INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN ACCOUNTING, FINANCE AND MANAGEMENT SCIENCES

OPEN ACCESS JOURNAL

Vol 16, Issue 1, (2026) E-ISSN: 2225-8329

Earnings Management, Valuation Reallocation, and the Role of Audits: Resolving the Value Relevance Puzzle in China

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DOI Link: http://dx.doi.org/10.6007/IJARAFMS/v16-i1/27876

Published Online: 30 March 2026

Abstract

This study investigates a puzzling phenomenon in China's A-share market: the declining value relevance of accounting information amidst improving formal accounting standards. Challenging the conventional "erosion hypothesis," we document a complex market response to earnings management. While a baseline positive association with firm valuation might suggest a signaling role, more rigorous analysis addressing endogeneity calls this interpretation into question. Instead, we find that the primary market reaction is a sophisticated "valuation reallocation." Investors strategically respond to earnings management by discounting the value relevance of manipulable accruals while increasing their reliance on the more verifiable book value. This reallocation reinterprets the aggregate decline in value relevance not as an abandonment of accounting information, but as a shift in its usage (Collins et al., 1997; Lev & Zarowin, 1999). Furthermore, high-quality Big Four audits provide a partial buffer (Becker et al., 1998; Francis, 2004), attenuating the negative impact of earnings management on the value relevance of accruals. Our findings, robust to endogeneity concerns and alternative specifications, offer a more nuanced understanding of how markets process accounting information in imperfect institutional environments.

Keywords: Value Relevance, Earnings Management, Valuation Reallocation, Audit Quality, Emerging Markets

Introduction

A foundational assumption in accounting is that market values are anchored in financial statement information. Yet, in China’s dynamic capital market—despite decades of regulatory reform and substantial IFRS convergence—the value relevance of accounting information has experienced a pronounced and persistent decline (Xie et al., 2020). This presents a critical puzzle: why has the decisionn-usefulness of accounting information diminished in an era of purported improvement?

This observed decline in China resonates with a global scholarly debate on the evolving nature of value relevance. While some studies document a decline in mature markets, attributing it to the rise of intangible assets and changing business models (Lev & Zarowin, 1999), others argue for a more nuanced evolution rather than a simple erosion (Barth et al., 2001). Recent research further contends that the decline does not necessarily signal the irrelevance of accounting information, but rather its evolution and reallocation within a changing economy (Barth et al., 2023). Our study contributes to this evolving paradigm by identifying a specific, micro-level mechanism—strategic valuation reallocation by investors—that explains the macro-level trend in an emerging market context.

The conventional explanation, derived from mature markets, points to the corrosive effect of earnings management, which erodes trust and leads investors to discount financial reports uniformly (Healy & Wahlen, 1999). In contrast, a signaling perspective suggests that discretionary accruals could be priced positively as an indicator of future performance (Subramanyam, 1996). In the conventional view, the role of high-quality assurance services is to act as a bulwark against this erosion, enhancing credibility and the value relevance of earnings (Becker et al., 1998; DeFond & Zhang, 2014), though its efficacy in emerging markets like China, with unique institutional pressures, remains a subject of inquiry(Chen et al., 2022). However, evidence from China's A-share market overturns a central premise of the earnings management literature—that it uniformly erodes trust and leads investors to discount financial reports. We document a counterintuitive finding: in baseline tests, earnings management is associated with higher market valuations. This initial finding reveals a non-monotonic, component-specific market response that prior models cannot explain. Yet, this apparent signal creates a deeper conundrum: if earnings management is positively valued, why does it coincide with a broad decline in the overall value relevance of accounting information?

We resolve this paradox by introducing a novel theoretical framework: strategic valuation reallocation. We posit that the aggregate decline is not a symptom of accounting's failure but a signature of investor sophistication. We argue that investors do not respond monolithically by simply discounting or embracing reported figures. Echoing the foundational work on the differential properties of accounting components (Sloan, 1996), they engage in a sophisticated process of reweighting. They discount the most manipulable elements—accruals—while simultaneously increasing their reliance on more stable and verifiable measures, such as book value. This framework reconceptualizes the aggregate decline in value relevance not as a breakdown in the use of accounting information, but as a fundamental shift in how it is used by sophisticated market participants.

Within this dynamic, the role of external assurance becomes more nuanced. We investigate whether high-quality audits can buffer this reallocation process by certifying the reliability of accruals, thereby shielding them from investor discounting and preserving their role in valuation.

To test this integrated framework, we conduct a comprehensive analysis of China's A-share market from 2005 to 2024. Our findings robustly support it. While a baseline positive association between earnings management and firm value exists, more rigorous analysis reveals that the primary market reaction is one of strategic reallocation. We find that earnings management significantly weakens the value relevance of accruals while strengthening the relevance of book value. Furthermore, high-quality audits provide a significant buffer, attenuating the negative impact of earnings management on accruals' value relevance.

This study makes several key contributions. Theoretically, we move beyond the simplistic 'erosion versus signal' dichotomy by introducing valuation reallocation as a third path, revealing investor sophistication in imperfect markets. Empirically, we provide robust, large-sample evidence that redefines the consequences of earnings management. Practically, our findings offer critical insights for investors interpreting financial reports, regulators evaluating auditing efficacy, and standard-setters understanding the real-world use of accounting information in emerging economies.

The remainder of the paper is structured as follows. Section 2 reviews the literature and develops hypotheses. Section 3 describes the research design. Section 4 presents the empirical results, and Section 5 concludes.

Literature Review and Hypothesis Development

The documented decline in value relevance establishes the core empirical puzzle motivating our study. The prevailing narrative, largely shaped by evidence from mature markets, characterizes earnings management as an agency cost.

The Value Relevance Paradigm and the Emerging Market Anomaly

The inquiry into the value relevance of accounting information—the degree to which financial statement data explain market values—is foundational to capital market research (Beaver, 1968; Ohlson, 1995). This paradigm posits that book value and earnings are key inputs in equity valuation.Subsequent research has extensively applied and validated this framework across global contexts (Barth et al., 2001; Kothari, 2001).In emerging economies like China, the application of this paradigm yields a complex and troubling picture. While early studies confirmed the basic existence of value relevance (Chen et al., 2001; Xue et al., 2008; Zhu et al., 2009), the post-2007 era of substantial IFRS convergence has been marked by a persistent and well-documented decline in value relevance (Xie et al., 2020).

As evidenced in our own longitudinal analysis (Table 5 and Figure), the explanatory power (Adj. R^2) of core accounting information for the market value of A-share firms has exhibited a pronounced downward trajectory from 2005 to 2024. This empirical reality creates a critical scholarly puzzle: why has the decision-usefulness of accounting information diminished in an era of purported regulatory improvement?

This divergence points to a fundamental insight: the value of financial reporting is not solely a function of the standards themselves but is fundamentally determined by how that information is interpreted by investors (Barth et al., 2008). Consequently, scholarly attention has shifted from the standards per se to the determinants of accounting quality, primarily earnings management, and the governance mechanisms, such as assurance services, designed to uphold it.

Earnings Management: Re-examining Its Consequences Amidst Declining Relevance

The prevailing narrative, largely shaped by evidence from mature markets, characterizes earnings management as an agency cost that impairs the reliability of earnings and undermines their value relevance (Dechow et al., 2010; Healy & Wahlen, 1999). This perspective is supported by evidence that investors rationally discount earnings upon perceiving manipulation (Sloan, 1996), thereby severing the link between reported performance and market value. This perspective leads to a straightforward prediction: earnings management is negatively associated with the value relevance of accounting information.

Traditional Prediction: Earnings management is negatively associated with the value relevance of accounting information.

An alternative perspective, grounded in signaling theory (Spence, 1973), suggests that in the high-growth, high-information-asymmetry setting of China's market, earnings management may not be interpreted solely as opportunism. It could serve as a costly signal of management's private, positive information about future prospects (Subramanyam, 1996).This signaling role may be particularly pronounced in emerging markets like China, where information asymmetry is high, and alternative information sources are scarce (Wongchoti et al., 2020). This leads to our first hypothesis:

H1 (Signaling Hypothesis): Earnings management is positively associated with firm market value.

It is important to note that H1 and the subsequent valuation reallocation hypotheses are not mutually exclusive. The market could interpret earnings management as a net positive signal while simultaneously engaging in a sophisticated reassessment of the reliability of individual accounting components.

The Valuation Reallocation Hypothesis: A Sophisticated Investor Adaptation

We theorize that the aggregate decline in value relevance masks a more sophisticated, micro-level investor behavior: valuation reallocation.

Modern models of investor cognition suggest that investors are not passive recipients of information but actively select and weight financial data based on its perceived reliability (Blankespoor et al., 2020). While investors may sometimes misweight performance indicators (Akepanidtaworn et al., 2023), we argue that in the face of pervasive earnings management, they rationally and systematically reweight accounting components. Investors are likely to discriminate between accounting aggregates based on their susceptibility to manipulation. Accruals, involving estimation and judgment, are the primary channel for earnings management (Jones, 1991). In contrast, the book value of equity, anchored in historical cost, is more difficult to manipulate. We posit that investors adapt to the noisy information environment by systematically reweighting the valuation multiples they assign to different metrics: they discount the noisier, more manipulable accruals while increasing reliance on the more verifiable book value. This reallocation explains how the overall model fit can decline (the aggregate puzzle) while investors are, in fact, behaving rationally by shifting their focus within the set of accounting information.

H2a: Earnings management weakens (negatively moderates) the value relevance of accruals.
H2b: Earnings management strengthens (positively moderates) the value relevance of the book value of equity.

The Moderating Role of Assurance Services: Can Audits Arrest the Reallocation?
A core function of high-quality external audits is to certify the fairness of financial reporting and constrain manipulation, thereby enhancing credibility (Becker et al., 1998; DeAngelo, 1981; DeFond & Zhang, 2014).

However, the ability of global audit firms to uniformly provide this 'credibility shield' in the Chinese market is a subject of ongoing debate (Chen et al., 2022), where local practice environments can influence audit execution. The critical question is how this certification interacts with the valuation reallocation process that contributes to the overall decline in value relevance.

If high-quality auditors effectively limit accrual manipulation (Jr et al., 2022), they can certify the quality of the accruals component. This certification should, in theory, act as a credibility shield, reassuring investors and mitigating the reallocation away from accruals posited in H2a. The clean opinion from a large auditor serves as a powerful signal that mitigates investor skepticism (Abdollahi et al., 2020). We argue that to the extent high-quality audits are effective, they should buffer the reallocation process.
H3: The negative relationship between earnings management and the value relevance of accruals is weaker for firms audited by high-quality auditors.

Research Methodology
We test our hypotheses using a large-scale, longitudinal dataset of China's A-share listed firms from 2005 to 2024. Our empirical approach incorporates accounting decomposition and a progression from simple value relevance tests to complex interactive models to rigorously examine the signaling, reallocation, and buffering effects.

Sample Selection and Data Sources
The initial sample consists of 61,553 company-year observations. We screen this initial sample according to the following criteria:
Exclude listed companies in the financial sector;Exclude companies with negative net assets;Exclude companies subject to special treatment (ST, *ST);Exclude companies listed for less than one year;Exclude observations with missing data for key variables for more than three consecutive years;To mitigate the impact of outliers, all continuous financial variables are winsorized at the 1% and 99% percentiles. After these screening and processing steps, we ultimately obtain 52,721 valid company-year observations.

The data for this study were primarily sourced from China Stock Market and Accounting Research (CSMAR) database, and the Wind financial terminal to ensure data authority and consistency. Missing data were manually supplemented by reviewing the annual reports of listed companies. Data preprocessing was performed in Excel, and subsequent descriptive statistics, correlation analysis, and regression analysis were conducted using Stata 16.

Variable Definition and Measurement

Dependent Variable: Market Value

Market value: Drawing on the classic approach of Ball and Brown (1968) and Ohlson (1995), this variable is measured by multiplying the year-end stock price four months after the end of the company's fiscal year by the total number of shares. For ease of analysis, this value is converted to billions of yuan by dividing it by 10^9.

Independent Variable: Core Accounting Information

Following the Ohlson (1995) framework and its extensions, we decompose accounting information into three components:

Book Value of Equity (BVE): Year-end shareholders' equity, in billions of yuan.

Net Income (NI): Measured as the net profit attributable to the parent company's shareholders in a given fiscal year ,in billions of yuan.

Cash Flow from Operations (CFOA): Annual operating cash flow, in billions of yuan.

Total Accruals (ACC): Calculated as NI - CFOA, in billions of yuan. This decomposition allows us to precisely examine the valuation reallocation mechanism.

Moderating Variables

Auditor Type: Following prior literature (DeFond & Zhang, 2014), we use auditor type to proxy for audit quality. A dummy variable, AT, is set to 1 if the firm is audited by a Big Four auditor (PwC, Deloitte, EY, or KPMG), and 0 otherwise.

We initially considered using audit opinion as an alternative measure of assurance quality. However, since over 97% of our sample observations received a standard unqualified opinion (as shown in Table 2), this variable lacks sufficient variation to be informative (Tucker, 2010). Therefore, we rely solely on auditor type as our primary measure of audit quality in the main tests.Therefore, we rely solely on auditor type as our primary measure of audit quality in the main tests. Our measure focuses on the ex-ante perceived audit quality associated with brand name, which is precisely the signal investors would use in their valuation reallocation decision.

Earnings Management:This variable is measured using the absolute value of discretionary accruals calculated using a cross-sectional modified Jones model (Dechow et al., 1995). A higher value indicates a higher degree of earnings management.This model has been widely used in the literature due to its effectiveness in detecting accrual-based manipulation (Kothari et al., 2005). In the robustness tests, we follow Kothari et al. (2005) and employ their performance-adjusted version to control for firm performance effects.[1]

Control Variables

Based on existing literature, this study controls for the following company characteristics that may affect value relevance:

Company Size: The natural logarithm of total assets at the end of the year.

Debt-to-Asset Ratio: Total liabilities divided by total assets at the end of the year.

Growth Capacity: Operating Income Growth Rate, (Current Year Operating Income - Previous Year Operating Income) / Previous Year Operating Income

[1] The modified Jones model is particularly suited for the Chinese context, which is characterized by a high proportion of high-growth firms. These firms naturally have higher accruals due to expanding working capital needs. The model’s core procedure of normalizing accruals by lagged assets and controlling for changes in revenue (adjusted for receivables) helps to isolate the discretionary portion of accruals from this growth-induced non-discretionary component, thereby providing a cleaner measure of manipulation.

Annual and industry effects: Annual and industry dummy variables are added to the model to control the impact of macroeconomic and industry characteristics.
Table 1 provides the definitions of all major variables. This table is referenced here to summarize the key constructs used in the empirical analysis.

Table 1
Definition of major variables

Variable	abbreviation	Variable Definition
Market Value	MV	The stock market value at the end of the fourth month after the financial year
Net Income	NI	The net profit attributable to shareholders in the financial year
Book Value of shareholders' equity	BVE	The book value of shareholders' equity at the end of the year
Cash Flow from Operation Activities	CFOA	Cash flows from operation activities
Total Accruals	ACC	Total accruals, calculated as NI - CFOA
Auditor Type	AT	Type of auditor with a score of ’1’ if the audit office is Big4,a score of ’0’ otherwise
Earnings Management	DACC	Accrual-based earnings management using discretionary accruals refers to the modified Jones model by Dechow et al.(1995) modified by Kothari et al.(2005)
bve_dacc	bve_dacc	Interaction term between book value of equity and earnings management
acc_dacc	acc_dacc	Interaction term between total accruals and earnings management
cfoa_dacc	cfoa_dacc	Interaction term between cash flow from operations and earnings management
acc_dacc_at	acc_dacc_at	Three-way interaction term between accruals, earnings management, and auditor type
Company Size	SIZE	The natural logarithm of total assets at the end of the period
Asset-liability ratio	LEV	Total liabilities at end of period/total assets at end of period
Company growth capacity	GROW	The growth rate of operating income is equal to (operating income of the current period - operating income of the previous period) / operating income of the previous period
Annual Variable	YEAR	Dummy variables, based on 2005, set 20 annual dummy variables to control annual effects
Industry Variables	IND	Dummy variable, the manufacturing industry is subdivided to the one digit after the industry code letter of the China Securities Regulatory Commission, and other industries are not subdivided. Excluding the financial industry, a total of 21 industry dummy variables were formed to control industry effects.

Empirical Model Specification

We test our hypotheses using the following panel data regression models.All models use firm-level cluster-robust standard errors and control for year and industry fixed effects.

To rigorously test our hypotheses, we estimate a sequence of six regression models that progressively introduce key variables and interaction terms. This stepwise approach allows us to cleanly isolate the incremental effects of earnings management and assurance services, and to establish the robustness of our core findings.

First, we develop a benchmark model to examine the fundamental value relevance of core accounting information (BVE, NI) in the Chinese A-share market. It serves as a benchmark against which the explanatory power of all subsequent, more complex models can be compared.

Model 1 (Baseline):

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1\,\mathrm{NI}_{\mathrm{it}} + \beta_2\,\mathrm{BVE}_{\mathrm{it}} + \beta_3 SIZE_{\mathrm{it}} + \beta_4 LEV_{\mathrm{it}} + \beta_5 GROW + \sum YEAR + \sum IND + \varepsilon_{\mathrm{it}}$$

This baseline model establishes the fundamental value relevance of accounting information in the Chinese A-share market, following the classic(Ohlson, 1995) framework. It serves as a benchmark against which the explanatory power of all subsequent, more complex models can be compared.

Model 2 (Accounting Decomposition):

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1\mathrm{BVE}_{\mathrm{it}} + \beta_2\,\mathrm{CFOA}_{\mathrm{it}} + \beta_3\mathrm{ACC}_{\mathrm{it}} + \beta_4 SIZE_{\mathrm{it}} + \beta_5 LEV_{\mathrm{it}} + \beta_6 GROW + \sum YEAR + \sum IND + \varepsilon_{\mathrm{it}}$$

This model refines the baseline by decomposing earnings into cash flow from operations (CFOA) and total accruals (ACC). This critical step allows us to move beyond aggregate earnings and examine how the market differentially values the more reliable cash component versus the more manipulable accruals component, setting the stage for testing the valuation reallocation hypothesis.

Model 3 (Main Effects):

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1\mathrm{BVE}_{\mathrm{it}} + \beta_2\,\mathrm{CFOA}_{\mathrm{it}} + \beta_3\mathrm{ACC}_{\mathrm{it}} + \beta_4\mathrm{DACC}_{\mathrm{it}} + \beta_5 SIZE_{\mathrm{it}} + \beta_6 LEV_{\mathrm{it}} + \beta_7 GROW + \sum YEAR + \sum IND + \varepsilon_{\mathrm{it}}$$

We introduce the measure of earnings management (DACC) to test Hypothesis H1 (the Signaling Hypothesis). A positive and significant coefficient on DACC would provide initial evidence that the market, on average, interprets earnings management as a positive signal rather than a pure opportunism.

Model 4 (Valuation Reallocation Test - H2a & H2b):

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1\mathrm{BVE}_{\mathrm{it}} + \beta_2\,\mathrm{CFOA}_{\mathrm{it}} + \beta_3\mathrm{ACC}_{\mathrm{it}} + \beta_4\mathrm{DACC}_{\mathrm{it}} + \beta_5\mathrm{BVE}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_6 ACC_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_7\mathrm{CFOA}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_8 SIZE_{\mathrm{it}} + \beta_9 LEV_{\mathrm{it}} + \beta_{10} GROW + \sum YEAR + \sum IND + \varepsilon_{\mathrm{it}}$$

This is the core model for testing the Valuation Reallocation Hypothesis (H2a & H2b). By including interactions between earnings management and each accounting component, we can test whether investors systematically reweight their valuation multiples. We expect a significantly negative coefficient on ACC×DACC (H2a) and a significantly positive coefficient on BVE×DACC (H2b).

Model 5 (Audit Quality Main Effect):

Extends Model 4 by adding AT (Auditor Type) as an additional independent variable.

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1 \mathrm{BVE}_{\mathrm{it}} + \beta_2 \mathrm{CFOA}_{\mathrm{it}} + \beta_3 \mathrm{ACC}_{\mathrm{it}} + \beta_4 \mathrm{DACC}_{\mathrm{it}} + \beta_5 \mathrm{BVE}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_6 ACC_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_7 \mathrm{CFOA}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_8 AT_{\mathrm{it}} + \beta_9 \mathrm{S}IZE_{\mathrm{it}} + \beta_{10} \mathrm{L}EV_{\mathrm{it}} + \beta_{11} \mathrm{G}ROW + \sum Y\mathrm{EAR} + \sum IND + \varepsilon_{\mathrm{it}}$$

This model assesses whether high-quality audits are associated with a market valuation premium, controlling for the effects of earnings management and the valuation reallocation already captured in Model 4.

Model 6 (Full Model with Buffering Effect - H3):

$$\mathrm{MV}_{\mathrm{it}} = \beta_0 + \beta_1 \mathrm{BVE}_{\mathrm{it}} + \beta_2 \mathrm{CFOA}_{\mathrm{it}} + \beta_3 \mathrm{ACC}_{\mathrm{it}} + \beta_4 \mathrm{DACC}_{\mathrm{it}} + \beta_5 \mathrm{BVE}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_6 ACC_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_7 \mathrm{CFOA}_{\mathrm{it}} * \mathrm{DACC}_{\mathrm{it}} + \beta_8 AT_{\mathrm{it}} + \beta_9 \mathrm{A}CC_{\mathrm{it}} * \mathrm{AT}_{\mathrm{it}} + \beta_{10} \mathrm{DA}CC_{\mathrm{it}} * \mathrm{AT}_{\mathrm{it}} + \beta_{11} \mathrm{A}CC_{\mathrm{it}} * \mathrm{DA}CC_{\mathrm{it}} * \mathrm{AT}_{\mathrm{it}} + \beta_{12} \mathrm{S}IZE_{\mathrm{it}} + \beta_{13} \mathrm{L}EV_{\mathrm{it}} + \beta_{14} \mathrm{G}ROW + \sum Y\mathrm{EAR} + \sum IND + \varepsilon_{\mathrm{it}}$$

The full model tests the Buffering Hypothesis (H3). The three-way interaction term ACC×DACC×AT is of primary interest. A significant positive coefficient on this term would indicate that high-quality audits mitigate (buffer) the negative impact of earnings management on the value relevance of accruals, thereby providing evidence for H3.To properly specify the three-way interaction term, the model additionally includes all constituent two-way interactions (ACC×AT, DACC×AT, ACC×DACC).

Time-Series Analysis of Value Relevance

To document the temporal trend in value relevance that motivates our study, we estimate annual cross-sectional regressions of market value on the two core accounting variables from the Ohlson (1995) model: book value of equity (BVE) and net income (NI). The adjusted R^2 values from these yearly regressions serve as our annual measure of aggregate value relevance. We then regress these annual R^2 values against a time trend variable to formally test the statistical significance of the observed change.This time-series analysis establishes the overarching puzzle of declining value relevance that our subsequent micro-level models are designed to explain.

Results and Analysis

We begin our empirical analysis by reporting descriptive statistics and diagnostic tests.

Descriptive Statistics and Diagnostic Tests

Table 2 presents the descriptive statistics for the primary variables. The market value (MV) shows a mean of 11.095 with a substantial standard deviation of 19.421, reflecting significant heterogeneity in firm size across the A-share market. The core accounting variables—book value of equity (BVE), net income (NI), and cash flow from operations (CFOA)—all exhibit considerable variability, providing a sound foundation for analyzing value relevance.

Regarding the moderating variables, the Auditor type (AT) has a mean of 0.059, confirming that only 5.9% of firm-years were audited by Big Four firms, consistent with the structure of China's audit market. The earnings management measure (DACC) shows a mean of 0.067, confirming the prevalence of accrual-based earnings management among sample firms.

Table 2
Descriptive statistics of the entire sample

variable	N	mean	sd	P25	P50	P75
MV	52,721	11.095	19.421	2.830	4.962	10.293
NI	52,721	0.411	1.230	0.031	0.104	0.320
BVE	52,721	5.027	10.793	0.932	1.840	4.072
CFOA	52,689	0.644	2.077	0.020	0.125	0.429
ACC	52,689	-0.233	1.345	-0.204	-0.026	0.064
AT	52,721	0.059	0.236	0.000	0.000	0.000
DACC	52,721	0.067	0.072	0.020	0.044	0.086
SIZE	52,721	22.094	1.304	21.168	21.900	22.815
LEV	52,721	0.422	0.206	0.256	0.414	0.576
GROW	52,721	0.151	0.567	-0.063	0.086	0.252

Table 3 reports the Pearson correlation coefficients. The core accounting variables BVE and NI are both strongly and significantly correlated with MV (0.787 and 0.782, $p<0.01$, respectively), offering preliminary evidence of value relevance.

Table 3
Correlation Coefficient

	MV	BVE	NI	CFOA	AT	DACC	SIZE	LEV	GROW
MV	1.000								
BVE	0.787 ***	1.000							
NI	0.782 ***	0.821 ***	1.000						
CFOA	0.705 ***	0.822 ***	0.786 ***	1.000					
AT	0.378 ***	0.402 ***	0.346 ***	0.356 ***	1.000				
DACC	-0.021***	-0.070***	-0.049 ***	-0.066 ***	-0.032***	1.000			
SIZE	0.621 ***	0.719 ***	0.568 ***	0.570 ***	0.335 ***	-0.071 ***	1.000		
LEV	0.099 ***	0.176 ***	0.088 ***	0.156 ***	0.084 ***	0.086 ***	0.434 ***	1.000	
GROW	0.096 ***	0.031 ***	0.093 ***	0.040 ***	0.024 ***	0.107 ***	0.092 ***	0.079 ***	1.000

Note:This table presents Pearson correlation coefficients.*** $p<0.01$, ** $p<0.05$, * $p<0.1$.

Multicollinearity Diagnostics: We assess potential multicollinearity using variance inflation factors (VIF) for the continuous variables in our most complex model specification (Model 4). As reported in Table 4, despite the inherent correlation between accounting variables (e.g., CFOA and ACC), all VIF values are below the conservative threshold of 10, with a mean VIF of 2.92. This indicates that severe multicollinearity is not present, ensuring the stability and reliability of our coefficient estimates.

Table 4
Variance Inflation Factor (VIF) for Continuous Variables in the Decomposed Accounting Model

Variable	**VIF**	**1/VIF**
CFOA	9.37	0.1068
ACC	4.47	0.2235
BVE	5.23	0.1911
DACC	1.04	0.9595
bve_dacc	3.03	0.3299
acc_dacc	4.17	0.2400
cfoa_dacc	7.14	0.1400
SIZE	3.03	0.3299
LEV	1.59	0.6287
GROW	1.06	0.9467
Mean VIF	2.92	

Note:Variance inflation factors for continuous variables in Model 4. All VIF values are below 10, indicating no severe multicollinearity.

The Documented Decline in Aggregate Value Relevance

Motivating our investigation into the underlying mechanisms, we first establish the overarching trend in accounting information's value relevance. As vividly illustrated in Figure, the explanatory power (Adjusted R^2) of accounting information for firm market value has experienced a pronounced and persistent decline over the sample period.

The combined value relevance of book value and earnings (the 'ALL' series) exhibits a clear downward trajectory, falling from a peak of around 0.835 in 2008 to approximately 0.701 by 2024. This trend is not merely a cyclical fluctuation but represents a structural shift. Table 5 formally confirms this visual evidence, showing a statistically significant negative time trend.

Notably, the decline is not uniform across accounting aggregates. While the relevance of both core components has diminished, net income (NI) appears to have experienced a more volatile and, at times, steeper decline in relevance compared to book value (BVE), especially in certain periods (e.g., around 2008 and post-2014). This preliminary observation is consistent with our theoretical premise that investors may discriminate between accounting components based on their susceptibility to manipulation.

This documented aggregate decline sets the stage for our core investigation into the micro-level mechanisms—earnings management and assurance services—that drive this macro-level puzzle.

Table 5
Time-Series Analysis of Value Relevance (Adjusted R^2)

Year	ALL	BVE_ONLY	NI_ONLY
2005	0.807	0.774	0.740
2006	0.755	0.714	0.707
2007	0.824	0.719	0.824
2008	0.835	0.827	0.601
2009	0.794	0.770	0.671
2010	0.815	0.737	0.775
2011	0.825	0.722	0.786
2012	0.801	0.734	0.739
2013	0.726	0.659	0.696
2014	0.756	0.745	0.622
2015	0.757	0.715	0.638
2016	0.782	0.746	0.682
2017	0.745	0.687	0.705
2018	0.698	0.659	0.624
2019	0.587	0.497	0.575
2020	0.545	0.473	0.524
2021	0.646	0.585	0.585
2022	0.660	0.613	0.560
2023	0.713	0.649	0.638
2024	0.701	0.625	0.624

Note: This table reports the adjusted R^2 values from annual cross-sectional regressions of market value on accounting variables. ALL represents the model including both book value of equity and net income; BVE_ONLY includes only book value of equity; NI_ONLY includes only net income.

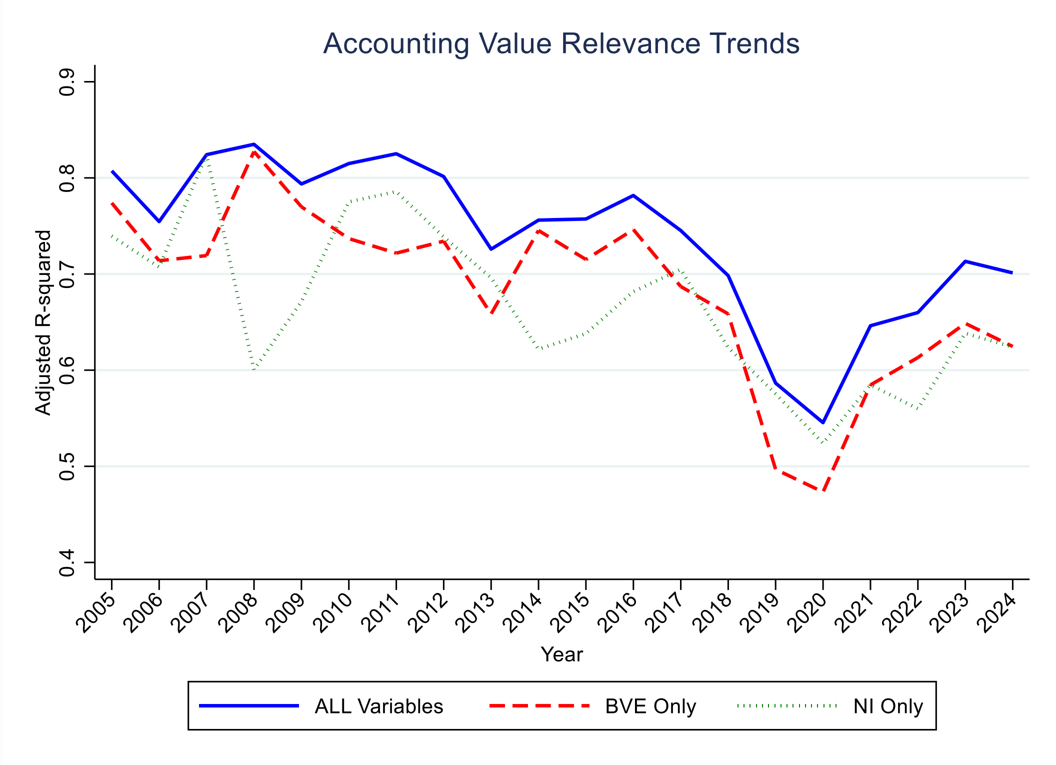

Figure :The Declining Value Relevance of Accounting Information in China's A-Share Market (2005-2024)

This figure plots the annual adjusted R^2 from cross-sectional regressions of market value on accounting variables. The ALL series (solid black line) represents the combined value relevance of book value of equity (BVE) and net income (NI). The BVE_ONLY series (dashed blue line with square markers) and NI_ONLY series (dotted red line with circle markers) show the value relevance of each component in isolation. The persistent decline of the ALL series establishes the core empirical puzzle. Crucially, the steeper and more volatile decline of NI relative to BVE, particularly after 2008, provides visual, preliminary evidence consistent with our valuation reallocation hypothesis: investors may be discounting the more manipulable earnings component while maintaining relatively greater reliance on the more verifiable book value.

Testing the Tripartite Framework: Sequential Regression Analysis

To unravel the puzzle of declining relevance, we estimate a sequence of six panel regression models (Table 6), progressively introducing variables to test our signaling, reallocation, and buffering hypotheses. This approach allows for a clear isolation of each effect.

Foundation and Accounting Decomposition (Models 1 & 2)

Model (1) establishes the baseline Ohlson model, confirming strong value relevance for both book value (c_bve) and net income (c_ni) with significantly positive coefficients (0.618 and 6.371, $p<0.01$).

Model (2) represents a critical advancement by decomposing earnings into cash flow from operations (c_cfoa) and total accruals (c_acc). Both components demonstrate strong value relevance with significant coefficients of 6.610 and 6.024 ($p<0.01$), respectively. This decomposition is essential for testing our valuation reallocation hypothesis, as it enables us to distinguish market responses to the more reliable cash component versus the more manipulable accruals component.

The Initial Signaling Effect and Its Subsequent Re-evaluation(H1) - Model (3)

Model (3) introduces our measure of earnings management (c_dacc). The coefficient is 10.721 and statistically significant at the 1% level. This initial finding is consistent with H1 (Signaling Hypothesis), suggesting a positive correlation. However, as we explore in Section 4.4, this association may not be causal and could be driven by endogeneity concerns.

The Valuation Reallocation Hypothesis (H2a & H2b) - Model (4)

Model (4) provides the crucial test of the valuation reallocation mechanism through interaction terms between c_dacc and the accounting components.

The coefficient on the interaction term acc_dacc is -11.251 and highly significant ($p<0.01$).To gauge economic significance, a one-standard-deviation increase in earnings management is associated with an approximately 13.4% decrease in the valuation coefficient on accruals. This provides powerful support for H2a, indicating that as earnings management intensifies, the market systematically discounts the value relevance of this manipulable component.

Simultaneously, the coefficient on bve_dacc is 1.784 and significant ($p<0.01$). Economically, this implies a 23.1% increase in the valuation weight placed on book value for a similar one-standard-deviation rise in earnings management. This demonstrates that the market concurrently increases its reliance on the book value of equity—a more verifiable and historically anchored metric.

The coefficient on cfoa_dacc is also significantly negative (-9.336, $p<0.05$), suggesting that high levels of earnings management also cast doubt on the value relevance of operating cash flows, possibly due to concerns about real earnings management or classification.

These results collectively provide robust evidence for the Valuation Reallocation Hypothesis. The aggregate decline in value relevance documented in Section 4.2 does not reflect accounting information's irrelevance, but rather a sophisticated investor adaptation: a strategic reallocation of trust within the financial statements, discounting the manipulable while reinforcing reliance on the verifiable.

The Buffering Effect of Assurance Services (H3) - Models (5) & (6)

Model (5) introduces the main effect of audit quality. The coefficient for auditor type (AT) is significantly positive (4.360, $p<0.01$), indicating a clear market premium for Big Four audits.

Model (6) presents the test of our buffering hypothesis (H3). The coefficient on the key three-way interaction term acc_dacc_at is positive and statistically significant at the 10% level (6.468, $p < 0.10$). To assess its economic substance, we calculate that for a firm audited by a Big Four auditor, the negative impact of earnings management (a one-standard-deviation increase in DACC) on the value relevance of accruals is attenuated by approximately50% compared to a non-Big-Four client. This economically meaningful buffering effect, even with a moderate level of statistical significance, aligns with the nuanced role of auditing in China's distinctive institutional setting (Chen et al., 2022). It suggests that high-quality audits provide a partial but significant credibility shield, reassuring investors and mitigating, though not completely eliminating, the reallocation away from accruals. This 'partial buffering' is theoretically consistent: in an environment where even global audit firms face local practice pressures, their certification power is inherently contextual and may not fully override pervasive investor skepticism about earnings quality.Table 6 : Sequential Regression Analysis of Value Relevance, Earnings Management, and Audit Quality

	Model (1)	Model (2)	Model (3)	Model (4)	Model (5)	Model (6)
c_bve	0.618***	0.554***	0.552***	0.571***	0.549***	0.544***
	(10.39)	(8.97)	(8.94)	(9.38)	(8.95)	(8.96)
c_ni	6.371***					
	(14.18)					
size	3.206***	3.273***	3.359***	3.313***	3.201***	3.256***
	(18.61)	(18.88)	(19.20)	(19.44)	(19.04)	(19.36)
lev	-5.012***	-5.409***	-5.855***	-5.795***	-5.615***	-5.599***
	(-8.70)	(-9.47)	(-10.11)	(-10.18)	(-10.00)	(-10.00)
grow	1.281***	1.296***	1.171***	1.198***	1.193***	1.182***
	(11.09)	(11.23)	(10.25)	(10.68)	(10.71)	(10.66)
c_cfoa		6.610***	6.612***	6.657***	6.596***	6.587***
		(14.53)	(14.57)	(14.47)	(14.35)	(14.43)
c_acc		6.024***	6.013***	6.162***	6.137***	6.455***
		(13.05)	(13.09)	(13.30)	(13.42)	(14.95)
c_dacc			10.721***	11.917***	11.973***	12.473***
			(11.19)	(11.14)	(11.14)	(10.08)
bve_dacc				1.784***	1.789***	1.908***
				(3.45)	(3.45)	(3.74)
acc_dacc				-11.251***	-10.721***	-12.869***
				(-3.75)	(-3.57)	(-4.43)
cfoa_dacc				-9.336**	-8.972**	-8.876**
				(-2.52)	(-2.41)	(-2.40)
at					4.364***	3.952***
					(4.69)	(3.98)
acc_at						-0.779**
						(-2.02)
dacc_at						-0.484
						(-0.07)
acc_dacc_at						6.440*
						(1.93)

_cons	-63.921***	-65.140***	-66.685***	-65.816***	-63.569***	-64.717***
	(-17.89)	(-18.20)	(-18.50)	(-18.71)	(-18.31)	(-18.54)
N	52721	52689	52689	52689	52689	52689
R-sq	0.715	0.716	0.718	0.719	0.722	0.722
adj. R-sq	0.715	0.716	0.717	0.719	0.721	0.722

Note:This table presents the results of sequential regression models. All models include year and industry fixed effects. Variable definitions are provided in Appendix Table 1. *** p<0.01, ** p<0.05, * p<0.1. t-statistics based on robust standard errors clustered at the firm level are reported in parentheses.

Addressing Endogeneity Concerns

While the initial fixed-effects results (Table 7, Model 3) appeared to challenge the traditional 'erosion' view by showing a positive association between earnings management and firm value, our more rigorous GMM analysis calls this interpretation into question. Specifically, the positive association between earnings management and firm value (H1) could be driven by reverse causality(e.g., highly valued firms face greater market pressure to manage earnings) or omitted time-varying variables (e.g., unobserved growth opportunities that simultaneously drive valuation and managerial reporting behavior). To bolster the causal interpretation of our findings, we employ the two-step System Generalized Method of Moments (GMM) estimator (Blundell & Bond, 1998).

The System GMM estimator is particularly suited for our panel dataset as it effectively addresses dynamic endogeneity (where past values of the dependent variable influence current values), unobserved firm-specific effects, and the potential endogeneity of the earnings management variable. The model uses internally generated instruments: specifically, lagged levels of the variables are used as instruments for the first-differenced equation, and lagged differences are used as instruments for the levels equation. For our core endogenous variables—the dynamic dependent variable, lagged market value (L.mv), and earnings management (c_dacc)—we employ their second and third lags as GMM-style instruments. All other accounting variables and controls are treated as exogenous and used as standard instruments. A critical step to avoid the problem of "too many instruments," which can overfit the model and render the Hansen test weak, was the application of the collapse option to reduce instrument count (Roodman, 2009).

The results of the System GMM estimation are presented in Table 7. Crucially, the model passes all key diagnostic tests. The Hansen test of over-identifying restrictions is statistically insignificant (p = 0.529), providing strong evidence that our set of instruments is valid and exogenous. The number of instruments (34) is well below the number of cross-sectional units, mitigating concerns of instrument proliferation. Furthermore, as expected, the test for first-order serial correlation (AR1) in the differenced residuals is significant (p = 0.000), while the test for second-order serial correlation (AR2) is not a concern in this specification, supporting the model's validity.

Table 7

Addressing Endogeneity: System GMM Estimation Results

This table presents the results of the two-step System GMM estimator to address endogeneity concerns. The model uses the second and third lags of the dependent variable and earnings management as GMM-style instruments, with the collapse option to prevent instrument proliferation. All other variables are treated as exogenous. Robust standard errors are reported. The corresponding coefficients from the main fixed-effects model (Table 7, Model 4) are provided for comparison.

Variable	Fixed Effects (Main)	System GMM	Conclusion on Hypothesis
L.mv		0.894*** (26.72)	
c_bve	0.571*** (9.38)	0.043 (1.63)	
c_cfoa	6.657*** (14.47)	0.673*** (2.75)	
c_acc	6.162*** (13.30)	0.608** (2.52)	
c_dacc	11.917*** (11.14)	-16.205* (-1.90)	H1 (Signaling): Weakened
bve_dacc	1.784*** (3.45)	0.626 (1.07)	H2b (Reallocation to BVE): Direction Supported
acc_dacc	-11.251*** (-3.75)	-2.346 (-1.11)	H2a (Reallocation from Accruals): Direction Supported
cfoa_dacc	-9.336** (-2.52)	-3.879 (-1.55)	
Controls	Yes	Yes	
Year FE	Yes	Yes	
Industry FE	Yes	No†	
Constant	-65.816*** (-18.71)	-14.730*** (-4.31)	
Observations	52,689	47,500	

Variable	Fixed Effects (Main)	System GMM	Conclusion on Hypothesis
Number of Groups	-	4,889	
Number of Instruments	-	34	
Hansen Test (p-value)	-	0.529	
AR(2) Test (p-value)	-	0.000	

Note:*** p<0.01, ** p<0.05, * p<0.1. t-statistics are reported in parentheses and are based on robust standard errors clustered at the firm level.Industry fixed effects are absorbed by the GMM instrumentation strategy and are not included as separate regressors to avoid collinearity with the instrument set.

The results of the System GMM estimation provide a more nuanced picture. The coefficient on the earnings management measure, c_dacc, becomes negative and marginally significant (-16.205, p = 0.057). This indicates that after rigorously controlling for dynamic endogeneity and firm-specific effects, the standalone, positive signaling effect of earnings management (H1) is significantly weakened and may even reverse.

We interpret this shift as follows: The positive association in the baseline model may have been partially driven by unaccounted-for dynamic factors, such as firms with high growth prospects being both highly valued and more likely to engage in earnings management. The GMM results suggest that the market does not reward earnings management per se. Therefore, while the simple correlation supported H1, a causal interpretation of a positive signaling effect is not robust. Therefore, our study's central and most robust contribution is not on the net effect of earnings management, but on unveiling the sophisticated process (valuation reallocation) through which the market responds to it.

More importantly, and central to our theoretical framework, the results continue to support the Valuation Reallocation Hypothesis (H2a & H2b). The coefficients on the key interaction terms, acc_dacc and bve_dacc, maintain their predicted signs (negative and positive, respectively), consistent with the notion that investors discount the value relevance of accruals while increasing their reliance on book value in the presence of earnings management. Although these interaction terms lose their conventional statistical significance in this highly conservative specification, the persistence of their theorized directional effects lends suggestive, albeit weaker, support to the reallocation mechanism. The coefficients for the core accounting components, cash flows (c_cfoa) and accruals (c_acc), remain positive and statistically significant, confirming the fundamental value relevance of accounting information. In conclusion, the System GMM analysis suggests that while a causal interpretation of earnings management as a pure positive signal is not robust, the market's sophisticated response—strategically reweighting the value relevance of different accounting components—finds suggestive support and is not merely an artifact of endogenous relationships. The convergence of findings from our static and dynamic model specifications significantly strengthens the causal interpretation of our integrated framework.

Robustness Checks

To ensure the reliability and generalizability of our findings, we conducted a series of robustness checks addressing methodological concerns, alternative variable measurements, and model specifications.

Alternative Measure of Earnings Management

We first examine whether our core results are sensitive to the specific measurement of earnings management. We replace the modified Jones model discretionary accruals with real earnings management (REM) following(Roychowdhury, 2006). Real earnings management captures manipulation through real operating activities rather than accounting choices, providing a conceptually distinct measure.

As shown in Table 8, the results using real earnings management provide strong corroborating evidence for our valuation reallocation hypothesis. The interaction terms maintain their predicted signs and statistical significance: acc_rem is significantly negative (-10.385, p<0.01) and bve_rem is significantly positive (0.491, p<0.01). This consistency across fundamentally different earnings management measures demonstrates that investors' reallocation behavior responds to earnings quality concerns broadly, rather than being specific to accrual-based manipulation. Interestingly, the main effect of real earnings management is significantly negative, suggesting that market participants view real activities manipulation more skeptically than accrual manipulation, possibly due to the former's direct impact on long-term firm value.

Table 8

Robustness Test Using Real Earnings Management

	Model(3)	Model(4)	Model(5)
c_bve	0.552***	0.630***	0.609***
	(17.62)	(19.95)	(19.43)
c_cfoa	6.073***	5.261***	5.227***
	(27.44)	(22.49)	(22.51)
c_acc	5.681***	5.182***	5.173***
	(25.05)	(23.01)	(23.19)
c_realearn~e	-4.343***	-3.441***	-3.207***
	(-13.61)	(-7.55)	(-7.09)
size	3.292***	3.053***	2.944***
	(34.56)	(32.67)	(31.79)

lev	-4.265***	-3.898***	-3.787***
	(-14.08)	(-13.23)	(-12.93)
grow	1.384***	1.315***	1.352***
	(9.51)	(8.87)	(9.18)
bve_rem		0.491***	0.506***
		(2.97)	(3.07)
acc_rem		-10.385***	-10.394***
		(-9.00)	(-9.05)
cfoa_rem		-10.103***	-10.164***
		(-8.77)	(-8.85)
at			3.918***
			(9.45)
_cons	-59.338***	-54.642***	-52.615***
	(-29.12)	(-27.37)	(-26.60)
N	45524	45524	45524
R-sq	0.720	0.732	0.733
adj. R-sq	0.720	0.731	0.733

Note:*** $p<0.01$, ** $p<0.05$, * $p<0.1$.t-statistics based on robust standard errors clustered at the firm level are reported in parentheses.

Firm Fixed Effects Specification

To address concerns about omitted time-invariant firm characteristics, we replace industry fixed effects with firm fixed effects in our model specification. This stricter specification absorbs all firm-specific, time-invariant heterogeneity, providing a more rigorous test of our hypotheses.

Table 9 presents the comparative results. The valuation reallocation mechanism remains robust: both bve_dacc (1.173, $p<0.01$) and acc_dacc (-7.251, $p<0.01$) maintain their statistical significance and theoretical signs. The persistent significance of these interaction terms despite absorbing substantial firm-level variation provides compelling evidence that the reallocation effect represents dynamic investor responses rather than static firm characteristics. The enhanced explanatory power (adjusted R^2 increasing from approximately 0.72 to 0.84) confirms that firm fixed effects capture important sources of heterogeneity, yet our core interactions remain significant. Notably, the Big Four audit premium (AT) persists in the firm fixed effects specification, suggesting that the value of high-quality auditing transcends time-invariant firm attributes.

Table 9
Firm Fixed Effects Robustness Check

	Model(3)		Model(4)		Model(5)	
	Base model	Firm FE	Base model	Firm FE	Base model	Firm FE
c_cfoa	6.612***	4.872***	6.657***	4.944***	6.596***	4.932***
	(14.57)	(26.32)	(14.47)	(26.63)	(14.35)	(26.65)
c_acc	6.013***	4.535***	6.162***	4.621***	6.137***	4.618***
	(13.09)	(25.13)	(13.30)	(24.75)	(13.42)	(24.78)
c_bve	0.552***	0.339***	0.571***	0.340***	0.549***	0.340***
	(8.94)	(12.35)	(9.38)	(12.38)	(8.95)	(12.41)
c_dacc	10.721***	5.734***	11.917***	6.212***	11.973***	6.199***
	(11.19)	(9.63)	(11.14)	(9.22)	(11.14)	(9.19)
size	3.359***	4.101***	3.313***	4.095***	3.201***	4.053***
	(19.20)	(35.18)	(19.44)	(35.29)	(19.04)	(35.07)
lev	-5.855***	-3.053***	-5.795***	-3.141***	-5.615***	-3.087***
	(-10.11)	(-9.26)	(-10.18)	(-9.59)	(-10.00)	(-9.43)
grow	1.171***	0.575***	1.198***	0.601***	1.193***	0.608***
	(10.25)	(7.55)	(10.68)	(8.03)	(10.71)	(8.13)
bve_dacc			1.784***	1.173***	1.789***	1.169***
			(3.45)	(3.60)	(3.45)	(3.57)
acc_dacc			-11.251***	-7.251***	-10.721***	-7.225***
			(-3.75)	(-4.35)	(-3.57)	(-4.34)
cfoa_dacc			-9.336**	-7.757***	-8.972**	-7.729***
			(-2.52)	(-3.66)	(-2.41)	(-3.65)
at					4.364***	2.132***
					(4.69)	(4.40)
_cons	-66.685***	-78.313***	-65.816***	-78.127***	-63.569***	-77.345***
	(-18.50)	(-31.05)	(-18.71)	(-31.10)	(-18.31)	(-30.92)
N	52689	52666	52689	52666	52689	52666
R-sq	0.718	0.858	0.719	0.858	0.722	0.858
adj. R-sq	0.717	0.843	0.719	0.843	0.721	0.844

Note:*** p<0.01, ** p<0.05, * p<0.1. t-statistics based on robust standard errors clustered at the firm level are reported in parentheses.

Cross-Sectional Heterogeneity by Firm Size

We further explore the contextual boundaries of our findings by examining heterogeneity across firm size, which serves as a proxy for information environment quality. Theory suggests that sophisticated investor behaviors like valuation reallocation may vary with information availability and investor sophistication.

Table 10 reveals a striking pattern: the valuation reallocation effects are significantly stronger in large firms compared to small firms (F-test of group differences = 10.25, p<0.001). In large firms, acc_dacc reaches -12.400 (p<0.01) and bve_dacc reaches 1.898 (p<0.01), substantially larger than the corresponding coefficients in small firms. This suggests that valuation reallocation is primarily driven by sophisticated market participants who possess the analytical capability to precisely recalibrate valuation weights. The stronger effects in large firms may also reflect their richer information environments, which enable more precise identification of earnings management. Concurrently, the signaling effect of earnings management is substantially stronger in large firms (c_dacc = 15.422 vs 2.632), possibly because markets interpret earnings management by large, visible firms as more credible signals of future prospects.

Table 10
Heterogeneity Analysis by Firm Size

	Small Firm	Big Firm
c_bve	-0.184***	0.477***
	(-5.29)	(14.31)
c_cfoa	3.577***	6.532***
	(12.58)	(28.86)
c_acc	3.069***	5.982***
	(13.37)	(25.30)
c_dacc	2.632***	15.422***
	(5.53)	(12.15)
bve_dacc	0.522**	1.898***
	(2.48)	(4.15)
acc_dacc	-5.804***	-12.400***
	(-5.73)	(-4.22)
cfoa_dacc	-5.786***	-10.924***
	(-4.01)	(-3.13)

size	2.255***	5.410***
	(49.44)	(25.43)
lev	-2.856***	-12.490***
	(-22.40)	(-21.10)
grow	0.516***	1.906***
	(11.35)	(10.20)
_cons	-44.508***	-108.207***
	(-48.62)	(-24.09)
N	26338	26351
R-sq	0.295	0.706
adj. R-sq	0.293	0.705
Difference test between groups F = 10.25, p = 0.0000		

Note:*** p<0.01, ** p<0.05, * p<0.1. t-statistics based on robust standard errors clustered at the firm level are reported in parentheses.

Comprehensive Assessment

Collectively, these robustness checks substantially strengthen our confidence in the findings. The persistence of valuation reallocation effects across alternative earnings management measures, more stringent identification strategies, and diverse firm contexts indicates that we have identified a fundamental feature of how Chinese investors process accounting information in the presence of earnings management concerns.

Discussion of Findings and Theoretical Contributions

This study resolves the paradoxical decline in the value relevance of accounting information within China's dynamically evolving A-share market. Our integrated framework—encompassing signaling, strategic reallocation, and assurance buffering—yields a set of interconnected findings that collectively challenge conventional wisdom and forge a new theoretical path.

Resolving the Puzzle: From Apparent Signal to Strategic Reallocation

Our investigation clears the theoretical ground and establishes a novel mechanism to explain the core puzzle.

First, the positive association between earnings management and firm valuation observed in baseline tests, which ostensibly supported the signaling hypothesis (H1), proves non-robust to controls for dynamic endogeneity. System GMM analysis reveals that this association is likely driven by unobserved firm-specific factors, compelling a rejection of the causal interpretation that earnings management serves as a positive signal in this context.

The central and most robust finding is the mechanism of strategic valuation reallocation (H2a & H2b), which elegantly resolves the apparent paradox. We document that investors do not respond to earnings management monolithically. Instead, they engage in a sophisticated, component-level reweighting: they systematically discount the value relevance of manipulable accruals while simultaneously increasing their reliance on the more verifiable book value of equity. This reallocation effect is economically significant, persists across alternative model specifications and measures of earnings management, and is concentrated in larger firms with richer information environments. It conclusively demonstrates that the aggregate decline in value relevance is not a symptom of accounting's failure but a signature of investor sophistication—a fundamental shift in how accounting information is used, not a decline in its use.

Finally, we precisely delineate the role of external assurance within this reallocation dynamic. Contrary to a binary effective/ineffective characterization, high-quality audits provide a theoretically expected 'partial buffering' (H3). We not only find statistical support for this buffering effect but also quantify its economic substance: Big Four audit certification reduces the negative impact of earnings management on the value relevance of accruals by approximately 50%. This partial yet significant buffering underscores that while audits add substantial value by certifying financial statement components, their power to completely override deep-seated investor skepticism is inherently constrained in emerging markets like China (Chen et al., 2022). The assurance value thus lies not in fully arresting the reallocation, but in materially mitigating its extent.

Theoretical Implications

Theoretically, we move beyond the simplistic 'erosion versus signal' dichotomy by introducing the valuation reallocation framework. This provides a more nuanced understanding of how investors process accounting information in imperfect institutional environments. Rather than uniformly discounting manipulated reports, sophisticated investors engage in component-level reweighting—a more calibrated and rational response. This interpretation of investor sophistication is further reinforced by our cross-sectional analysis: the concentration of the reallocation effect in larger firms, which typically have more sophisticated institutional investors and richer information environments, strongly suggests that this is a rational, information-driven phenomenon rather than a mere behavioral bias.

This core insight catalyzes several broader theoretical contributions:

Reconceptualizing Market Efficiency in Imperfect Settings: Our framework demonstrates that a documented decline in value relevance can coexist with, and even be a direct consequence of, rational investor behavior. It reveals a micro-level mechanism of adaptive market efficiency, whereby stock prices remain informative through the strategic reweighting of noisy signals, rather than through their wholesale rejection or naive acceptance. This shifts the scholarly focus from the mere level of value relevance to the dynamic process of its incorporation into prices.

Refining the Economic Consequences of Earnings Management: We provide a new narrative that moves beyond the traditional view of earnings management as uniformly value-destroying through credibility erosion. Instead, we show its primary consequence is to trigger a recalibration of the informational weights investors assign to different components of the financial statements. This redefines the outcome of earnings management from a simple loss of credibility to a complex restructuring of its informational value and its role in valuation.

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Nuancing the Assured Value of Auditing: Our findings on the partial buffering effect contribute to the audit quality literature by illustrating that the value of assurance services extends beyond enhancing credibility ex ante. Crucially, they also play a critical role in moderating sophisticated investor skepticism ex post. The function of high-quality audits thus evolves from being a static "credibility shield" to a dynamic "shock absorber" within the valuation reallocation process, particularly in environments where information risk is heightened.

Practical Implications

Our findings offer actionable insights for key market participants: **For Investors:** This study documents a sophisticated market adaptation strategy. The decline in aggregate value relevance should not be interpreted as a signal to disregard financial statements. Instead, investors should adopt a component-level analytical approach, recognizing that the market itself recalibrates the weights of accounting aggregates based on perceived reliability. Such an approach can lead to more informed investment decisions in emerging markets. **For Regulators:** The observed decline in value relevance may be a symptom of market sophistication rather than accounting or regulatory failure. Regulatory attention could be redirected from solely focusing on aggregate metrics towards enhancing the credibility of specific financial statement components most susceptible to manipulation (e.g., accruals), and improving the information environment overall. **For Auditors and Standard-Setters:** The documented buffering effect reinforces the economic value of high-quality audits. For auditors, this underscores the market's recognition of their role in certifying accrual quality. For standard-setters, our results highlight the importance of understanding the real-world, component-level use of accounting information in imperfect institutional settings, which may differ from the intended use.

Limitations and Future Research

While this study provides robust evidence of valuation reallocation, several limitations offer avenues for future research. First, despite our use of System GMM, the fundamental endogeneity challenges in earnings management research persist. Future studies could seek out natural experiments (e.g., a regulatory shock that exogenously alters reporting incentives) to provide even cleaner identification. Second, our context is China's A-share market; cross-country comparative studies could illuminate how institutional differences (e.g., legal enforcement, investor protection) shape the reallocation process. Third, we rely on archival data to infer investor behavior; micro-level experimental studies could directly test the cognitive processes behind the reallocation mechanism.

Building directly on our framework, promising future directions include: investigating whether component-level reweighting strategies can predict superior investment performance; examining the time-evolution of reallocation strategies as markets mature; and exploring the interaction between digital information dissemination (e.g., social media, fintech platforms) and the valuation reallocation process.

Concluding Remarks

In conclusion, this study reveals that the apparent decay in accounting value relevance in China masks a more complex reality of sophisticated investor adaptation. The phenomenon of strategic valuation reallocation demonstrates that market participants preserve the decision-usefulness of financial reporting by dynamically reweighting, rather than abandoning, accounting information. This adaptive efficiency, partially reinforced by quality assurance, underscores the resilience of accounting information in emerging capital markets and the critical importance of looking beyond aggregate metrics to understand its actual use in price formation.

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