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The impact of IFRS adoption on foreign direct investment

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A B S T R A C T

By analyzing a panel data set of over 1300 observations covering 124 countries, for the period from 1996 through 2009, this paper tests the basic argument that the adoption of International Foreign Reporting Standards (IFRSs) by a country results in increased foreign direct investment (FDI) inflows. Analysis of the data using an ordinary least squares (OLSs) approach provides evidence that adoption of IFRS leads to increased FDI inflows. The analysis indicates, however, that the overall increase in FDI inflows from IFRS adoption is due to the increase in FDI inflows by countries with developing, as opposed to developed, economies. A difference-in-difference test confirms these findings. A key potential driver for IFRS adoption by countries with developing economies is the desire to receive financial aid from the World Bank. This factor is explicitly taken into account using a two-stage instrumental variable (IV) model. The results using the IV model provide strong confirmation of the OLS results.

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1. Introduction

The adoption of International Financial Reporting Standards (IFRS) by well over 100 countries since 2004, with more countries moving towards adoption, has been a major development in accounting regulation throughout the world.[1] Accounting researchers have recognized the significance of the move

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[1] A notable exception to the countries adopting IFRS is the United States. However, the U.S. Securities and Exchange Commission (SEC) has already agreed to allow foreign registrants to file reports based on IFRS without reconciling to U.S. GAAP (Generally Accepted Accounting Principles), as discussed at: http://www.404.gov/news/speech/2008/spch060508jww.htm. Many, if not most, experts believe it is only a matter of time before the SEC adopts IFRS for domestic registrants (see: http://www.journalofaccountancy.com/Issues/2010/Apr/20102658.htm).

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to a set of harmonized global accounting standards and have analyzed a number of issues concerned with the economic effects of adopting IFRS (e.g., Aharony et al., 2010; Armstrong et al., 2010; Bhimani, 2008; Daske et al., 2008).[2] Indeed, there is a growing consensus that harmonization of accounting standards carries with it the potential to increase transparency, thus reducing information processing costs and asymmetric information (e.g., Humphrey et al., 2009; Shima and Gordon, 2011). As Shima and Gordon (2011, p. 481) note, "The recent global trend toward the use of IFRS may signal attempts by policy makers to reduce information asymmetries for international investors."

To the extent that IFRS adoption by a country leads to an increase in the transparency of financial reports, IFRS adoption should also lead businesses and individuals in other countries to be more likely to invest in that country. Countries where the transparency of financial reports is poor, relative to the transparency provided under IFRS, have the greatest potential for increasing transparency through IFRS adoption. In general, countries with developing economies have weaker domestic financial reporting regulations, with less transparency in their financial reports, than countries with developed economies (Ding et al., 2007). Thus, it is the former countries (i.e., those with developing economies, or what are often called emerging markets) that should have the greatest potential for an increase in foreign investment as a result of IFRS adoption. The Chairman and CEO of Ernst & Young clearly recognized the potential impact of global IFRS adoption on international investment decisions for countries with developing economies, when, in an *Op Ed* article in the *Wall Street Journal,* he noted, "There would also be benefits for emerging markets and the poorest countries of the world. A globally embraced set of standards can provide a readily available foundation for capital market activity. This could promote investment, strengthen the economy and improve people's lives (Turley, 2007, p. 18)." To the extent that Turley's argument is correct, policy setters in countries with developing economies would be wise to consider requiring the mandatory adoption of IFRS for firms in their countries.

To investigate the effect of IFRS adoption on the magnitude of foreign investment into a country, we examine the country's total foreign direct investment (FDI) inflows. FDI inflows are a measure of foreign investors' direct investments into a host country that represent lasting or controlling interests in businesses in the host country. FDI inflows are generally considered to be a major driver of economic development for a country, especially for countries classified as having developing economies (OECD, 2002). FDI has been, and continues to be, a fundamental concern to economic and international researchers, as well as policymakers. An important aspect of this concern has focused on assessing the determinants (or key drivers) underlying FDI. The literature investigating FDI determinants is extensive and goes back long before IFRS reached the agenda of the International Accounting Standards Board (the body that issues IFRS and is the successor of the International Accounting Standards Committee) in 2001.[3]

The study reported in this paper has two major, albeit related, objectives and contributes to both the literature on the economic consequences of IFRS adoption and the empirical literature on the determinants of FDI. The first objective is to examine the impact of adopting IFRS on total FDI inflows of all countries making such an adoption. The second objective is to determine if the impact of IFRS adoption on county-specific FDI inflows varies based on whether a country is classified as having a *developing* or *developed* economy. As discussed in the next section of the paper, to date there has been limited research examining the above issues.

The key findings from the current study support the argument that IFRS adoption is positively associated with an increase in the total FDI inflows to countries. However, while the impact of IFRS on the FDI inflows is statistically significant for the overall sample, this result is driven by the subsample of countries classified as having *developed* (as opposed to *developing*) economies, according to the World Bank classification scheme.[4] As discussed in the fifth section of this paper, these findings have important implications for researchers and policy setters.

[2] For an insightful discussion on the harmonization of global accounting standards during the evolutionary process that resulted in IFRS, see the article by Thorell and Whittington (1994) and the reflections on this article by Hopwood (1994).

[3] For an early review article on FDI determinants, see Agarwal (1980).

[4] The World Bank criterion for classifying the economies of countries is based on the gross national income (GNI) per capita. Countries in the category classified as high GNI per capita are generally classified as developed economies. Countries falling into the low, lower-middle, or upper middle GNI per capita are generally classified as developing economies. See the following website for a further explanation of the World Bank's classification scheme: http://data.worldbank.org/about/country-classifications/world-bank-atlas-method.

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