

Equity Financial Assets: A Tool for Earnings Management
– A Case Study of the Youngor Group

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Abstract: With China’s adoption of principal-based international accounting standards, companies now have discretion in how to account for the initial measurement, sale, and subsequent reclassifications of financial assets, providing room for earnings management. We use Youngor as a case study to illustrate how earnings were managed to exploit this discretion. We document that the company re-classifies its available-for-sale (AFS) assets as long-term equity investments to decrease the volatility of the company’s apparent profits. We also make some predictions regarding how the company will handle its financial assets under the new standards. Our research contributes to the continuous improvement of China's accounting standards and helps regulators better supervise and govern the capital market.

Keywords: Financial Assets, Earnings Management, Youngor, CAS 22

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I. Introduction

This paper is a case study of how Chinese accounting standards governing the reporting and measurement of financial instruments were used as tools to manage earnings, especially for the purpose of dampening the volatility of reported earnings. The case study reveals Youngor Group's attempts to smooth earnings over time by exploiting the evolving provisions of the standards.

Due to economic globalization over the past two decades, more than 150 countries and regions around the world have begun adopting International Financial Reporting Standards (IFRS) or have converged their national accounting standards towards IFRS. In the 1990s, China began to shift from a planned economy to a socialist market economy. In 1990 and 1991, the Shanghai Stock Exchange and the Shenzhen Stock Exchange were established. The transformation of the economic system created an urgency for China to integrate with the international capital market in order to attract more foreign investors. This resulted in the current Chinese accounting system reform (Peng and Smith, 2010), an effort by The Chinese Ministry of Finance to revise the accounting standards to both improve the quality of financial reports and allow foreign investors to understand Chinese companies' financial statements better. In 1992, the Ministry of Finance formally issued the first accounting standard in the history of China, *Accounting Standards for Enterprises No. 1*, demonstrating that China had begun to draw lessons from international accounting standards. From 1997 to 2001, the Ministry of Finance issued 16 specific guidelines, further indicating that Chinese accounting standards were gradually adapting to international practice. In 2006, the Ministry of Finance issued an updated basic standard and 38 specific criteria; with this issuance, Chinese accounting standards had mostly achieved

convergence with IFRS. The Ministry of Finance issued the *Chinese Accounting Standards and IFRS Convergence Roadmap* in 2010.

With the development of the economy and the improvement of the capital market, the size of Chinese public companies has expanded rapidly in the past five years. Available-for-sale financial assets alone reached a total of ¥15.3151 billion Yuan by the end of 2016. Because the imperfections in the *International Accounting Standards - Financial Instruments: Recognition and Measurement (IAS 39)* have been viewed as some of the critical factors that contributed to the outbreak of the 2008 financial crisis, China has continued to closely follow the pace of international standards and constantly revise guidelines for financial instruments to adapt to the rapid growth of the Chinese capital market. China created its first accounting standards for financial instruments in 2006, *Accounting Standards for Enterprises No. 22 - Recognition and Measurement of Financial Instruments* (the original CAS 22 hereafter). However, these standards gradually became outdated over time. Also, CAS 22 created many problems in practice. Examples of issues include: the financial assets classification standard relies on a highly subjective “managerial holding intention”; the measurement methods of financial instruments are too complex for financial statement issuers and investors; provisions for asset securitizations are lacking; guidance for application is insufficient, and so on. To solve these problems and achieve a complete convergence between Chinese accounting standards and international accounting standards, the Chinese Ministry of Finance began to revise relevant standards for financial instruments in early 2015. On March 31, 2017, following initial draft discussions, opinion solicitations, and final draft modifications, three new standards were issued, including *Accounting Standards for Enterprises No. 22 - Financial Instruments Recognition and Measurement* (the new CAS 22 hereafter). These standards cover the accounting treatments for

financial assets classification, impairment, and financial derivatives. This revision marks the first time in the past decade that China has substantially revised the accounting standard for financial instruments, in turn solving many of the problems present in the application of the original CAS 22 and further merging Chinese accounting standards with IFRS.

The complexity of financial assets and the adoption of principle-based international standards as part of the convergence project have provided firms with a substantial degree of flexibility and discretion over the classification of financial assets. For example, the original CAS 22 classifies financial assets based on management's intention to hold the financial assets, which is highly subjective. Many companies often classify the assets as available-for-sale so as to avoid reflecting fair value changes in the income statement and hence report smoother earnings over time. Under the new CAS 22, which is the same as IFRS 9, if an equity investment is not classified as held-for-trading, an entity can make an irrevocable election at initial recognition to measure the investment at FVTOCI with only dividend income recognized in profit or loss (IFRS 9, paragraph 5.7.5). IFRS 9 does not allow reclassification of equity investments measured at FVTOCI; when a corporation sells FVTOCI-equity, unrealized amounts residing in other comprehensive income are transferred to retained earnings, but not income. Additionally, under IFRS 9 all equity investments are to be measured at fair value in the statement of financial position, with present value changes recorded in other comprehensive income. Furthermore, unlike IAS 39, there is no cost exception for unquoted equities under IFRS 9; cost measurement can only be used when it is the best estimate of the fair value.

Our paper investigates three research questions. One, whether the revised new financial assets standards affect the way companies report their financial assets and, if so, how. Two,

whether firms change how they use financial assets to manage earnings. Three, whether the new CAS 22 creates new sets of problems such that further improvements are required.

The paper is organized as follows. The introduction provides a brief background and summary of our study and discusses our contribution. Section II summarizes prior literature. We provide institutional background in Section III. In Section IV, we describe in detail the case study of the Youngor Group. And finally, Section V concludes and provides suggestions for future research.

II. Literature Review

Earnings management has been a hot topic in capital market literature. Healy and Wahlen (1999) discuss three main reasons for firms to manage earnings: capital market pressure, compensation motivation, and regulatory factors. Ronen and Yaari (2008) emphasize that earnings management can be beneficial if managers, whose interests are aligned with shareholders, use it to signal long-term firm value. Healy and Whalen's (1999) definition of earnings management suggests that earnings management misleads investors so as to enrich managers. By contrast, Ronen and Yaari's (2008) definition of earnings management sees it as a means to signal managers' private information about long-term firm value to better inform investors. Whether earnings management is good or bad depends on the degree of alignment of managers' interests with those of shareholders: misaligned incentives induce pernicious earnings management, whereas aligned incentives induce beneficial earnings management. The pernicious version posits that, because accounting information is widely used by investors, security analysts, and regulators, managers have incentives to manipulate earnings to influence the short-term stock performance and facilitate compliance with debt covenants or regulatory requirements. The

discussion in this paper is focused on this view of earnings management and the way in which it is facilitated by the Chinese accounting standards governing fair value measurement.

In 2007, the Chinese accounting standards addressed fair value measurement in the context of property investment, biological assets, and financial instrument recognition and measurement, etc. Compared to historical costs, fair value measurement is believed to be more value relevant, conducive to reducing agency costs and improving management efficiency, and informative to the investors (Barlev et al., 2003). Penman and Zhang (2002), on the other hand, argue that the fair value measurement designed to improve the relevance of the balance sheet can impair income statement's ability to predict future earnings and cash flows. Many studies focus on the relationship between fair value measurement and earnings management. For example, Song (2008) finds that banks with higher earnings volatility are more willing to adopt fair value measurement and tend to use fair values when earnings are less than expected. Barth and Taylor (2010) study the relationship between earnings management and asset securitization and find that, since the accounting treatment of asset securitization earnings requires professional evaluation, managers use their discretion to estimate fair value so as to smooth earnings.

In 1993, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards No. 115 - Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115 hereafter), which requires companies to classify security investments as held-to-maturity, held-for-trading, or available-for-sale in accordance with managerial intention. SFAS 115 triggered waves of academic interest and discussions of financial assets and earnings management. Ivancevich et al. (1996) find that the phrase "managerial intentions" used in SFAS 115 provides firms with an opportunity to manage earnings, either by increasing or smoothing earnings. As a consequence, it is possible that

companies with similar security investments disclose very different numbers on their financial statements. Cocco and Lin (1997) argue that managers tend to classify equity investments with rising market prices as held-for-trading, which helps maintain EPS growth. Jordan et al. (1998) argue that insurance companies are the most affected by SFAS 115 and are more likely to classify security investments as available-for-sale to maintain liquidity and solvency. Indeed, as Abdel-khalik (2012) points out, the *Report of the Special Examination of Freddie Mac* details how Freddie Mac's management opportunistically exploited the different income effects resulting from the classifications of securities under FAS 115. In doing so, they achieved accounting results at an expense of incurring economic losses. Also, drawing from the same *Report of the Special Committee to Examine Fannie Mae*, Abdel-khalik (2012) quotes Mr. Parks, the vice president for financial standards, who, while lamenting the curtailing of Fannie Mae's ability to manage earnings through portfolio sales, nonetheless quips: "... Earnings management would still be possible, to some extent, by establishing a separate portfolio of available-for-sale securities". Mitigating the effects of pernicious earnings management is not easy, especially in light of auditors' lack of independence, potentially stemming from their conflict of interest. Dontoh, Ronen, & Sarath (2013) propose a financial statement insurance mechanism to reduce the auditors' conflict of interest.

In China, research related to the quantification of financial assets and earnings management began after 2006, when the accounting standards formally added fair value measurement to accounting for financial assets. Wu et al. (2009) find that listed companies often realize the gain on security investments by managing the sales time. Ye et al. (2009) provide empirical evidence that companies with more financial assets are more inclined to classify financial assets as available-for-sale, mainly to build a reserve for earnings management and

earnings smoothing; managers may choose to sell or retain the security to stabilize earnings during holding periods. Sun et al. (2010) develop a new measure of management intention and find that the management intentions that firms are instructed to use to classify financial assets by the accounting standards are not effective in practice. The motivation for the classification used in the real world is earnings smoothing. For example, He et al. (2012) use data from China's adoption of IFRS-based and fair value-oriented new accounting standards in 2007 and find empirical evidence of unintended consequences of fair value accounting implementation. Specifically, they argue that the new fair value accounting for trading securities does not improve transparency. Their results also demonstrate that such unintended consequences are more severe among firms with poor corporate governance and those in provinces with weak institutions.

To summarize, companies often take advantage of the accounting rules for financial assets classification and measurement to manage earnings.

III. Institutional Background

Evolution of Accounting Policies Related to China's Equity Investments

The 2001 Accounting Standards for Enterprises - Investment

This standard regulates the accounting treatment and disclosure requirement of business investments. It classifies investments into short-term and long-term investments according to the length of time the company plans to hold the investment.

Short-term investments include any investments that a company expects to hold for less than one year and are listed under current assets. A short-term investment is recorded at purchase price when acquired, and its fair value fluctuations are not recognized during the holding period. If the market price is lower than its book value when the investment is sold, the difference is

recognized as a loss from investment; any dividends received from the investee while holding the securities are used to reduce the investment's carrying value.

Long-term equity investments include any investments that a company expects to hold for more than one year. Long-term investments are classified into four categories based on the amount of control and influence the investing company has over the invested company: controlling investments, jointly controlling investments, investments with significant influence, and investments with no significant influence or control. For the first three categories, the investing company should adopt the equity method, which requires adjusting the investing company's book value and recognizing its share of the net profit or net loss of the invested company as gain or loss from investment. The book value of the investment is reduced if the investing company receives dividends from the investee. For the last category, the cost method is adopted, and the book value of the long-term equity investment is generally not changed. When the investee distributes dividends, the dividends are reflected as gains from the investment only up to the amount of the accumulated net profit generated after the investment. Any dividends received by the investing company are treated as reductions in the initial investment cost. An investing company should periodically check the book value of its long-term investments for impairment. When the market price of the investment continues to drop and the recoverable amount of the investment is lower than its book value, a loss from investment loss is recognized.

Two Guidelines for Equity Investments Established in 2006

1. Accounting Standards for Enterprises No. 2 - Long-Term Equity Investment

In 2006, China issued 38 accounting standards designed to attain convergence with IFRS. Compared with the 2001 accounting standards, the updated accounting standards include the following major changes:

First, the investing company should use the cost method to measure two types of long-term equity investments: controlling investments and investments with no significant influence or control without a readily available market price nor a reliably determinable fair value. The specific application of the cost method has not changed significantly from the 2001 accounting standards.

Second, the other two types of long-term equity investments are still measured using the equity method. However, the 2006 accounting standards take into account the fair value of the identifiable net assets of the investee when applying the equity method. For example, when the initial cost of the long-term equity investment is less than the investor's percentage share of the fair value of the identifiable net assets of the investee, the difference is included in current net income or loss, and the investment cost is correspondingly adjusted. Otherwise, the investment cost is not adjusted.

2. Accounting Standards for Enterprises No. 22 - Financial Instruments Recognition and Measurement

Under these standards, equity investment financial assets include held-for-trading financial assets and available-for-sale financial assets.

Held-for-trading financial assets, as the name suggests, are those held for the purpose of short-term exchanges. They are subsequently measured at fair value, and changes in fair value are included in net income or loss for the current period. Held-for-trading financial assets cannot be reclassified into another category.

Available-for-sale (AFS) financial assets are the other classification option and are also measured at fair value. However, any fair value changes of available-for-sale assets should be included in owners' equity and transferred to current profit or loss upon sale. If AFS financial

assets do not have a readily available market price and have no reliably determinable fair value, they can also be measured using the cost method.

The 2014 Accounting Standards for Enterprises No. 2 - Long-Term Equity Investment

After IAS 28 was revised in 2013, CAS updated the accounting treatment for long-term equity investment in 2014 in accordance with IFRS's provisions. The long-term investment classification does not include investments without significant influence even if the investments do not have a readily available market price and the fair value cannot be reliably determined, similar to IAS 28. All "without significant influence" equity investments follow CAS 22. The revised standard requires that changes in investment category are treated as sales.

The 2017 Accounting Standards for Enterprises No. 22 - Financial Instruments Recognition and Measurement (new CAS 22)

The newly issued CAS 22 is identical to IFRS9, which goes into effect beginning in 2018. The new CAS 22 is effective beginning in 2018 for corporations listed overseas. It will become effective beginning in 2019 for corporations listed in the mainland of China. It will be effective beginning in 2021 for other corporations that will be using the new accounting standards.

We review the financial statements for the finance industry corporations listed in both mainland China and Hong Kong. These corporations used IFRS or Hong Kong Financial Reporting Standards (HKFRS) in Hong Kong and CAS in the mainland of China. We find no differences among the various financial statements in the accounting treatments of financial instruments, suggesting CAS and IFRS treatments of financial instruments essentially coincided after 2009.

IV. Case Study

Background on Youngor Group

Youngor Group Co., Ltd., located in Ningbo City, Zhejiang Province, was established in June 1993 and listed on the Shanghai Stock Exchange in November 1998. The stock is referred to as “Youngor.” Youngor started off as a clothing company and has thus far formed a business structure featuring branded apparel, real estate development, and financial investment.

Youngor's financial investment business began in 1993. In 2007, a professional Youngor investment company was established. In 2012, Youngor started an investment project to “transform from financial to industrial.” At present, this project has become one of Youngor's core businesses, not only diversifying Youngor's business risks but also accelerating Youngor's diversified growth. By the end of 2017, Youngor had made a large number of equity investments, both in listed and private companies, with a total book value of ¥28.655 billion Yuan. This book value accounted for 42.81% of its total assets. According to Youngor's annual report of 2017, the company's realized investment income was ¥3.197 billion Yuan, while the company's annual net profit was only ¥294 million Yuan.

Analysis of Youngor's Use of Financial Assets for Earnings Management under the Original CAS 22

Category Selection When Financial Assets Were First Acquired

The classification of financial assets at the time of initial asset acquisition under the original CAS 22 depends entirely on managers' intention, which means that the classification is hugely subjective and correspondingly not amenable to forming reliable estimates of its accuracy by outsiders. Moreover, the accounting treatment of changes in the fair value of AFS further provides managers with opportunities to manage earnings. If the current profit is expected to be substantial and the company classifies a significant amount of equity financial assets as AFS, then the market price of these equity investments will not affect the net profit at all. However, if

the company expects lower profits, then the management can sell AFS the fair value of which has increased, transfer the unrealized gains accumulated in other comprehensive income to the income statement, and boost current year earnings.

Reviewing Youngor's financial statements over the past decade, we find that Youngor disposed of most of its held-for-trading financial assets in 2011. In 2012, the company sold the only 1 million held-for-trading financial assets left on its books. Until the end of 2017, the book value of Youngor's held-for-trading equity securities has remained at zero. Table 4.1 compares the amount of available-for-sale financial assets and held-for-trading financial assets Youngor held from 2008 to 2012. Table 4.2 lists the company's available-for-sale financial assets from 2013 to 2017. These tables show that Youngor has invested in a huge amount of financial assets in the past ten years. The book value of Youngor's financial assets accounted for 15% to 40% of its total assets. According to Sun et al. (2010), when a company holds more equity investments, managers will ignore the underlying holding intention of the available-for-sale asset and classify it as trading security in order to reduce the variance of reported earnings. Youngor's classification of financial assets is very much in line with this research's conclusion.

Table 4.1 Youngor's Financial Assets for 2008-2012

(¥ in millions)

	2008	2009	2010	2011	2012
Held-for-trading	0.82	893.25	1,136.59	1.00	-
Available-for-sale	4,672.34	11,247.02	12,188.69	9,361.67	8,431.85
Multiple	5,699	13	11	9,362	-
Proportion of total assets	14.77%	28.95%	27.61%	19.13%	16.91%

Note: Multiple = available-for-sale / held-for-trading financial assets

Table 4.2 Youngor's Financial Assets for 2013-2017

(¥ in millions)

	2013	2014	2015	2016	2017
Held-for-trading	-	-	-	-	None for equity investment
Available-for-sale	6,516.69	10,090.78	26,070.12	24,074.27	20,128.10
Proportion of total assets	13.48%	21.19%	39.33%	37.67%	30.08%

According to CAS 30, any investment with a holding intention of less than 12 months should be designated as held-for-trading securities and as AFS beyond 12 months. However, many Chinese companies choose to simply classify all investments as AFS regardless of the initial trading intention because the longer time horizon associated with AFS allows managers to wait for the right moment to sell (Du et al., 2015).

On further investigation of Youngor's annual reports for the past few years, it is not uncommon for Youngor to sell equity investments classified as available-for-sale over a short time span. For example, the company bought 12,833,125 shares of Luzhou Laojiao in 2013 and sold 3,940,445 shares during the same period; the remaining shares were sold in 2014. The company bought 7,414,154 shares of HIT Shouchuang Technology in 2013 and sold all plus more previously purchased shares in 2014. Youngor bought Ping An H shares in 2014 and sold all in 2015; it bought Ping An A shares in 2014, sold a portion in the same year, and the remaining were all disposed of in the following year. Youngor purchased Chunghsin Technology, DuZhe Publishing & Media stocks in 2015 and sold all in 2016. Table 4.3 presents a log of these aforementioned transactions. All of these short-term investments were classified and reported by Youngor as available-for-sale financial assets. Even though it might be difficult to determine the company's underlying holding intention of these stocks, classifying all equity investments as

available-for-sale yet having such frequent short-term transactions calls for suspicion of using equity investment as a tool for earnings management.

Table 4.3 Youngor's available short-term trading of financial assets available for trading in recent years

(in shares)

Available-for-sale financial assets	Number of shares in 2013	Number of shares in 2014	Number of shares in 2015	Number of shares in 2016
Luzhou Laojiao	12,833,125 (3,940,445)	(8,892,680)	-	-
HIT Shouchuang Technology	7,414,154	(41,560,809)	-	-
Ping An Insurance of China H Shares	-	10,690,000	(10,690,000)	-
Ping An Insurance of China A Shares	-	14,005,794 (1,235,794)	(12,770,000)	-
Chungsin Technology Group	-	-	1,000	(1,000)
DuZhe Publishing & Media	-	-	1,000	(1,000)
Shijiazhuang Tonhe Electronics Technologies	-	-	500	(500)
Shanghai Fortune Techgroup	-	-	500	(500)

As for Youngor's insistence on classifying frequently traded financial assets as available-for-sale financial assets, we believe that the main reason for this decision is to reduce the volatility of profits. As previously discussed, fair value changes of held-for-trading financial assets directly affect the current net income, while fair value changes of available-for-sale assets are included in other comprehensive income. Classifying most or even all of the equity financial assets as available-for-sale can effectively smooth away significant changes in net income due to

fair value fluctuation, thereby reducing the instability and unpredictability of the company's profits. Table 4.4 compares Youngor's available-for-sale fair value changes and its net income or loss between 2013 and 2017. This table shows a significant fluctuation in available-for-sale financial assets' fair value over the five-year period, generating an investment profit as high as 3 billion in 2017 and an investment loss as high as nearly 40 billion in 2016. In contrast, Youngor's net profit has consistently increased in the past five years, except for a decline in net profit in 2017. If the available-for-sale financial assets were classified as held-for-trading, the volatility of net profits would have increased substantially, and Youngor's profitability would have fluctuated drastically. Moreover, in 2013 and 2016, Youngor's net profit decreased compared with the previous year, and the fair value changes of available-for-sale financial assets were also negative. If these fair value changes were included in the net income, the decline in net income would have been even greater. To increase reported earnings and minimize the volatility of net profit, Youngor classified all equity financial assets as available-for-sale, taking full advantage of the accounting standards to manage company earnings. This earnings management strategy seems to have been very successful.

Table 4.4 Comparison of Youngor's fair value change of available-for-sale financial assets and net profit in the past five years

(¥ in millions)

	2013	2014	2015	2016	2017
Available-for-sale fair value changes	-345.29	489.22	199.36	-3,985.84	2,875.92
Net income	1,358.96	3,214.82	4,376.01	3,687.34	293.92
Proportion	-25.41%	15.22%	4.56%	-108.10%	978.48%

Proportion = available-for-sale fair value changes / net income

Utilization of Fair Value Changes of Available-For-Sale at Subsequent Measurement of the Financial Assets

According to the original CAS 22, AFS should be recorded at fair value, and changes in the fair value are included in other comprehensive income without affecting current profit. When AFS is sold, the difference between the income from disposal and the carrying amount of financial assets is included in the investment income. At the time of sale, the accumulated amount of fair value changes initially recorded in other comprehensive income is to be transferred to investment income, which will have an impact on net income. This accounting treatment also provides companies with opportunities for earnings management. In order to manage their reported earnings, companies can sell AFS in a manner that works best given the actual profit in that year combined with the AFS market conditions. In other words, the initial classification of financial assets as AFS creates a “water reservoir” for the company to smooth earnings: during the holding period when the company encounters a bad year, it can use AFS to increase earnings; when the company has a good year, it can continue to hold the security, even though selling the asset would be profitable, in order to retain unrealized profits in other comprehensive income to be used in later periods.

Since Youngor set up an investment company in 2007, the scale of equity investment on its books has continuously increased, and the contribution of investment income to profits has also been increasing. In some years, investment profits accounted for a majority of the company’s total profit. Since the end of 2012, Youngor has kept a zero held-for-trading equity investment balance on its book, with all financial assets classified as available-for-sale. The company’s relevant investment income consists of three parts: investment income obtained during the holding period, investment income as a result of differences between sales proceeds

and the book value at the time of disposal, and investment income transferred from comprehensive income to net income at the time of disposal. Table 4.5 presents these three types of investment income for the past five years. This table suggests that investment income from holding and disposing of available-for-sale financial assets brought substantial profits to the company, which accounted for more than 65% of the total profits in 2014. This proportion also approached 50% in 2015 and surpassed 200% in 2017.

All indications suggest that, in order to maintain the stability of reported profits and create a good performance trend, Youngor made full use of the discretions allowed within the accounting standards. After classifying all equity financial assets as available-for-sale, the firm chose an appropriate time to dispose of the securities. With this action, they not only received a significant amount of investment returns, but also successfully managed earnings by transferring cumulative fair value changes accumulated in other comprehensive income into investment income.

Table 4.5 Details of Youngor's Investment Income from Available-for-Sale in Recent Five Years

(¥in millions)

Year	Investment income earned during the holding period	Investment income obtained at the time of disposal	Investment income transferred from other comprehensive income	Total profit	Percentage of total profit
2013	193.46	196.53	176.72	2,129.23	26.62%
2014	204.16	1,570.36	811.84	3,899.31	66.33%
2015	298.77	1,220.35	1,114.97	5,363.93	49.11%
2016	480.88	360.86	219.58	4,567.93	23.23%
2017	701.32	4,065.14	-2,945.03	809.13	225.11%

Reclassification of Financial Assets and Long-term Equity Investments

According to the original CAS 22, no reclassification between FVTPL and other financial assets is allowed after an initial category is selected. What kind of approach should a firm take if it wants to release the AFS fair value changes stored in other comprehensive income to the current profit and loss without selling the assets?

On January 21, 2014, Youngor released a statement titled *Announcement on Changing the Accounting Methods of Ningbo Bank Co., Ltd.* According to the announcement, the company will adjust the accounting method for its investment in Bank of Ningbo Co., Ltd. (Ningbo Bank hereafter) beginning January 1, 2014, changing the original available-for-sale classification to long-term equity investments. The reason for this adjustment was that Youngor held a total of 10.10% of Ningbo Bank's outstanding shares, being the third largest shareholder of Ningbo Bank. After Ningbo Bank changed its board of directors, Youngor's president Hanqiong Li became one of Ningbo Bank's eight directors. Youngor, therefore, is considered to have a significant influence over Ningbo Bank.

The term "significant influence" refers to the investor's right to participate in decision-making regarding the financial and operating policies of the investee, though the investor cannot fully control or jointly control these policies. Table 4.6 details Youngor's equity investment in Ningbo Bank and director appointments in the recent years. Although Youngor's shareholding ratio at Ningbo Bank in 2011 and 2012 was less than 10%, Youngor's president has been serving as a director of Ningbo Bank. In 2013, Youngor's shareholding in Ningbo Bank surpassed 10%, making it the third largest shareholder of Ningbo Bank. Youngor's president, Rucheng Li, also became one of eight directors at Ningbo Bank. By the definition of "significant influence,"

Youngor had significant influence over Ningbo Bank’s decision-making on essential issues both prior to and after the announcement of the accounting adjustment. However, the company had been using available-for-sale assets to account for its equity investment in Ningbo Bank prior to the announcement, which was changed in 2014 to long-term equity investment on the books.

Table 4.6 Youngor's Changes in the Classification of Equity Investment of Bank of Ningbo, 2011-2014

Year	Book value at the end of the period (in millions Yuan)	The shareholding ratio at the end of the period	Classification	Note
2011	2,082.98	7.89%	Available-for-sale	The company sold 220 million shares of Ningbo Bank this year and earned revenue of 192 million RMB. Company president Rucheng Li serves as a director at Ningbo Bank.
2012	2,227.94	7.25%	Available-for-sale	The company sold 144 million shares of Ningbo Bank in the current year and earned revenue of 163 million RMB. Company president Rucheng Li serves as a director at Ningbo Bank.
2013	2,689.16	10.10%	Available-for-sale	The company changed its financial investment business and increased strategic investment in Ningbo Banks by a total of 898 million Yuan. Company president Rucheng Li serves as a director at Ningbo Bank.

2014	3,797.43	10.93%	Long-term equity investment	The company reclassified Ningbo Bank as a long-term equity investment. Company's president and managing director Hanqiong Li serves as a director of Ningbo Bank.
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On April 30, 2015, Youngor issued a *Plan for A Non-Public Share Issuance in 2015*. On the same date, the Board of Director Meeting #13 was held, in which the pricing reference date was announced. The stock pricing principle requires that the offer price on a non-public offering date be no lower than 90% of the average stock trading price of 20 trading days before the pricing reference date. Although Youngor's 2014 annual report was issued on April 30, 2015, Youngor released an *Express Announcement of 2014* on April 11, 2015; this date was 20 trading days before the annual report release, as per the stock pricing principle. The announcement shows that the company's operating income and total profit increased over the previous year. The net profit attributable to the shareholders increased by more than 130%, primarily due to the company's adjustment of the accounting treatment of Ningbo Bank from AFS to equity method in 2014. Under IAS 28, reclassification is treated as disposal, which does not require unrealized items in other comprehensive income to be transferred to profit or loss. The significant growth of the company's performance in 2014 gave a healthy boost to Youngor's stock price. On April 10, 2015, Youngor's stock closed at ¥11.36 Yuan per share, while the non-public issuance price could not be lower than ¥17.58 Yuan per share, demonstrating that releasing the company's 2014 earnings numbers had a huge impact on Youngor's stock price increase. Youngor's changes in the accounting treatment of Ningbo Bank stockholdings in 2014 is the critical contributor to the successful implementation of a high-priced non-public offering. We cannot determine whether Youngor's management began developing the non-public offerings in early 2014, but it is very

likely that Youngor adjusted its accounting treatment of Ningbo Bank to make the non-public offering in 2015 at a relatively high price.

In 2015, Youngor increased its shareholding in Zheshang Insurance from 18% to 21% and claimed that, as a result, it gained significant influence over Zheshang Insurance. The 18% shares cost ¥270 million. Youngor paid ¥87.75 million for the additional 3% shares, which indicates that Youngor paid $(87.75 \div 3\%) / (270 \div 18\%) = 1.95$ times the shares' value in premium for the 3% new shares. Youngor did not recognize gain or loss for the reclassification. We can conclude that Youngor accounted for the investment under the assumption that the fair value of Zheshang Insurance's stock could not be reliably estimated and, consequently, the investment had to continue to be recorded at cost under the equity method. It seems that corporations acquiring private entities can invoke in active markets to avoid fair value measurement used under the old CAS 22.

On April 8, 2016, Youngor issued an *Announcement on Changes to the Accounting Methods of Ningbo Yak Technology Industrial Co., Ltd.*, stating that Youngor will adjust the accounting treatment of Ningbo Yak Technology Industrial Co., Ltd. (Ningbo Yak hereafter) beginning on March 17, 2016. The accounting treatment would change from long-term equity investment to available-for-sale financial assets. The reason for the adjustment is that Youngor's shareholding ratio after Ningbo Yak had completed an asset restructuring was reduced from 30.08% to 13.18%, causing Youngor to drop from the first to the second largest shareholder. Additionally, the number of recommended Youngor directors decreased from two to one, and Ningbo Yak added two additional outside directors to form a nine-member board. Consequently, Youngor's percentage of seats held at Ningbo Yak's board decreased.

Compared to Ningbo Bank, Youngor's proportion of board seats at Ningbo Yak is

smaller, but the proportion of shareholding is larger. Therefore, Youngor's decision to change the accounting treatment of Ningbo Bank from available-for-sale assets to long-term equity while changing the accounting treatment of Ningbo Yak from long-term equity to available-for-sale assets seems exceptionally unreasonable. When long-term equity investment is changed to available-for-sale financial assets, the difference between the book value and the fair value on the conversion date must also be included in investment income. Therefore, changing the accounting treatment of Ningbo Yak created ¥1.241 billion Yuan of current investment income for Youngor. Youngor's total net profit was only ¥3.685 billion Yuan in 2016, of which 33.67% was generated by changing Ningbo Yak's accounting method. This suggests Youngor probably chose to manage earnings using equity investment reclassifications, resulting in very significant increases to their net profit.

Analysis of Earnings Management Potentials under the New CAS 22

The new CAS 22 puts forward more extensive requirements for fair value measurement of financial assets. Under the original CAS 22, AFS is measured at fair value, but when there is no readily available market price and its fair value cannot be reliably measured, AFS is to be measured at cost. However, under the new CAS 22, both FVTPL and FVTOCI require the use of fair value measurement. Only under limited circumstances can cost be used instead of fair value, and the seven indicators that cost might not be representative of fair value include, but are not limited to: A significant change in the: (1) Performance of the investee compared with budgets, plans or milestones; (2) Market for the investee's equity or its products/potential products; (3) Performance of comparable entities, or in the valuations implied by the overall market; (4) Global economy or economic environment in which the investee operates; (5) Changes in expectation that the investee's technical product milestones will be achieved; (6) Internal matters

of the investee such as fraud, commercial disputes, litigation, changes in management or strategy;
(7) Evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties. (Same as IFRS 9.B5.2.4)

Entities that invest in unquoted equity instruments that are measured at cost under the original CAS 22 must proactively consider how fair value will be determined when adopting new CAS 22. This may include consulting with a valuation specialist and establishing processes to obtain information from relevant investees in order to measure fair value and provide the CAS 39 Fair Value Measurement disclosures at each reporting period.

The new standard creates a big challenge for Chinese companies for two reasons. First, China's capital market is still immature. Because of this, information asymmetry is prevalent and many financial instruments are not actively traded, making it exceptionally difficult to acquire reliable fair value estimates. This challenge is especially acute in the case of equity investments in unlisted companies. Moreover, in the case of companies listed on the new third market, it is difficult to obtain fair values due to the lack of liquidity. Second, under the original standard, many companies rarely estimated the fair value of financial assets in order to minimize the costs of preparing financial statements. As a result, the fair value estimation technology used under the new standard is in its infancy: fair value estimation involves many complex issues such as constructing the model and selecting parameters. It is a long and difficult process that requires a great deal of time and resources for companies to improve estimation accuracy gradually. The application of level 3 fair value measurement relies extensively on subjective judgment and estimates, providing opportunities for earnings management (Dechow, 2010) and reducing the reliability of accounting information. For instance, Benston (2006) points out that the managers

at Enron and WorldCom did not hesitate to inflate current profits using level 3 fair value measurement. Christensen et al. (2012) state that, because of the complexity and uncertainty of level 3 fair value measurement, high-quality auditing may become unobtainable. As a result, the new CAS 22 is forcing companies to present at fair value low-holding equity investments or investments in equity instruments that are thinly traded in the relatively undeveloped Chinese capital market, where valuation techniques are unsophisticated as of yet. This potentially contributes to two consequences. First, the estimation may not be realistic, even while imposing significant costs on the company. Second, companies will choose from a variety of potentially unreliable measures to come up with an estimated number, resulting in managed earnings that serve the potentially short-term interests of managers. Neither consequence is intended by the new CAS 22, yet both are likely to happen.

To summarize the above analysis, the changes in the new CAS 22 on financial asset classification, subsequent measurement, and provisions for impairments reduce companies' abilities to manage earnings through investing in financial assets. This reduction seemingly leaves companies with less discretion. At the same time, however, the enhanced requirements on fair value measurement introduce new opportunities for earnings management. How will companies respond to the new CAS 22? Are there any imperfections in the new accounting standards that need further improvement? In the subsequent part of this paper, we use Youngor as an example to elaborate the potential effects of applying the new standards.

Predictions about Youngor's Accounting Treatment of Its Financial Assets under the New CAS 22

Initial Financial Assets Classification

Equity investment is one of the three major businesses of Youngor. Investment income

related to financial assets has always contributed considerable profits to the company. In the past five years, Youngor's investment income from financial assets accounted for 26.62%, 66.33%, 49.11%, 23.23%, and 225.11% of its total profit, respectively. Table 4.5 details these numbers. Most of Youngor's investment income comes from the sale of available-for-sale financial assets. Youngor will use the new CAS 22 beginning in 2019. According to the new CAS 22, however, Youngor can only classify equity investments as either FVTPL or FVTOCI. If a financial asset is classified as FVTOCI, any changes in fair value can only be included in the other comprehensive income section. Even if the asset is sold, the company cannot move investment income into current profit, and the designation of an asset as FVTOCI is irrevocable. For Youngor, if all of its financial assets are classified as FVTOCI, Youngor's profits will shrink dramatically. Equity investment is one of the three major businesses of Youngor, but the investment profits cannot be included in the income statement from the beginning to the end. Therefore, we predict that Youngor will designate most of its financial assets as FVTPL. Among companies that follow the new CAS 22 in China, Huatai Securities, also listed overseas, explicitly classified almost all of its equity investment financial assets as FVTPL instead of FVTOCI in its 2018 first quarterly report.

What will happen if Youngor classifies all of its financial assets as FVTPL? The most obvious impact would be a significant increase in profit volatility. Equity investment is one of the three major businesses of Youngor, and the amount of financial assets involved has always been considerable. As shown in Table 4.7, Youngor's financial assets accounted for 13.48%, 21.19%, 39.33%, 37.67%, and 30.08% of its total assets in the past five years, respectively. The scale of financial assets in the recent few years has continued to grow, especially the available-for-sale assets measured at fair value. If all available-for-sale financial assets are classified as

FVTPL, the sizeable fair value changes would directly affect current profits. As shown in Table 4.8, the amount of fair value changes of the available-for-sale assets classified in Youngor's other comprehensive income over the past five years is huge. This amount varies from year to year, with the proportion of fair value changes making up as high as 56.62% of 2013's total profit. The amount of fair value changes in 2014 and 2015 decreased and further declined in 2016, but, in 2017, the fair value of available-for-sale changed by nearly 2.9 billion RMB. If this fair value change was added to the current profit, Youngor's profits would fluctuate violently. Moreover, this volatile profit would be the result of Youngor's timely disposal of available-for-sale financial assets for earnings management. The new accounting standards completely eliminate the possibility of such earnings management. We can, therefore, imagine the amount of fluctuation in current profits that would occur under the new CAS 22 if all financial assets were classified as FVTPL. The volatility of profits after the assets are all put into FVTPL will be even more severe. In China, any listed firms with two consecutive losses are marked as ST (Special Treatment) companies. Classifying financial assets as FVTPL will create a great deal of pressure for companies to classify financial assets as long-term equity investments, measured using the equity method to avoid the potential volatility.

Table 4.7 Details of Youngor's Available-for-sale Financial Assets in the Recent Five Years

(¥in millions)

	2013	2014	2015	2016	2017
Measured at fair value	6,516.69	5,570.54	22,204.95	20,438.55	16,580.49
Measured at cost	0.00	4,520.24	3,865.16	3,635.72	3,547.60
Proportion of total assets	13.48%	21.19%	39.33%	37.67%	30.08%

Table 4.8 Impact of Fair Value Changes of Available-for-sale on Total Profit in the Recent Five Years

(¥ in millions)

	2013	2014	2015	2016	2017
Fair value changes of available-for-sale	1,205.58	489.22	199.36	-3,985.84	2,875.92
Total profit	2,129.23	3,899.31	5,363.93	4,567.93	809.13
Fair value changes as a percentage of total profit	56.62%	12.55%	3.72%	-87.26%	355.43%
Total profit including fair value changes	3,334.81	4,388.52	5,563.30	582.09	3,685.05

Reclassification of Financial Assets and Long-term Equity Investments

When the investing company has significant influence or joint control over the invested entity, the long-term equity investment should be accounted for using the equity method. Comparing the accounting treatments of long-term equity investments and the new CAS 22 equity-related financial assets, one noticeable difference is that the impact of fair value changes on long-term equity investments is smaller. In order to retain the equity investment and at the same time reduce the impact of fair value changes on investment return, thereby reducing the volatility of company profits, we believe that Youngor will consider increasing the holding of some financial assets by gaining significant influence or joint control of the invested entity. Profitable long-term equity investment can secure a decent investment return without introducing volatility into the income statement due to fair value changes.

Long-term equity investment is one of the prominent businesses of Youngor. Investment income related to long-term equity contributes to the profits by a fair amount (see Table 4.9). In

the recent years, the proportion of long-term equity investment income in total profits has continuously increased. In particular, when the company performance declined in 2017, this proportion exceeded 130%, with the long-term equity investment income under the equity method being as high as ¥1.043 billion Yuan. This fact suggests that Youngor has accumulated significant experience in long-term equity investment management in recent years and has also earned a significant amount of profit. Under the new CAS 22, Youngor is expected to further streamline its long-term equity investment management to reduce the fluctuation of profit from changes in fair value of financial assets.

Table 4.9 The contribution of long-term equity investment income to total profit

(¥in millions)

	Long-term equity investment income under the equity method	Investment income from disposal of long-term equity investment	Total investment income	Total profit	The proportion of investment income in total profit
2012	98.78	54.66	153.44	2,216.85	6.92%
2013	28.87	2.58	31.45	2,129.23	1.48%
2014	565.97	-5.44	560.53	3,899.31	14.38%
2015	884.14	0	884.14	5,363.93	16.48%
2016	991.06	1,368.53	2,359.59	4,567.93	51.66%
2017	1,043.40	64.67	1,108.07	809.13	136.95%

At the same time, we expect that Youngor will increase the holding of some equity investment so as to enhance its influence in investees by increasing shareholding and designating board members. By reclassifying the financial assets as long-term equity investments, Youngor will be able to reduce the impact of equity investment fair value changes on the volatility of

company earnings while still preserving the return on investment. Of course, Youngor will choose the right time and select appropriate stocks to increase holdings. Doing so will help smooth earnings by reducing earnings volatility, as Youngor did in 2014 by changing the accounting treatment of Ningbo Bank.

On April 10, 2018, Youngor issued an *Announcement on Changing the Accounting Treatment of the CITIC Group*, stating that beginning March 29, 2018, Youngor will now classify its investments in CITIC as long-term investments instead of available-for-sale financial assets. There are two reasons associated with this change: first, the company's vice president and chief financial officer Youguang Wu was appointed as a non-executive director of CITIC on March 20, 2018. Second, Youngor is the third largest shareholder of CITIC Group, and its holding of CITIC shares increased from 4.99% to 5.00% on March 29, 2018. This shareholding increase resulted in Youngor gaining a significant impact on the operating decisions of CITIC, as well as a non-operating income of ¥9.302 billion RMB⁴, yet it is unclear if the shareholding increase and recent appointment will be sufficient to allow Youngor to have a significant impact on the business decisions of CITIC. Facing a sharp drop in its performance in 2017 and the needs to plan ahead for the new CAS 22, which will be effective in 2019, Youngor apparently began to reclassify its financial assets to reduce the volatility of future earnings. On April 25, 2018, Youngor disclosed a *Comment Letter from the Shanghai Stock Exchange Regarding Changes in Accounting Treatments* that suggested the announced accounting treatment change attracted the

⁴ According to the relevant accounting standards, when the initial cost of a long-term equity investment is less than the percentage shares of the investee company's fair value of the net identifiable assets, the difference should be recorded as current non-operating income. Youngor regarded CITIC Limited's net assets as the fair value of its net identifiable assets and recognized the difference between its percentage shares of CITIC's book value and the net identifiable assets of ¥9.302 billion Yuan as non-operating income. Youngor spent ¥17 billion Yuan to purchase CITIC shares in 2015, averaging \$14 HK Dollars per share. CITIC had a closing price of \$13.72, \$11.1, and \$11.28 HK Dollars per share between 2015 and 2017. On March 29, 2018, CITIC had a net asset per share of approximately \$18.94 HK Dollars with a trading price of only \$10.98 HK Dollars per share.

attention of the Shanghai Stock Exchange. On April 26, 2018, Youngor released an *Announcement on the Cancellation of Changing the Accounting Treatment of the CITIC Group*, confirming that this accounting treatment change was not merited. From the file No.ZA193 (BDO China, 2018), auditors of the Shanghai Stock Exchange commented that holding 1,000 more shares will not substantially increase Youngor's influence over CITIC, not to mention that the top two CITIC controlling groups hold 78.13% of CITIC's total shares. Youngor's 5% voting right as the third largest shareholder is therefore not seen as enough to exert significant influence. Additionally, the non-executive directors appointed by Youngor did not serve on any major committees at CITIC. Therefore, Youngor's basis for changing the accounting of CITIC from available-for-sale financial assets to long-term equity investments is insufficient.⁵

We believe that Youngor reclassified the investment in CITIC from AFS to long-term equity investment to avoid having increased earnings volatility, a potential result of implementing the new CAS 22 in 2019. Reclassifying the investment would allow Youngor to avoid making a choice between FVTPL and FVTOCI when reporting a non-operating income. In addition, CITIC has continuously reported annual net income of about \$40 billion HK Dollars in the past few years. If this trend continues, Youngor can record an investment income of over \$2 billion HK Dollars each year under the equity method.

Application of Fair Value

By the end of 2017, Youngor's available-for-sale financial assets measured at cost is

⁵ The Shanghai Stock Exchange's intervention fully demonstrates that the quality of Chinese auditors is affected by relationship and supervision (Du et al., 2015). Du et al. (2015) find that Guanxi undermines auditors' ability to correct earnings management. Specifically, when auditors have close bonds (Guanxi) with managers, they are less likely to recommend adjustments. Oppositely, the Shanghai Stock Exchange's attention to the listed company has a positive effect on auditors' performance, as harsh penalties/sanctions enhance their willingness to challenge managers' decisions. Whether it is Youngor or other companies, the practice of reclassification between financial assets and long-term equity investment for earnings management will likely continue, but it will be implemented more cautiously after the aforementioned incident.

¥3.548 billion RMB, accounting for 5.30% of its total assets, and available-for-sale assets measured at fair value is ¥16.580 billion RMB, accounting for 24.78% of its total assets. Table 4.10 provides more details. It is reasonable to conclude from the table that Youngor chooses the measurement method according to whether the investee is listed, as fair value measurement is straightforward for listed companies. For non-listed companies, though, Younger measured all non-listed equity investments at cost. Under the new CAS 22, this accounting treatment is almost always prohibited. Under the new standard, what will Youngor do with these financial assets?

Table 4.10 Details of Youngor's major available-for-sale financial assets at the end of 2017

(¥ in millions)

Classification	Invested company	Book value at the end of the period	Shareholding/number of shares (million shares)
Measured at cost	China UnionPay Merchant Services Co.	116.83	1.50%
	Ningbo Jintian Copper (Group) Co.	133.20	3.05%
	Mianyang Sci. & Tech. Mega-Center Development Investment (Group) Co.	76.57	2.22%
	Jiangxi Lianchuang Silicon Valley Paradise Integrated Circuit Industry Fund Partnership (Limited Partnership)	34.00	10.00%
	PetroChina Pipeline Co., Ltd.	3,000.00	1.32%
	CITIC Mezzanine (Shanghai) Investment Fund (Limited Partnership)	42.00	1.96%
	Ficont Industry(Beijing) Co., Ltd	50.03	3.79%
	Subtotal	3,402.61	
	Measured at fair value	00267.HK CITIC Limited	13,714.53
600000 Shanghai Pudong Development Bank Co.		901.62	7,161.42

	002470 Kingenta Ecological Engineering Gp Co	1,231.59	13,460.00
	300451 B-Soft Co Ltd	260.37	1,204.29
	002036 LianChuang Electronic Technology Co Ltd.	472.38	2,910.53
	Subtotal	16,580.49	

Under the new CAS 22, the amount of financial assets that can be measured at cost are very limited. The new standards not only state that all equity financial assets must be measured at fair value, but it also lists the specific circumstances where cost cannot represent the best fair value estimate. These circumstances include changes in the operating performance, technologies, products, markets, and strategies of the investee, as well as changes in the global economy and the economic environment surrounding the investee and whether the investee is involved in equity transactions with a third party. However, the reality is that, due to the imperfection of the Chinese capital market and the immaturity of companies' valuation techniques, it is almost impossible to measure equity financial assets entirely at fair value, as has been previously discussed. Therefore, Youngor needs to increase its investment in valuation techniques. This will entail setting up valuation processes and internal control systems, increasing the accounting personnel's training on valuation techniques, using appropriate technologies and models in valuation (e.g., the market approach, the income approach, the cost approach), choosing appropriate parameters, and paying close attention to the evolving performance of the investee. Valuation experts will have to be hired if necessary. Additionally, Youngor will need to make proper disclosures in its annual reports to inform investors about the reason for the choosing cost as the best estimate of fair value, as well as valuation processes and techniques used and the

input values. In light of these difficulties and uncertainties, Youngor will continue to have opportunities to manage earnings using fair value measurements.

The Conclusion of the Case Study

To summarize, below are some predictions on how Youngor will use financial assets to manage earnings under the new CAS 22:

First, the new standards will expand the range of financial assets measured at fair value. Youngor will need to increase investment in fair value estimation techniques, gradually establishing appropriate valuation processes and internal control systems. It may need to hire valuation experts. Youngor is likely to use fair value estimation to manage earnings.

Second, Youngor will continue to use the reclassification of financial assets into long-term equity investments by increasing shareholdings in individual companies. It will also continue to attempt to gain significant influence or joint control over investees through appointing directors. These actions will be undertaken for the purpose of reclassifying financial assets into long-term equity investments, thus helping to retain investment income while avoiding the impact of fair value changes on the volatility of earnings. However, after Youngor's failed attempt to change the accounting treatment of CITIC Group, we believe that Youngor will be more cautious when trying to apply the same changes in the future.

V. Conclusion

The continuous convergence of the Chinese accounting standards and the IFRS has brought specific changes to the institutional environment of Chinese companies. The new standards limit the potential for companies to use financial assets to manage earnings by tightening the requirements on the classification and measurement of financial assets. These adjustments help improve the quality of accounting information, reduce information asymmetry

between companies and financial statements users, and increase the quality of the decisions of interested stakeholders. Additionally, the new standards provide timely feedback to the company regarding financial risks and help effectively prevent and resolve these problems. The new standards require companies to introduce high-quality fair value estimation techniques aimed at further enhancing the company's accounting quality. Nonetheless, we point out a few potential issues associated with the accounting treatment of financial assets under the new CAS 22:

First, according to the classification requirements introduced by the new standards, more equity financial assets are to be classified as FVTPL, with any changes in fair values directly affecting current profits and losses. Although the company can classify a financial asset as FVTOCI, this designation is irrevocable, and any changes in fair value cannot be transferred to current profit or loss even upon disposal. Therefore, it is expected that most of the equity financial assets will be classified as FVTPL.

Some companies have uncovered a way to boost book income indefinitely by classifying stock investments as FVTOCI. This method recognizes dividend as income and ignores any profit or loss from stock price fluctuation, especially for dividend-paying mature profitable companies trading in stable or even depressed stock markets. FVTOCI equity investment does not recognize any profit or loss except for dividends. The treatment is not only incompatible with the conceptual framework, but it also provides companies with the flexibility to manage earnings in the future. Firms may classify investments as FVTPL or FVTOCI based on the characteristics of the investee companies, which leads to the same outcome as before: managers classify the investments based on their holding intentions.

Second, the standards require all equity financial assets to be measured at fair value. The standards list seven situations where cost cannot be used to represent the best fair value estimates,

providing very limited situations where measuring financial assets at costs are permitted. In practice, however, equity investments in non-listed companies are almost always measured at cost. The new standards impose more rigorous requirements for quantifying equity financial assets, which are very difficult to apply in practice. The only reference companies can use for guidance is the 2014 *Accounting Standard for Enterprises No. 39 - Fair Value Measurement*. The standard does not detail how to estimate unlisted equity investments, which in turn leads to greater difficulties for companies in selecting valuation techniques and parameters. It may also create additional opportunities for companies to use fair value estimation for earnings management. For a country like China where the market is not active and auditors are not sufficiently independent, an option for non-listed companies to measure investments at cost should be considered.

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