THE UNWANTED EFFECTS OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) ADOPTION ON INTERNATIONAL TRADE AND INVESTMENTS IN DEVELOPING COUNTRIES

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ABSTRACT

The year 2010 witnessed two major business phenomena in the world. First, an unprecedented degree of consensus among more than 120 countries to require or permit the use of International Financial Reporting Standards (IFRS) in their jurisdictions and; second, for the first time in history Foreign Direct Investment (FDI)inflows to developing countries reached a half of that of global investment, and are further expected to lift up to over $2 trillion in 2012. When the International Organization of Securities Exchange Commissions (IOSCO) ratified International Financial Reporting Standards (IFRS) in 2002, FDI inflows started to grow from $0.6 trillion to $1 trillion in 2005. Furthermore, when the European Union (EU) required its member to use IFRS in 2005, FDI inflows has doubled and reached its peak in 2007 at more than $2 trillion. The global trade also experienced the same increasing trend. Assuming that adopting IFRS promotes higher comparability and transparency of accounting information, the bigger question is that does IFRS adoption affect developing countries' FDI inflows and values of international trade?

To answer this question, we examine the effects of IFRS adoption on international trade and FDI inflows in developing countries. After controlling generally accepted determinants of FDI inflows and international trade, we find a contradictory fact that developing countries adopting IFRS are unlikely to experience higher FDI inflows and international trade.

INTRODUCTION

Recently, 123 countries has either required or permitted the use of International Financial Reporting Standards (IFRS) in their jurisdictions, indicating that the acceptance of IFRS has been growing substantially (IASPlus, 2010). It appears that the global convergence of national accounting standards and International Accounting Standards (IAS, superseded by IFRS) has been successfully achieved (IASB, 2007). The International Accounting Standards Board (IASB) itself maintains that IFRS is perceived as "a single set of high-quality, understandable and enforceable accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions" (IASB, 2007, p. 4). As a

result of this rapid diffusion of IFRS, it is expected that countries adopting IFRS would have higher degree of transparency and comparability of financial reporting, would decrease asymmetric information and at the end would attract more investment and foster higher international trade.

Japanese FDI provides a perfect example on how international investment, and to some extent international trade are always searching for the best place where it is valued the most. In 1980s it was mainly allocated to North America and Europe, and shifted to East Asia in the late 1980s, then distributed to ASEAN in 1990s, and finally poured to China. The movement of Japanese FDI suggests that international trade and investment are always looking for trade and investment friendly factors, such as pro-globalization policies, robust economic growth, lower business costs, political and social stability, and sufficient infrastructure. However, after countries` efforts of creating trade and FDI-friendly features are entwined each other and saturated with no direct significant positive outcome, these features eventually become only prerequisites instead of advantages of having more investment and trade. In other words, possessing these factors does not necessarily result in better international trade and investment performances. Consequently, countries need to find additional factors that could significantly attract investment and trade and it might be the adoption of IFRS.

The IASB contends that the acceptance of IFRS represents unification of business language and institutions, which increase the quality of economic information that could help investors, firms, and governments to make better economic decisions. Reasonably, countries turn to IFRS to attract more international investment and trade. Unfortunately, not only adopting IFRS requires high costs of newly established institutions, regulations, infrastructure, and the acceptance that national standards are usurped by international standards, but also although the arguments of adoption of IFRS results in economic benefits are strong and reasonable, little supporting empirical evidence has been found. Botswana, Haiti, Nepal, Panama, Papua New Guinea, Tajikistan, and Venezuela are among countries that substantially adopt IFRS yet have not able to obtain desirable economic benefits from the adoption (Lasmin, 2011). This phenomenon raises an important question: Do countries adopting IFRS experience higher value of international trade and attract higher value of investment? Therefore, it is important to examine whether IFRS adoption has been playing catalytic roles in promoting international investments and trade in developing countries.

The significance of this study is that it is expected to be able to confirm the importance IFRS adoption on Foreign Direct Investments (FDI) inflows and International trade. In this regard, this study could clarify whether single set of accounting standards fits all countries. In addition, it will add depth to current literature because bringing IFRS into FDI and international trade`s country-level analysis is a relatively new approach to understand the impact of standardization and globalization of international accounting standards and so far, to the best of our knowledge, there is no study on the effects of IFRS adoption in developing countries from macroeconomic perspective. Finally, accounting regulators and business participants, especially

those from developing countries will be aware of that the cost of IFRS adoption cannot be necessarily paid off.

FRAMEWORK AND METHODOLOGY

IFRS Diffusion

The International Accounting Standards Board (IASB), the Organization for Economic Cooperation and Development (OECD), the European Union (EU), the International Organization of Securities Commissions (IOSCO), and the United Nations (UN) are international bodies that have been actively promoting the unification of global accounting standards (Wyatt, 1997). Among these organizations, the IASB is the most prominent at international level (Rivera, 1989), and the most active international body with the responsibility to promulgate international accounting standards (Iqbal, Melcher, & Elmallah, 1997).

In 1997, Mueller explained the growing importance of the IASB by stating:

> *Now IASC has evolved as the preferred mechanism for global accounting harmonization. Around the world, including at European Union, there will be more and more joint development projects with IASC, national and regional standard setting agencies will increasingly align their standards with IAS's and the model of private sector IAS-type accounting standard setting appears to have gained the upper hand ...*
> *(Mueller, 1997, p. 11.30).*

The International Accounting Standards Committee (IASC, predecessor of IASB) was established in 1973 by professional accountancy bodies of Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the UK and the US. The IASB itself was established in 2001 as part of the International Accounting Standards Committee (IASC) Foundation. The objectives of the IASC stated in its Constitution (2000) are (1) to develop in the public interest, a single set of high-quality, understandable and enforceable accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions; (2) to promote the use and rigorous application of those standards; (3) to bring about convergence of national accounting standards and International Accounting Standards to high-quality solutions (IASB, 2007, p. 4). As of January 2000, the IASB membership consisted of 143 professional accounting organizations from 104 countries (Radebaugh & Gray, 2002).

As of 1 January 2007, the IASC has issued 49 accounting standards comprise 8 International Financial Reporting Standards (IFRS) and 41 International Accounting Standards (IAS).3 The most recent study by Deloitte uncover the implementation of IFRS in countries around the world as follows (IASPlus, 2010)

- IFRSs not permitted — 31 jurisdictions
- IFRSs permitted — 26 jurisdictions
- IFRSs required for some firms — 6 jurisdictions
- IFRSs required for all firms — 91 jurisdictions

Choi & Levich (1997) explained that successful harmonization could positively affect capital market efficiency and flows of capital:

> *Harmonization would increase the number of readers qualified to examine accounting statements from foreign countries and it might increase the confidence that people had in their understanding of foreign companies. This, in turn, would expand the volume of international investing and issuing activities. These capital flows would increase capital market efficiency, providing benefits to both investors and issuers in the markets.*
> *(Choi & Levich, 1997, p. 6.21).*

Standards pronounced by the IASB have positively affected the efficiency of global capital market, and this fact is admitted by International Organization of Securities Commissions (IOSCO) that in May 2000 IOSCO recommended its members to use IFRS as a basis to prepare financial statements (Roberts, Weetman, & Gordon, 2002). Further progress made by the IASB when in 7 December 2007, Securities and Exchange Commission (SEC) announced that foreign private issuers in their filling with the Commission financial statements prepared in accordance with IFRS can be used in the US without have to be reconciled with US GAAP (SEC, 2007).

It appears that for countries adopting IFRS, the higher the degree of harmonization with IFRS the bigger the expected benefits they can exercise because the extent of the harmonization influences the extent of cost of capital of investors and at the same time, the extent of efficiency of financial reporting of reporting entity. Rationally, if harmonizing national accounting standards with IFRS has been successful, investors do not have to perform additional works in order to obtain desirable financial information. Likewise, reporting companies do not have to do extra works to produce a higher quality and comparable financial statements.

IFRS Adoption and Developing Countries

What probably overlooked by the proponents of internationalization of IFRS is that most developing countries share business characteristics that could limit their abilities to realize the expected benefits associated with IFRS adoption. While IFRS adoption seems reasonable for developed countries, developing countries might not be able to exercise the same expected economic benefits enjoyed by developed economies due to certain distinctiveness of their accounting and business infrastructure. For instance, lack of skills and knowledge of their accounting professions, companies, and investors; smaller and less developed capital markets; lower level of governance; and limited numbers of international business participants.

Accounting professions in developing countries that in general do not possess sufficient developed skills to comprehend international accounting standards, would suffer from deficient knowledge and interpretation on especially newly enacted standards, that in turn would lead to unreliable financial reporting and auditing. Thus, even if IFRS is adopted in a country; the commensurate benefits are far from reality due to insufficient and incomplete assurances of the quality of its financial reporting. In other words, the decision to converge with IFRS does not necessarily lead to aforementioned economic benefits because convergent at standard-level is not necessarily followed by convergent at practical-level (Lasmin, 2010).

For companies in developing countries, as the preparers of financial reporting, implementing single set of global accounting standards would not bring the same benefits to them in a same way to multinational enterprises (MNEs). MNEs which rarely come from developing economies, would harvest the benefits of IFRS adoption but local or national companies are likely to face its consequences. Several possible difficulties related to IFRS adoption that will be faced by national companies in developing countries are: (1) they have less opportunity to influence the process of international accounting standard, (2) their business and economic circumstances may not be faithfully represented by the prescribed accounting procedures of the global standard, and (3) they may be faced with high costs of changing from one set of standards with little or no correspondent benefits (Roberts, Weetman, & Gordon, 2002).

Similar to the effects of IFRS adoption to companies in developing countries, the benefits reaped by big investors can not outweigh the disadvantages faced by small and medium investors. Small and medium investors relatively do not have adequate expertise and skills to understand the basis on which a financial statement is produced. Furthermore, considering that IFRS is crafted to support developed capital markets, smaller investors especially those that come from less developed capital markets would encounter hard times comprehending the reported figures and interpreting newly enacted standards. This is because implementing IFRS: (1) creates comparability in appearance but conceals real differences in commercial activity and (2) reduce precision of economical transaction recording by instilling too many alternatives, which sometimes are not needed and not relevant to local setting.

Although adopting IFRS might reduce the costs of standards setting process and standards implementation monitoring, the governments as accounting regulators and/or standards setters have to be well aware that the notion of one accounting system fits all countries might not be the only answer. Considering that the composition of international and national stakeholders in individual country varies greatly, so does the need of adopting IFRS. Especially, the potential benefits of adopting international standards might not be materialized because of weak interpretation and implementation. In developing countries, the problems of governance are notorious, rules are often misinterpreted. What was written might not be appropriately implemented. The result is that the comparability of accounting standards may not lead to the comparability of actual financial reporting practices. Another issue is that countries might adopt

IFRS not because potential economic benefits associated with the adoption, but just because countries want to be perceived as socially acceptable and legitimate jurisdictions for doing international business (Judge, Li, & Pinsker, 2010; Lasmin, 2011).

Hypotheses

Previous section makes it clear that in developing countries there are considerable constraints in exercising economic benefits of IFRS adoption. Consequently, IFRS that is tailored by developed countries and supported by international organizations and multinational enterprises might not be suitable for developing countries. Imposing international standards in expense of national standards is regarded as an action that does not recognize the environmental diversities amongst different countries. Countries have their own specific economic, social, political and legal settings, which contribute to the unique financial reporting systems in their jurisdictions. Applying single set of standards to such diverse systems denies the reality of financial reporting diversities and to some extent the sovereignty of developing countries.

Even if adopting IFRS might increase the comparability and transparency of national financial reporting, for developing economies, the high degree of disclosure tends to negatively contribute to national competitiveness because their disadvantages are vividly revealed. Furthermore, accounting standards that are used to reveal their weaknesses are out of their controls because the standards are created by and more suitable for developed economies.

Hence, our hypotheses comprise:

H1. Developing countries adopting IFRS do not experience higher international trade.

H2. Developing countries adopting IFRS do not experience higher FDI inflows

RESEARCH DESIGN

Research Model

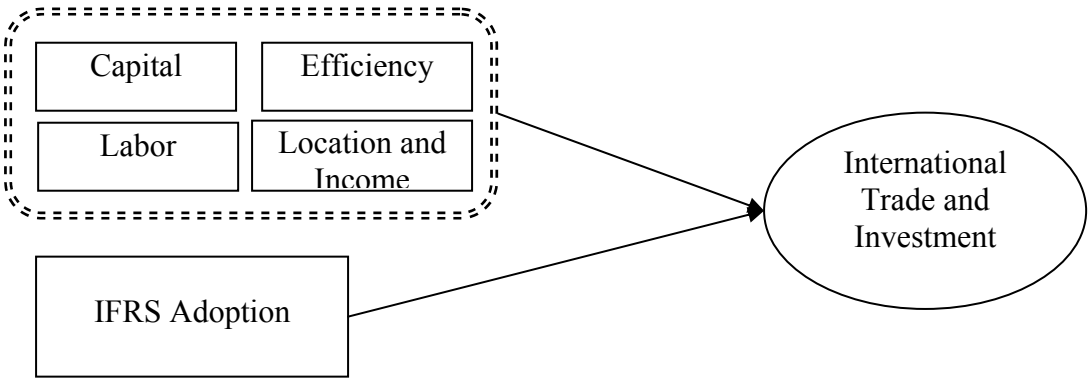
Drawing on a Cobb-Douglas production function where a country's level of production is the function of its respective capital, labor, and efficiency parameter (Cobb & Douglas, 1928), (Xu & Wang, 2000), (Bitzer & Gorg, 2008), we apply these inputs and parameter as control variables in estimating the effects of IFRS adoption on international trade and investment (see Figure 1).

We then use an ordinary least square (OLS) estimation, which is defined as:

$$Y = \beta_0 + \beta_1 IFRS_i + \beta_2 INC_i + \beta_3 POP_i + \beta_4 ICT_i + \beta_5 GOV_i + \beta_6 REGi + \beta_7 GROUP_i + \varepsilon_i$$

Where: Y is the value of FDI inflows, Exports, or Imports; β_0 is the intercept; β_1-β_4 are the slopes/regression weighs that represent the relationships between dependent variable and independent variables; and *ADOPTION* is countries` degree of IFRS adoption, *INCOME* is countries` Gross Domestic Product (GDP) per capita, *POPULATION* is countries` total population, *ICT* is the countries` degree of information and communication technologies, *GOV* is Countries` level of governance, *REG* and *GROUP are* additional control variables for the location and income groups of selected countries.

Figure 1 Research model



== : Control variables, derived from Cobb-Douglas (1928)

Variables

Dependent variable, which represents the value of FDI inflows, Exports and Imports in 2009, retrieved from the World Bank`s World Development Indicators (World Bank, 2010). The independent variable, the level of adoption of IFRS, is retrieved from Deloitte - IASPlus (2008) report surveying current status of the adoption in a wide variety of jurisdictions as of 2008. Consistent with (Hope, Jin, & Kang, 2006) and (Judge, Li, & Pinsker, 2010), a country is codified "1" if it fully adopts IFRS, where all listed domestic and international firms are required to use the standards; otherwise it is codified "0".

For controlling variables, we select 2008 GDP per capita as a proxy for capital, 2008 total population as a proxy for Labor, 2008 internet subscription as a proxy for Information and Communication Technology (ICT) parameter, and 2008 levels of freedom from corruption as a proxy for countries` levels of governance. We also add the two dummy variables, namely countries` region and income groupings. Level of governance is retrieved from the 2008 Fraser Institute`s Economic Freedom annual report (Gwartney & Lawson, 2008). Other controlling

variables are collected from the World Bank`s World Development Indicators (World Bank, 2010).

Proxies for capital and labor are relatively straightforward and are widely used [(Schneider and Frey (1985), Wheeler and Mody (1992), Tsai (1994), Jackson and Markowski (1995), Taylor (2000), Chakrabarti (2001) in (Nunnenkamp & Spatz, 2002)], (Gholami, Lee, & Heshmati, 2003), and (Baxter & Kouparitsas, 2006)].

ICT is found as one of key determinants for FDI in developing countries (Addison & Heshmati, 2003), and as a main new determinant (Gholami, Lee, & Heshmati, 2003) for ICT could foster innovation and entrepreneurship and transparency, which are in turn, could promote larger volume of investment. Moreover, ICT also decrease time and distance needed to complete a transaction, for example internet marketing, investor inquiries tracking, after sales supports, and partnerships developing (Economou, 2008). Furthermore, ICT offers a unique opportunity for countries to free themselves from the domination of geography. Similarly, goods and services from such countries can be offered on the global market as efficiently as those from any other country through the use of ICT (Addison & Heshmati, 2003).

Specifically, internet usage is found to be significantly related to higher volume of trade, particularly it was found that internet usage has a greater impact on trade among smaller economies than among larger economies (Demirkan, Goul, Kauffman, & Weber, 2009) because it helps to lower prices by reducing search costs, entry barriers and intensified competition, and thus results in higher productivity. Finally, it could substantially decrease inventory costs through direct link among suppliers, producers, and customers, in which a leaner supply chain is created (Economou, 2008) and open up the possibility of accessing commercial and political information that was previously unavailable or severely restricted (Gholami, Lee, & Heshmati, 2003).

Corruption as a proxy for countries` level of governance, has been significantly linked to international capital flows and International Trade. Levels of corruption were found to be grease and sand toward FDI inflows. By and large, high levels of corruption lead to lower volume of FDI inflows (Wei, 2000) (Habib & Zurawicki, 2002) and that of international trade (Gatti, 1999) (Bandyopadhyay & Roy, 2007). However, corruption could also serve as a stimulus for FDI (Egger & Winner, 2005). Finally, to control countries` economic and geographic position in international trade and investment equilibrium, we added two dummy variables that are based on countries groupings from the World Bank geographic and economic classifications (World Bank, 2010), namely region and income group.

RESULTS

Sample Description

We use UNDP's Classification of countries report (UNDP, 2010) to separate developing countries from developed countries. We then run the check on the availability of data on each country and exclude countries whose data are missing. In total complete data of 48 developing countries are able to be collected (see Table 1). The sample consists of relatively balance representation of countries` status toward the adoption of IFRS: 26 adopters and 22 non-adopters, which we believe it provides a fair depiction of current status of IFRS and covers developing countries from all continents.

Regression Results

We first examine the descriptive statistics of all variables. Table 2 shows the statistics of dependent, independent and control variables. To maintain the quality of our model, White test, Breusch-Pagan / Cook-Weisberg test, and variable inflation test are used to assess the existence of heteroskedasticity and multicollinearity for Ordinary Least Squares. In addition, Cameron & Trivedi`s decomposition of IM-test is used to examine the degree of heteroskedasticity, skewness, and kurtosis. We apply the natural logarithm transformation on dependent variables to reduce the skewness and to satisfy the results of Box Cox fitting model, in which it is found that the log-linear model is more efficient.

Table 1: Countries Sampled and Their Adoption Status

Adopters	Non Adopters
Armenia	Argentina
Bahrain	Bangladesh
Botswana	Brazil
Chile	China
Croatia	Colombia
Egypt, Arab Rep.	Cote d'Ivoire
Fiji	Ecuador
Georgia	India
Ghana	Indonesia
Guyana	Korea, Rep.
Hong Kong SAR, China	Malaysia
Jamaica	Mexico
Jordan	Pakistan
Kazakhstan	Philippines
Kenya	Russian Federation
Kyrgyz Republic	Saudi Arabia
Lebanon	Singapore

Table 1: Countries Sampled and Their Adoption Status	
Adopters	Non Adopters
Macedonia, FYR	Sri Lanka
Mauritius	Thailand
Namibia	Tunisia
Nepal	Turkey
Panama	Vietnam
Peru	
Serbia	
South Africa	
Ukraine	

Table 2: Descriptive Statistics					
Variable	Mean	Std. Dev.	Min	Max	Corr to FDI
FDI	21.44215	1.839882	17.45772	25.08244	1.0000
EXPORT	24.11218	1.751263	21.00911	27.91872	0.8575
IMPORT	24.23670	1.545219	21.28297	27.73829	0.8595
ADOPTION	.5208333	.5048523	0	1	-0.4130
GDP	4706.969	6827.068	253.5529	34519.73	0.3101
POP	9.20e+07	2.47e+08	763437	1.32e+09	0.4439
ICT	1.59e+07	4.42e+07	103000	2.98e+08	0.4578
GOV	36.89362	15.76627	20	94	0.2290
REG	3.395833	2.090908	1	7	-0.3640
GROUP	1.125	.3342187	1	2	0.1633

Table 3 shows that the effects of adopting IFRS are significant for all dependent variables and negatively signed, suggesting that all hypotheses are supported. The results show that the effects of the developing countries` decision to adopt IFRS on the volume of their FDI inflows and international trade are considerably unenthusiastic. Developing countries experience declining FDI inflows one year after they decided to embrace IFRS. Likewise, countries adopting IFRS also have to accept the facts that the values of their export and import do not increase as previously expected.

Table 3: Regression Results						
Variable	DV: FDI		DV: EXPORT		DV: IMPORT	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
ADOPTION	-.9080047	-1.96***	-1.575832	-4.63*	-1.315056	-4.39*
GDP	.0001205	1.56	.0001121	1.99***	.0001045	2.11**
POP	2.63e-09	1.60	1.54e-09	1.29	1.80e-09	1.71***
ICT	2.56e-09	0.28	6.78e-09	1.01	4.89e-09	0.83
GOV	.003852	0.16	-.0042818	-0.25	-.0061911	-0.41

Table 3: Regression Results						
Variable	DV: FDI		DV: EXPORT		DV: IMPORT	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
REG	-.1674625	-1.42	-.1173639	-1.37	-.1057255	-1.40
GROUP	-1.107877	-1.00	-..0174033	-0.02	-.0908842	-0.13
Intercept	22.72419	15.87	24.69801	23.66	24.84235	27.04
F value	5		12.21		12.36	
R-squared	.4730		.6923		0.6948	
Adj R-squared	.3784		.6356		0.6386	
Note: *p<0.01; **p<0.05;***p<0.1						

For robustness check, we exclude FDI and export/import influential non adopters from our data set. Specifically, we run series of regressions after omitting BRIC countries (Brazil, Russia, India, and China) whose volume of FDI inflows, export, and import are substantially larger compared to those of other non adopters. Table 4 provides the results that still support our hypotheses. In general, we find no significant positive relationships between developing countries` decision to adopt IFRS and their subsequent FDI inflows, export and import performances. Specifically, the results reveal that although it is not significant, IFRS adoption has a negative relationship with FDI inflows; and the adoption significantly contribute to lower volume of export and import.

Table 4: Regression Results (Without BRIC)						
Variable	DV: FDI		DV: EXPORT		DV: IMPORT	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
ADOPTION	-.1034085	-0.19	-.7596928	-2.10**	-.5137414	-1.70***
GDP	.000093	1.24	.0000967	1.95	0.0000899	2.17**
POP	8.75e-09	1.44	5.93e-09	1.47	6.37e-09	1.89***
ICT	4.10e-08	1.19	6.75e-08	2.95	6.43e-08	3.36**
GOV	.0202627	0.84	.0083403	0.52	.0060404	0.45
REG	-.133949	-1.15	-.0563965	-0.73	-.0470721	-0.73
GROUP	-.8420228	-0.79	.0387645	0.05	-.0409026	-0.07
Intercept	20.82134	13.33	22.95778	21.94	23.14437	26.49
F value	3.85		13.50		15.14	
R-squared	.4352		.7354		.7571	
Adj R-squared	.3223		.6809		.7071	
Note: *p<0.01; **p<0.05;***p<0.1						

DISCUSSION AND CONCLUSIONS

Most studies of countries decision to adopt IFRS has been focusing on the effects of the adoption to accounting quality, comparability of financial reporting, income smoothing, investors' reaction, and auditors' behaviors. Our study is one of the first of its kind that examines the macro-level effects of IFRS adoption. The results suggest that adopting IFRS does not significantly lead to higher volume of international trade and investments.

Main stream belief contends that higher quality of accounting standards, as a result of adopting IFRS, are substantially related to the chance of obtaining economic benefits such as a higher FDI inflow and higher volume of international trade. This belief stands on one premise that all countries share common institutional context where the relation of the adoption and its associated economic benefits established in a particular country or a particular group of countries is also applicable to a country or a group or country in other regions. However, IFRS that is crafted by developed countries and appears to work well in those countries (Marques-Ramos, 2008), might not able to create the same relationship in developing countries because of different socio-economy and political-economy environments (Lasmin, 2011).

Moreover, it is extremely difficult to develop a high-quality financial reporting infrastructure that could guarantee the continuing effective harvest of implementing global accounting standards. While adopting IFRS demonstrates the desire to have a consistent, comprehensive and based on clear principles accounting standards that could potentially help developing countries to obtain certain economic benefits from adopting IFRS, merely adopting is not enough. Other infrastructures that might not be satisfied by developing countries are: (1) Effective corporate governance practices and strong internal controls; (2) Sound auditing practices; and (3) A strict enforcement or oversight mechanism (Tweedie, 2005).

We concede that the results of our study should be interpreted carefully due to several limitations. First, we heavily rely on archival data. The decision of countries to adopt or not to adopt IFRS must be examined further by revealing the real motives and by expanding the definition of adoption. Second, considering that the effects of adopting IFRS might change over time, investigating the diffusion of IFRS and its impacts in a longer observation period and bringing new models or more variables in would improve the quality of our study.

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