



Reply



Reply to the Discussion of Cost  
of Capital for Exempt Foreign  
Private Issuers: Information  
Risk Effect or Earnings  
Quality Effect?  
It Depends

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Received 26 March 2014

Available online 2 May 2014

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## 1. Introduction

We appreciate the thorough discussion provided by Professor Han Donker. His comments raise a legitimate issue, which we seek to address here. Our response below follows the structure of the discussant's paper.

## 2. Weak versus strong investor protection

Following extant literature (Alzahrani & Lasfer, 2012; Behn et al., 2013; Jeanjean, 2012; Paligorova & Zhaoxia, 2012), we use the anti-self-dealing index developed by Djankov et al. (2008) to measure legal investor protection across countries. The anti-self-dealing index is calculated based on the legal rules existing in 2003 in 72 countries and is focused on private

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enforcement mechanisms (disclosure, approval, and litigation). The discussant suggests that “indices related to shareholder rights and securities law do not entail elements associated with financial disclosure and earnings quality.” Hence, he suggests that we test the robustness of the investor protection variable based on Djankov et al. (2008) using the World and Economic Forum (WEF) data (Schwab & Porter, 2008); specifically, he suggests that we use the indexes for *protection of minority shareholders*, *strength of auditing and reporting standards*, and *efficacy of corporate boards* in each country. These indexes, the discussant argues, are more strongly associated with financial disclosure and earnings quality and are, thus, more

Table 1

Cost of equity capital: implied expected rate of return — ETSS model (Easton, 2006)

$$\frac{EPS_{i,t+1}}{BPS_{i,t}} = \gamma_0 + \gamma_1 \frac{PRC_{i,t}}{BPS_{i,t}} + \gamma_2 Exemption_{i,t} + \gamma_3 Exemption_{i,t} * \frac{PRC_{i,t}}{BPS_{i,t}} + \gamma_4 AbnACCR_{i,t} + \gamma_5 AbnACCR_{i,t} * \frac{PRC_{i,t}}{BPS_{i,t}} + Controls + \varepsilon_{i,t}.$$

Variables	WEF 2008		WEF 2008 2		WEF 2008 3		
	Exp.	(1)	(2)	(3)	(4)	(5)	(6)
	Sign	$\frac{EPS_{i,t+1}}{BPS_t}$	$\frac{EPS_{i,t+1}}{BPS_t}$	$\frac{EPS_{i,t+1}}{BPS_t}$	$\frac{EPS_{i,t+1}}{BPS_t}$	$\frac{EPS_{i,t+1}}{BPS_t}$	$\frac{EPS_{i,t+1}}{BPS_t}$
	Strong	Weak	Strong	Weak	Strong	Weak	
PRC <sub>i,t</sub> /BPS <sub>i,t</sub>		0.016 (6.41)***	0.000 (1.54)	0.016 (7.36)***	0.000 (1.63)	0.000 (1.93)*	0.000 (0.33)
Exemption		0.033 (1.93)*	0.038 (4.39)***	-0.022 (-1.30)	0.055 (5.05)***	-0.017 (-1.12)	0.052 (4.86)***
Exemption * (PRC <sub>i,t</sub> / BPS <sub>i,t</sub> )		-0.008 (-2.41)**	-0.000 (-2.24)**	0.019 (3.81)***	-0.000 (-2.03)**	0.010 (3.50)***	-0.000 (-1.29)
abnACCR		0.001 (0.04)	-0.047 (-2.58)***	-0.028 (-0.85)	-0.059 (-2.79)***	0.005 (0.19)	-0.051 (-2.59)***
abnACCR * (PRC <sub>i,t</sub> / BPS <sub>i,t</sub> )		-0.000 (-0.05)	0.000 (2.85)***	0.008 (0.81)	0.000 (3.16)***	0.001 (0.81)	0.000 (2.70)***
Size		0.015 (5.05)***	0.001 (0.37)	0.009 (3.48)***	0.001 (0.29)	0.010 (3.66)***	0.000 (0.01)
NiTA		0.356 (10.18)***	0.468 (13.84)***	0.366 (11.12)***	0.496 (11.16)***	0.395 (11.69)***	0.529 (11.69)***
Constant		-0.028 (-0.30)	0.057 (0.32)	0.055 (0.61)	0.065 (0.39)	0.031 (0.33)	-0.268 (-2.16)**
Year, country, and industry fixed effects		Yes	Yes	Yes	Yes	Yes	YES
Observations		1325	2105	1660	1294	1500	1408
R-squared		0.325	0.217	0.307	0.273	0.282	0.270
Test of significance of $\gamma_2 + \gamma_3$	(+)	0.025 (1.56)	0.038 (4.38)***	-0.003 (-0.19)	0.055 (5.05)***	-0.007 (-0.51)	0.052 (4.86)***

Columns 1, 3, and 5 (2, 4, and 6) present the results for firms from strong (weak) investor protection regimes. T statistics are in parentheses. Significance levels are based on two-tailed tests. \*\*\*, \*\*, and \* denote significance at 1%, 5%, and 10% levels, respectively.

All variables are defined in Appendix 1 of the original paper.

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