



# Overseas listing and accounting conservatism: evidence from Chinese H-share companies

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## Abstract

**Purpose** – The objective of this paper is to examine the incremental effects of overseas listing on earnings conservatism. In particular, it investigates whether mainland Chinese companies listed “overseas” in Hong Kong exhibit a higher degree of earnings conservatism than companies without overseas-listing.

**Design/methodology/approach** – The paper employs the concept of “conditional conservatism” and adopts Basu’s (1997) conservatism model, examining data for Chinese companies overseas listed on the Stock Exchange of Hong Kong as H-shares, to test hypothesis concerned with the difference in the speed with which economic gains and losses are captured in accounting earnings.

**Findings** – The empirical findings indicate that both overseas-listed and China-only-listed Chinese companies demonstrate a minimal degree of earnings conservatism in the earlier sample sub-period. However, companies listed overseas provide a higher degree of earnings conservatism overall. Furthermore, this conservatism becomes statistically significant in the 2006 to 2008 sub-period.

**Originality/value** – The evidence in this study shows that differences in earnings conservatism arise from differential information demands and differential regulations. Hence the findings have direct policy implications for the regulatory agencies in China and Vietnam and in the ex-communist countries further afield such as Russia, the former Soviet Union, and Eastern Europe.

**Keywords** Accounting conservatism, Accounting regulation, Basu model, Accounting, Communism, Earnings conservatism, Earnings quality, Maoism, China

**Paper type** Research paper

## Introduction

In 1993, the China Securities Regulatory Commission (CSRC) gave permission to the first group of Chinese companies to launch initial public offerings (IPOs) abroad. Of the nine well-established companies, selected by the Commission of the State Council, six completed their IPOs in that very year while the other three finalized their IPOs in the July of the following year. Overseas investors reacted positively to the Chinese companies issuing their IPOs overseas and this fact prompted the Chinese Government to grant permission to the second and third groups of companies to issue IPOs abroad, a move that expanded in a timely manner the number of state owned enterprises (SOEs) listed overseas.

As Chinese companies become listed in overseas markets, they are subject to local regulations, systems and supervision which may gradually improve their corporate governance and efficiency. However, their headquarters and major business operations remain within the mainland Chinese borders, where the system and cultural environment continue to influence the H-share companies’ financial reporting.



In order to reform the SOEs, the Chinese Government has been conducting a series of legal and institutional changes over the past few years. These changes include: the Split Share Structure Reform; implementing accounting standards that parallel International Financial Reporting Standards (IFRS); introducing the Qualified Foreign Institutional Investor program (QFII); and mandatory filing of quarterly reports for all publicly held companies. Such changes are expected to contribute to gradual improvements in corporate governance for listed Chinese companies and overhaul the quality of financial reporting.

The objective of this paper is to investigate the incremental effects of overseas listing on earnings conservatism, examining data for mainland Chinese companies overseas listed on the long-established Stock Exchange of Hong Kong (SEHK) as H-shares. We employ the concept of “conditional conservatism” to operationalize earnings conservatism. “Conditional conservatism” is defined as the tendency to accelerate losses and defer gains. This characteristic of conservatism is referred to in the literature as asymmetric loss recognition timeliness (Ball and Shivakumar, 2005; Beaver and Ryan, 2005; Pae *et al.*, 2005). Ball and Shivakumar (2005) assert that conditional conservatism, which enhances relevance and representational faithfulness, is one of the primary attributes of financial reporting quality. They also contend that conditional conservatism enhances contracting efficiency because it makes financial reporting more informative and useful, and thus allows stakeholders to better monitor a company’s performance and bail out of loss-making projects.

Previous studies suggest that, as a domestic company goes public in an overseas securities market with more stringent regulations, its controlling shareholders tend to suppress self-profiting behaviors and increase the level of protection for minority shareholders. They do this because they are confronted by laws and regulations that are more stringent than those in their own country (Roëll, 1996; Coffee, 1999, 2002; Stulz, 1999; Karolyi, 2006; Ferris *et al.*, 2009). The result of such a change in behavior is improved corporate governance. In order to improve corporate governance among mainland Chinese companies, the Chinese Government passed a series of regulations on overseas listing in 1993, hoping to assist domestic companies in establishing modern corporate structures.

Chinese companies, including the prestigious “showcase” cross-listed companies, continue to have cultural and political reasons not to report conservatively. The primary reason is that senior managers are accountable primarily to Chinese Communist Party (CCP) bureaucrats higher up the chain of command (Hung *et al.*, 2008) and these bureaucrats do not necessarily demand conservatism. The crucial roles that “consciousness” and “correct revolutionary attitudes” have played historically within Maoism suggest that bureaucrats even today may be continually nervous about their standing in the Party. Mao’s interesting interpretation of the theory of “dialectical materialism” is relevant here in that Mao saw syntheses as transient and unstable but fragmentations and divisions as normal (Žižek, 2008)[1]. Mao argued, contrary to Marx, Engels, Lenin, and Stalin, that contradictions still exist within communist countries and that they exist right inside the communist parties. The contradiction Mao had in mind here was between sincere communists and those “reactionaries” who prefer reversion to capitalism. The Cultural Revolution of 1967-1969 was based on the Maoist logic of attacking reactionary elements inside the CCP. It was hence a substitute for the Stalinist purges. The financial reporting implications of this cultural legacy from Maoism are that senior bureaucrats might well be unwilling to report conservatively since they may not perceive that their CCP superiors demand it and

they may be exceedingly nervous about their own standings within the Party. Based on this background, this paper predicts that the reliability and transparency of H-share companies' financial reporting is relatively low. However, H-share companies will outperform their A-share counterparts in terms of the quality of financial reporting.

The remainder of the paper is structured as follows: Section 2 discusses the literature and develops the hypothesis. In Section 3, we proceed to present the research methodology. Section 4 discusses the empirical evidence and provides a brief recap. Section 5 summarizes the study's conclusions and implications.

### **Literature review and hypothesis development**

Coffee (2002) introduces the "bonding hypothesis," stating that, irrespective of higher listing fees compared with other countries, the securities market in the US enjoys the protection of a sound justice system, and is also supported by high-quality accounting standards and corporate governance. Foreign companies seeking listings in the US securities market are subject to local rules and regulations, which translates into better legal protection for the shareholders of such companies as compared to in their domestic markets. The outcome of this is greater security for the shareholders. According to Moel's (1999) findings, when companies are listed in an offshore market with more comprehensive disclosure rules, they are compelled to abide by more stringent transaction regulations and accounting standards. This is conducive to improving quality and transparency, decreasing the information cost borne by investors, reducing informational asymmetries between investors and managers, and upgrading the value of the listed company.

Recent studies have shown that official legal protection for investors has tremendous influence on a company's external financing. As La Porta *et al.* (1997) point out, in countries where there is weak legal protection for investors, companies often encounter great difficulties in obtaining external finance. On the contrary, if a company is located in a country where investors enjoy sound legal protection, it will be able to attract external investors with relative ease. Stulz (1999) and Coffee (1999, 2002) suggest that, with sound legal protection, controlling shareholders will often refrain from misappropriating funds when a good investment opportunity emerges, and instead look out for the interests of small shareholders.

In addition to acquiring greater sources of funding by listing overseas, companies also anticipate that, with the help of stringent listing requirements and disclosure rules on corporate financial reporting, analysts will provide more accurate forecasts of the company's future profits. Overseas listing also helps reduce informational asymmetries between managers and investors, improves the reliability of financial reporting, and enhances corporate governance (Coffee, 2002; Lang *et al.*, 2003; Huijgen and Lubberink, 2005; Sun *et al.*, 2008; Hung *et al.*, 2008; Ferris *et al.*, 2009). Bartov and Bodnar (1996) and Boone and Raman (2001) contend that improved quality of financial reporting diminishes the information asymmetries between investors and managers. This reduces the buy-sell spread and boosts the market value of company stock, improving the overall business operations (Sun *et al.*, 2008).

In 2002, the Chinese Government introduced foreign institutional investors as a channel for foreign investors to invest in the Chinese security market, as well as government bonds, convertible bonds, and corporate bonds in the domestic market. The introduction of foreign institutional investors is to open the door to allow foreign capital to enter the domestic capital market. Based on Pound's (1988) "efficient monitoring hypothesis," institutional investors, as opposed to shareholders in general,

have easier access to information, greater experiences in investment management, and have larger pools of professional talent, allowing them to monitor companies with lower monitoring costs. The presence of institutional investors compels companies to achieve greater transparency and stronger business operations. In March 2003, the CSRC required all publicly traded Chinese companies to publish quarterly reports which will help improve the timeliness and relevancy of corporate disclosures and aid effective decision making. The Government launched the split share structure reform in April 2005, demanding all publicly traded companies to begin circulating their non-tradable stocks. In the wake of this key reform, the interests of tradable and non-tradable stockholders will gradually converge. Furthermore, the release of state-owned shares into the market will mean that the Government will no longer play the dual role of shareholder/overseer of the securities market. This will bring about positive changes to corporate governance and the quality of financial reporting. In February 2006, the Ministry of Finance promulgated the Accounting Standards of Enterprises, upgrading the accounting standards in China to a level that matches the IFRS. The application of these new standards is expected to improve the financial reporting of publicly listed Chinese companies.

A review of the aforementioned shows that, since the headquarters of H-share companies and their major operations are within mainland China (not Hong Kong), the series of legal and institutional reforms will improve the quality of H-share companies' financial reporting. This study thus postulates that, with improved legal regulations and better corporate governance of Chinese companies listed overseas, H-share companies listed in Hong Kong will see a steady increase in their earnings conservatism over time. In view of this, this paper offers the following hypothesis:

*H1.* Chinese companies listed overseas exhibit a steady increase in their earnings conservatism over time.

La Porta *et al.* (1997) argues that, when a country provides investors with comprehensive legal protection, it vastly reduces the frequency of controlling shareholders misappropriating minority shareholders' invested funds. Coffee (2002) proposes the "bonding hypothesis," stating that, as domestic enterprises enter overseas securities markets with more stringent accounting standards, more stringent financial disclosure requirements, and more adequate corporate governance regulations, the behaviors of controlling shareholders will change. As controlling shareholders are subject to more stringent laws and regulations, they will reduce their self-profiting behaviors and instead step up protection of minority shareholders' interests. This will eventually improve the company's corporate governance. Therefore, it can be concluded that obtaining additional funding is only one of the reasons why companies from developing countries seek overseas listings. Another significant purpose is to improve the reliability of their financial statements by way of the stringent listing and financial reporting requirements in offshore markets.

Chinese H-share companies listed in Hong Kong are obliged to adhere to local (i.e. Hong Kong) listing regulations and disclosure requirements. These companies are required to publish financial statements prepared in accordance with IFRS. Such practice differs from the companies listed in China, which are only required to follow the Chinese accounting standards. Although the accounting standards in China parallel the IFRS, Ding and Su (2008) point out that, after the Government implemented the new Accounting Standards for Enterprises, listed companies still see their earnings

subject to excessive manipulation. To make matters worse, poor mechanisms of Government oversight, coupled with a lack of professional training among accountants in listed companies, means that the quality and reliability of financial reporting in mainland China may still remain comparatively low (despite all of the Chinese Government's interventions to improve this quality). Financial reporting of H-share companies listed in Hong Kong are subject to audits by the Big Four or other international accounting firms, whereas those of companies traded only in China are only subject to audits done by local (mainland Chinese) accounting firms. As international accounting firms surpass their mainland Chinese counterparts in terms of experience, professional competence, the quality of audits, and independence, the quality of financial reporting of the two types of companies may diverge.

Based on the aforementioned "bonding hypothesis," this study predicts that H-share companies listed in Hong Kong, faced with more stringent external supervision and greater stakes, will enjoy higher earnings conservatism than their A-share counterparts not listed overseas:

*H2.* Chinese companies listed overseas exhibit a higher degree of earnings conservatism than companies without overseas listing.

### Research design

#### *Data collection and sample*

To test the hypotheses, and proposed arguments, above, we begin by collecting data of Chinese listed companies which issued A-shares either on Shanghai Stock Exchange (SHSE) or Shenzhen Stock Exchange (SZSE) and SEHK main board-listed H-share companies from 2003 to 2008. Our sample comprises 1,673 A-share companies and 60 H-share companies. After deleting observations with incomplete data and extreme values, the final sample consists of 7,310 and 232 firm-year observations for A-share and H-share companies, respectively. All data are collected from the databases of China Security Market and Accounting Research (CSMAR) database. Some missing items are supplemented by Datastream and *Taiwan Economic Journal (TEJ)* database.

#### *Empirical model*

Following prior studies, Basu's (1997) conservatism model is used to test hypotheses concerned with the difference in the speed with which economic gains and losses are captured in accounting earnings. Basu's conservatism regression model takes the following form:

$$EPS_t = \beta_0 + \beta_1 DR_t + \beta_2 RET_t + \beta_3 DR_t \times RET_t + \varepsilon_i \quad (1)$$

where  $EPS_t$  is the earnings-per-share deflated by price at the beginning of year  $t$ ;  $RET_t$  is inter-announcement stock returns measured from May of year  $t$  to April of year  $t+1$ ;  $DR_t$  is a dummy variable for bad news, code one if  $RET_t$  is negative; and zero otherwise.

Because Equation (1) posits that accounting earnings (a lagging variable) as the dependent variable and stock returns (a leading variable) as the independent variable it estimates the slope coefficient better. A bad news dummy  $DR_t$  is included in the regression to distinguish bad news from good news. The slope coefficients  $\beta_2$  and  $\beta_3$  in Equation (1) are used to measure the responsiveness of reported earnings to the news captured in contemporaneous returns. These slope coefficients have been termed

“return response coefficients” in the prior literature. The bad news slope coefficient is steeper than the good news slope when conservatism exists. Under conservative reporting, the slope coefficient  $\beta_3$ , which measures the level of the incremental response of earnings to bad news over the response to good news, is expected to be positive and significant.

This study extends Basu’s (1997) model by incorporating an additional dummy variable as an indicator code to differentiate overseas-listed H-share companies from local Chinese-only A-share companies. The estimated general model is as follows:

$$EPS_t = \beta_0 + \beta_1 DR_t + \beta_2 RET_t + \beta_3 DR_t \times RET_t + \beta_4 OVERSEA_t \times DR_t + \beta_5 OVERSEA_t \times RET_t + \beta_6 OVERSEA_t \times DR_t \times RET_t + \varepsilon_i \quad (2)$$

where  $OVERSEA_t$  is a dummy variable for H-share companies, code one if the sample is an overseas-listed H-share company.

The coefficient  $\beta_3$  captures the marginal effect of sensitivity to bad news for companies where  $OVERSEA_t$  equals zero, and the interaction coefficient  $\beta_6$  captures the incremental earnings conservatism where  $OVERSEA_t$  equals one (i.e. the sample company is an H-share company). It also is expected that, for more conservative reporting for H-share companies, the interaction coefficient  $\beta_6$  will be significantly positive.

Dietrich *et al.* (2007) claim that the popular Basu model specification is biased. Therefore, they suggest that alternative measures be used for robustness purposes. Thus, we also apply the alternative empirical model of earnings conservatism developed by Ball and Shivakumar (2005) to test our hypotheses. Ball and Shivakumar (2005) measure earnings conservatism as the asymmetric timeliness of accruals in economic loss recognition relative to economic gain recognition. Ball and Shivakumar use operating cash flows to proxy for economic losses and gains during the year to test the asymmetry in accruals as follows:

$$ACC_t = \beta_0 + \beta_1 CFOD_t + \beta_2 CFO_t + \beta_3 CFOD_t \times CFO_t + \beta_4 OVERSEA_t \times CFOD_t + \beta_5 OVERSEA_t \times CFO_t + \beta_6 OVERSEA_t \times CFOD_t \times CFO_t + \varepsilon_i \quad (3)$$

where  $ACC_t$  is the mean of total accruals of company  $i$  multiplied by  $-1$  and standardized by beginning-of-period total assets. Accruals are defined as earnings before exceptional items and extraordinary items minus cash from operations;  $CFO_t$  is operating cash in year  $t$  dividend by beginning total assets;  $CFOD_t$  is a dummy variable set equal to one if  $CFO_t$  is negative and zero otherwise.

In this model, the coefficient  $\beta_3$  is expected to be significantly negative showing negative correlation between accruals and cash flows, and the coefficient  $\beta_6$  is expected to be significantly positive in the presence of greater conditional conservatism of overseas-listed H-share companies.

## Results

### *Descriptive statistics*

Panels A and B of Table I present descriptive statistics for both the overseas-listed and Chinese-only-listed sub-samples for the variables used in our empirical model. The difference in means test yields a  $t$ -statistic which indicates that the earnings ( $EPS_t$ ) and

	Year	N	Mean	Median	SD	t-value	
<i>Panel A: Summary statistics for earnings of both the overseas-listed and the Chinese-only-listed sample</i>							
			$EPS_t^a$				
	2003	A-Share	1123	0.02	0.02	0.03	-2.60**
		H-Share	32	0.04	0.03	0.45	
	2004	A-Share	1179	0.02	0.02	0.03	-3.42***
		H-Share	34	0.04	0.04	0.03	
	2005	A-Share	1215	0.02	0.02	0.04	0.50
		H-Share	34	0.01	0.04	0.16	
	2006	A-Share	1230	0.03	0.03	0.04	-1.24
		H-Share	35	0.06	0.05	0.10	
	2007	A-Share	1247	0.04	0.04	0.03	-1.78*
		H-Share	42	0.05	0.06	0.05	
	2008	A-Share	1316	0.01	0.01	0.02	0.60
		H-Share	55	0.01	<0.01	0.03	
<i>Panel B: Summary statistics for stock returns of both the overseas-listed and the Chinese-only-listed sample</i>							
			$RET_t^b$				
	2003	A-Share	1123	-0.15	-0.21	0.29	-5.25***
		H-Share	32	0.20	0.13	0.38	
	2004	A-Share	1179	-0.23	-0.24	0.22	-2.40**
		H-Share	34	-0.13	-0.17	0.23	
	2005	A-Share	1215	-0.22	-0.25	0.24	0.59
		H-Share	34	-0.19	-0.23	0.23	
	2006	A-Share	1230	0.48	0.34	0.53	-1.23
		H-Share	35	0.59	0.33	0.76	
	2007	A-Share	1247	1.22	1.51	0.45	-2.78***
		H-Share	42	1.75	1.55	1.23	
	2008	A-Share	1316	-0.58	-0.65	0.14	4.57***
		H-Share	55	-0.67	-0.67	0.11	

**Notes:** t-statistics in parentheses. <sup>a</sup> $EPS_t$  is defined as earnings-per-share deflated by price at the beginning of year  $t$ ; <sup>b</sup> $RET_t$  denotes inter-announcement stock returns measured from May of year  $t$  to April of year  $t + 1$ . \*, \*\*, \*\*\*Significant at the 10, 5, 1 percent levels

**Table I.**  
Descriptive statistics

returns ( $RET_t$ ) are only marginally significantly different between the A-share and H-share companies. Moreover, the mean (median)  $RET_t$  shows a greater variation over the sample period and a relatively higher volatility for the Chinese-only-listed sample which are features characteristic of emerging markets. Both  $RET_t$  and  $EPS_t$  are right-skewed (means exceed medians), indicating a low level of earnings conservatism for both the overseas-listed and Chinese-only-listed sub-samples. Furthermore, the SD of the  $EPS_t$  variable is always smaller than the SD of  $RET_t$ , consistent with Ball *et al.*'s (2000) point that accounting income is a lagged function of past and present years' stock returns.

*Regression results*

Panel A of Table II reports the estimation results for the Basu (1997) model. Panel A reveals that, based on the Basu (1997) model, overseas-listed Chinese H-share companies recognize losses on a timelier basis than gains over the period from 2006

Year	<i>N</i>	$\beta_0$	$\beta_1$	$\beta_2$	$\beta_3$	Adjusted $R^2$
<i>Panel A: Annual estimation for overseas-listed H-share sample</i>						
2003	32	0.03 (1.60)	0.01 (0.42)	0.08** (2.57)	0.08 (0.94)	0.04
2004	34	0.05*** (3.12)	0.01 (0.14)	0.02 (0.21)	0.06 (0.64)	0.05
2005	34	0.07 (0.92)	0.09 (0.87)	-0.07 (-0.16)	0.62 (1.37)	0.16
2006	35	0.01 (0.58)	0.07 (0.60)	0.07*** (2.97)	0.18** (2.05)	0.15
2007	42	0.08** (2.36)	0.02 (0.61)	0.01* (1.73)	0.14* (1.94)	0.04
2008	55	0.03* (1.89)	0.06 (0.10)	-0.07 (-0.54)	0.14*** (2.70)	0.06
<i>Panel B: Annual estimation for Chinese-only-listed A-share sample</i>						
2003	1123	0.04*** (3.29)	0.01 (0.08)	0.06 (1.57)	0.14*** (2.70)	0.04
2004	1179	0.09** (2.36)	0.10** (2.46)	0.05 (0.40)	0.41*** (3.42)	0.09
2005	1215	-0.01 (-0.23)	0.01 (0.41)	0.07*** (3.02)	0.17** (2.13)	0.03
2006	1230	-0.01 (-0.31)	-0.01 (-0.05)	0.01 (1.01)	-0.33 (-0.24)	0.01
2007	1247	0.07*** (12.34)	-0.02** (-2.26)	-0.01* (-1.77)	0.10*** (4.68)	0.05
2008	1316	0.01 (2.51)	-0.01* (-1.70)	0.01 (0.75)	-0.01 (-0.60)	0.01

$$\text{Model 1: } EPS_t = \beta_0 + \beta_1 DR_t + \beta_2 RET_t + \beta_3 DR_t \times RET_t + \varepsilon_t^a$$

**Notes:** *t*-statistics in parentheses. <sup>a</sup> $EPS_t$  is defined as earnings-per-share deflated by price at the beginning of year *t*.  $RET_t$  denotes inter-announcement stock returns measured from May of year *t* to April of year *t* + 1.  $DR_t$  is a dummy variable for bad news, code one if  $RET_t$  is negative; and zero otherwise. \*, \*\*, \*\*\*Significant at the 10, 5, 1 percent levels

**Table II.**  
Test results using earnings-return regressions

through 2008 (inclusive), i.e. they report earnings conservatively. However, the earnings conservatism coefficients of other years, while uniformly positive, fail to attain statistical significance. Panel B of Table II presents the estimation results of the Chinese A-share (Chinese-only-listed) companies. The results show that earnings conservatism of A-share companies does not show stability. Compared with Panel A, the earnings conservatism ( $\beta_3$ ) of the H-share sub-sample over the period 2005-2008 is higher than for the A-share companies. In 2006 and 2008, the positive sign disappears for the Chinese-only-listed sub-sample, suggesting “conditional aggression” or “negative conservatism,” but these signs are not significant. In the earlier years (2003 or 2004), H-share companies report less conservatively than A-share companies suggesting that the “show-case” companies listed overseas may be under some pressure from the Chinese Government and business community to report good profits so as to reflect well upon the country in foreign locations (Hung *et al.*, 2008). These attitudes would be consistent with both the cultural legacy from Maoism and the more modern Chinese nationalism fostered by Deng Xiaoping and subsequent leaders (“Dengism”). In sum,



the evidence supports *H1* and is consistent with our conjectures that the series of legal and institutional reform in the Chinese capital market has improved the quality of H-share companies' financial reporting. For instance, the split share structure reform of listed companies provides ground rules to shift the balance of share ownership from state ownership to public ownership by majority and minority shareholders.

Table III contains the results of the estimation of model (1) and (2) that assess the association between overseas-listing and earnings conservatism. For this Table, all years are combined. Rows 1 and 2 of the Table show the pooled regression results for H-share and A-share companies. The results show that the  $\beta_3$  coefficients for H-share (0.14;  $t = 2.63$ ) and A-share (0.04;  $t = 1.84$ ) are positive and significant, indicating earnings conservatism for both H-share and A-share companies. It is worthwhile to notice the small size of the positive returns coefficient  $\beta_2$  and the much larger size of the negative returns coefficient  $\beta_3$ .

Both H-share and A-share sub-samples are also combined into a single pooled sample which pools across both years and listing locations. Row 3 of Table III shows the results of the estimation of model (2). The results of the combined sample has satisfactory explanatory power (adjusted  $R^2 = 0.17$ ) with  $F$  statistically significant ( $p < 0.01$ ). The interaction coefficient  $\beta_6$  that captures asymmetric timeliness of H-share companies over A-share companies is significantly positive at the 5 percent level (0.03;  $t = 2.44$ ), indicating that overseas-listed H-share companies are associated with higher conditional conservatism than Chinese-only-listed A-share companies. This result applies for the entire sample period but not necessarily for individual years. This is in agreement with our prediction that overseas-listed H-share companies report earnings more conservatively than their A-share counterparts, sustaining *H2*.

*Alternative model of earnings conservatism from Ball and Shivakumar (2005)*

Table IV contains the estimation of model (3). The results based on the model of Ball and Shivakumar (2005) are largely consistent with our findings documented above.

<i>N</i>	$\beta_0$	$\beta_1$	$\beta_2$	$\beta_3$	$\beta_4$	$\beta_5$	$\beta_6$	Adjusted $R^2$
<i>H-Share sample</i>								
232	0.04*** (3.17)	0.01 (0.26)	0.02** (2.24)	0.14** (2.63)				0.09
<i>A-Share sample</i>								
7,310	0.03*** (9.23)	0.01 (0.89)	-0.17*** (-5.30)	0.04* (1.84)				0.05
<i>Combined sample</i>								
7,542	0.03*** (35.80)	-0.01*** (-5.06)	0.01*** (8.50)	0.03** (11.97)	0.02*** (2.67)	0.01*** (4.77)	0.03** (2.44)	0.17

Model 1:  $EPS_t = \beta_0 + \beta_1 DR_t + \beta_2 RET_t + \beta_3 DR_t \times RET_t + \epsilon_t^3$

Model 2:  $EPS_t = \beta_0 + \beta_1 DR_t + \beta_2 RET_t + \beta_3 DR_t \times RET_t + \beta_4 OVERSEA_t \times DR_t + \beta_5 OVERSEA_t \times RET_t + \beta_6 OVERSEA_t \times DR_t \times RET_t + \epsilon_t^3$

**Table III.**  
Test results using earnings-return regressions-combined sample

**Notes:**  $t$ -statistics in parentheses. <sup>a</sup> $EPS_t$  is defined as earnings-per-share deflated by price at the beginning of year  $t$ .  $RET_t$  denotes inter-announcement stock returns measured from May of year  $t$  to April of year  $t + 1$ .  $DR_t$  is a dummy variable for bad news, code one if  $RET_t$  is negative; and zero otherwise.  $OVERSEA_t$  is a dummy variable for H-share companies, code one if the sample is an overseas-listed H-share companies. \*, \*\*, \*\*\*Significant at the 10, 5, 1 percent levels

$N$	$\beta_0$	$\beta_1$	$\beta_2$	$\beta_3$	$\beta_4$	$\beta_5$	$\beta_6$	Adjusted $R^2$
6,448	-0.02*** (-4.15)	-0.16*** (-5.06)	-0.83*** (-13.14)	-1.12* (-1.78)	1.16*** (5.65)	-0.49** (2.35)	0.05*** (4.03)	0.15

$$\text{Model 3: } ACC_t = \beta_0 + \beta_1 CFOD_t + \beta_2 CFO_t + \beta_3 CFOD_t \times CFO_t + \beta_4 OVERSEA_t \times CFOD_t + \beta_5 OVERSEA_t \times CFO_t + \beta_6 OVERSEA_t \times CFOD_t \times CFO_t + \varepsilon_t^a$$

**Notes:**  $t$ -statistics in parentheses. <sup>a</sup> $ACC_t$  is the mean of total accruals multiplied by  $-1$  and standardized by beginning period total assets. Accruals are defined as earnings before exceptional items and extraordinary items minus cash from operations;  $CFO_t$  is operating cash in year  $t$  dividend by beginning total assets;  $CFOD_t$  is a dummy variable set equal to one if  $CFO_t$  is negative and zero otherwise.  $OVERSEA_t$  is a dummy variable for H-share companies, code one if the sample is an overseas-listed H-share companies. \*, \*\*, \*\*\*Significant at the 10, 5, 1 percent levels

**Table IV.**  
Test results using alternative model of earnings conservatism

The interaction coefficient  $\beta_6$  is significantly positive at the 1 percent level (0.05;  $t = 4.03$ ). Again, this shows that overseas-listed H-share companies supply more earnings conservatism than their A-share counterparts. Therefore,  $H2$  is also supported using an alternative empirical model of earnings conservatism.

### Conclusion and implications

In this paper, we assess the incremental effects of overseas listing on earnings conservatism. In particular, we investigate whether Chinese companies listed overseas in Hong Kong exhibit a higher degree of earnings conservatism than Chinese companies with no overseas listing. The politically connected overseas-listed Chinese companies still operate, to some extent, in a cultural, political, and institutional environment characterized by “crony capitalism” where the Government is willing to intervene regularly in the companies’ activities to achieve political and social objectives (Gul, 2006; Hung *et al.*, 2008).

Summarizing, the findings demonstrate that both overseas-listed and Chinese-only-listed Chinese companies demonstrate a minimal degree of earnings conservatism in the early part of the sample period. The findings coincide with Gul’s (2006) finding in that managers of companies with political connections are motivated to conceal their real financial positions to avoid defaulting on debt contracts. In this case, the reliability of their financial reporting is relatively low. Bushman and Piotroski (2006) also note that companies with higher portions of government stockholdings see their earnings respond less timely to negative news and more so to positive news. The reason is that bad performance increases the risk of a Government takeover. To avoid falling into the hands of the Government, companies waste no time in recognizing and publishing the good news, while the bad news can wait. Such behavior leads to poor quality of corporate financial reporting. However, the findings of this paper are consistent with our conjectures that the series of legal and institutional reforms in the Chinese capital market have improved the quality of H-share companies’ financial reporting albeit this improvement is from a low base. Earnings conservatism is statistically significant for the H-share companies in 2006, 2007, and 2008.

Companies listed overseas provide a higher degree of earnings conservatism than Chinese-listed-only companies overall, although Table II suggests that this result may be restricted to the later part of the sample period. Consistent with the corporate governance argument, our results suggest that overseas-listed companies facing

stringent disclosure rules and legal regulations in overseas securities markets facilitate better corporate governance and financial reporting of overseas companies (Cheung and Lee, 1995; Lang *et al.*, 2003; Huijgen and Lubberink, 2005). A cultural shift may also have occurred within these companies.

Collectively, the evidence in this study shows consistently that differences in earnings conservatism arise from differential information demands. More specifically, the level of earnings conservatism is an equilibrium outcome of market forces set in motion by market participants acting in their own self-interest, and reflecting differences in demand for conservative financial reporting. Accounting reporting practices for overseas-listed H-share companies are focussed more often on meeting the needs of their shareholders (including minority shareholders) and stakeholders.

Our result for *H2* still suggests, for the overall sample period, that in a country with many elements of communist and Maoist culture still present, at least in the form of lingering specters (to quote the opening sentence of Marx and Engels' *Communist Manifesto* (1994)), reporting losses rapidly to the capital market may not be considered a matter of urgency. Full/excess employment, social order, and social stability are likely to be regarded as more important objectives. Accountability to those higher up the chain in command of the CCP, in practice if not in theory, may well remain more important than accountability to the "market" especially for cross-listed companies where Government shareholdings are higher. The rise of Dengism and its associated nationalism mean that cross-listed companies are seen as "showcase" companies (Hung *et al.*, 2008). The large and stable reported profits of overseas-listed companies are presented and viewed as evidence of the startling economic transformation of China since 1949 and even more so since 1978. In reality, however, the absence of earnings conservatism in China suggests that Mao-era incentives to overstate production outputs, so characteristic of the "Great Leap Forward" campaign of the 1950s, still exert an important cultural influence over financial reporting in China. The Russian revolutionary V.I. Lenin once remarked that there is no historical precedent for a peaceful transition from capitalism to communism. The road back to capitalism is probably not much easier.

Our results are relevant for other developing countries in process of transition from communist culture to capitalist culture such as Russia, Vietnam, the former Soviet Union republics, and the countries of Eastern Europe.

#### Note

1. Li (2008) contains a recent well-researched defense of Mao's legacy touching upon economic, social, and political issues.

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