

# SECURITIES LAW TRANSITION AND VALUE RELEVANCE: EVIDENCE FROM CHINA

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## Abstract

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This research investigates the impact of securities law transition on the value relevance of earnings and book value. This research adopts the Ohlson (1995) model to measure the value relevance. Using the panel data of 2,116 Chinese listed companies from 2015 to 2022, we analyze the impact of the Chinese securities law amendment (which happened in 2019) on the value relevance. The results reveal that the value relevance of earnings increased after the securities law amendment, while the value relevance of the book value decreased during the same period. These results indicate that under a stricter securities law, investors put more emphasis on the earnings than the book value. This research contributes to existing literature (Choi et al., 2018; Oz & Yelkenci, 2018) by providing insights into the interplay between the legal environment and market reaction to accounting information. These insights aid stakeholders in comprehending the effects of securities law transition on value relevance. This research also provides empirical evidence to the lawmakers and aids in formulating more effective regulatory strategies. By grounding regulatory decisions in empirical findings, lawmakers can ensure that regulations are evidence-based and aligned with market dynamics.

**Keywords:** Value Relevance, Legal Environment, Securities Law, Earnings Management

**Authors' individual contribution:** Conceptualization — J.Y.; Methodology — J.Y.; Validation — J.Y.; Formal Analysis — J.Y.; Investigation — J.Y.; Resources — J.Y.; Data Curation — J.Y.; Writing — Original Draft — J.Y.; Writing — Editing & Review — J.Y.; Supervision — M.S.H. and H.M.N.

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## 1. INTRODUCTION

Value relevance, which measures the overall usefulness of accounting information, is a key indicator for assessing accounting quality (Cascino et al., 2021). It depicts the market reaction to the accounting figures, such as earnings and book value of equity (Menicucci, 2020). Studies have consistently highlighted that earnings management activities are important factors that significantly diminish the value relevance of financial information (Al-Shattarat, 2021; Ratnaningrum et al., 2021).

Earnings management not only distorts the information on financial performance but also worsens information asymmetry and undermines the predictive power of accounting figures (Maines & Wahlen, 2006). Managed earnings make it challenging for investors to accurately evaluate a company's future earnings and financial performance (Mostafa, 2017), leading to a decrease in its value relevance.

Meanwhile, studies also revealed that the legal environment plays a pivotal role in constraining earnings management activities (Choi et al., 2018; Oz & Yelkenci, 2018). The law and regulations

impose requirements for transparency, accuracy, and disclosure, serving to detect and deter earnings management activities (Cassell et al., 2015; Qatawneh & Bader, 2021). In addition, legal systems typically include enforcement mechanisms such as regulatory oversight, audits, and penalties for non-compliance with accounting standards and securities regulations. The threat of enforcement actions acts as a deterrent to companies considering engaging in earnings management (Lev, 2018).

While prior studies have provided evidence of the crucial role of the legal environment in constraining earnings management and the negative impact of earnings management on value relevance, the relationship between the legal environment and value relevance was seldom investigated. This remains a gap in understanding the interaction between the legal environment and market reaction. To fill this gap, this research focuses on the impact of securities law transition on the value relevance of accounting information.

Securities law is the most relevant to the capital market (Stulz et al., 2009). This is because the securities law regulates the affairs related to the share issue, information disclosure, and investor protection (Newman & Trautman, 2021). Chinese securities law was amended in 2019. This amendment allows us to investigate the transitional effect of the legal environment on the value relevance of accounting information. This research follows the method developed by Ohlson (1995), which is commonly adopted in the value-relevance research field. Using the panel data of 2,116 Chinese listed companies from 2015 to 2022, this research tests the reaction of share price to the earnings and the book value of equity, and the impact brought about by the securities law amendment. More specifically, the research questions in this research are:

*RQ1: Does the value relevance of earnings increase after the new securities law became mandatory?*

*RQ2: Does the value relevance of the book value increase after the new securities law became mandatory?*

The findings indicate that the new securities law has a different impact on the value relevance of earnings and book value. The mandatory of the new securities law improved the value relevance of earnings while decreasing the value relevance of book value. These results indicate that the transition of the securities law has reshaped investors' decisions and behavior. Under the new securities law, investors place greater emphasis on earning while diminishing the importance of book value. This shift reflects that investors regard the earnings as more relevant accounting information during their decision-making.

This research contributes to the literature in two ways. First, this research revealed the interplay between the legal environment, earnings management, and value relevance of accounting information. It combined the legal framework under the securities law and the market reaction to the accounting information, providing evidence for the impact of the legal environment on investors' perception of the accounting figures. This helps scholars and market participants to understand the market consequences of different legal requirements, such as the costs for violations and the mechanism of investor protection. Second, this research also provides lawmakers and regulators with empirical evidence of the real effects of the law transition. This contributes to the evaluation of

the new legal framework under the securities law, informs the regulatory decision-making process, and facilitates further adjustments or enhancements.

The remainder of this research is structured as follows. Section 2 is the literature review and hypotheses development. Section 3 outlines the research methodology. Section 4 presents empirical results. Section 5 provides the robustness test results. Section 6 concludes the study.

## 2. LITERATURE REVIEW

### 2.1. Legal environment and earnings management

Previous studies primarily concentrated on investigating how the legal system influences earnings management. For example, Choi et al. (2018) examined whether and how the strength of the legal regime of a specific country and the Big 4 auditors affect a company's real earnings management (REM) activities. Using cross-country data from 22 countries all over the world, they find that in the countries with strong legal regimes, REM is more prevalent. The reason is that companies are more likely to resort to REM rather than accrual-based earnings management (AEM) to manipulate their earnings. Their findings also suggest that the Big 4 auditors can effectively reduce the REM and AEM. Meanwhile, the Big 4 auditors positively moderate the relationship between the strength of the legal regime and REM. They argued that these results suggested that high-quality auditors constrain companies' REM activities.

Similarly, the study conducted by Oz and Yelkenci (2018) investigates how AEM and REM are influenced by legal origins. Their sample involves companies from 14 countries that follow the International Financial Reporting Standards (IFRS). They examine whether the enforcement intensity and IFRS adoption affect the earnings management types. Meanwhile, they test the effect on countries with different legal origins, i.e., the code law and common law tradition. The results indicated that the effect of enforcement intensity and IFRS adoption on earnings management activities varied in different legal origins. Notably, the study suggests that strengthening enforcement may not yield consistent outcomes across different traditions. Furthermore, the research provides evidence that IFRS constrains AEM in code law origin countries while exerting a constraint on REM in common law countries.

The above-mentioned studies collectively underscored the intricate relationship between legal factors and earnings management. These studies shed light on the role of legal factors such as legal regimes and legal origins in shaping financial reporting practices. However, they primarily focus on the mechanisms through which legal environments impact earnings management. The broader question of how legal considerations affect the market reaction, e.g., the value relevance, remains less addressed. This highlights the need for further studies on the connection between legal factors, earnings management practices, and the broader financial decision-making process.

### 2.2. Earnings management and value relevance

Prior studies have indicated that earnings management is an important factor that affects the value relevance of accounting information

(Al-Shattarat, 2021). They generally suggest that earnings management activities hinder the usefulness of accounting information and deter the value relevance (Al-Shattarat, 2021; Mostafa, 2017). For instance, Al-Shattarat (2021) investigated the correlation between earnings management and value relevance of book value and earnings. His research examined how different types of discretionary accruals (categorized as short-term versus long-term) affect the value relevance. The hypothesis posits that firms engaging in earnings management would exhibit lower value relevance of earnings and book value compared to those not involved in earnings management practices. The findings indicate that discretionary accruals associated with earnings management have a greater impact on the value relevance of book value and earnings over the long term rather than the short term.

Some researchers further investigated the relationship between earnings management and value relevance from different dimensions. For instance, Ratnaningrum et al. (2021) examined the impact of earnings management on the value relevance of earnings. They focused on both the impact of magnitude and changes in earnings on the value relevance. The analysis centers on manufacturing firms listed on the Indonesia Stock Exchange (IDX) and comprising a dataset of 606 observations. The findings indicate that the magnitude of earnings lacks value relevance, but changes in earnings exhibit significance in value relevance. Moreover, the earnings' value relevance decreased in the presence of earnings management. These results indicated that earnings management diminished the overall value relevance of earnings.

Collectively, the aforementioned studies revealed the relationship between earnings management and the value relevance. Earnings management activities generally play an important role in deterring the value relevance. As the legal environment is an important factor that constrains earnings management, it can be expected to have an impact on value relevance. However, studies that focus on the relationship between legal environment and value relevance are limited. This creates a significant gap in the existing literature and signals further research is necessary. This research fills the gap and investigates the effect of the legal environment on the value relevance of accounting information.

### 2.3. The main points of the Chinese securities law amendment

Chinese securities law was initially enacted in 1999 and has undergone several amendments since then. The latest amendment happened on December 28, 2019 and led to a new securities law (we refer to the securities law existing before the 2019 amendment as the "old securities law", while designating the securities law after the 2019 amendment as the "new securities law"), which became mandatory on March 1, 2020 (Wang et al., 2024). The improvement of the new securities law is embodied by several aspects, including modifying and improving the securities issuance system, substantially increasing the costs of illegal activities, establishing a specific chapter to regulate investor protection systems, refining the securities trading system, and so on (Deng, 2020). Among

these new characteristics, the most relevant advancement to accounting information is the enhancement of investor protection.

Under the old securities law, the economic interests of small and medium-sized investors are usually harmed by fraudulent information disclosure, and investors often face challenges in obtaining compensation (Yao & Shen, 2017). The primary reason was the absence of a class action system (Hu & Ma, 2021). In addition, under the old securities law, when disputes arose in the securities market due to inappropriate statements, the court only entertained civil compensation cases if punitive decisions were made by the China Securities Regulatory Commission (CSRC) (Song, 2022). Meanwhile, the court only accepts individual or joint lawsuits and does not accept class actions (Zhang, 2023). The lack of a class action system made information disclosure violations difficult to punish by the corresponding legal system and greatly reduced the cost of information disclosure fraudsters (Jiao, 2023). This led to capital market disorder, the quality of accounting information declined, and irregularities in information disclosure grew (Jiao, 2023), which significantly impeded investors' confidence in the market and reduced the value relevance of accounting information.

The new securities law has introduced a dedicated chapter outlining the investor protection system and involves a series of institutional arrangements (Wang & Zhang, 2022). One particularly notable addition is the establishment of the representative action system, commonly known as the class action system (Deng, 2020). The key strength of a class action lies in its collective nature, once initiated by one person, all others with similar interests can join the lawsuit, leading to potentially significant damages to the wrongdoers (Wang, 2024). Under this class action mechanism, a victory for the securities representative in court results in a judgment covering all registered investors. This approach facilitates the effectiveness of the litigation, lowers the cost of investor rights protection, and enhances the deterrent effect against illegal activities. Once the victory successfully defends their rights, listed companies and their managements will face severe penalties. The deterrent from the fines and other penalties, as well as the damage to the reputation, discourage the management of listed companies from engaging in fraudulent activities (Mafei et al., 2023; Xu et al., 2022). The potential legal consequences force listed companies to comply with the requirements set up by the securities law and facilitate the integrity of their accounting practice (Qian et al., 2023). Thereby, the class action system can be expected to effectively enhance investor protection, constrain earnings management, and improve the value relevance of accounting information.

In summary, the amendments to the securities law may bring about a better legal environment for the capital market and help to improve the quality of accounting information. The introduction of a class action system serves to urge the listed companies to reduce earnings management and improve accounting quality. Consequently, it contributes to greater transparent and trustworthy financial information, facilitating the improvement of value relevance.

## 2.4. Hypotheses development

Among the companies' accounting information, earnings are the most important accounting figure to the investors' decision-making (Wu et al., 2023; Gurung et al., 2024). Investors often prioritize earnings because they provide key insights into a company's financial performance, profitability, and potential for future growth (Qian & Zhixuan, 2023; Wu et al., 2023). By analyzing earnings, investors assess a company's ability to generate returns for shareholders, evaluate its competitiveness within its industry, and make informed decisions about buying, holding, or selling its stock (Wu et al., 2023). Consequently, earnings play a central role in financial analysis and are considered a critical accounting metric by investors when evaluating investment opportunities. When the legal environment improves, earnings management activities are constrained (Kalantonis et al., 2021), and the value relevance of earnings is expected to increase correspondingly.

Based on the analysis above, we put forward the first hypothesis:

*H1: The new securities law positively influences the value relevance of earnings.*

When the value relevance of earnings increases, it may lead to a decrease in the value relevance of book value (Bepari, 2015). This inverse relationship occurs because when earnings become more informative and more reliably reflecting a company's financial performance, investors rely less on book value as a measure of firm value (Chen et al., 2020). When the reported earnings better capture the underlying economic realities of the company, including its profitability, growth prospects, and future cash flows, investors place greater emphasis on earnings when assessing a company's value and making investment decisions. In contrast, book value, which represents the historical cost of assets minus liabilities, may not fully reflect the current market value or future earning potential (Chen et al., 2020). As a result, its relevance in determining firm value diminishes when compared to more informative earnings. Therefore, with the value relevance of earnings improves, investors prioritize earnings-related metrics over book value in their valuation analyses, leading to a relative decrease in the importance of book value.

Based on the analysis above, we put forward the second hypothesis:

*H2: The new securities law negatively influences the value relevance of book value.*

$$SP_{it} = \alpha_0 + \alpha_1 EPS_{it} + \alpha_2 BVPS_{it} + \alpha_3 NSL + \alpha_4 EPS_{it} * NSL + \alpha_5 BVPS_{it} * NSL + u + v + \varepsilon_{it} \quad (1)$$

where:

- $SP$  = share price. It is the closing price of April 30 of the year  $t+1$ .
- $ESP$  = earnings per share at the end of the year  $t$ . It is the net profit divided by the number of outstanding shares.
- $BVPS$  = book value per share at the end of year  $t$ . It is the book value of equity divided by the number of outstanding shares.

## 3. RESEARCH METHODOLOGY

### 3.1. Research design

In this research, we follow the method developed by Ohlson (1995). Firstly, we test the value relevance of earnings (which is proxied by the relationship between share price and earnings) and the value relevance of book value (which is proxied by the relationship between share price and book value of the firm's equity). Then we introduce the dummy variable to examine the impact of the new securities law.

### 3.2. Sample selection and data collection

This research uses the panel data of the Chinese listed companies from 2015 to 2022. This timeframe encompasses eight years, e.g., four years before and four years after the enforcement of the new securities law. The new securities law was officially announced on December 28, 2019, and became mandatory on March 1, 2020. Listed companies are required to disclose their financial statements before April 30 of the subsequent year. The financial statements for the year 2019 were disclosed before April 30, 2020, after the implementation of the new securities law. Consequently, the period from 2015 to 2018 represents the era before the law's enforcement, while the period from 2019 to 2022 represents the post-enforcement period.

All Chinese listed companies (a total of 5,696) are selected as samples and the data is collected from the CSMAR database by the end of 2023. The Special Treatment (ST) companies (ST indicates that the company has abnormal financial conditions or other abnormal conditions and is at risk of delisting), a total of 192, were excluded. Companies with missing data (share price, earnings per share, and book value per share), a total of 3,388, were excluded. Finally, 2,116 companies and 16,928 observations were obtained. To eliminate the effect of extreme values, we winsorized the data at 1% and 99%.

### 3.3. Research methodology

This research is based on the Ohlson (1995) model and the dummy variable, which represents the new securities law ( $NSL$ ), is introduced. The model is constructed as follows:

- $NSL$  = new securities law, a dummy variable, which equals 1 when the period is after the mandatory of the new securities law (2019 to 2022) and 0 otherwise (2015 to 2018).
- The variables  $u$  and  $v$  = the company and time fixed effect respectively.

## 4. EMPIRICAL RESULTS

Tables 1, 2, and 3 present the descriptive statistics, correlation analysis, and regression results, respectively.

Table 1. Descriptive statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
SP	16928	13.617	13.402	0.947	82.13
EPS	16928	0.549	0.661	0.009	3.93
BVPS	16928	5.548	3.935	0.808	24.208
NSL	16928	0.5	0.5	0	1

Table 2. Correlation analysis

	SP	EPS	BVPS	NSL
SP	1			
EPS	0.485***	1		
BVPS	0.435***	0.697***	1	
NSL	-0.111***	0.088***	0.084***	1

Table 3. Regression results

Variable	Coefficient	Std. Err.	t	P > t
EPS	3.617	0.171	21.190	0.000
BVPS	1.749	0.041	42.890	0.000
EPS*NSL	0.373	0.117	3.180	0.001
BVPS*NSL	-0.242	0.029	-8.440	0.000
NSL	-7.901	0.239	-33.000	0.000
_cons	2.544	0.190	13.370	0.000
Number of obs. = 16,928				
Prob > F = 0.0000				
Adj R-squared = 0.7515				
		Code	Yes	
		Year	Yes	

Note: Dependent variable — SP.

The regression results indicate that the coefficients of *EPS* and *BVPS* are 3.617 and 1.749, respectively. Both of them are positive and statistically significant. This indicates that *EPS* and *BVPS* have value relevance. The coefficient of the interaction term of *EPS\*NSL* is 0.373. It is also positive and statistically significant. This suggests that the implementation of the new securities law has a positive effect on the value relevance of *EPS*, supporting our first hypothesis. This result is in line with the existing literature on value relevance (Mulenga & Bhatia, 2020), which suggests that both earnings and book value are perceived as important accounting information and value-relevant. The improvement of the value relevance of earnings brought about by the new securities law indicates that the regulatory reform has a positive effect on the quality of accounting information. The new securities law enhanced investor protection and helped to guarantee value relevance. The new securities law also tightened the disclosure requirements and enhanced the transparency of accounting information. All these improvements contribute to the greater reliability and credibility of earnings. Consequently, investors put more emphasis on earnings and perceive it as a reliable indicator of the firm's value. Further, the positive impact of the new securities law highlights the dynamic role of institutional transition in shaping the value relevance of accounting information.

Conversely, the coefficient of the interaction term of *BVPS\*NSL* is -0.242. It is negative and statistically significant. This implies that the implementation of the new securities law negatively impacts the value relevance of *BVPS*, aligning with our second hypothesis. This result

suggests that the stricter new securities law makes investors shift their focus from book value to earnings. When the new securities law introduced tightened disclosure requirements and improved the quality of earnings information, investors paid more attention to earnings and regarded earnings as a forward-looking indicator of a firm's performance. Meanwhile, the improved emphasis on earnings diminishes the importance of book value. This finding consists of the existing literature which argues that the value relevance of accounting information can evolve in response to the legal environment (Choi et al., 2018; Oz & Yelkenci, 2018). While book value traditionally serves as a proxy for a firm's liquidation value or net assets, its importance may diminish when alternative metrics, such as earnings, are perceived as more reliable and informative in a reformed regulatory environment.

## 5. ROBUSTNESS TEST

To make our results more convincing, we conducted several robustness tests. First, following Qu and Zhang (2015), we excluded the companies that issue B shares. The formal name for B shares is Renminbi (RMB) special shares. They are denominated in RMB and traded in foreign currency, such as USD and EUR. The companies that issued B shares are listed on the securities exchanges within China (Shanghai, Shenzhen), and are foreign-funded ([https://www.gov.cn/zhengce/202203/content\\_3338361.htm](https://www.gov.cn/zhengce/202203/content_3338361.htm)). Second, we replace *EPS* with comprehensive income per share (*CIPS*). The regression results do not change significantly, indicating that our results are robust. Tables 4 and 5 illustrate the robustness test results.

Table 4. Regression results without B share companies

Variable	Coefficient	Std. Err.	t	P > t
EPS	3.695	0.175	21.060	0.000
BVPS	1.755	0.042	42.060	0.000
EPS*NSL	0.371	0.120	3.100	0.002
BVPS*NSL	-0.241	0.030	-8.120	0.000
NSL	-8.064	0.246	-32.78	0.000
_cons	2.806	0.193	14.520	0.000
Number of obs. = 16,400				
Prob > F = 0.0000				
Adj R-squared = 0.7471				
		Code	Yes	
		Year	Yes	

Note: Dependent variable — SP.

Table 5. Regression results of CIPS

Variable	Coefficient	Std. Err.	t	P > t
CIPS	3.208	0.163	19.640	0.000
BVPS	1.774	0.041	43.680	0.000
CIPS*NSL	0.410	0.114	3.610	0.000
BVPS*NSL	-0.249	0.028	-8.820	0.000
NSL	-7.801	0.239	-32.600	0.000
_cons	2.614	0.191	13.700	0.000
Number of obs. = 16,928				
Prob > F = 0.0000		Code	Yes	
Adj R-squared = 0.7500		Year	Yes	

Note: Dependent variable — SP.

## 6. CONCLUSION

In this research, we investigate the impact of securities law transition on the value relevance. The findings revealed that the mandatory adoption of new securities law improves the value relevance of earnings but reduces the value relevance of book value. These results indicate that the securities law transition has influenced investors' behavior by increasing the importance of earnings and reducing the significance of book value in investors' valuation process. The findings of this research expand prior research by providing a broader examination of the interplay among legal environment, earnings management, and value relevance. By integrating insights from securities laws and the significance of accounting information in market valuations, this research offers evidence for both scholars and practitioners. It sheds light on how varying legal frameworks, such as the mechanisms for investor protection, shape the market's response to financial information. Moreover, by investigating the impact of securities laws on the value relevance of accounting information, this research contributes to regulatory assessment efforts. By scrutinizing the effectiveness of regulatory frameworks, it aids regulators in refining regulatory strategies, ensuring alignment with regulatory objectives, and facilitating adjustments or enhancements where necessary.

Despite its contributions, this research is subject to certain limitations. First, the data and analysis in this research are limited to Chinese listed

companies. This limits the generalizability of the findings to other countries. Chinese legal system follows the civil law tradition, which is different from the common law tradition. In addition, the different market environments in different countries may also affect value relevance. The different legal traditions and market environments may influence value relevance in different ways. Second, this research focuses on the overall impact of the new securities law. The mechanism underlying the effect of the new securities law, such as the specific provisions and legal enforcement practice, is not considered by this research. Third, this research only focuses on the transition period. The long-term effects of the new securities law have not been investigated. To compensate for the limitations of this research, future research may extend the analysis to other countries or conduct cross-border analysis, so that the effect of securities law on the value relevance in different institutional environments can be understood. In addition, specific mechanisms such as a specific legal provision, legal enforcement intensity, or penalties may also be directions for future research. Investigating these factors may provide deeper insights into the effect of the securities law influencing value relevance. Moreover, longitudinal studies could examine whether the observed shifts in value relevance persist or evolve as investors and firms adapt to the new regulatory landscape.

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