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## Foreign Direct Investments and International Financial Reporting Standards Adoption in Africa

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### Abstract

This study examines the relationship between Foreign Direct Investments (FDI) and International Financial Reporting Standards (IFRS) adoption in Africa. Data were collected from Forty-six countries in Africa out of the fifty four countries making up the African continent; where it was reported in extant literature that only 54% of African countries have adopted the IFRS product. The Ordered Logistic Regression (OLR) technique under the E-view 7.0 software was used to analyse the data collected. The study reveals that foreign direct investment has a positive but not significant relationship with adoption of IFRS in Africa. This not significant relationship is attributable to the scanty flow of FDI to Africa. Based on this result, it was recommended that policy effort should be put in place to enhance the flow of foreign direct investment into the African economy, may be by creating an enabling environment free from corruption and inadequate security of life and properties. More of this will stir economic/capital market growth and deepen the need to practice or adopt the International Financial Reporting Standards (IFRS) in Africa

**Keywords:** IFRS adoption, foreign direct investment, Rational choice theory, Gross domestic product and population

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## **Introduction**

Globalisation and capital flow across the globe call for uniform reporting standards for various reasons: (1) harmonization of financial reporting across the globe will promote uniformity of reporting, (2) international harmonization of accounting standards is much concerned with consistency, comparability and reliability of financial information from different countries. The world-wide financial scandals (for example, Enron, Worldcom & Cadbury) that occurred in time past also pushed regulators and professional bodies in different countries to call for uniformity in accounting standards in order to regain the confidence of the users which has been shredded during the scandals. Therefore, there has to be a kind of standard that narrows down seemingly divergent practices. The latter is the role of the International Accounting Standard Board, IASB.

The International Accounting Standard Committee (IASC) was founded in June 1973 in London with an attempt to formulate uniform global accounting standards aimed at reducing the discrepancies in international accounting principles and reporting practices. To achieve its goal, IASC proposed some International Accounting Standards (IASs) towards championing the uniformity and standardization of accounting principles (Carlson, 1997). In April 2001, the IASB took over the setting of IASs from the IASC. Henceforth, the IASB updated the already existing IASs and referred to them as the International Financial Reporting Standards (IFRS).

IFRS are used in many parts of the world, including the European Union, Hong Kong, Australia, Malaysia, Pakistan, Russia, Turkey and about 41% of African countries (Mwaura & Nyaboga, 2009). As of 31<sup>st</sup> December, 2011 more than 120 countries around the world, including all of Europe permit IFRS reporting. Though the number of countries that have adopted IFRS is quite on the low side, there is hope that there will be more adopters in the near future (IASPlus, 2010).

As at 31<sup>st</sup> December, 2011, 54% of African countries have adopted IFRS; amongst which are Angola, Botswana, Cameroon, Southern Africa, Kenya, Malawi and Morocco. The remaining 46% which are

yet to embrace the IFRS include Benin, Cote D'Ivoire, Cape Verde, Burkina Faso, Niger and Togo (Simon Fraser University, 2011). Nigeria adopted IFRS in 2012. The concern at this point is why is there heterogeneity in IFRS adoption decisions amongst countries with particular reference to African countries.

In extant literature on IFRS adoption (e.g. Ramanna & Sletten, 2009), Foreign Direct Investment (FDI) has been identified as a determinant of IFRS adoption amongst countries. FDI has been seen by most African countries as a source by which their economy can be improved (Uwubanmwun, 2010). This may compel them to adopt IFRS which is seen by investors as a tool that lowers information costs to an economy, particularly as capital flows and trade become more globalized.

Many studies have been conducted in developed countries with respect to the role of FDI in IFRS adoption. These include Marques-Ramos, 2008; Ramannah & Sletten, 2009; Chen, Ding & Xu, 2011; Lamin Ritsumeikan Asia Pacific University, 2011. Compared to the developed economies, not much studies on IFRS adoption have been conducted in Africa and awareness of the importance of researches on adoption of IFRS in developing economies only came into limelight in 2009 (Ramanna & Sletten, 2009; Gyasi, 2010; Lamin, Ritsumeikan Asia Pacific University, 2011). Some findings of these studies that IFRS adoption has significant impact on attracting foreign direct investment are consistent with one another and what have been found in developed markets, while others are inconsistent. The point is that, the results are mixed which makes the issue inconclusive. In the light of this, the objective of the study, therefore, is to ascertain the relationship between adoption of IFRS and foreign direct investment in African countries.

## Literature Review

This chapter discusses the relationship between IFRS adoption and FDI as presented in extant literature. It also presents the theoretical underpinnings of this study.

### **Foreign Direct Investment and IFRS Adoption**

The worldwide harmonization of financial reporting through the international financial reporting standards is an accounting response to the integration of world capital markets. The existence of significant differences among various national accounting systems causes an information asymmetry of local investors at the expense of foreign ones, who do not possess detailed knowledge of local economic and political environment. The gradual adoption of the IFRS all around the world reduces and eliminates the costs of gaining information for the decision-making, as companies (mainly listed) use the same system of financial reporting standards regardless of their domicile. In this way, the IFRS as an international accounting standard contributes to the smooth functioning of global capital markets and promotes the flows of foreign capital to adopting countries. Despite this important feature, research analyzes the benefits from the IFRS implementation only from investors', *i.e.* microeconomic perspective (Ball, 2006).

Macroeconomic consequences of the IFRS adoption are, although, on the edge of accounting research. The research about the relationship of the IFRS adoption on foreign direct investments is relatively new and just few studies have been carried out in this area. The first comprehensive analysis of the effects of FDI on IFRS was performed by Marques-Ramos (2008) on the sample of EU countries. The author uses a gravity model. The results provide evidence that the IFRS adoption has positively influenced FDI. He made an assumption that the accounting harmonization is a workable strategy to attract foreign investors by reducing their risks for investing abroad.

A different approach was adopted by Farooque, Yarram, & Khandaker (2009) who studied the interdependence of corporate governance and FDI inflows on the sample of twelve year data of 173 countries. Their research comprises also the evaluation of IFRS adoption and legal origin on FDI and governance. Their findings show that IFRS have stronger effect on the governance rather than on FDI. However, through an increased quality of governance, the IFRS allows free movement of capital around the world. Beneish, Miller & Yohn (2010) found that the IFRS adoption in the European

Union had significant impact on foreign debt investment. The effect on foreign equity investments is relatively small. More so, differences in empirical results from Marques-Ramos (2008) and Farooque *et al.* (2009) may be attributable to sample selection. Marques-Ramos (2008) focused on only countries in the EU, while Farooque *et al.* (2009) went beyond the EU to include three other continents (Africa, Asia and North America). Also, Marques-Ramos (2008) took an assumption that the accounting harmonization is a workable strategy to attract foreign investment by reducing their risks for investing abroad.

The net economic value of IFRS is intended to capture direct pecuniary benefits as they are usually conceived in economic models of networks. Accordingly, Ramanna & Sletten (2009) test whether economies that are more reliant on foreign investment and trade are more likely to adopt IFRS and whether the likelihood of IFRS adoption decreases with the quality of domestic governance institutions (a proxy for both opportunity and switching costs). They find no evidence that the level of and expected changes in foreign investment and trade affect the likelihood of adoption. Thus, they cannot confirm that IFRS lowers information costs in more globalized economies.

Pagano, Roell & Zechner (2002) in their study on why companies list abroad, they found that there is no significant relationship between cross-country investments and adoption of international accounting standard. This according to them is because prohibitive informational obstacles to cross-country investments occur. Beneish, *et al.* (2010) findings on the relationship between the IFRS adoption and foreign direct investment as earlier stated is in consonance with the findings of Marques-Ramos (2008) when they found out that IFRS adoption in the European Union has significant impact on attracting foreign direct investment. However, the result of the study is impaired because only four (4) non-EU countries were used as control factors.

Chen, Ding & Xu (2011) in their study on convergence of accounting standards and foreign direct investment, found that the shift from local accounting standards to IFRS contributed positively to the foreign direct investment growth during the period between 2001 and 2005. Epstein (2009) found out that adoption of IFRS

increased market liquidity, decrease transaction costs for investors; lower cost of capital and facilitate international capital formation and flows. Various studies (e.g. Beneish *et al.*, 2010) conducted on the adoption of IFRS indicated that countries that adopted IFRS experienced huge increases in foreign direct investment flows across countries (Irvine & Lucas, 2006). The results from these studies should be applied with caution because Chen *et al.* (2011) concentrated their study on only the effect of wide spread adoption of IFRS on bilateral foreign direct investment within the OECD countries for example. Therefore, their result cannot be said to have universal application.

Results from Marques-Ramos (2008) study is in line with that of Kosi & Florou (2009), who show that mandatory IFRS reporting has no impact on the cost of loans. Therefore, IFRS are of great importance to foster investments in equity capital. These results provide that increases in transparency in the destination country reinforce the comparability effect of IFRS adoption on FDI.

Beneish *et al.* (2010) further posit that IFRS adoption countries with weaker investor protection and greater financial risk are able to attract more FDI. This means there is a positive and significant relationship between IFRS adoption and FDI. The result also indicates the importance of other variables to receive a larger amount of foreign capital inflows, such as cultural closeness to the countries offering the IFRS product. Then familiarity effect seems to predominate in the FDI relationship between well-established capitalists and transition countries (Marques-Ramos, 2009).

In their study on a sample of 48 developing countries in Asia, Africa, South America and some non-EU member countries in Europe, Lamin, Ritsumeikan Asia Pacific University (2011) found out that developing countries adopting IFRS are unlikely to experience higher FDI inflows and international trade. This result contradicts Marques-Ramos (2008) result but is in consonance with that of Ramanna & Sletten (2009). This result may be attributable to the weak institutional framework and capital markets in these developing countries.



### Theoretical Framework

The theory underpinning this study is hinged on the rational choice theory. The rational choice theory implies that all action is fundamentally 'rational' in nature and a country will calculate the possible costs and benefits of any action before making decision of what to do (Elster, 1986; Coleman, 1990; Scott, 2000). The rational choice theory analyses the actions and behaviour of an individual or a country as a rational, discriminating selector who aims to maximize one's utility (Munch, 2002). In brief, rational choice theory attempts to explain why people or countries do what they do, given certain choices; as to whether to adopt an international standard like IFRS or make do with their domestic accounting standard.

According to Bejan (1981), a country in evaluating a new standard, will compare the expected utility of each accounting information user in the economic equilibrium based on existing standards to his expected utility in the equilibrium resulting after a reporting change. For a new accounting standard to be optimal, he argues that it is necessary for the total expected utility differential to be non-negative for all users. Rationality clearly dictates that a country will not adopt an accounting standard if adopting it will make it worse off. Therefore, for an accounting standard to be optimal, it is necessary that:

$$ADP = B - C \geq 0$$

Where;

- ADP = a country's IFRS adoption decision  
 B = Change in the country's expected benefit because of change in accounting standard.  
 C = Cost component

Relating the rational choice theory to economic benefits expected to be derived by a country on adoption of IFRS, proponents of IFRS (Leuz, Nanda & Wysocki 2003; Barth, Landsman & Lang, 2008) argue that the standard reduce information costs to an economy, particularly as capital flows and trade become more globalized; it is cheaper for capital market participants to become familiar with one set of global standards than the several local standards.

Accordingly, in this study, we tested whether countries with high levels of expected increases in foreign direct investment (benefits) are more likely to adopt IFRS.

$$1ADP = f(\text{FDI})$$

Where;

FDI = foreign direct investment

## **Methodology**

The survey research design was adopted in this study. The reason is that the researcher wants to reach to several countries in the African continent and data was collected at a particular point in time; therefore the researcher was involved in a cross-sectional survey research design. The research population comprised the 54 countries in Africa. A survey of the sampled countries with respect to the determinants of IFRS adoption was carried out. The sample size is 46 countries. The reason for taking a sample size of 46 countries is to ensure robustness of the study and representativeness of the sample.

The cluster sampling technique was adopted in this study. This was complemented with the simple random sampling technique. The reason for the choice of the cluster sampling technique is that the population of study (the 54 countries making up Africa) is distributed in five clusters. For each country in a given cluster to have equal chance of being selected, the simple random sampling technique was then introduced.

The clusters are; West Africa (16 countries), East Africa (16 countries), Middle Africa (9 countries), Southern Africa (6 countries) and North Africa (7 countries). The next step in the sampling was to number the countries in each of the clusters in the adequate range. West Africa was numbered 01 to 16; East Africa 01 to 16; Middle Africa 01 to 9; Southern Africa 01 to 06; and North Africa 01 to 07. After which, a computer package (Excel) was programmed to select 46 random numbers within the specified ranges in proportion to the cluster's share of the total population. The numbers thus generated were used to choose the countries included in the study sample.

The secondary source of data was adopted in this study. Data for foreign direct investment was sourced from World Bank's World Development Indicators (WDI) database E-view 7.0 software was used to analyse the data collected. The ordered logistic regression analysis was used to regress decision to adopt IFRS because the dependent variable (IFRS adoption) is in five (5) categories. Categories were named zero (0) to four (4) where:

- Zero (0) means decision not to adopt IFRS by the country;
- one (1) means efforts to implement IFRS is still being identified by the country;
- two (2) means publicly listed entities and significant public interest entities are to prepare their financial statements using applicable IFRS,
- three (3) means all other public interest entities mandatorily adopts IFRS for statutory purposes;
- and Four (4) means Small and Medium-sized Entities (SMEs) mandatorily adopts IFRS.

The variables that were used in this study are: IFRS adoption decision, foreign direct investment, gross domestic product and a country's population. Gross domestic product and population are introduced as control variables.

IFRS ADOPTION is defined in this study as the decision a country has taken either to adopt IFRS or not (see Ramanna & Sletten, 2009). To measure or arrive at the score for decision on IFRS adoption by an African country, in this study we computed the total of the stages of adoption of the IFRS product for each country that has decided to adopt IFRS. If a country is yet to adopt IFRS as at the date of this study, it was scored zero (Ding *et al.*, 2007).

FOREIGN DIRECT INVESTMENT is defined as that investment which is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The investor's purpose is to have effective voice in the management of the enterprise (International Monetary Fund, 1997). To measure foreign direct investment - it was taken as the ratio of foreign

capital inflow into a country to the gross domestic product (Ramanna & Sletten, 2009).

### Derived Model

As earlier stated under the theoretical framework, when testing the relationship between IFRS adoption decisions and institutional variables, it was done from the perspective of the rational choice theory. The rational choice theory implies that a country will take decision to adopt or not to adopt IFRS after taking into cognizance the possible costs and benefits of such a decision. Therefore, IFRS adoption decision by a country is a function of costs and benefits accruing from such a decision.

$$ADP=(B,C) \quad (1)$$

Where:

ADP = IFRS adoption decision

B = economic benefits

C = cost component

Therefore, the economic benefit derivable by a country from taking a rational decision to adopt IFRS can be represented as:

$$ADP = f(\text{FDI}) \quad (2)$$

Where:

FDI = foreign direct investment

Assuming a linear relationship, we can write the above equation (2) in an explicit functional form after taking into cognizance control variables as:

$$ADP = \beta_0 + \beta_1 \text{FDI} + \beta_2 \text{GDP} + \beta_3 \text{POP} + U \quad (3)$$

Where

Gross Domestic Product (GDP) and Population (POP) are control variables.

$\beta_0$ ,  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are parameters to be estimated. The apriori expectation is that;  $\beta_1 > 0$ ,  $\beta_2 > 0$ , and  $\beta_3 > 0$

Note that 'U' is the error term and  $\beta_0$  is the constant term.

## Result

The result of data analyzed for all the countries in Africa as a whole is presented in the table below.

### Regression Result

Dependent Variable: ADP
Method: ML - Ordered Logit
Included observations: 46
Number of ordered indicator values: 5
Convergence achieved after 5 iterations

Variable	Coefficient	Std. error	z-statistic	Probability
FDI	1.070068	3.25684	0.32856	*0.7425
GDP	0.142275	0.14922	0.55371	*0.3741
POP	1.529846	0.85291	1.62463	*0.1473
LR statistic	10.45239	Avg. log likelihood		-0.418371
Prob (LR statistic)	0.025261			

Source: E-views 7.0 \*not significant at 5% level

The above tabular results can be represented in an equation form as shown below:

$$\text{ADP} = \beta_0 + \beta_1 \text{FDI} + \beta_2 \text{GDP} + \beta_3 \text{POP} + U$$

$$1.070068 \quad 0.1142275 \quad 1.529846$$

From the ordered logistic regression result above, all the variables appeared not to be statistically significant at 5% level although statistically the effect of all the variables is positive. However, together all the regressors have a significant impact on IFRS adoption, as the LR statistic is 10.45, whose  $p$  value is about 0.025261, which is very small.

### Hypotheses test

The following hypothesis was specified for the study:

$H_0$ : Foreign direct investment has no significant relationship with adoption of IFRS in Africa.

H<sub>1</sub>: Foreign direct investment has significant relationship with adoption of IFRS in Africa.

From the statistical test of the null hypothesis at 5% level, we observe that the evaluation of the slope coefficients of the explanatory variables reveals the existence of positive relationship between Foreign Direct Investment (FDI) and IFRS adoption (0.32856) but not statistically significant at 5% ( $p=0.00 < 0.05$ ). Thus, there is the likelihood of no significant relationship between foreign direct investment in Africa and IFRS adoption decision of countries in Africa.

### **Discussion of Findings**

From the result conducted for the African continent, Foreign Direct Investment (FDI) was observed to exert a positive effect on IFRS adoption as depicted by the slope coefficient (0.32856) but statistically not significant at 5% level ( $p \leq 0.5$ ). This result is in consonance with the finding of Farooque, et al. (2009) who studied the interdependence of corporate governance and FDI inflows on the sample of 173 countries. Their findings show that FDI do not have significant effect on IFRS adoption.

Our finding is also consistent with that of Ramann and Sletten (2009) who tested whether economies that are more reliant on foreign investment and trade are more likely to adopt IFRS. They find no evidence that the level of and expected changes in foreign investment and trade affect the likelihood of IFRS adoption. Also in tandem with our finding is the result of Pagano, Roell & Zechner (2002). In their study on why companies list abroad, they found that there is no significant relationship between cross-country investments and adoption of international accounting standard. This according to them is because prohibitive informational obstacles to cross-country investments occur.

However, the result in this study that there is no significant relationship between Foreign Direct Investment (FDI) and IFRS adoption is not in consonance with the finding of Marques-Ramos (2008) who found out that IFRS adoption is significantly affected by FDI. The reason for this disagreement may be attributed to Marques-Ramos (2008) assumption that the accounting harmonization is a workable strategy to attract foreign investors by

reducing their risks for investing abroad which is unrealistic. Also, Epstein (2009) found out that adoption of IFRS increased market liquidity, decrease transaction costs for investors, lower cost of capital, and facilitate international capital formation and flows amongst European countries.

## **Conclusion**

The objective of the study, therefore, is to ascertain the relationship between adoption of IFRS and foreign direct investment in African countries. The rational choice theory was used to develop the hypotheses tested in this study. The conclusion in this study was based on the overall result of the analysis carried out on Africa. Based on the overall result, the following conclusion is reached: There was evidence that FDI is positively related to IFRS adoption, though not significant. Thus, the study accepted the null hypothesis for foreign direct investment.

## **Policy Implication**

The result showed that the relationship between FDI and IFRS adoption is not statistically significant among the African nations studied but positive. This shows that there is a relationship between the two variables the statistical insignificance notwithstanding. The statistical non-significance could be attributed to the scanty flow of FDI to African nations. This shows that there is need for policy shift in favour of foreign capital flow to Africa if the international financial reporting standard is to be more adopted by countries in Africa.

## **Policy Recommendation**

Based on the foregoing, the study recommends that policy effort should be put in place to enhance the flow of foreign direct investment into the African economy, may be by creating an enabling environment free from corruption and inadequate security of life and properties. More of this will stir economic/capital market growth and deepen the need to practice or adopt the International Financial Reporting Standards (IFRS).

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