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Discussion

Discussion of "Convergence of Accounting Standards and Foreign Direct Investment"☆

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1. Introduction

Although considerable accounting research is devoted to the topics of worldwide application of or convergence with the International Financial Reporting Standards (IFRS), most articles focus on the impacts or consequences of IFRS adoption at the firm level. Marquez-Ramos (2008, 2011) initially shifts the research focus from firm-level analysis to country-level analysis and examines the consequences of IFRS adoption within national economic environments. As a result, the work of Chen, Ding, and Xu (henceforth CDX) adds a refreshing research direction in this area.

CDX examines the level and the change of foreign direct investment (FDI) contributed by the conformity of national accounting standards to the IFRS and the IFRS convergence of accounting standards in Organisation for Economic Cooperation and Development (OECD) countries. These authors raise two main research questions: Is an accounting system a component of the national institution infrastructure that explains FDI? How does the IFRS convergence affect the change in FDI?

The theoretical foundation for responses to these questions can be traced to two areas of research. First, the theory of information asymmetry suggests that high-quality financial reporting can reduce information cost and facilitate investment decisions. Second, international accounting suggests that accounting harmonization can make accounting systems worldwide more understandable and comparable. Thus, convergence in accounting standards reduces

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information asymmetry between domestic and foreign investors, thereby facilitating cross-border movement of capital. Although the logic behind the predicted relationship sounds straightforward, the empirical challenge lies in how to prove the relationship between IFRS convergence and FDI in the context of an economic environment affected by a variety of factors.

The key innovation of CDX is to examine this relationship as a "quasi-experimental opportunity provided by the mandatory adoption of IFRS" in European Union countries in 2005, which allows for a relatively "pure" setting of the IFRS effect. The second innovation in research design is the use of bilateral FDI flow among 30 OECD countries to proxy for the country-level outcome of IFRS convergence, which overcomes the limitation in prior work concerning the small number of country-level observations. The authors have conducted a number of robustness checks to suggest alternative explanations of the tested relationship. They provide evidence indicating a positive effect of IFRS adoption on FDI and a moderate role of accounting similarity on FDI changes.

Despite these strengths in research design and methodologies, some issues arise in linking the theory and the hypotheses to the empirical tests. My discussion focuses mainly on two issues. First, why is linking FDI with IFRS necessary, given that research in international trading and economy has reported a variety of FDI determinants? Second, what difficulties arise in examining the relationship between FDI and IFRS?

2. Why does it make sense to explain FDI by IFRS?

The literature of international trading and economy has identified numerous major factors that affect FDI. Most of the research takes the perspective of the host-country incentives (e.g., Dunning, 1998) or host-country or state characteristics (Coughlin, Terza, & Arromdee, 1991; Habib & Zurawicki, 2002), such as economic policies, cultural distance, and physical infrastructure.

Among these determinants of FDI, institutional infrastructures such as the financial and capital market development are important when studying international business activities (Dunning, 2006). While the link of a nation's financial and accounting systems with FDI is not surprising, when CDX develops their hypotheses predicting the potential relationship between IFRS and FDI, two relevant questions arise: Does an effect of IFRS on FDI make sense? Why is the association between IFRS conformity and FDI positive?

Accounting literature has voluminously documented the advantages of applying or converging with IFRS. Ball (2006) reports that the IFRS reflect economic substance more than legal form, improve accounting quality both at measurement and disclosure, reflect economic gains and losses in a more timely fashion, and so on. In particular, IFRS-based earnings are more informative because IFRS provide more useful information for investors and more accurate earnings forecasts for analysts. In extending these benefits from firm level to country level, CDX provides a general theoretical argument that accounting harmonization reduces information asymmetry between domestic and foreign investors, thereby facilitating cross-border capital movement. However, this conclusion rests on one assumption, that similarity in accounting systems is sufficiently important to affect FDI decisions. This assumption might be valid in some countries, but it does not hold in others. For instance, some developing countries tend to impose favorable national economic or trading policies to attract