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The Impact of Local Financial Markets and Accounting/Reporting Quality on Foreign Direct Investment (FDI)

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Abstract

Whereas many researchers focus on the macroeconomic and political institutional factors as key determinants of foreign direct investment (FDI), the objective of this study is to explore other factors such as financial markets and accounting qualities that could well be key determinants of Foreign Direct Investment. Additionally, the paper examined whether the impact varies for developed and developing countries. Using a sample of 115 countries, 90 developing, and 25 developed from 2007 to 2016, results show that financial markets and accounting quality are associated with FDI flow into a country. The results also indicate that the relationship is stronger for developing countries than for developed countries.

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Contents

Tables and Exhibits

Appendix

Chapter 1

Introduction

Whereas many researchers focus on the macroeconomic(Alam & Shah, 2013; Asamoah, Adjasi, & Alhassan, 2016) and political institutional factors(Biglaiser & Staats, 2010; Jensen, 2003; McLean, Zhang, & Zhao, 2012; Sun, 2014) as key determinants of foreign direct investment (FDI), in this paper I explore that other factors such as financial market efficiency and accounting qualities, could very well be key determining factors for FDI. Over the years many theories have been advanced to explain why companies invest overseas and highlight the benefits of FDI to the host country. Studies have shown that investments made by multinational corporations (MNCs) overseas have contributed greatly to the economic growth in many countries (Ali & Ahmad, 2010; Borensztein, De Gregorio, & Lee, 1998). Because of the benefit of FDI to economic growth and development, over time, many countries have looked for strategic ways to become more competitive in attracting foreign investors into their markets (Porter, 1990). For example, countries have liberalized their economies, privatized state owned enterprise, joined the World Trade Organization (WTO), and signed regional economic trade blocs to stay competitive in the global market. The factors that drive a nation's competitiveness on the world's stage have been the subject of inquiry for many years. Economist Adam Smith for example contended that division of labor and specialization drives productivity and competitiveness. Others have emphasized factor endowment, and investment in physical capital, while many argued that political institutions and macro-economic factors affect FDI.

While these factors are important and many empirical researches have shown them to be key drivers of FDI, I explore in this paper that other factors such as financial market efficiency and accounting qualities could be key factors affecting FDI. The role of an efficient financial market in reducing transaction costs, allocating resources efficiently, promoting economic growth, and enhancing economic activities have been extensively discussed in the finance and economic literature (Greenwood & Jovanovic, 1990; Levine, 1997). Recently research shows that easy access to banks and local market equity affects poverty and labor market(Bruhn & Love, 2014); an effective securities exchange market promotes stock market development and enhances economic growth(La Porta, Lopez-De-Silanes, & Shleifer, 2006); strong investors and shareholders protection improve financial development and increase the availability of external financing(Brown, Martinsson, & Petersen, 2013; McLean et al., 2012), and good credit rating attract investors to a company(Afonso, Furceri, & Gomes, 2012; Bolton, Freixas, & Shapiro, 2012). Studies have shown that a sound banking system plays a major role in enhancing economic activities and the overall economic growth of a country (Fitma, 2014; Bourkhis & Nabi, 2013).

Likewise the important role of accounting quality in a nation's economic activities has been extensively documented in the accounting literature. Among others, most accounting researchers have shown that accounting/reporting quality (timely loss recognition, reduce smoothing accounting numbers, and the ability of financial statements to capture and explain the stock price, returns, and value of the firm accurately) reduces information asymmetry, increases transparency, market liquidity, equity valuation, and lowers cost of capital(Barth, Landsman, & Lang, 2008; Bischof &

Daske, 2013; Daske & Gebhardt, 2006; Jeanjean & Stolowy, 2008; Lambert, Leuz, & Verrecchia, 2007). Other studies indicate that quality accounting/reporting increases the likelihood of cross-border merger (Erel, Liao, & Weisbach, 2012), and increases the financing and investing capacity of a firm(Balakrishnan, Core, & Verdi, 2014).

Technically, accounting/reporting quality includes timely recognition of losses; reduces smoothing of accounting numbers, comparability, full disclosure, and value relevance. However, this paper will focus not only on the quality of the reported accounting numbers but rather on the efficiency and quality of accounting standards that protect investors and reduce transaction cost. . For example, Studies have shown that the adoption of IFRS, which may or may not improve the quality of accounting numbers, improves comparability of financial statements across boarders thereby reducing asymmetric information and transaction cost (Brochet, Jagolinzer, & Riedl, 2013; Gordon, Loeb, & Zhu, 2012). In other words, the paper will look at the quality of accounting standards in a broader term that includes an enforcement mechanism that protect minority shareholders, investors, and reduce the cost of doing business in across-boarders. For example, Studies have shown that an effective corporate board is associated with accurate earnings forecast and higher quality financial statements disclosure (Karamanou et all, 2005 & Klein 2002), because the corporate board includes an audit committee which oversees the preparation of financial statements. Additionally, the strength of shareholder protections has been shown to affect the availability of external financing of a company (Brown et al, 2013; La Porta et al, 2000)because among the variables used to measure the strength of shareholder protections are enforecement, the

quality of accounting standards and the comprehensiveness of the corporate annual reports.

Notwithstanding the apparent general agreement about the role of accounting quality and financial markets on economic activities, it seems the accounting and finance literature has largely ignored its potential effect on FDI. I can think of at least three reasons why the link between FDI and accounting and financial markets has been largely ignored by the literature. First, and most importantly, the data to link the three may not be readily available. Second, economists tend to focus on macroeconomic factors, and third, political scientists tend to focus on the political institutional factors that affect a nation. However, there are good reasons to deduce that within the eclectic theory of location advantage, local domestic institutions such as financial markets and accounting institutions may be additional important factors that determine FDI. Efficient financial market and quality accounting standards, I infer, are location advantages because they reduce information asymmetry and transaction cost for foreign investors and are therefore able to attract foreign investors and foreign direct investment. Therefore, a country with efficient financial markets and accounting qualities has the greatest competitive potential and will most likely attract FDI.

Objective of the Study and Contribution to the Literature

The objective of this study is to explore that other factors such as financial markets and accounting qualities could well be key determinants of Foreign Direct Investment. Additionally, the paper will examine whether the impact varies for developed

and developing countries. The paper contributes to the extensive literature on the key determinants/drivers of FDI and on the economic consequences of quality accounting standards and an efficient financial market.

Significance of the Study

Various studies have evaluated the importance of macroeconomic and political institution variables and conclude that they are key determinants of FDI. As a result, governments over the years have done everything to improve those macroeconomic and political institution variables in order to attract FDI. The significance of this study is that it goes beyond previous studies (which only examined macro-economic and political institutional factors as key determinants of FDI), and instead show that domestic economic institutions such as financial markets efficiency and accounting quality are key determinants of FDI. Specifically, the paper show that ease of access to loans, venture capital availability, soundness of banks, regulation of securities exchange, strength of audit and reporting standards, investors protection, and protection of minority shareholders are key determinants of FDI. Because of the availability of the Global Competitive Index (GCI) data, I empirically show that these factors truly affect FDI.

Therefore, countries today, by making their domestic institutions efficient, can become more competitive in the global market. From a policy perspective this is an important factor for countries seeking to attract FDI. In such a competitive and global environment, this may be the time for developing countries to focus on improving domestic economic institutions along with their macroeconomic and political institutions.

Chapter 2

Literature and Hypotheses

Background of FDI

The World Bank defines Foreign Direct Investment (FDI) as a long-term investment made by a company based in one country, into a company based in another country. Companies making direct investments typically have a significant degree of influence and control over the company into which the investment is made. Multinational Corporations (MNCs) over the years through FDI have invested in multiple countries at the same time. They have done this either through cross-border acquisition, joint ventures with local firms, or establishing new facilities in the host countries. Investing overseas have contributed enormously to the rapid growth of Multinational Corporations (MNCs). At the same time, Foreign Direct Investment (FDI) have contributed enormously to rapid economic growth in many countries. Therefore, both MNC and host countries have benefited greatly from FDI. Because of this mutually recognizable benefit, from 1970 to the present, FDI has grown significantly and has been a major source of private capital and economic development in both developed and developing countries. Even though some have argued that FDI destroys local communities by extracting natural resources without adequately compensating the host countries, according to the World Bank 2017 World Investment Report, FDI has grown from $50 billion in 1970 to $1.75 trillion in 2016(UNCTAD, 2017).

Benefit of FDI

Foreign Direct Investment, which is the focus of this dissertation, has been defined by the World Bank as a long-term investment made by a company based in one country, into a company based in another country. Companies (most often Multinational Corporations) making direct investments typically have a significant degree of influence and control over the company into which the investment is made.

Foreign direct investment has proven to be very beneficial for developing countries. For example, FDI has brought technology to regions which were not technologically advanced. It has also served as a vehicle in the transferring of capital, of primary resources that are keys to the growth of these economies, and of a vast wealth of knowledge passed on in the training of the host country's labor force (Loungani & Razin, 2001). These kinds of activities stimulate economic growth which results in increased taxable revenues from more people being employed and the expansion of the domestic market. It goes without saying that this kind of economic growth also improves the standard of living for the host country's citizens.

The scope of the benefits of FDI goes much deeper than local employment opportunities and improved standard of living. FDI brings with it the transfer of knowledge, thereby turning an otherwise inefficient local labor force into skilled workers through training and educational programs provided by MNC investing in the host country. The result is that the host country increases it skilled labor force which in turn attracts more investors (MNC) because of the availability of skilled workforce.

The transfer of technical skills brought to host countries through training in advanced technologies (De la potterie & Lichtenberg, 2001) is one of the factors of FDI which has both short-term and long-term benefits. In a short period of time, valuable