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The international harmonization progress of China Accounting Standards: A review of quantitative research

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Abstract In recent years, an increasing number of quantitative researches have been conducted in the field of international harmonization of China Accounting Standards(CAS). However, differences even contradictions do exist in the conclusions due to different research perspectives, samples, variable and period selection as well as the method adopted. Firstly, this paper systematically reviews the quantitative research literature on the international harmonization progress of CAS from the following four aspects: the degree of harmonization of specific items in CAS with that of in International Accounting Standards (IAS), differences in accounting numbers, accounting information, and earnings quality in various financial reports compiled based on CAS or IAS respectively. Lastly, suggestions for future research are provided.

Keywords China Accounting Standards, progress of international harmonization, quantitative research

摘要 近年来, 检验中国会计准则国际协调效果的量化研究日益增多, 但由于研究的切入点、样本、变量及期间的选择和采用的方法不同, 结论存在诸多差异甚至相互矛盾, 以致这些研究的理论价值和现实意义值得系统探讨。该研究首次系统地分类探讨我国会计准则国际协调效果的量化研究, 从我国会计准则与国际会计准则具

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体条款的协调程度, 以及基于我国会计准则和国际会计准则编制的会计报表数据差异、会计信息含量差异和会计盈余质量差异四个方面, 对我国会计准则国际协调效果量化研究的文献进行了回顾, 最后对全文进行了总结并对后续研究提出建设性意见。

关键词 中国会计准则, 国际协调效果, 量化研究

1 Introduction

The international harmonization or global convergence¹ of accounting standards has become a hot issue in the accounting field in recent years. Up to the end of March 2008, a total of 110 different countries and regions adopted the International Financial Report Standards (IFRS) to different extents (Fan, 2008). The China Accounting Standards (CAS)² are also constituted based on IFRS³. To further deepen accounting reform in China, it is of great practical importance and theoretical significance to know the concrete progress of CAS's international harmonization.

Recently, the research methodology on the progress of international harmonization of CAS has gradually shifted from normative-dominant approaches to empirical-dominant ones. The former mainly focuses on comparing differences in specific terms between CAS and IAS. Conclusions are reached based on theoretical analysis, systematic comparison and logical judgment. Along with the expansion of China's capital market and the development of database technology, an increasing number of scholars have adopted quantitative methods to empirically examine the international harmonization effect of CAS. This paper attempts to systematically review domestic literature on the CAS's international harmonization progress and to explore the topic further.

Based on the different perspectives adopted in existing quantitative literature, this paper reviews and comments on previous researches from four different

¹ It is very difficult to identify the difference between international harmonization and global convergence of accounting standards because accounting internationalization is a gradual process. This paper adopts the term of international harmonization in most circumstances because the literature reviewed was mainly based on the International Accounting Standards (IAS).

² For all the laws, rules, standards, regulations, supplemental provisions and interpretations of China accounting standards, we call them CAS for short.

³ It is a common sense to refer to all the standards and interpretations issued by International Accounting Standards Committee (IASC) and International Accounting Standards Board (IASB) as IFRS. However, due to that most studies reviewed in this paper were based on IAS, we used the term IAS instead.

aspects, namely the degree of harmonization of specific items in CAS with that of in International Accounting Standards (IAS), and the differences in accounting numbers respectively based on CAS and IAS, accounting information content, and the quality of reported earnings.

2 Degree of harmonization of specific items in CAS

In studying the degree of harmonization of specific items in CAS with that of in IAS, the three methods frequently adopted by Chinese scholars are scoring analysis method, discriminant analysis method and average distance method. Wang and Sun (2003) compared, in detail, items in CAS with corresponding items in IAS. According to the discrepancy level of contrast point, they distinguished 5 kinds of conditions and assigned different values to these conditions, and then calculated the degree of harmonization of different items in CAS. The weighted average of the degree of harmonization of all CAS items was used to stand for the total degree of international harmonization (Z). Their result showed that the Z value is 0.11⁴, reflecting that a large discrepancy still exists among items in CAS with corresponding items in IAS. In a similar vein, Wang (2005) calculated a Z value of 0.42⁵ (the Z value is 0.45 when disclosure difference is excluded). Wang thus concluded that among the 16 issued accounting standards, 25% have a high degree of harmonization, 50% medium degree and another 25% low degree. As a whole, this statistics indicate that CAS reached a median degree of harmonization with IAS. In 2005, Wang et al. adopted the discriminant analysis method and average distance method to measure the degree of harmonization of CAS. Results show that the total degree of harmonization of CAS is high but differences among items in CAS and IAS still remain. They also found that the degree of harmonization in measurement items is higher than that of disclosure items.

The above-mentioned researches provide quantitative evidence of the progress of international harmonization on corresponding items in CAS from a new perspective. By attempting to directly reflect the degrees of international harmonization of CAS, these studies are of certain referential significance to future research in this field. However, an obvious shortage of these research methods lies in the subjective selection of contrast points and value assignment, which considerably weakens the reliability of research conclusions and makes

⁴ In the paper, the authors defined Z value as follows: if $Z < -0.5$, the degree of harmonization is high; if $-0.5 \leq Z < 0.5$, medium degree; if $Z \geq 0.5$, low degree.

⁵ In the paper, Z value was defined as: if $Z < 0$, the degree of harmonization is high; if $0 \leq Z < 1$, it medium degree; if $Z \geq 1$, low degree.

comparability among different research conclusions impossible.

Since the names of accounting items vary greatly in different accounting systems, and even the content of same-titled items may also differ, the selecting of contrast points has been proved to be a difficult task. Though there have been a large number of papers studying the topic of contrast points selection, we recommend the contrast points proposed by Deloitte as an authoritative one. As one of the most prestigious consulting firms in China, Deloitte boasts more than a decade of experiences in studying and applying CAS and IAS/IFRS. Since the contrast points developed and adopted by Deloitte have been recognized by China accounting standards regulatory bodies, they can be used as benchmark contrast points in future researches.

As for the values of different contrast points, it is also worth further studying. In an attempt to build a comparison matrix of different accounting conventions, Arcy and Ordelheide (2001) showed that accounting methods adopted under different accounting systems are very complicated. Even for the same event, as many as six types of different accounting methods can be used under different systems. Therefore, it is necessary to combine other methods to measure the degree of international harmonization of items in specific standards.

3 Comparison of differences in accounting numbers under CAS and IAS

Researches in this area investigate the international harmonization effect through examining the differences in accounting statement numbers under CAS and IAS. As a rule, researchers usually choose China B-Share Company as samples to examine the differences in net profit (net assets, return on net assets) disclosed under CAS and IAS respectively and thus to explore discrepancy level and change tendency of accounting statement numbers to reflect the progress of CAS's international harmonization. The main conclusions of this kind of research are as follows:

(1) For B-Share Company, there is a significant yet declining difference in net profits under CAS and IAS. Earlier research found that the net profit under IAS was usually significantly lower than that of under CAS. But the difference showed a tendency of decline. For instance, Li (1997) took AB-Share Company⁶ in 1996 as samples and found large difference in net profit under CAS and IAS in these companies. The net profit under IAS was usually lower than that of under CAS. Chen et al. (1999) investigated accounting information of B-share Company in Shanghai Stock Market from 1994 to 1997. Their conclusion was

⁶ We call the company issuing both the A-share and B-share as AB-share Company.

that the systematical difference between CAS and IAS resulted in a 20% to 30% net profit difference, and the net profit under CAS was higher than that of IAS. By taking B-Share Company in 1992–1998 as samples, Li (2000) found that the difference in net profit under different accounting standards was getting smaller after 1995, especially after the implementation of *Limited liability Company Accounting System* in 1998.

More diversified research conclusions were reached in other researches. Chen et al. (2002) studied AB-Share Company in 1997–1999 as samples. They found that the implementation of *Limited liability Company Accounting System* in 1998 and other new standards did not eliminate or reduce the substantial differences in net profit in different accounting systems. Xu et al. (2003) founded out, however, that the net profit differences in AB-Share Company were significant in 2000 and 2001, but not in 2002. Gai et al. (2004) analyzed the accounting numbers of B-share Company in 2002. The results showed that the net profit difference between CAS and IAS was declining with the implementation of *China Accounting System for Business Enterprises* and other compulsory accounting standards. The authors also found great changes in the composition of different accounting items. Xu et al. (2004) took AB-share Company as samples and compared the net profit, net assets and return on net assets both before and after the implementation of *China Accounting System for Business Enterprises*. They concluded that the differences in net profit and return on net assets were significant in 2000 and 2001, but not significant in 2002; and the difference in net assets was not significant in 2000 and 2001, but significant in 2002. They explained that it happened maybe because some accounting items in CAS did not influence the income statement but influenced the balance sheet. As a result, it reduced the net profit difference and enlarged the net assets difference between the two sets of standards.

(2) Difference in accounting information under the two sets of standards in Shanghai Stock Market is greater than that of in Shenzhen Stock Market. This phenomenon was first discovered by Li (1997), which was later confirmed in both Li (2000) and Jiang (2002). These authors summarized that the differences in geographical locations, accounting reform infrastructure and ownership structure combined to cause the above differences in two stock markets, revealing the fact that the implementation effects of accounting standards are greatly influenced by local economic environment.

(3) Difference in accounting information under the two sets of standards in AB-Share Company is higher than that of in B-Share Company. Jiang (2002) pointed out that because B-Share Company could not have seasoned equity offerings and right issues to foreign investors, that is, there is no chance of profit manipulation, the accounting numbers disclosed by these companies are more prudent, showing that corporate governance mechanism can influence the

implementation effects of accounting standards.

(4) Difference in accounting information under the two sets of standards is also influenced by the size of the public accounting firm auditing these B share companies. But consistent conclusions have not been reached yet. Huang (2003) found that the variances in net profit of relative company⁷ are lower than that of non-relative company. Wang et al. (2004) found evidence showing that variances in net profit of companies audited by domestic top-10⁸ accounting firms are higher than that of audited by other accounting firms.

(5) Variances in net profit for AB-share company under the two sets of accounting standards are mainly caused by accountants' professional judgments rather than accounting standards. Liu and Wang (2006) took AB-Share Company as samples to investigate the specific period (1998–2000) of accounting system reform. The results indicated that variances in net profit of AB-Share Company was not caused by accounting standards but by accountants' professional judgment and the motivation behind it is to avoid delisting.

There are two problems for the research of comparing the difference in accounting information between CAS and IAS. First, though net profit is a very comprehensive index, to what extent can it represent financial report still need further discussion. Realizing this, some scholars (e.g. Xu et al., 2004) introduced new variables such as net assets and return on net assets to get more persuasive conclusions. Second, the comparison of accounting information should be extended to include the analysis of causes of these differences, such as what is the reason of differences? Is the difference temporary or permanent? How to reduce the difference?

4 Comparison of differences in accounting information under CAS and IAS

Because the final effect of international harmonization could affect the usefulness of earnings under different accounting standards, researches explore differences in accounting information under IAS and CAS by means of investigating the correlation between accounting income and shares return.

The majority of researches studying the correlation between accounting income and shares return under IAS and CAS show that there is no incremental information content in financial reports adjusted in accordance with IAS and accounting information under IAS does not have significantly higher value

⁷ The term *relative company* here means the company audited by the top-5 international accounting firms and their affiliated subsidiaries.

⁸ *Domestic top-10 accounting firms* refer to the ten biggest Chinese accounting firms in 2001.

relevance. Under certain circumstances, earnings information under CAS is more useful than that of under IAS. To illustrate, Hong and Pi (2001) found, after studying the listed companies' data from 1994 to 1999, that the correlation between accounting income and shares return under IAS is not more significant than that of under CAS, indicating that financial reports adjusted in accordance with IAS fail to bring useful information to investors. Using B-Share Company in Shanghai Stock Market (from 1994 to 1999) as samples, Hu (2002) found that accounting information under CAS has a stronger correlation with B shares' prices. Pan et al. (2003) compared the value relevance of accounting earnings of AB-Share Company under different standards systems in 2001. The results showed that accounting earnings under CAS was more useful than that of under IAS. Li (2004) used the adjusted return model and adjusted market value model to test the value relevance of accounting information of AB share companies under IAS and CAS, respectively. He found that the value relevance of accounting information under IAS in 2000–2002 is not significantly higher than that of under CAS. Lin and Chen (2005) also found, when studying AB share companies in Shanghai and Shenzhen Stock markets from 1995 to 2000, that the earnings and book value of net assets under CAS were more relevant with stock pricing than that of under IAS; earnings under CAS was more relevant with share returns in A-share market, though changes in earning were also reflected in B-Share Market. But Bao and Chow (1999) found opposite evidence. When studying B share companies in both Shanghai and Shenzhen stock markets from 1993 to 1996, they found that earnings and book value of net assets under IAS have more explanatory power in explaining the B-Share prices than that of under CAS.

In summary, research conclusions concerning the differences in accounting information content are as follows: the degree of international harmonization of CAS and IAS is not high in terms of information content, and the information under CAS is more useful to potential investors. One common explanation is that because IAS depends more on accountants' profession judgments, the lack of efficient accounting infrastructure in China makes IAS less efficient. In comparison with the flexibility of IAS, the more rigid CAS is more capable of generating useful accounting information under the Chinese context (Eccher and Healy, 2000). To a certain extent, CAS is more suitable for most practical situations in China (Chen, 2004). It should be pointed out that the prerequisite of the above research concerning information content is "an efficient market which can evaluate the usefulness of different kinds of information." Because there are so many unexplainable events in China's stock market, it is important for readers to understand the above research results under the unique context of China's eco-political background.

5 Comparison of differences on the quality of reported earnings under CAS and IAS

Although there have been a lot of researches focusing on earnings quality, research about the effect of international harmonization on accounting standards from the perspective of comparing differences in accounting earnings quality was not conducted until three years ago.

Wang (2005) used modified Jones model and below-line items to estimate the abnormal accruals to represent earnings quality. He analyzed the data before and after 2001 accounting standard reform and found that the earnings quality of AB-Share Company was not significantly different under either CAS or IAS, indicating that full application of IAS at present can not remarkably improve the quality of accounting earnings. Meanwhile, the absolute value of the difference in earnings quality between the two accounting systems has been on a steady decline, showing that the internationalizing accounting system reform in China has considerably enhanced the CAS's international harmonization progress,, which in turn has improved earnings quality. However, just as Wei (2003) pointed out that although earnings management is the key factor to lead the separation of formal harmonization and material harmonization, earnings management, as one of the many explanation variables of the degree of accounting harmonization, differ from accounting harmonization in nature. We thus argue that earnings management as a means of manipulation of financial statements, its relationship with international harmonization of accounting standards mainly involves in accounting policy choice and alternation, while the business restructure or even financial fraud have little relationship with international harmonization of accounting standards. Therefore, we should be prudent when investigating the effect of international harmonization on accounting standards from the perspective of earnings management. Future research should pay special attention to distinguish earnings management from accounting harmonization, identify the relationship between earnings management and accounting policy choice, accounting estimation and accounting changes, and determine exactly the detecting variables of earnings management to reasonably explain the influence of earnings management on accounting harmonization.

Jiang et al. (2006) demonstrated that hedge portfolio formed on the basis of total accruals under IAS could gain 20% abnormal return, while hedge portfolio formed on the basis of accruals under IAS and on the difference between IAS and CAS could gain 30% abnormal return. The result supported the undergoing IAS-orienting CAS reform in China. Qu and Qiu (2007) empirically investigated the effects of compulsory standards changes in China from the perspective of earnings conservatism. The result demonstrated that the implementation of

Limited liability Company Accounting System did not significantly improve the earnings conservatism of China's listed firms during 1998–2000; whereas the implementation of *Accounting System for Business Enterprises* did significantly improve the earnings conservatism during 2001–2004. They therefore argued that simply changes in accounting standards are unlikely to improve accounting information quality unless these changes are accompanied with corresponding strengthening of law and enforcement. The above-mentioned studies meaningfully explored the effect of accounting harmonization from the perspective of accounting earnings quality, which will be very beneficial to relevant researches in the future.

6 Comments and future research directions: A study framework of international accounting harmonization

As above, domestic quantitative research on the progress of CAS's international accounting harmonization has obtained preliminary achievement in recent years, which could be generalized from the following aspects: the degree of international harmonization of CAS has been improved gradually; the previous higher net profit under CAS (as compared with that of under IAS) has shown a tendency of decrease; the formal harmonization between CAS and IAS has promoted the material harmonization between the two. However, due to the differences on research methods, perspectives, variables, periods and samples, some of the above research conclusions are inconsistent with one another. Thus any comments on the progress of CAS's international harmonization need to be further studied and confirmed. More reliable empirical evidences are to needed to avoid drawing any misleading conclusions. To explicitly demonstrate the present situation of accounting international harmonization studies in China and to predict future study tendency in the field, we put foreword a research framework for the international harmonization of accounting standards (See Fig. 1). We hope it could guide future research in this field to a certain degree.

Fig.1 shows the suggested research framework for the international harmonization of accounting standards. The accounting harmonization evaluation could be classified into three aspects: formal harmonization, material harmonization and the accounting information quality. In addition, detailed analysis on quantitative research should combine the infrastructure system and macro environment.

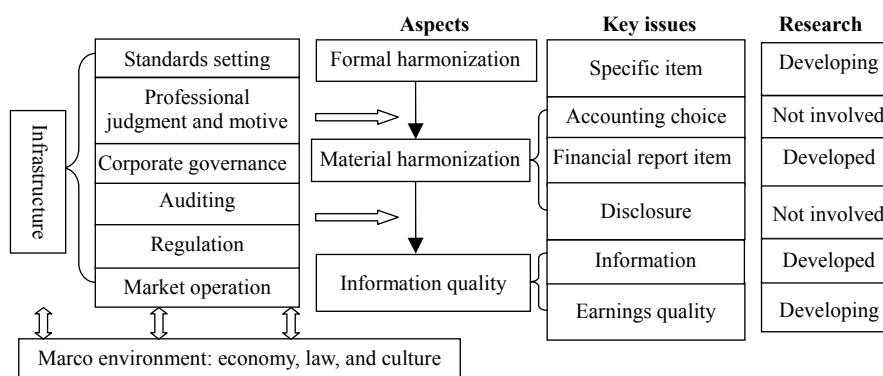


Fig.1 Research framework for international accounting harmonization

(1) Formal harmonization

This kind of quantitative research in China just starts and the focus is still on comparison of specific accounting items. Future research can be developed along two directions: firstly, some statistic methods can be adopted as reference, for example, Rahman et al. (2002) used the Jaccard coefficient to test the material and formal degree of international harmonization between the accounting standards of Australian and New Zealand. Also, the researcher could develop from one period to multi-periods to reflect the harmonization progress of CAS. Due to dramatic changes in IAS in recent years, the harmonization progress of CAS was also influenced, it is therefore necessary to evaluate the degree of international harmonization from a dynamic perspective.

(2) Material harmonization

The objective of formal harmonization is to improve material harmonization through offering high quality standards to promote the accounting treatments and the preparation of financial statement. Research at this level has, with good reasons becoming popular in recently years. The material harmonization involves many factors. Merely from the aspects of implementation results of accounting standard, relevant study should include at least three parts, namely harmonization of accounting choice, harmonization of financial statement items and harmonization of financial information disclosure.

As mentioned earlier, extant domestic literature mainly focuses on the differences in specific financial statement items under CAS and IAS, few research has studied the harmonization of accounting choice and harmonization of financial information disclosure. With the achievements in the harmonization of accounting standards, the difference in financial report item is decreasing, so the future research needs to focus on the convergence of accounting method choice. Some foreign scholars adopted H index, C index, I index to measure the

comparability of different financial reports. Recently a new and more comprehensive index—T index has been proposed and adopted in relevant studies. All of these new progresses in material harmonization studies need to be further expanded and perfected in the future.

The harmonization of financial information disclosure has long been ignored by researchers. Present studies mainly focus on the recognition and measurement parts of financial statements. But we believe that disclosure itself is also a very important part of material harmonization. The information disclosure regulations issued by China Securities Regulatory Commission and Ministry of Finance shall serve as important guidelines for listed company when disclosing financial reports. How do these disclosure regulations promote the material harmonization? What are the effects of those regulations? These questions need to be answered in future researches.

(3) Accounting information quality

The objective of material harmonization is to give users high quality accounting information, so the evaluation of accounting information quality is another aspect of research on international harmonization. Accounting information quality is a board concept and most empirically researches focus on earnings quality. Future examination should extend to the other indicators of accounting information (earnings) quality (such as transparency, comparability, consistency, persistence, etc.) to test the difference of accounting information (earnings) quality between different set of accounting standards from the perspectives of different indicators, and then explore the reasons behind these differences.

Accounting information (earnings) quality is a fruitful yet controversial research area, so conducting studies on this topic needs reasonable research design and acute insight of existing institutional background. The multi-indicator tests of accounting information (earnings) quality will provide us more convincing evidences and broader research perspectives.

(4) Infrastructure system and macro environment

The formal harmonization does not necessarily lead to material harmonization. One important reason is that there are many factors influencing the implementation of accounting standards. Factors of macro-environment such as economy, law, and culture, etc. are usually considered in the research on country comparisons, while factors of infrastructure system are more suitable for country-specific researches. In comparison, authentication mechanisms (e.g. auditor, public accounting firm, and auditing quality) were widely discussed in previous researches, but the professional level of financial report preparers, characteristics of corporate governance, regulation system and operating system of capital market were seldom mentioned. How do those important factors influence the implementation of accounting standards? To what extent do these

important factors influence the implementation of accounting standards? We need more empirically evidences to answer these questions. Future research need to explore these differences and the causes behind these differences from a broader perspective of economic environment and institutional background so as to reflect more explicitly the progress of CAS's international harmonization and a better direction for future accounting standard reform in China.

Another thing worth mentioning is that most previous researches focused only on the horizontal comparability based on accounting information when studying the effects of different accounting standards on accounting information and neglected the implementation of one specific accounting standard. For example, what are the implementation effects of one specific accounting standard? Does it promote the international harmonization of the accounting items it involves? Study focusing on the implementation effects of certain specific accounting standard is beneficial for us to understand the changes happened after the implementation of certain accounting standards, which is helpful to the studies of the progress of CAS's international harmonization.

Based on the analysis of above researches, we think that it is necessary to introduce more quantitative methods to examine the progress of international harmonization from both the whole and specific perspectives. On one hand, to improve the research design such as adding more controlling variables based on the special institutional background and to adopt some new methods such as T index, Jaccard coefficient and comparability measurement, the objectivity of the research on standards harmonization can be improved greatly; on the other hand, to deepen the research on the comparison of specific items between CAS and IAS, and to conduct quantitative research on specific standards to reflect the progress of CAS's international harmonization. Future research could combine different research methods with conclusions to give a comprehensive evaluation of the progress of CAS's international harmonization as a whole, and then to offer more suitable suggestions for policy makers and regulatory bodies.

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