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Discussion of “Accounting quality and loan pricing: The effect of cross-country differences in legal enforcement”

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1. Introduction

Anagnostopoulou (2017) finds that stronger legal enforcement (at the country level) is associated with investors believing that accounting information is more credible and reliable when assessing future cash flows and the probability of default. More specifically, the question addressed is whether accounting quality (AQ) is value-relevant in the determination of loan pricing. This is an important finding because if the goal is to have uniform accounting standards across countries, it is important for the market to view accounting as credible.

Over the last decade, the concept of designing one global set of accounting standards has, theoretically, sounded like a great idea. As more and more countries adopt IFRS and as major accounting issues between U.S. GAAP and IFRS converge, researchers have begun examining a related issue: what happens if accounting standards are not equally enforced among different countries adopting supposedly uniform accounting standards? This paper fits into this stream of research.

In this discussion, I will examine the theory underlying the hypotheses and the proxies the author used to measure legal enforcement and accounting quality. I will also address how these issues might affect future research in areas related to this paper.

2. Legal enforcement

Legal enforcement has been examined in a variety of contexts (see Leuz, Nanda, & Wysocki, 2003). In most settings, researchers wish to control for legal enforcement at the country level. In particular, researchers desire to measure strong versus weak legal enforcement. Typically, legal enforcement is treated as a dichotomous variable following the index using Kaufmann, Kraay, and Mastruzzi (2010). Treating legal enforcement as a dichotomous rather than as a continuous variable has advantages and disadvantages. The disadvantages of dichotomization include loss of information, biased regression estimates, and potential loss of power to detect significance. Because this index is continuous, most researchers choose a cut-off value to convert legal enforcement into a dichotomous variable. Because there is no theory guiding how to determine the cut-off, it is basically arbitrary and could result in differing results from study to study.

Legal enforcement is defined in Anagnostopoulou (2017) as strong if the Kaufmann et al. (2010) index is greater than 1.3. This cutoff is a bit difficult to defend, especially since the theory used in this paper needs a measure of the strength and quality of legal enforcement (which is more readily evaluated using a continuous variable). While other proxies for measuring legal enforcement exist, the advantage of the Kaufmann et al. index is that it is continually adjusted over time. Because the index changes, there are some issues that need to be addressed when evaluating the results of the paper.

In Fig. 1, the average legal enforcement index by country from high to low enforcement is provided. The dotted line represents the cumulative percentage of the sample composed of the countries, and is measured on the right axis. The solid horizontal line is the dichotomous cutoff point for determining strong versus weak legal enforcement. If a country's bar is above the solid line, the country is a strong legal enforcement country. If a country's bar is below the solid line, the country is a weak enforcement country. Notice that the smaller countries make up most of the weaker enforcement sample. In addition, the Philippines might be considered an outlier

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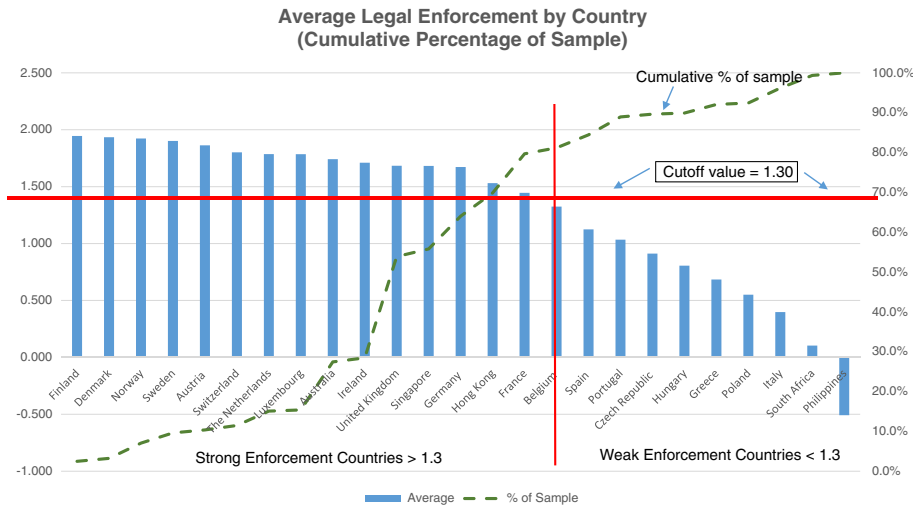


Fig. 1. Average legal enforcement by country (cumulative percentage of sample).

when defining legal enforcement (with significantly smaller and negative numbers). In this case, larger countries have greater economies of scale, more complex accounting issues, and perhaps differing debt structures. In [Anagnostopoulou \(2017\)](#), ten of the 25 countries are classified as weak legal enforcement countries (40% of the countries), but since these are smaller countries, the observations from these countries make up less than 20% of the observations used in the study (the dotted line is the cumulative percent of the sample).

A second issue with a dichotomous legal enforcement variable is that countries are continually changing and the index for a country might be increasing or decreasing. This information is lost in the analysis. In [Fig. 2](#), the trends in the slope of legal enforcement are computed by country. Countries listed above the horizontal line have increasing enforcement indices over time, while countries below the line have decreasing enforcement indices. Thirteen of the 25 countries have increasing legal enforcement over time while twelve of the 25 countries have decreasing legal enforcement. Only one country crossed the cut-off during the sample time period. Belgium switched from weak to strong legal enforcement in 2007. As seen in [Fig. 2](#), the rates of change for some countries are meaningful, especially for Poland and Greece.

In [Fig. 3](#), the legal enforcement index is plotted by country and year. A cursory observation leads one to think that there may be more than two levels of enforcement. I suggest that three levels, and perhaps as many as four, are more apparent. There are two

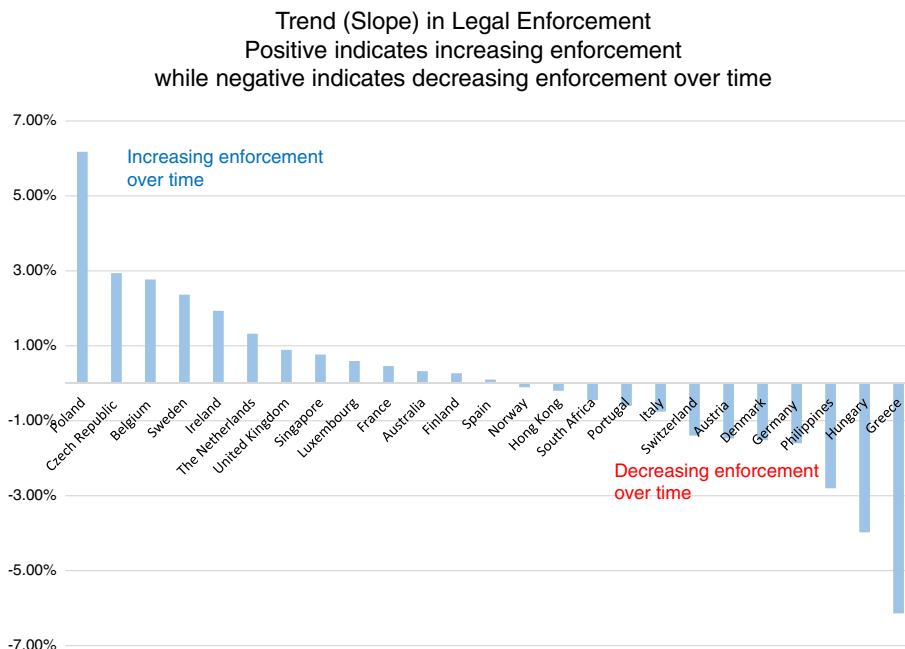


Fig. 2. Trend (slope) in legal enforcement positive indicates increasing enforcement while negative indicates decreasing enforcement over time.

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