standards. Moreover, there are also some differences in the depreciation methods. Under IFRS, it is required that every relevant part of a given item of fixed assets should be depreciated separately while, under the New PRC GAAP, only the relevant parts are required to be separately depreciated. Undoubtedly, these depreciation methods can affect the depreciation expenses and then cause differences in net income and net assets reported under both accounting standards. Rutledge et al. also wanted to focus on the value relevance of information, so they wanted to measure value relevance under PRC GAAP and IFRS, from 2006 to 2011. The Pearson correlations between share price and accounting information is used on an overall basis. Results reveal that the correlations between EPS and BVPS are 78% for PRC GAAP and 75% for IFRS. Generally, the correlations among the independent variables are not expected to be that high. The third hypothesis guesses an increase in value relevance of reported net income under PRC GAAP between 2006 and 2011. According to their results, reported earnings are shown to have improved the value relevance, supporting Rutledge et al.'s hypothesis. Hence, findings demonstrate that there has been an overall improvement in terms of value relevance of net assets over the sample period, but not so relevant as expected as the improvement for earnings. The fourth hypothesis aims to make a comparison between New PRC GAAP and IFRS' value relevance. It is here hypothesised that New PRC GAAP is able to provide more value relevant accounting information than IFRS for dual-listed AH-share Chinese companies. As discussed above, both PRC GAAP in the A-share market and IFRS in the H-share market provide value relevant accounting information based on significant regression statistics throughout the years studied. It is appeared that the value relevance for PRC GAAP was less than the one under IFRS before New PRC GAAP were introduced. It is now possible to conclude summarising the main finding of Rutledge et al.'s study. First of all, the results on the tests made on the convergence process between New PRC GAAP with IFRS show that there are still some relevant differences between net income reported under both New PRC GAAP and IFRS for the sample firms in 2006. In 2007, consequent to the establishment of New PRC GAAP, and throughout the end of the sample period in 2011, no relevant differences has been highlighted in reported net income or net assets between the two sets of standards. Thus, we can conclude that there has been a substantial convergence between New PRC GAAP with IFRS. Findings related to the value

relevance of PRC GAAP accounting information show that New PRC GAAP has improved value relevance and in particular, New PRC GAAP EPS does not report a significant value relevance during the first three years of sample, but it does, instead, in the last three years examined. Evidences support the thesis that there is an effective improvement in the value relevance of New PRC GAAP. The point examined aimed to make a comparison between the value relevance of New PRC GAAP and IFRS. Results show that that both accounting standards are able to disclose useful accounting information and for this reason is possible to conclude that they are both significantly value relevant. Under each set of standards, EPS and BVPS are useful and relevant to explain the variation in share price, and each has significant value relevance. H-share investors are said to have a great reliance on financial information provided under IFRS, which may be responsible of the stability of value relevance of accounting information under IFRS during the sample period. It seems also that investors in the A-share market have increased their reliance on New PRC GAAP accounting information, causing an improvement in the value relevance of PRC GAAP amounts. Consequently, since 2010, New PRC GAAP has been able to provide a more useful and relevant accounting information to the stock market than IFRS for AH-share Chinese companies. These results may be the result of features of Chinese environment, for example because of a taxation-oriented financial system, government interventions, an insufficient market-oriented economy, and an inefficient internal control mechanism within Chinese companies. The convergence process between Chinese accounting standards and IFRS is seen a great change for Chinese companies, but this does not mean that the efforts towards convergence should end. In fact, in 2010, the MOF has released a Roadmap of continuous convergence between China Accounting Standards and IFRS. This document doesn't not predict a complete adoption of IFRS, but rather an increase in consistency between Chinese standards and IFRS, considering China's unique political, economic and legal environment.

The following study is the one made by Dai et al. (2015). This research aims to study the underlying correlation between earnings per share and stock price. Dai et al. took as sample period the years from 2005 to 2008, examining AB-share listed companies in Shenzhen, assessing if there are any changes in value-relevance of accounting earnings before and after accounting standards change of 2007. They highlighted the fact that the new IFRS convergent accounting standards have affected both positively and negatively A-share listed companies from many points of view. For instance, according to the new standards, when companies with high debt get debt exemption, the proceeds can be

directly evident in their income statement, so this will make some high-debt companies increase their profits without any reluctance, by using debt restructuring. Moreover, the regulation that asset impairment provisions are not reversed cuts off a major route to increase profits for listed companies. The different influence that these new accounting standards has on accounting earnings may lead us to consider the fact that there are also changes in the value relevance of accounting earnings. The main point in this study is to assess if before the convergence process accounting earnings in A-share market or in B-share market would report an higher value relevance. Given the assumption that the value relevance of accounting earnings in the two share markets were different, Dai et al. would then study whether the accounting standards are able to lessen the value relevance of accounting earnings of A-share listed companies. Dai et al. organised their research according to two main hypothesis we proposed the following hypotheses: the first one supposes that, before Chinese accounting standards convergence process, the value relevance of the earnings in A-share market is less than the value relevance in B-share market. The second one wants to prove if the value relevance of the earnings in A-share market will be increased thanks to these new accounting standards.

First of all they wanted to know if there is a change in accounting earnings between A-share market and B-share market before and after the accounting standards change. Then they made a comparison of the impact of accounting standards change on value relevance of accounting earnings in A-share market and B-share market. Given the fact that B shares had to comply with IFRS followed by the B-share because they are listed on a foreign stock exchange, they had fixed the value relevance of accounting earnings in B-share market as a reference and then compared it with the value relevance of accounting earnings in A-share market before and after the accounting standards change.

Before the accounting standards convergence process, the difference of A and B shares in earnings per share was not relevant, while the difference of A and B shares in stock price was significant because B-shares reported a significant discount. It is now important to examine whether A-shares and B-shares have value relevance before the accounting standards change. If both have, they would then compare which one has an higher correlation. Then Dai et al, analysed stock price and earnings per share before the 2007 Chinese GAAP and IFRS convergence. Both A-shares and B-shares report a relevant positive correlation in stock price and earnings per share. However, Pearson coefficient of A-shares is less than B-shares, which is an evidence that stock price and earnings per share in B-shares have an higher correlation than in A-shares. Before the convergence process of accounting standards took place, the value-relevance in the A-share market

was higher compared to the one of B-share market, validating the hypothesis that value-relevance of accounting earnings under CAS is lower than under IAS. As a consequence, the first hypothesis has been proved, before accounting standards change, the value relevance of A-shares was less than the value relevance of B-shares. So international coordination and improvements made in accounting standards can be considered as an inevitable trend. In the end, it is certain that complying with the new accounting standards lead to an increase in the value relevance of accounting earnings in A-share market. After the Chinese CAS ad IFRS convergence process, a significant reduction in accounting earnings value-relevance in A-share market and B-share market has been highlighted, which means that Chinese accounting standards had a significant impact in the international coordination procedures. As already said, Dai et al. set the value relevance of accounting earnings in B-shares as the reference in this study, this because B shares had to comply with IFRS even before the convergence process so they hypothesised that the value relevance of accounting earnings in B-share market may not vary before and after the accounting standards change. It is possible now to compare the value relevance of accounting earnings in A-share market before and after the accounting standards shift. The difference of accounting earnings in A-shares and in B-shares became smaller. Considering the same period, before accounting standards change, the value relevance of accounting earnings in A-share market was lower than in B-share market, while considering the period after accounting standards change, the value relevance of accounting earnings in A-share market is almost identical with the one of B-share market. For this reason, after the 2007 convergence procedure, value relevance of accounting earnings in A-share market has been improved, proving the second hypothesis provided in the study. Dai et al. conclude their work providing some proposals that may enhance the value relevance of accounting earnings. First of all, the proposed to proactively improve the guidelines for the implementation mechanism, in this way one can be sure that there has been a successful transition from the form to the substance of coordination of the accounting standards. Secondly, they suggest to improve accounting information disclosure, focusing mainly on regulations and eventual punishments that may derive from manipulations. If there is no appropriate implementation, the value relevance of accounting earnings would not be effective, regardless the set of accounting standards that is used. Moreover they pointed out the necessity of strengthening accounting practitioners' training; if the accounting practitioners have high professional judgment and professional ethics, the possibility of deliberately hiding accounting information, disclosing irrelevant and, some times, unreliable informations, or even manipulating

profit with the precise aim of misleading or deceiving investors would surely decrease. They conclude saying that it is fundamental to ameliorate professional ethics and professional judgment of accountants, because this can help in maintaining a good accounting market environment and in improving the quality of accounting information. The last study analysed in this section is the one carried out by Ball (2016). In his latest study he wanted to prove the progresses made by IFRS after 10 years to the contemporary adoption in over 100 countries, comprehending China, which is analysed in the very last part of his study. Ball made a juxtaposition between how IFRS standards were perceived in 2005 and in 2015, ten years later. In 2005, IFRS were generally perceived as high-quality standards, but they were incomplete. In comparison, in 2015, they are still perceived as high quality standards and they are now substantially more complete. At a first glance, many benefits were expected from IFRS adoption, such as more efficient cross-border transactions, increased transparency of financial reports, increased inter-company comparability of financial data, better efficiency in terms of asset prices, diminished cost of capital, and the simplification of the contracting process through balance sheets. However, Ball (2016) also said that it is not possible to prove if all these benefits have been realised due to the fact that there is limited evidence. Even though the general conviction that IASB has developed a set of standards that requires the so called high quality, it is not so evident which is the meaning of this point. Ball has gained four main properties that are at the basis of this assumption:

- The IFRS standards were expressly developed outside governmental bodies and their principal purpose was not to comply with political criteria or to match with tax accounting rules;
- The standards are developed with the aim of making financial statements truly reflect the economic substance of a company's financial affairs, rather than its legal form;
- Fair value accounting is largely used, in contrast with historical cost. In this way, IFRS balance sheets and earnings are able to be more informative and this enables the recording of economic gains and losses in a more timely manner;
- The standards are developed to diminish managers' inclination to manipulate provisions, in ways that were still considered valid under many of the adopting countries' prior rules, for instance, with the aim of smoothing reported earnings or hiding losses.

These four properties are not independent and they can be easily summarised them is to say that IFRS are designed to increase financial reporting transparency, which means providing complete and accurate information about the company's financial position. Increased transparency in financial information may bring to considerable confidence in the future of financial reporting under IFRS, and this confidence was fomented by a broad formal adoption of IFRS around the world.

The final part of Ball (2016) research deals with China and its unique condition towards the IFRS adoption. In specific Ball said:

“China has not formally adopted IFRS, but signed a memorandum with the IASB in November 2005 endorsing convergence of its domestic Accounting Standards for Business Enterprises (ASBE). This memorandum was updated in November 2015, for example, by announcing a joint working group to advance the use of IFRS in the country. Soon after the first agreement, in early 2006 China announced a revision to ASBE that incorporated IFRS. One might conclude that China is almost an IFRS-adopting jurisdiction. This is the impression one might garner from the IASB's detailed review, which it summarised by answering its question What is the jurisdiction's status of adoption? with China has adopted national accounting standards that are substantially converged with IFRS. However, China retained its domestic rules on accounting for related-party transactions, government subsidies and the reversal of impairments of depreciable assets. These are areas of great domestic political and economic significance in China. Especially for politically connected enterprises, the difference between ASBE and IFRS treatments could have substantial effects on their financial statements and on their financial reporting quality. For example, related-party transactions are considerably more common in China than in most western countries, and consequently reported numbers are rendered more malleable by the ability of related parties to vary the terms on which they transact. Implementation is another problem area. China does not yet possess the institutional structures that are complementary to high-quality accounting standards. For example, in formal terms China has adopted fair value accounting. Implementation of fair value rules is problematic even for short-cycle assets such as marketable securities, because the Chinese government controls the price of many unlisted securities. In general, a combination of political incentives to massage the numbers, weak corporate governance, weak shareholder rights, a compliant press, and inconsistent regulatory enforcement leads one to conclude that China's substantial convergence exists more in form than in substance. The case of China illustrates the importance of national political and economic forces. It also highlights the limitations of scoring convergence by counting the number of common standards, as distinct from measuring actual outcomes in the financial statements (Ball et al. 2016).”

3.3 Literature review of the main studies on accounting quality in China

In this section, the focus shifts from the convergence process to the quality of accounting in China. Here the main studies made in this field will be analysed. The studies analysed

in this section are the most recent studies, published after the IFRS and Chinese GAAP convergence process. The first relevant study in this field is the one made by Wang and Wu (2011). The aim of their study is to analyse restatements as a means able to show the poor quality of past accounting information reported within China's capital market. In this study, it is shown that almost a quarter of firms listed in mainland China undoubtedly recognised the poor quality of their financial information, by making a restatement of their previous financial reports between 1999 and 2005. A greatest part of these firms managed their earnings through below-the-line items, with the aim of avoiding losses and avoid being delisted. Low accounting quality is more likely among firms that show a feeble profitability and when shareholders are submitted to state-control, with diffused ownership and a low proportion of shares held by institutional investors. For these reasons, Chinese Investors' are said to lack reliance on earnings compared to a mature market, like in the US. As a consequence, there is a lack of credibility in Chinese accounting information. However, several efforts have been made by regulators to enhance and improve the quality of financial information and disclosure among listed firms, in fact the frequency of restatements decreased over the sample period taken into account, which supports the hypothesis that there are some undergoing prospects to further improve China's capital markets. In efficient capital markets, high-quality financial reporting is rewarded because it can help in raising and allocating funds and, consequently, it also can create benefits for investors. In the past decade, China's stock market gained more and more relevance among domestic investors, in fact the total market value of equity invested in the Chinese stock exchange has grown consistently during the 1999–2007 period. From 2005 to 2007, the Shanghai and Shenzhen Stock Exchange Composite Index underwent a significant increase. This rise generated a general concern over the quality of financial reporting in China. In fact, Wang and Wu (2011) highlighted the fact that a significant amount of companies listed on the Shanghai and Shenzhen Stock Exchanges have restated their annual reports between 1999 and 2005. Interestingly, in contrast to the enormous publicity that US earnings restatements have received, in China restatements have received exiguous coverage in Chinese media, even if it is a problem that deserves more relevance. Restatements are an evident violation of the accounting rules, so admitting to having restated the annual financial statements means that low quality information has been disclosed in companies' previous financial reporting. Wang and Wu (2011) made a comparison between how restatement is seen in both US and China. There are several studies that say that in the US, if a firm makes earnings restatement, it will surely be interested by a consequent decline in the stock

price, penalising the restatement firm (Palmrose et al., 2004). Some other American resources find out that after a restatement, the market relies less on earnings information disclosed by that company. This is an evidence of investors' loss of confidence in the company's financial reports and, for this reason, a company is obliged to pay a higher cost for equity capital (Hribar and Jenkins, 2004). These studies explain which are the consequences that low financial reporting can cause in a mature market. However, given the fact that China is an emerging market, these same reactions are unlikely to occur. Another question that may arise is whether earnings restatements can reduce investors' reliance on accounting earnings for setting stock prices, or increasing the firm's cost of equity capital, as demonstrated by US research. In addition, we should consider that many of the restatements in China are likely to be the result of opportunistic behaviour, but of course, what changes are the motivations that may lead to restatement. Of course, they will be completely different given the different institutional setting. Thus, China's restatements of financial reporting are linked with another phenomenon, which refers to the value that an emerging market attributes to the quality and credibility of financial reports. Wang and Wu wanted to outline the features of poor-quality firms, here defined as firms that issuing restatements. Moreover, they wanted to quantify the incentives to report poor-quality financial information previously released by such firms. Further, they examined the consequences of disclosing low information quality, in terms of stock market reaction. Their final point is to understand why Chinese companies are likely to provide poor-quality financial reporting. This study offers insights on the overall quality of Chinese accounting information and helps in understanding China's increasingly important capital markets. As already said, thanks to previous literature (Wu, 2002; Anderson and Yohn, 2002), we are able to know that, in the US market, restatements are indicators of the poor quality of prior financial reporting and as a consequence, low accounting quality is penalised by the capital market. The penalties imposed are seen as a deterrent to companies' delivery of poor accounting quality via accounting manipulation and similar means. Findings of this study demonstrate that there are no penalties provided by Chinese law. Wand and Wu suggest that the establishment of an effective penalty system through government regulation is needed, which can help China's emerging market to become a complete capital market. Researches on Chinese accounting quality often set their focus on earnings management, which grants a fertile background for the restatement question. Common incentives used in the States to manipulate earnings are not used in China. For instance, in China there is a great demand for financing while incentives granted to meet analysts' expectations are minimal.

Compensation plans of China's listed companies are not likely to be based on incentives. As a consequence, managers do not manipulate a firm's earnings inflating stock prices aiming to benefit from their own compensation. Chinese companies also do not face pressure from debt covenant constraints. Earnings management is likely to occur when companies are conducting their IPOs. It has been assessed that state-owned enterprises in unprotected industries are more likely to manage accounting accruals to improve their earnings and eventually list those business units while they are having temporarily high profits, which are the result of high accounting accruals during the process of financial packaging. Earnings management also is likely to occur when listed companies conduct secondary issuances or rights issuances. Given the assumption that listed companies are required to achieve a minimum average return on equity of 10% for the three years prior to secondary issuances or rights issuances, and given the fact that the CSRC has limited resources to control all applicants, Chen and Yuan (2004) show that many firms were able to gain the approval for rights issues through earnings management and subsequently performed worse than those that did not employ such practices. Thus, capital resources might have been better allocated if the regulators had examined the management of earnings more accurately. Chinese listed companies also are likely to manage earnings to avoid reporting three year of consecutive losses, which would bring them in the condition of being under special treatment, which may lead in delisting. In fact, earnings management generally is achieved through non-operating items that are here defined as below the line (Chen and Yuan, 2004). Wang and Wu (2011) developed several hypothesis in their study. The first one concerns restatement firms. Firms issuing restatements are likely to receive financing incentives before or during the restated year. In particular, they guess that restatement firms are likely to be those that offered secondary or rights issues before or during the restated year. The second hypothesis states that firms issuing restatements are likely to be under delisting pressure before or during the year restated. We should precise that these two cannot contemporarily exist in the same firm, because as already said, profitability requirement of 10% for refinancing surpasses the break-even point, and if a company meets this criterion, it will be likely to be delisted. Before developing the third hypothesis, they wanted analyse which aspects can affect a company's will to issue restatements in China's A-share market. Wang and Wu listed some testing variables that are organised in three categories: corporate governance, motivations and firm performance. Chinese state-owned enterprises underwent a reform, which can be considered as successful in terms of solving short-term managerial incentive problems, but not long-term ones. Another point that the reform has

missed is the problem of management selection. This because managers of Chinese SOEs are selected and appointed by bureaucrats, who are not supposed to bear the consequences of the managers they appoint. Thus, they have no proper incentives to find and appoint high-caliber managers, which negatively affects the quality of financial reporting. Concentrated ownership, like in Chinese companies, may cause a reduction in the rights of minority shareholders. As a consequence, decisions made by controlling owners are not contestable, also because of a weak legal system or because of an ineffective corporate governance, like boards of directors and the market for corporate control (Shleifer and Vishny, 1997; La Porta et al., 1999). Subsequently, it is arguable that controlling owners can report biased accounting information, for their own purposes, thus causing a reduction in the credibility of reported earnings for outside investors in East Asia (Fan and Wong, 2002). Additionally, engagement by institutional investors can promote corporate governance. In Chinese research, return on assets (ROA) is widely adopted as the prime performance indicator, rather than ROE, because ROE is likely to be modified due to the CSRC basing various thresholds on it. Given this background, they developed the third hypothesis, which states that restatements tend to be issued more frequently in firms with poor corporate governance, more concentrated ownership and poorer financial performance. Wang and Wu (2011) observed that there has been considerable number of restatements in China in the sample period but the strange thing is that it did not attracted the attention it deserved. The authors have guessed that it can be because the market lacks of reliance on financial reports and attaches an almost-independent value to listed companies. In fact in China, Stock prices rarely reflect the real value of companies. Moreover, changes in stock prices are hardly a reliable reflection of the changes in available information. Differently from mature markets, accounting reporting does not benefit from a central in China's capital market, thus financial reports that overstate or unreliably state a Chinese firm's performance may have a limited effect on the firm's stock evaluation. Thanks to these aspects, hypotheses 4 and 5 are developed. The fourth hypothesis deals with the fact that stock market fails to punish the poor quality of financial reports. They developed the three following corollaries to this main hypothesis. The first corollary wants to prove if the stock market fails to punish the poor quality of financial reports after restatement announcements. Wang et al. guess that given the assumption that stock market gives no proper relevance to the announcement of earnings restatements means that there is no penalty for restatements. To prove this corollary, we focus on the short-term stock price reaction to restatement announcements. They examined various windows up to two weeks before and after the announcements

for any information leakage or delay to the stock market. The stock market can't anticipate the poor quality of financial reports before restatement announcements. For this case a long-term event study is conducted, which means to examine the year preceding the restatement. The aim is to prove if any information has been leaked to the stock market, through insider trading or analysts' warnings, while issuing the financial report restatement. Failure to reject these first two null hypotheses would mean that the stock market in China does not require any punishment for poor financial statements. The third corollary aims to prove that the stock market itself does not penalise the poor quality of accounting information, that is not covered by regulatory inspection. As already mentioned, restatements disclosed in compliance with the regulatory inspection outcomes are considered as required restatements. Wang and Wu (2011) aimed to prove if the market effectively penalises enforced restatements. They tested the market reaction around the disclosure date of the enforced restatements, taking as a sample period six months earlier and six months after the disclosure date, which is a reasonable period for routine regulatory procedures before and after the formal announcement. They developed the fifth hypothesis of the study, organising it in two sub hypotheses. The first sub hypothesis states that:

1. The stock market attaches minimal value to financial information.
2. Stock price changes poorly reflect revelations of low-quality earnings.

In this part of their research, they wanted to test how the market reflects the value of the company and its reaction to current annual earnings and past earnings, which can be adjusted by the given corrected amount. They guess that the market does not have a significant reaction, at least to the adjusted past earnings. Moreover, they wanted to see the market's reaction to the change in the accounting information setting, that comprehended two unexpected factors: the unexpected current earnings and unexpected past earnings. These unexpected parts are calculated as current earnings, considering them to be the difference between current earnings and one-year-prior earnings. Also here, Wang and Wu guess that there is no significant market's reaction to unexpected past earnings. The second sub hypothesis states that equity market's reliance on earnings information is minimal.

The first hypothesis has been developed to test separately before and after the sample firms admitted their poor quality in accounting information; the second one is the pooled test with a dummy variable T_i representing the period after restatement. Both results are expected to be irrelevant. According to the data used in this study, it is important to highlight that due to the lack of a restatement database, Wang and Wu (2001) had to

collect manually their samples from domestic companies issuing A-shares on the Shanghai Stock Exchange and/or the Shenzhen Stock Exchange. They found the annual reports of their sample companies from the Correction of Material Accounting Mistakes section in the footnotes. The sample period goes from January 1, 1999, when the Old Standard for restatements became effective, to December 31, 2005, just weeks before the announcement of the 2006 ASBE. This means that the 2005 annual reports were the last annual reports filed by listed companies under the 2002 ASBE. Excluding restatements due to mergers and acquisitions, dividend distributions and changes in accounting policies and accounting estimation, 1092 restatement announcements were found because of accounting misrepresentation, irregularities, fraud or errors during the research period. Market and accounting data are from the CSMAR database while institutional investors' information is taken from the Genius database. They report that between 1999–2000, 21 companies for each year restated their financial reports, this means that approximately 2% of listed companies had issued a restatement. However, the number of restating firms rocketed in 2001 and 2002, reaching 282 and 250 companies, which corresponds approximately to 24.96% and 20.85% of public companies. This relevant increase is considered as a foreseeable consequence following the adoption of the Old Standard. However, the number of restating firms decreased in subsequent years, but still covers more than 10% of listed companies. This reduction can be interpreted as a direct consequence of both restatements of previous years and also of the 2001 Rules and the CSRC's intensive and extensive inspection throughout all provinces, after observing the increase in qualified auditors' reports. What is still vague is why there are so many Chinese firms issuing restatements. On April 4, 2001, the CSRC published the Index of Listed Companies' Industry Classification, which is an industry classification. In the Table below adopts this standard for the distribution of restatement companies by industry. The classification is based on the Index of Industrial Distribution of Listed Companies, issued by the CSRC on April 3, 2001.

Industry Distribution	Number of firms observations	Percentage of total firms
Agriculture, Forestry, Fishing and Hunting	36	3.30
Mining	11	1.00
Manufacturing	610	55.84
Food and Beverage	50	4.56

Textile, Apparel, Leather	36	3.28
Wood Product	3	0.27
Paper, Printing	23	2.10
Petroleum, Chemical Product, Rubber, Plastics	123	11.22
Electronic Equipment	31	2.83
Metal, Nonmetallic Mineral Product	93	8.49
Machinery, Equipment, Meter	163	14.93
Medicine, Biologic Products	77	7.05
Other manufacturing	11	1.00
Electricity, Gas, Water Supply	64	5.84
Construction	22	2.01
Transport, Storage	28	2.55
Information, Technology	61	5.57
Wholesale and Retail Trade	80	7.30
Real Estate	38	3.47
Social Services	29	2.66
Transmission, Culture	8	0.73
Conglomerate	105	9.58
Total	1092	100

Table 2 Source:CRSC, 2001.

As it is easy to see from the table, the greatest part of the restatements has been issued by manufacturing firms. Machinery, Equipment and Meter, Petroleum and Chemical Products, and Rubber and Plastics making double-digit also give a great contribution to the percentage the restated firms. Following the issuance of the 2001 Rules, the CSRC then started to examine listed companies' financial reports, corporate governance structures and independence from related parties. The 2001 Rules require the correction of any irregularities found in the inspection and to publicly disclose them within 30 days from the official notice. Given the fact that restatement of financial reporting is possible result of a strict regulatory inspection, this kind of disclosure let them classify the restatements caused by CSRC's inspection and those voluntarily disclosed by firms. The prescribed restatements are only 6% of the sample, largely concentrated between 2001–

2003. However, we should consider that, in those same years, the number of voluntary restatements increased in China, probably as a consequence of the stricter rules imposed by CSRC in 2001. Wang and Wu (2011) do not exclude the possibility that they have misidentified a complete set of enforced restatements due to a possible incomplete disclosure issued by listed companies in general. However, in their research they said that none of the firms analysed mentioned that the restatement was suggested by its auditor. They report that, between 1999 and 2005, 637 companies issued a total of 1092 restatements. Some of them issued just one restatement, while there are some other that restated several times. What is important to understand are the reasons for restatements. They found seven main categories reasons for issuing a restatement. In brackets we can see the total number of restatements of that kind and the relative percentage.

1. Mistakes from Subsidiaries (403 - 38%)
2. Tax Miscalculations (369 - 34%)
3. Costs and Expenses (224 - 20%)
4. Depreciation and Provisions (189 - 17%)
5. Revenue Recognition (73 - 7%)
6. Subsidies Revenue and Tax Refunds (43 - 4%)
7. Other Mistakes and Misclassifications (359 - 33%)

The first category, mistakes in subsidiaries, is the most common. This kind of restatement is more technical. It refers to the fact that parent companies can not have a complete control over subsidiaries' financial reports. The more subsidiaries a parent company has, the more difficult the management process may be and the greater the likelihood of error and subsequent restatement. Unfortunately, there is no database available on this matter, so this hypothesis has not been tested. The second category, Tax Miscalculations, is very frequent in China, as we can see from the total in brackets. In fact, approximately three-quarters of the companies in this category have underestimated they tax paid. It is here easy to suspect that this underestimation can be intentional. Misstating the cost of goods sold or operating expenses is also common in China, while manipulation of recognised revenue is not a major vehicle, in fact only of restatements are caused by inflated revenues or early recognition of revenue. According to the fourth category, Depreciation and Provisions, we can say that this 17 % is not particularly surprising, given the existence of several types of provisions in China. In fact in 1999, there were four types of provisions requiring estimation: bad-debt reserve, provision for inventory impairment, provision for short-term investment impairment and provision for long-term investment impairment.

In 2001, four more types of provisions were introduced: provision for fixed-assets impairment, provision for intangible-assets impairment, provision for construction-in-progress impairment and provision for entrusted-loans impairment. The estimation of these provisions requires a relevant professional judgment. This means that is quite difficult for accounting professionals having a limited experience in a relatively young capital market. Meanwhile, other kinds of provisions also were object of manipulation, which is understandable from the CSRC's 2004 Notice, in which is emphasised that listed companies should not abuse asset impairments, change of accounting estimates or correction of material mistakes for the purpose of manipulation.

Before understanding the occurrence of the fifth category, Tax refund policy, it is crucial to precise that it has served as an incentive to encourage exports in Mainland China for years. In July 2000, the Chinese MOF issued the Rules of Accounting Treatments for Tax Refunds to prevent companies from manipulating earnings. These Rules required the adoption of cash accounting, rather than accrual accounting, for income from subsidies and tax refunds. However, as we can see from the numbers in brackets, only few listed companies continue to violate the tax refund rules and adopt their own recognition rules. Before highlighting the findings of this study, we should precise that Chinese investor structure is disproportionate relative to that in mature markets. The scale of institutional investors is small. Individual investors, especially medium and small investors, account for a significant proportion of trading accounts and trading turnover. Short-term speculation dominates long-term investment (CSRC, 2008). Their findings imply that accounting information plays a significant role in the investment decision process. However, developing institutional investment and improving investors' education are crucial tasks for government and regulators. What Wang and Wu (2011) highlight is a lack of a precise regulation on the disclosure of financial reporting. In fact, poor disclosure leads to market inefficiency in China. In their research, the problem of having limited information disclosed is evidenced. For instance, when a restatement interested more than one year, there is no precise indication of the related number of prior years that it have affected, and when more than one reason for restatement is involved, there is no further explanation about the relative weight of the reasons. Even if CSRC 2004 Regulation Notice defined the need for a timely and separate disclosure of significant events, including restatements, the specification is not reliably followed. Wang and Wu (2011) think that a regulatory and administrative enforcement is necessary. The CSRC is not allowed to quantify the proper amount of monetary penalties for companies violating corporate behaviour. The executor of the justice system, the court, is in charge for

deciding the size of monetary penalties, in compliance with the Law of the People's Republic of China on Administrative Penalty and the Securities Law of the People's Republic of China. However, the CNY 600,000 penalty imposed to companies is paltry because it is too low to be as an effective deterrent for violating companies. Nevertheless, there are some alternative punishments enforced by the CSRC, which could either exert pressure on a listed company's future application for rights or secondary issuances, or publicly criticise violating companies directly on the stock exchange. Disallowing refinancing is a severe discouragement for companies with financing needs. However, the financial status of companies issuing restatements usually obstruct their effective appliance for equity financing. These kind of companies are not interested in financing needs because struggling for survival is their main priority. The option of public criticism does not inflict much real damage to companies. We can conclude that there is a lack of regulatory and administrative penalties in China, so it is evident that they should be working on this aspect. Class action lawsuits, which are a common practice in the US to inflict damage, are a rarity in China. First, their findings on stock market reaction show that a company revealing mistakes in previously released financial reports incurs irrelevant on inexistent damages. Second, although there is damage from the decline in the individual stock price, China's courts simply will not accept damage cases because to the courts, these cases are not as relevant as other civil lawsuits. As a consequence, these situations encourage companies to report poor-quality financial statements because later discovery and restatement will be virtually costless and without any significant punishment. The introduction of a proper legal procedure for processing cases, along with an effective punitive legal system dealing with violations of accounting rules should provide a valuable complement to China's capital market. China's credit market is far from being mature. In fact, the scale of the credit market, especially the corporate bond market, is quite small (CBRC, 2006). Bank loans are considered as the main form of corporate debt. The introduction of a free lending rate into the market from the People's Bank of China (PBOC) has caused crucial implications for the debt capital market. The floating range of financial institutions' lending interest rate is regulated by the PBOC. Under the regulated lending system, the rate a company received should not necessarily reflect the rate it should have potentially received on the basis of a company's overall risk, including accounting quality. In specific, poor accounting information quality was not punished with an higher lending rate. The low additional cost imposed from loan borrowings cannot effectively enhance companies' disclosing high quality financial reports instead of poor financial statement. Throughout the vast majority of the period,

banks lacked incentives to clearly differentiate firms with dissimilar credit levels, until state and top-tier banks were listed on the Hong Kong Stock Exchange in 2005, consequent to the introduction of the IFRS converged accounting standards and new banking rules. From an examination made on accounting restatements in the sample of China's A-share listings, it is possible to conclude that companies with weak profitability, state-controlled shareholder and diffused ownership are more likely to issue poor financial statements and later resort to restatement. In an emerging market like China, however, the stock market does not have a relevant reaction to restatements forced by low-quality accounting because the stock market is only able to fully understand partial accounting information and the credibility of accounting is low. All these findings, together with Chinese inefficient debt market, weak regulatory system and legal punitive system emphasise why restatements were so recurrent during the sample period. In China, accounting credibility is low and an accounting misstatement is less costly than in a mature market, like in the United States, because the market system itself fails to discourage firms' misstatements. What is necessary in China is the strengthening of market regulation and supervision, the sustainment of the legal system, further improvement of free-market mechanisms and investors education.

The CSRC made significant efforts issuing several reforms to improve market infrastructure and functionality. One of the main points of the reforms was to enhance the quality of listed companies and to simplify institutional investors' entrance in the capital market. As a consequence, they found out that their sample size started to decrease during the final two to three years of the sample period. This is a consequence of four main factors:

1. The CSRC's adoption of a decentralised supervision system in 2004, a measure taken with the purpose of improving the quality of listed companies and whose regulatory efficiency was immediately evident (CSRC, 2008);
2. The CSRC's Rule 19, introduced at the end of 2003, and the 2004 Notice on Further Improving Financial Information Disclosure of Listed Companies;
3. the CBRC's introduction of a free lending-rate system in 2004;
4. the listing of big banks in Hong Kong since 2005, following various international industry standards.

Accounting quality is improving, this is evident thanks to the decreasing amount of firm issuing restatements, probably thanks to the result achieved by regulatory efforts. China's capital market is expected to become mature for the foreseeable future. As a direct consequence, investors' behaviour will change, becoming more and more similar to the

one of investors in mature markets. Specifically, in relation to our studied cases, investors will be able to differentiate bad accounting quality from high accounting quality.

The next study is the one made by Wang and Dou (2015). In this research, the impact that the transformation of accounting firms' organisational structure on audit quality is analysed. Together with the reforms in China's economy, Chinese accounting firms rapidly developed. However it is said that Chinese audit quality is poor. As a consequence, it has gained the attention, along with the poor credibility that Chinese CPAs have, has been due to frequent cases of accounting fraud. Their research question concerns whether the shift from Limited Liability (LL) to Limited Liability Partnership (LLP) companies has increased audit quality in China. From a risk perspective point of view, the transformation from limited liability to LLPs gave its contribution in increasing partners' legal risks. LLP, can be defined as a new form of business designed exclusively for professionals, like accountants, lawyers and doctors. It is possible to say that a LLP and a partnership are approximately similar in point that the auditor is supposed to bear the results of audit failure by suffering losses of his own property (unlimited liability). A LLP, however, can assure that the auditor, from the joint liability, may not suffer from the faults caused by other auditors by overcoming the shortcomings of joint liability inherent in an unlimited liability partnership. In accordance with the law, accounting firm's partners should not only compensate for audit failures through the firm's total investment, but they are also expected to employ their assets with the purpose of compensating for audit failures. Thus, more time and effort are needed to implement audit procedures with the purpose of improving audit quality. According to the organisation, it is possible to assess that accounting firms may benefit from changes in a firm's organisational structure, in terms of sharing and insurance for audit risks and more opportunities for CPA promotion. However, it is important to consider that in China this transformation process is dominated by the government, thus accounting firms are likely to gain also other benefits from the transformation. However, it is quite difficult to measure the transformation's effect on audit quality, so this is still an open question. In their research, in order to assess the effect of the transformation of accounting firms' organisational structure on audit quality they used Chinese A-share listed companies and took as a sample period the years between 2007 and 2012. It has been found that the shift in the organisation structure has had a significantly negative effect on the value of discretionary accruals of audited companies. In addition, findings show that the transformation significantly reduced the level of positive discretionary accruals, but no significant effect on negative discretionary accruals has been found. Moreover, the

transformation's positive effect on audit opinions only has one year duration. Another point they wanted to prove is if the transformation can impact audit quality in terms of accounting and client firms' characteristics. Findings show that accounting firm size and listed company ownership don't significantly affect the underlying relationship between the transformation and audit quality. This transformation process has the power to increase audit risk in terms of greater legal obligations, which can induce the partners in being more cautious about undertaking an audit work. Partners are also more prudent in coping with upward earnings management, as it is more inclined to audit failures. However, transformed accounting firms tend to be larger, it is not found that findings differ in terms accounting firm size and listed company ownership. It is possible to say that this study gives its contribution to literature in several ways. First of all, it supplement literature on the transformation from limited liability to a LLP of Chinese accounting firms. In fact, it is possible to say that this research gives its contribution the reform of the transformation of accounting firms in China. Chinese Ministry of Finance and Business Administration issued the Regulations, with the particular purpose of transforming larger accounting, from limited liability to LLPs. The effects that transformation has on audit quality are examined and findings provide a theoretical reference for the improvement of the Regulations and the selection of organisational forms for accounting firms. Before deepening our understanding in Wang and You (2015) research, it is important to understand the background that may have led to this research. Before 1998, the vast majority of Chinese accounting firms were state-owned, which means that they belonged to the local or central government, universities or government departments (DeFond et al., 2000; Yi, 2003). In 1998 a reorganisation took place, and from that moment accounting firms were required to become independent legal entities, without any affiliation. Once this period was completed, any accounting firm had to choose an organisational form, in compliance with their own conditions, which meant choosing between such as limited liability (LL) or partnership. However, we should also consider several factors, such as partners who decide to bear unlimited and joint liability: any partner's negligence or malpractice can lead to the punishment of all of the partners, which can led to bankruptcy. The partnership can provoke extremely contrasting gains and risks, making it unpopular among accounting firms. LLPs, can prevent from the risks caused by other partners' improper attitude, but also prevent investors by allowing them to recover their losses from audit failures. In recent years, there have been several financial frauds and audit failure cases which not only have provoked firms' bankruptcy but also strongly undermined overall audit quality and CPA industry's reputation. Of

course, Chinese MOF tried to strengthen their supervision upon this matter and to improve audit quality and enhance the protection of investors' interests. The transformation of an accounting firm's organisational form increases the risk faced by its partners, which can result in behavioural changes. Audit risk means that an accounting firm must bear the economic and even criminal liability when mistakes in the conclusion of its audit report lead to investors or audit clients' losses. If an audit failure occurs, investors are entitled to appeal to the courts to force the listed company to compensate them for their losses. They can also require the accounting firm to take joint responsibility for the audit failure. The transformation from limited liability to LLP increases the loss suffered by the partner who experiences audit failure. The partners must bear the responsibility for the liability, which is not limited to their investment in the accounting firm, but also includes their personal property. Based on the transformation process of Chinese accounting firms from limited liability, Wand and You (2015) aimed to assess whether an increase in auditors' debt risk may lead to an improvement in audit quality. Legally, if the users of financial statements suffer losses due to improper audit opinions issued by auditors, they have the right to be reimbursed from the auditors. This is why the debt risk is associated with the national legal system. However, in China the requirements on CPAs' legal liability are still quite vague. Although some accounting firms are warned about, ordered to address for corporate financial reporting irregularities, the processes are limited to administrative penalties, which makes the CPAs' violation costs very low. As long as accounting firms are not retreated, the firms can still earn money thanks to IPO and annual audits. To lessen the risks of litigation and financial losses caused by audit failure, auditors attempt to enhance their own audit quality control, investing more resources on the auditing process. In particular, if changes in an accounting firm's organisational form occur, partners may face greater debt service obligations in case of audit failure, and this will increase audit quality requirements.

However, because the entire transformation process is, as it is easy to guess in China, dominated by the government, and the transformed firms gain additional benefits, "The Notice of Accounting Firm Commitment of Central Governance Enterprises" requires that, given the same conditions, large accounting firms that underwent the transformation are suggested to engage in H-share business and gained priority to undertake audit work for central government business groups. In addition, to engage in H-share business, accounting firms must become LLPs. Accounting firms must transform in order to benefit from these provisions, which may lead internal conflict of interests and thus reducing audit quality. The first hypothesis they came up with aimed to assess whether the

transformation of accounting firms' organisational form has nothing to do with audit quality. Even if the development of the CPA industry in China is quite prompt, however, there are still some unsolved problems, for instance the great amount of small-scale accounting firms, extremely low audit fees. The literature has shown that firm size correlates with independence and audit quality (DeAngelo,1981) it is also said that the larger an accounting firm is, the more independent the auditors are and thus the higher the audit quality. The transformation process begins in medium and large accounting firms and it may affect audit quality because of the high audit quality of these transformed accounting firms. Therefore, they guessed that that the size of the audit firm may positively affect the level of audit quality. The second hypothesis aims to prove that the level of audit quality is higher if the transformed accounting firm is a Big Four international accounting firm.

The third and last hypothesis deals with the audit clients' features, because these features may impact audit quality. It is important to consider that the greatest part of Chinese listed companies are state-owned. Wang et al. (2008) suggested that state-owned listed companies may benefit from an advantage when dealing with financial difficulties due to governmental support. If listed companies, that were once state-owned, show signs of bankruptcy, the government makes an effort to support it in order to solve their difficulties. Similarly, auditors face lower audit risk with state-owned listed companies, compared with other listed companies. In fact, the probability of audit failure for the former is lower. The characteristics of state-owned listed companies refer to the fact that the transformation of accounting firms has a limited impact on the audit services for state-owned listed companies. Given these assumption, they formulated their last hypothesis, that guesses that accounting firms' transformation impact on audit quality is positive for non-state- owned listed companies rather than state-owned listed companies.

In the empirical model they developed, a fundamental distinction has been made between the accounting firms that changed their organisational structure in LLP, that they call transformed firm (Change, equal to 1), while accounting firms that didn't change their organisational form are called non-transformed firm (Change, equal to 0). They also developed three variables to prove the subsequent effects of transformations in accounting firms, for instance the transformed year (Post0), one year after transformation (Post1), and two years after transformation (Post2). Given that the current observations only go to 2012, the span from 2010 to 2012 is just two years, it is possible to say that Post0, Post1 and Post2 are sufficient to cover the effect of accounting firm transformations on audit quality. Performance-matched Jones model advanced by Kothari

et al. (2005) has been employed to find the paired company with the most similar performance for each sample company, with discretionary accruals (DA) gained through the following regression cross-sectionally within each year and industry. We consider DA as the proxy for audit quality. Wang and Dou (2015) use the DID model to prove if the transformation of accounting firms impacts audit quality. They focused on the relationship between the transformation (Change) and DA and further examine the subsequent effects of the transformation event on DA in the current and post-transformation years.

Wang and Dou (2015) findings show that when discretionary accruals are positive, this means that accounting firm transformations have significantly lessened the level of discretionary accruals while discretionary accruals are negative if the effect is not relevant. They also found that accounting firm transformations has a positive effect on audit opinions only one year after the transformation. According to the effects of accounting firms transformations on audit quality, they concluded that accounting firm size and listed company ownership significantly affect the relationship between transformations and audit quality. The transformation in LLP increases audit risk that the partners of accounting firms have to bear. Thus, given this increasing debt risk, partners tend to focus more on improving audit procedures, improving also audit quality. Partners are more careful in coping with increasing earnings management behaviour because it may lead to audit failures. According to the policy, transformed accounting firms are likely to be large firms. Thus, no differences has been found on accounting firm size and listed company ownership. In this research they found out that accounting firms transformations may improve audit quality, the continual implementation of the policy can have a positive effect, encouraging auditors to provide higher quality audit services, that will be beneficial also for the capital market in terms of transparency. To conclude, they also proved that CPAs are more likely to issue modified audit opinions in the first year after the transformation, while there is no proper evidence that can prove that accounting firm size and listed company's ownership can affect the relationship between the transformation and audit quality.

The last study is the one made by Zhai and Wang (2016). In their study, Chinese accounting quality is analysed through a company's governance efficiency and its capital investment choices. This paper highlighted that in China, between 2000–2011, 63.7% of funds were allocated to non-core operating activities, opposed to the original investment plans with an average of 53 million yuan for each change, the average 6.7 months of change frequency, and the average 3.6 times change for every firm. Moreover, almost

69.6% of all the changes are considered inefficient. It is already known that in China there are frequent changes in terms of capital investment, which can significantly damage the capital allocation efficiency. Given this important issue, Zhai and Wang (2016) examined how accounting information can affect the governance function and wanted to prove if higher accounting information quality enhance management to make efficient capital investments. However, it is important to consider that Chinese capital market has quite a variety of external forces that can enhance the impact of accounting information on governance function. Institutional investors are fundamental in China, because their function is to reveal and communicate listed firms' information, and can also provide a timely response to suspicious accounting information. In other words they can enhance market efficiency. Zhai and Wang (2016) are convinced that in the long term, high-quality accounting information can be the means these investors can use to detect inefficient investments. In any efficient market, the decrease in stock prices will enable management to make profitable investments. At the same time, individual investors and media have also understood that it is important to pay more attention to how accounting information is interpreted, by supervising the managements' investment behaviour. Thus, accounting information quality has become significantly important in China because it can be seen as a means of improving corporate capital investments. This paper aims to examine if and how accounting information quality has a role on corporate investment choices, thanks to the governance function of accounting information. This feature is crucial to government, market participants, investors, and listed firms. The governance function of accounting information is a means that can help them make good decisions. Beaver (1989) in his study supported the hypothesis that the main purpose of accounting information is to help its users in their decision making process. Given this assumption, the quality of accounting information can be determined in two ways:

- The way to determine the accounting information quality is through its usefulness, which means that the information is useful to investors to make decisions. This feature is related to the pricing function of accounting information.
- The second way to determine the accounting information quality is through contract validity, because the accounting information can enhance contracts, particularly those subscribed between investors and administrators. This feature is related to the governance function of of accounting information.

It is possible to deduce that accounting information has two fundamental functions: pricing and governance. Firstly, accounting information realises its pricing function by

influencing capital costs and stock prices. Having high-quality information can significantly reduce information asymmetry, and as a consequence, reduce the capital cost of external financing (Myers and Majluf, 1984). Secondly, the aim of accounting disclosures is to give useful and reliable information to external stakeholders. It is important to consider that the quantity and quality of accounting information will influence an investor's judgment on the intrinsic value of a company. Hence, accounting data is a means by which it is possible to understand whether a company's stock price is over or underestimated. Investors should pay attention to the quality of accounting information because it is the better way to fully comprehend a company's current situation. In addition, having high-quality accounting information enables external stakeholders to understand a firm's fundamentals and to supervise management behaviour. High-quality accounting information also benefit external stakeholders, because they are able to affect management, to achieve a full understanding of a company's funds use and performance, and thus affecting its choice of capital investment. Zhai and Wang (2016) then developed their first hypothesis, which assesses that companies benefitting from higher accounting information quality are more likely to invest more capital in their core business. In China, the vast majority of the listed companies were established during the Chinese planned economy era. As a direct consequence, they had a close relationship with the government, later complicated by the fiscal decentralisation reforms in the late 1970s. Local governments' economic and political goals were related to the listed companies, that were under their control, such as state-owned enterprises (SOEs). At that time, the legal framework of Chinese listed companies needed to be redesigned. This situation reflected its gravity in the fact that companies didn't comply with the law and there were no controls for the enforcement of such law. Even if listed firms in China have, but just in theory, created a board of directors, in reality there are still a number of doubts on how much the board is independent. This because, first of all, the great majority of board members are also managers, particularly in SOEs, which can lead to serious internal problems. Secondly, another relevant issue is that independent directors have an ambiguous role because they are appointed just to comply with the requirements of regulators, instead of strengthening corporate governance. To conclude, in China, the board of directors lacks of independence and the difficult external governance environment obstructs corporate governance to have any tangible effect. Investors, on the contrary, can have an effective external supervision by boycotting unreasonable investments and enhancing an efficient resource allocation. High-quality accounting information can help investors to identify

inefficient investments, thereby leading to a potential share price revaluation and putting pressure on the board of directors, which in turn push management to focus on the company's core business and improve the efficiency of capital allocation. As a consequence, if a company has a weak internal and external governance framework, the resulting effect of high-quality accounting information on capital investment choice would be more evident. Zhai and Wang (2016) then developed their second hypothesis, which aims to assess if the influence of high-quality accounting information on management capital investment choices is more pronounced in case of a weak external governance framework.

Prior literature measures accounting information quality by two approaches, the first through earnings characteristics while the second through a company's stock price. Because of the to weak capital market in China, in this paper they measured accounting information quality as earnings characteristics based on financial statement data, the first method. Four measures in place of accounting information quality are developed: Accruals Quality, Earnings Persistence, Earnings Predictability and Earnings Smoothing. The first one, accruals quality is determined through the Dechow and Dichev model (2002), that accounts a company's accruals in the current period (year t). The second measure for accounting quality, earnings persistence, is measured by regressing its current return on assets on its previous one (Lev, 1983; Ali and Zarowin, 1992). Earnings predictability, the third measure, reflects a company's current earnings ability to predict future earnings. The standard deviation of the residuals, resulting from the regression can be used to measure the prediction error in company earnings. Larger r (residuals) are evidence of poor earnings predictability or accounting information quality.

Earnings smoothing represents the variation between accruals and cash in terms of net income, which can be measured by the ratio of the standard deviation of net income to operating cash flow or by the correlation between changed accruals and operating cash flow in the current period. Given the fact that the two methods are based on the variation between accruals and cash in terms of net income, they should produce the same results. They used the ratio of the standard variation of net income to operating cash flow, that is, $\sigma(\text{net income})/\sigma(\text{operating cash flow})$, where a larger ratio is evidence of a greater degree of artificial earnings smoothing and lower degree of accounting information quality. All data they used are taken from Wind Database, from 1998 to 2008 as the calculation cycle and data of operating cash flow disclosed. The empirical results in this study show that the higher the quality of accounting information is, the greater the correspondence and synchronicity of operating income increase between the listed firm and its industry. In

addition, Zhai and Wang discovered that the relationship between accounting information quality and capital investment choice is greater when the corporate governance of a company is weak. This finding imply that high-quality accounting information has a significant governance role. This paper gives several contributions to literature. First, it brought new empirical evidence in a developing capital market such as China. Second, findings comply with the assumption that regulators should set a transparent and reliable accounting information framework that enables accounting information to play its effective role to enhance listed firms to focus on their core business, to make efficient firms' capital investment choices, and then increase resource allocation efficiency. However, there is one limitation in this paper that refers to the fact that a company's investment choice is intended to be effective only if it invests capital in its core business. In some cases, it is better for some companies to change their current business, instead of increasing the level of investment in their main business, in particular in case of an industry recession or excess capacity.

CONCLUSION

The purpose of this study is to understand how is the current accounting information environment in China in terms of accounting quality. The reason why this study has been developed is related to the assumption that Chinese accounting is said to suffer from low quality accounting information, which affects the whole accounting system in China.

Based on this study, it is possible to say that China, although its particular social, political and economical environment, has made significant steps forward to be competitive on a global basis. In the past few years, China has faced the great change of converging its accounting standards with IFRS. This change has significantly simplified Chinese economic growth and increased the possibility of foreign investments.

However, even if the Chinese New PRC GAAP are substantially converged with IFRS, there are still some discrepancies. In fact, there are some controversial points that have been highlighted in this research. First of all, it is important to underline that, thanks to literature, it is possible to affirm that there are a number of factors that enhance the disclosure of low quality financial reports in China. Firstly, Chinese legal system is said to grant a poor rights framework and there is a lack of incentives for manager to properly comply with rules. Secondly, another point highlighted is that there is a lack of trained accountants and certified public accountants. As a consequence, there is also a shortage of training and supervision of auditors. Thirdly, it is crucial to underline the fact that, in Chinese environment, pressure exerts a significant impact on companies and managers. In fact, managers are devoted to reach certain goals and, in order to do so, sometimes they are also likely to manage earnings. In addition, Chinese companies feel the constant pressure of being delisted. Moreover, Chinese institutional environment is not so strong in terms of public law, while is extremely powerful in terms of personal connections.

Moreover, a company's ownership structure is also considered to be crucial in China, due to the fact that companies are mainly owned by political institutions and, as a consequence, the company's goals are considered to be less important compared to the political ones. Another question arises concerning the lack of independence in the Board of Directors. Furthermore, there is a weak supervisory board in terms of weak governance role. All these factors gave their contribution in formulating the assumption that China is likely to provide low quality accounting information. However, the adoption of International Accounting Standards in China underwent several debates because it is common to think that complying with IFRS means increasing the quality of financial reporting and helping investors in their decision-making process (Daske, Hail, Leuz,

Verdi, 2008) In addition, IFRS are considered to be a high quality set of standards, thus complying with IFRS means having high quality financial information (Ball, 2015). However, in terms of accounting quality, thanks to the analysis provided in this study, it is possible to say that the overall quality of Chinese financial statement has substantially improved in terms of value relevance, reported earnings, timeliness and predictability. One thing that should be pointed out is that all of the studies analysed came up with different findings, concerning different aspects of accounting quality in China. Sometimes, researches provided findings that discredited findings from other studies, like in Ball (2016), where it is assessed that China reached the convergence more in form than in substance. Given the fact that papers provide controversial results, it is possible to affirm that literature still lacks an overall and reliable research assessing whether accounting quality is increased in China, both thanks to the convergence process and in general. As a consequence, further developments in this field are needed. However, there are some points that China should consider in order to have higher accounting quality. To reach this goal, it is fundamental to reduce the political intervention on the market, because establishing an open market can increase professionalism among companies. State owned companies should comply with the same rules of private companies. In addition, Chinese companies should be provided with more ways to raise capital. Having more options reduces pressure on earnings and also diminished the occurrence of earnings management. Chinese government should work to prevent all kinds of corruption, provide a precise and strict system of punishment and reduce the role that interpersonal connections have in society. China should also invest in supporting and training capable accountants, that should be aware and trained on Chinese Accounting and its latest developments.

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