

Reply

Response to Discussant “Convergence of Accounting Standards and Foreign Direct Investment”

Charles J.P. Chen, Yuan Ding*, Bin Xu

China Europe International Business School, Shanghai, China

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1. Introduction

Minyue Dong provides a thorough discussion of our paper. In what follows, we offer a response to the issues raised by the discussant.

2. Theory and methodology

The discussant asks why it makes sense to explain FDI by IFRS. Specifically, there are two questions. First, is similarity in accounting systems so important as to affect FDI decisions? Second, if there is a positive association between FDI and IFRS, how can one ascertain that the causality goes from IFRS to FDI, but not the other way around?

As indicated by the discussant, our hypotheses are based on the recognition that institutional infrastructures such as accounting systems are important when studying international business activities (Dunning, 2005, 2006). Convergence in accounting standards reduces information barriers faced by foreign investors, thereby facilitating cross-border capital movement. The discussant indicates that this is a valid but a general argument, and the specific question is whether the effect from accounting standards harmonization is sufficiently large to impact FDI decision. We agree that this is fundamentally an empirical question.

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* Corresponding author at: China Europe International Business School, 699 Hongfeng Road, 201206 Shanghai, China

E-mail address: dyuan@ceibs.edu (Y. Ding).

Therefore, the empirical design becomes crucial.

The discussant recognizes that one innovation of our empirical design is the use of bilateral FDI flows among 30 OECD countries, which overcomes the limitation in prior work arising from the small number of country-level observations. Indeed, a relatively large sample size is essential for isolating the effect of IFRS from other institutional factors. This issue is related to a concern of the discussant about omitted variables. There are so many factors that impact FDI decisions, how can we identify the effect of IFRS? One way is to include a long list of control variables. We argue, however, that the approach of adding more control variables is a less effective way to resolve the omitted variable issue. First, it is impossible to include an exhaustive list of variables in the regression. Second, when more and more control variables are added, the number of observations without missing values for the regression tends to fall significantly. We argue that a more effective way of solving the omitted variable issue is to perform panel-data regressions with time and country-pair dummies. Our baseline results are obtained after controlling for both the time fixed effects and country-pair fixed effects, so we believe that they provide evidence of a positive association between FDI and IFRS that is less subject to the omitted variable issue.

But how can we make sure that the causality goes from IFRS to FDI, not the other way around? The discussant expresses the concern of a possible reverse causality by stating that an increase in FDI may push companies to adopt IFRS to fulfill information requests of foreign investors. We admit that this is a legitimate concern. However, the possibility of reverse causality is relatively low in our study because we use bilateral FDI between a pair of countries as the FDI variable. A country's IFRS adoption may be influenced by its overall level of FDI with the rest of the world, but is much less affected by the country's FDI with an individual country.

3. Data and measurement

The discussant raises several questions regarding the data used in our study. First, the data do not cover non-OECD countries (such as China and Russia) that are important in the global FDI flow. Second, the data do not distinguish between FDI in different legal forms while the accounting issue is less relevant for some forms of FDI. Third, the FDI data are based on all companies while the IFRS mandatory adoption applies only to listed companies. We admit these data limitations. As recognized by the discussant, one advantage of our study is the use of bilateral FDI-flow data, which overcomes the limitation in prior work due to the small number of country-level observations. To take advantage of bilateral FDI data, we have to restrict our sample to OECD countries. However, the lack of distinction between listed and non-listed companies in measuring IFRS adoption effect should not distract from our main results as this data limitation should be biased against finding significant results, but not against overestimating the statistical significance. Our goal is rather moderate: we hope to detect some empirical relationships between IFRS and FDI at the aggregate level despite imperfect measurement of IFRS and FDI variables. In the concluding section of our paper, we admit that concentration of our study on 30 OECD countries limits the generalizability of our results.

The discussant also has some concerns regarding measurement of FDI and IFRS conformity. In the baseline regressions, we use the total absolute value of FDI flows (FDI

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