Discussion of
"The State Expropriation Risk and the Pricing of Foreign Earnings"

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I. INTRODUCTION

Hasan et al. (2021) examine the association between country-level expropriation risk and the pricing of foreign earnings in multinational corporations (MNCs). They contend and find that, when subsidiary country expropriation risk declines, the value relevance of foreign earnings increases. Hasan et al. (2021) view their evidence as consistent with the idea that investors discount foreign earnings when they perceive the risk of expropriation and unfair treatment by foreign governments to be high.

The study of Hasan et al. (2021) aims to contribute to the longstanding stream of the literature that examines the pricing and value relevance of foreign earnings (e.g., Thomas, 1999; Callen et al., 2005; Hope et al., 2009), as well as to the nascent literature that investigates the within-MNC determinants of financial reporting transparency (e.g., Dyreng et al., 2012; Beuselinck et al., 2019).

My discussion focuses on three key issues. First, related to the study's theoretical underpinnings, a maintained assumption of Hasan et al. (2021) is that the pricing of foreign subsidiary earnings is only explained by investors discounting foreign subsidiary earnings to account for subsidiary country risk of expropriation in their investment decisions—that is, investors rely less (more) on foreign subsidiary earnings when subsidiary country risk of expropriation is high (low). I argue that Hasan et al. (2021)'s maintained assumption is rather strong, as it neglects the realistic possibility that the pricing of foreign subsidiary earnings is also a function of subsidiary earnings quality. Second, the evidence in Hasan et al. (2021) mainly relies on a cross-sectional identification strategy and thus their findings are to be interpreted with this caveat in mind. Third, while Hasan et al. (2021) are careful in designing a number of sensitivity tests to account for the influence of confounders, potential alternative explanations for their documented findings are hard to rule out.

The remainder of my discussion unfolds as follows. Section 2 provides some perspectives on the theoretical underpinnings of Hasan et al. (2021). Section 3 focuses on the empirical challenges. Section 4 discusses potential alternative explanations for the documented findings. Section 5 concludes.

II. THEORETICAL UNDERPINNINGS

The central tenet of Hasan et al. (2021) is that, when pricing the earnings of MNCs, investors discount the foreign earnings of subsidiaries domiciled in countries with high risk of expropriation. Accordingly, Hasan et al. (2021) hypothesize a negative association between the degree of subsidiary country expropriation risk and the value relevance of foreign subsidiary earnings.

The maintained assumption of Hasan et al. (2021)'s theoretical development—that is, the pricing of foreign subsidiary earnings is only determined by investors discounting foreign subsidiary earnings to account for subsidiary country risk of expropriation—neglects, however, the realistic possibility that the pricing of foreign subsidiary earnings may also be a function of subsidiary earnings quality.

I believe the maintained assumption of Hasan et al. (2021) to be challenging because the multiplicity of factors that influence MNCs' decisions to invest abroad are also likely to shape MNCs' financial reporting strategies and thus subsidiary earnings quality (Dyreng et al., 2012; Beuselinck et al., 2019).

MNCs' foreign direct investment policy—that is, the decision to invest in subsidiaries domiciled in foreign countries—is certainly not *random*. In fact, MNCs may seek to invest abroad, among other reasons, to increase the scope of their geographic and industrial diversification, to take advantage of a cheaper (or differentially skilled) labor force, or to benefit from more convenient tax regulations. MNCs may deliberately invest in countries with high risk of expropriation if they find it net beneficial overall. Furthermore, the very same factors that influence MNCs' foreign direct investment decisions are also likely to shape subsidiary earning quality.

The *political cost hypothesis* (Watts and Zimmerman, 1978; 1986), for example, would predict that MNCs that establish subsidiaries in countries posing expropriation risks likely exercise their financial reporting discretion to manipulate these subsidiaries' earnings downwards when they perceive the risk of expropriation (i.e., a political cost) to be high.[1] More generally, MNCs may manipulate the earnings of their subsidiaries domiciled in countries with lax financial reporting enforcement as a part of a deliberate financial reporting strategy orchestrated at the MNC headquarters level (Dyreng et al., 2012; Beuselinck et al., 2019).[2]

In light of the above discussion, it is reasonable to assume that the quality of subsidiary earnings is likely determined by *both* (i) the foreign direct investment policy of MNCs, and (ii) the financial reporting choices made by MNCs. As such, it is unclear whether the lower value relevance of foreign subsidiary earnings documented by Hasan et al. (2021) reflects investors' expropriation risk considerations or, instead, investors' lower reliance on subsidiary earnings because of transparency considerations, or a combination of both.[3]

III. EMPIRICAL CHALLENGES

At a conceptual level, Hasan et al. (2021) examine whether subsidiary country risk of expropriation affects the pricing of earnings reported by foreign subsidiaries. Empirically, however, Hasan et al. (2021) measure: (i) subsidiary country risk of expropriation using a proxy for the *strength of contract viability*; and (ii) investors' reliance on foreign subsidiary

[1] For a recent study that provides a novel test of the political cost hypothesis, see Boland and Godsell (2020).
[2] Prior studies (e.g., Dyreng et al., 2012; Beaver et al., 2019; Beuselinck et al., 2019) show that within-MNC factors influence several subsidiary-level decisions, including financial reporting choices.
[3] Cascino et al. (2014) and Cascino et al. (2021) examine the usefulness of financial reporting information for capital providers.

earnings information using the *value relevance* of the foreign earnings reported by MNCs. I believe the two chosen proxies for the constructs of interest likely limit the inferences of the study for several reasons.

First, a potential drawback associated with the choice of value relevance as a proxy for the usefulness of foreign subsidiary earnings to MNC investors is that the ensuing value relevance regressions likely capture MNC investors' assessments of both subsidiary country expropriation risk *and* subsidiary earnings quality.

Second, because Hasan et al. (2021) proxy for subsidiary country risk of expropriation using a country-level measure of the strength of contract viability—that is, the extent to which a country enforces private contracts—a more natural earnings attribute to examine would be one that captures the usefulness of accounting information for contracting (e.g., conservatism) as opposed to the usefulness of accounting information for equity valuation (i.e., value relevance).

Third, the empirical measure of strength of contract viability does not appear to exhibit substantial time-series variation and, moreover, is likely associated with other—potentially confounding—country-level factors. As such, it is unclear the extent to which the documented value relevance effects can be (entirely) attributed to changes in the strength of contract viability. Relatedly, the cross-sectional nature of Hasan et al. (2021)'s identification strategy prevents the authors from establishing a causal link between expropriation risk and the value relevance of foreign subsidiary earnings. Thus, future research could perhaps exploit plausibly exogenous changes in strength of contract viability provided by country-level "expropriation events" (Lin et al., 2019) to better isolate the effect of subsidiary country expropriation risk on the pricing of foreign subsidiary earnings.

Fourth, Hasan et al. (2021) do not observe reported foreign subsidiary earnings *directly*. In contrast, because of data limitations, they simply use MNCs' foreign earnings as a proxy for foreign subsidiary earnings. However, because MNCs may generate foreign earnings even absent a direct investment in a foreign country (i.e., MNCs may also generate foreign earnings by means of selling directly from their home countries), the findings of Hasan et al. (2021) should be interpreted with this data limitation in mind.

Lastly, as the main model specification in Hasan et al. (2021) does not include MNC fixed effects, the documented value relevance estimates are not purged from the effect of MNC-level variation. Thus, the reported effect of expropriation risk on subsidiary earnings value relevance may be explained, at least in part, by fundamental financial reporting quality differences across subsidiaries of different MNCs.

IV. POTENTIAL ALTERNATIVE EXPLANATIONS

Although Hasan et al. (2021) conduct a series of sensitivity tests to mitigate the possibility that their estimates could be biased because of (unobservable) confounders, the discussion of the research design limitations in the preceding section highlights that potential alternative explanations for their documented findings are inherently hard to rule out.

First, as previously mentioned, MNCs choose destination countries for their foreign direct investments for a variety of reasons. Often, MNC foreign direct investment decisions are motivated by the degree of proximity between the MNC country and the subsidiary country (e.g., the MNC country and the subsidiary country may have the same legal origin, share a common language, or have a similar judicial system, etc.). Therefore, the documented extent of foreign earnings value relevance may reflect factors associated with MNC foreign direct investment choice rather than subsidiary country expropriation risk.

Second, subsidiary country expropriation risk is likely to vary depending on the degree of political hostility between the MNC country and the subsidiary country. Therefore, to the extent that the documented findings in Hasan et al. (2021) are solely based on a sample

MNCs headquartered in the United States, it is hard to say whether the results would generalize to MNCs headquartered in other countries. This is especially important since prior research has shown that factors associated with specific MNC/subsidiary country-pair combinations are important determinants of subsidiary earnings quality (Beuselinck et al., 2019).

Third, as subsidiary earnings quality is largely affected by MNC-level reporting policies, and MNCs may have incentives to obfuscate reported numbers in subsidiary countries with high expropriation risk, the documented value relevance effects may, at least in part, be driven by MNC headquarters' financial reporting policies.

V. CONCLUSION

Hasan et al. (2021) present evidence of a negative association between subsidiary country risk of expropriation and value relevance of foreign subsidiary earnings. While Hasan et al. (2021) are careful in designing a number of tests to support their main findings, the evidence they document should be interpreted with caution. The inherent data availability limitations, the cross-sectional nature of their identification strategy, and the potential alternative explanations for the findings that Hasan et al. (2021) document call for future research to identify more suitable settings and sharper empirical designs to further improve our understanding of the pricing determinants of foreign subsidiary earnings.

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