ARTICLE IN PRESS

International Journal of Accounting xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

International Journal of Accounting

journal homepage: www.elsevier.com/locate/intacc

Response to Discussion of “Accounting Quality and Loan Pricing: The Effect of Cross-country Differences in Legal Enforcement” Reply to the Discussant's Report

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I am grateful to the discussant, Professor Paul Chaney, for his detailed comments and insightful remarks about my paper. In this response, I provide clarifications to address the discussant's comments, and suggest ways to address some of these issues in future research, where possible.

1. The definition of strong vs. weak legal enforcement

The discussant stressed the need to use a more detailed legal enforcement breakdown by distinguishing, for example, three rather than two levels of enforcement among sample countries. The discussant also commented on the fact that legal enforcement varies with country size; relatively smaller countries have low legal enforcement.

Regarding the definition of strong vs. weak legal enforcement at the country level, this is defined in the paper by using 1.3 as the cut-off point for the Kaufmann, Kraay, & Mastruzzi (2010) *Rule of Law* index, in accordance with earlier studies by Ahmed, Neel, & Wang (2013). Nevertheless, the concerns raised by the discussant are certainly valid, given the structure of the sample and the tendency for smaller countries to be weaker legal enforcement jurisdictions, and vice versa, while a more detailed country breakdown for the definition of legal enforcement should provide evidence on the robustness of the results.

In order to address these concerns, results were repeated according to three legal enforcement groups, and also three GDP per capita groups, by performing coefficient comparison tests for the effect of accounting quality (hereafter, AQ) on loan spread between the different groups. Relevant results are reported in Panels F and G of Table 7, respectively.

The results from Table 7 Panel F indicate that identifying three (rather than two) different levels of enforcement provides results in the same direction as was the case in Table 5. The coefficient comparison tests for the effect of AQ on loan spread confirm the existence of a relatively stronger economic impact of AQ on loan pricing, as the strength of legal enforcement at the country level increases. Results from Table 7 Panel G additionally confirm that country size is not operating as a factor mimicking the behavior of the strength of legal enforcement at the country level. The effect of AQ on loan pricing is actually stronger for the middle (as opposed to the top) size group, with relevant results to be confirmed by comparison of coefficients for AQ in the different size groups.

Regarding the existence of possible time-series trends in the behavior of the Kaufmann et al. (2010) *Rule of Law* index across time at the country level, Table A1 at the end of this Reply document provides information on Kaufmann et al.'s (2010) *Rule of Law* index (by making use of data following the 2013 data update for this index) before 2005. Despite the fact that the topic of interest in this study is not the relative impact of AQ on loan pricing before vs. after IFRS adoption, it can be readily observed from Table A1 that on average, *Rule of Law* index scores appear to be following a rather steady trend despite some changes on a per country basis in the periods before or after IFRS adoption.

At the same time, a definition of high vs. low enforcement countries with reference to the median Kaufmann et al.'s score, calculated among the sample countries used by this study, has been included among robustness checks. The same applies for the use

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http://dx.doi.org/10.1016/j.intacc.2017.05.001
Received 4 March 2017

Please cite this article as: Anagnostopoulou, S.A., International Journal of Accounting (2017), http://dx.doi.org/10.1016/j.intacc.2017.05.001

of a static score (as of year 2005), although a static vs. time-varying Kaufmann et al. (2010) *Rule of Law* index exhibits a very high Pearson correlation coefficient of 99% (footnote 6).

The discussant further raised a valid point by highlighting that the entire study is based on the strong assumption that the concept of legal enforcement within a country coincides with the enforcement of accounting standards. To a large extent, the two levels of enforcement together impact the efficiency of the institutional mechanisms in a given country. Indeed, the validity of this relationship constitutes the basis for the entire analysis and is discussed in the introductory section.

For this reason, it remains an issue for future research to examine the sensitivity of debt markets to accounting information considering the levels of legal and accounting enforcement across countries, as well as the efficiency of the protection of creditor rights.

2. The definition of accounting quality

The discussant stressed the need for using alternative AQ measures, such as a measure based on the market's assessment of accounting information, by making explicit reference to proxies for conservatism and timeliness. Up to this point, the two AQ measures are (a) based on Dechow & Dichev (2002), as extended by McNichols (2002), by explicitly examining how changes in working capital accounts relate to current, past, and future values of cash flows from operations (CFO), and (b) based on the performance-adjusted Modified Jones model (Dechow, Sloan, & Sweeney, 1995; Kothari, Leone, & Wasley, 2005), assessing the quality of accruals, in an effort to ensure that the findings are not driven by the method employed to estimate accruals quality.

As the purpose of this study is to examine whether firm- (rather than country-) specific AQ has a significant effect on loan pricing depending on the strength of legal enforcement at the country level, there was a need to employ alternative AQ proxies that could be calculated at the firm level. At the same time, in an effort to base all calculations on data that applied the same accounting rules, the calculation of proxies for AQ could not begin before 2005.

In this way, I calculated the conservatism-timely loss recognition score based on Khan & Watts (2009), incorporating both the incremental timeliness of bad news and the timeliness of good news (G-Score + C-Score, Khan & Watts, 2009; p. 136). As reported by the discussant, (untabulated) results are consistent, although weaker, when replacing AQ measure based on Khan & Watts (2009).

3. IFRS adoption

In relation to the question about whether the study should include the time period before and after IFRS adoption, the scope of this study is to examine whether accounting quality is more or less value-relevant for loan pricing determination, depending on the strength of legal enforcement at the country level. There is, therefore, a need for a sample of countries reporting under a common set of accounting rules in an order to isolate differences in the quality of accounting standards. For this reason, I use a sample of countries which had mandatorily adopted IFRS by year 2005.

4. The role of the auditors

To address this concern, the baseline model results (as reported in Table 5 of the paper) are repeated by including two auditor-related variables. The first variable is a binary indicator of whether the auditor issued an unqualified opinion (Wordscope item WC07546), and the second variable is a binary indicator variable of whether the auditing firm is a BIG4 auditor (Wordscope item WC07800). However, in the case of this last item, this is available from Worldscope in a static form, with reference to its most recent value, so it is not considered to be as informative as it would have been if it was available in time-series form. Relevant results are reported in Table A2 of this Reply document, and they remain qualitatively similar to the results reported in Table 5 of the paper. For reasons of brevity, these results are not reported in the paper, but there is reference to them in the form of an untabulated robustness control in Section 4.3 of the paper.

Appendix A