ACCOUNTING STANDARDS AND FOREIGN DIRECT INVESTMENT INFLOWS IN SELECTED AFRICAN COUNTRIES (1980 – 2015)

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Abstract

This study empirically examined the effect of changes in accounting standards particularly the consequence of the adoption of IFRS on FDI inflows of Selected African countries for the period 1980 – 2015. The study obtained data from six African countries for the period of study, these include: Egypt, Nigeria, Kenya, Morocco, Tunisia, and South Africa. We investigated the effect of accounting standards measured by the adoption of IFRS on FDI alone and further introduced control variables of Exchange Rates, Inflation Rates and GDP. The empirical analysis began with the descriptive test; the granger casualty test, hausman test, and regression analysis were further performed. The results indicate that adoption of IFRS has a significant positive effect on FDI inflows, although the coefficient of determination was only 12.7%, however, when other control variables were introduced it shows adjusted R^2 of 37%, this is in line with the granger casualty test, which indicates that IFRS cannot singularly be used to predict FDI inflows. We therefore conclude that adoption of IFRS alone cannot guarantee increased FDI inflows to African countries and care must be taken as to policies developed to attract FDI. We recommend that right policies should be set to aim at making African countries economically stable to be able to attract foreign direct investment.

Keywords: FDI, Inflation, GDP, Exchange Rates, IFRS, Africa, Egypt, Nigeria, Kenya, Morocco, Tunisia, South Africa.

1. Introduction

Investors all over the world are more concerned and motivated to invest where there is adequate understanding of where to invest. Osinubi & Amaghionyeodiwe (2009) opined that there were increased flows of investment around the world in the 1980's and developing countries especially in Africa still lag behind other regions in attracting Foreign Direct Investment (FDI). There is no country that is independent economically, under the pressure of globalization processes, capital movements have almost wiped out boundaries between countries, and this justifies the need for a cross-border investment. FDI has become a well-known process and a tool for countries to enhance their economic development. With fast improvement of financial markets attracting large volumes of FDI, there is need for more clear and comparable accounting reports.

In general, Foreign Direct Investment encourages the necessity of a unified financial language and the accounting standard that seeks to unify the accounting process globally is the International Financial Reporting Standard. The adoption of the International Financial Reporting Standards (IFRS) by countries around the world has brought about the quest whether or not it would be gainfully measured in monetary terms. In these same dispositions, Garkovi and Levin (2012) observed a common rhetorical question that "do the rules attract the money?" that curiosity has influenced by examining financial reporting rules in countries and the subsequent inflow of foreign direct investment. Some studies opined that the adoption of IFRS will result in improved investment flow because IFRS can be associated with increased transparency in financial reporting, reduced information asymmetry and cost of processing financial information (Aharony, Barniv & Falk, 2010; Shima & Gordon, 2011; Gordon, Loeb & Zhu, 2012).

Since IFRS can be associated with increased transparency and higher disclosure requirements, it has been argued that FDI can equally be influenced by the country's political environment, foreign exchange volatility and other peculiar factors (Osinubi & Amaghionyeodiwe, 2009), these factor are outside the adoption of IFRS. It can be deduced that by adopting IFRS with its associated high cost of training and re-training of staff and its other obstacles, it's attending benefits of attracting more FDI becomes questionable as such African countries may have misplaced priority. Therefore, in this study, stepwise regression models were estimated by examining the effect of accounting standard measured by the IFRS adoption on FDI separately and then introducing specific control variables into the model, the control variables include: exchange rates, inflation rates and GDP. In the same vein, Gordon, Loeb and Zhu (2012) contend that IFRS adoption cannot lead to Foreign Direct Investment Inflow without considering the level of development of the affected countries. Also, to make the study more robust the granger causality test was done to examine the predictability of adoption of IFRS on the explained variable, FDI inflows, and subsequently the extent to which FDI inflows can be used to predict IFRS adoption.

The remainder of the paper is divided as follows; section 2 is the review of extant literature, section 3 deals with the methodology and analysis of empirical results, and section 4 gives the conclusion and recommendation.

2. Review of Extant Literature

Several opinions have been given in the existing literature on the issues of foreign direct investment and IFRS adoption. The United Nation Conference on Trade and Development (UNCTAD, 2007), opined that FDI is seen as an investment involving management control of a resident entity in one economy by an enterprise resident in another economy. Rutherford (1992) viewed FDI as an investment in the business of another country which often takes the form of setting up of local production facilities or the purchase of existing business. He contrasts FDI with portfolio investment which is the acquisition of securities. We can deduce from their views that FDI involves long-term relationship reflecting an investor's ongoing interest in a foreign entity but these definitions differ greatly across countries. However, an agreed framework explanation of Foreign Direct Investment (FDI) exists. That is, FDI is an investment made to gain a lasting management or controlling interest in a business enterprise operating in a country other than that of the investor according to residency (World Bank, 1996). In the same vein

Kumar (2007), explained FDI as an investment in foreign country where the investor retains control over the investment. Foreign direct Investment flows are by and large an investment by transnational or multinational corporations of foreign countries for the purpose of controlling assets and managing production activities in those countries (Ogundipe & Aworinde, 2011).

The historical background of FDI in selected African countries started after the 1884 berlin conference which coincided with the industrial revolution in Europe whereby most companies were looking for raw material sources, activities of the entrepreneurs were therefore, concentrated in export – oriented mineral and agricultural product as well as in public utilities that will facilitate the British commercial services. The large market of African countries' economy soon attracted foreign investors from developed economy (nations) who now competes with the British firms and this development led to the sharing of the market with a cartel under the auspices of the Association of West African Merchants (AWAM). Foreign investment concentrated on input such as equipment, warehousing for the procurement of raw materials as well as those that will facilitate distributive trade (Aremu, 1997).

The importance of FDI to an economy or any nation cannot be overemphasized, so is it for the adoption of IFRS. FDI is a facilitator of economic growth and development which is believed to result in industrialization of the economy in the long run. Feldstein (2007) maintains that a number of advantages accrue to developing countries through FDI inflows. Consequently upon technology transfer, it is possible also that FDI can promote competition in the domestic input market. Secondly recipients of FDI often gain employee training in the course of operating the new businesses, which directly contributes to human capital development in the host country. Therefore, government has viewed it as part of their social contract and political mandate to attract economic activities to their countries through FDI.

The adoption of IFRS benefits on the other hand is numerous. In general, it offers organizations opportunity for a fresh look at their processes and policies. It also gives room for one basis of accounting (simplify local statutory reporting, cross border transactions, strengthening of controls and efficiencies in future reporting). Furthermore, it may lead to standardization of practices across countries (that is, consistency of global accounting policies and procedures, shared Service Centre deployment and streamlined merger and acquisition activities). Finally, it can lead to improved comparability across borders and within global industries, with worldwide peers and competitors. The adoption of IFRS has been said to induce the inflow of capital, technical know-how and managerial capacity which can stimulate entrepreneurial activities in the sub-Saharan Africa.

The major challenges facing FDI and IFRS adoption in the African countries are that investors have to cope with complex tax administration procedures, confusing land ownership laws, arbitrary application of regulations, corruption, financial crime, insurgency, kidnapping etc. that are peculiar to each countries/economy. There is widespread infrastructural decay that has resulted in poor state of road networks whereby to transport goods and persons have become a nightmare. Others include, epileptic water and power supply, inept ports system, dilapidated railways have posed a major challenge to doing business. Abdulkadir (2012), opined that African countries; for instance Nigeria to be precised, has been predicted to face a lot of challenges in implementing the IFRS. One of the principal challenges they encounter in the practical implementation process is the shortage of accountants and auditors who are technically

competent in implementing IFRS. Usually, the time lag between decision date and the actual implementation date is not sufficiently long to train a good number of professionals who could competently apply international standards. Secondly training materials on IFRS are not readily available at affordable costs in Sub-Saharan African countries to train such a large group which poses a great challenge to IFRS adoption. Thirdly the tax considerations associated with the conversion to IFRS, like other aspects of a conversion, are complex. IFRS conversion calls for a detailed review of tax laws and tax administration.

It is prominent from the foregoing review that so much has been said by existing literature on the issue of IFRS adoption and FDI. However, the issue has received less attention in literature as an area of study for selected African countries in general unlike a lot of literatures for individual countries on the subject matter and therefore, this study intends to contribute to the literature by looking at the effect of accounting standards measured by IFRS adoption on the FDI inflows of selected African countries. Also adopting four (4) thresholds for measuring IFRS adoption and moderating variables for FDI inflows, all analysis and test were done using recent tests.

2.1 Empirical Review

Caves (1996) observed that efforts made by various countries in attracting FDI are due to the potential positive effects that this would have on the economy. FDI is regarded to have made a meaningful contribution to GDP growth rates and it is also seen as a vital tool for economic progress. Equally, economic growth is the basic determinant of the rate of inflow of foreign direct investment in the country (Andenyangtso, 2005). The focus of this work is to empirically review the effect of accounting standards measured by the adoption of IFRS on FDI inflows in African countries. Attempts have been made in prior researches to examine the benefits of IFRS in general and in relation to cross border investments, some of these are discussed here.

There is empirical evidence that there exists higher information comparability in the post-IFRS era than the pre-IFRS era (Yip & Young, 2009). Easley and O'Hara (2004) found that detailed accounting information directly lowers a company's cost of capital because it reduces the risk of the asset to be acquired. Furthermore, Chen, Ding & Xu (2010) observed that reduced information barriers facilitate international capital movements and has received both theoretical and empirical support over the years. In the same vein Covrig, Defond & Hung (2007) observed that IFRS adopting countries have access to a larger pool of investment capital, which should increase share liquidity and thereby make it easier to raise capital to finance worthwhile projects. Bruggemann, Daske, Homburg, & Pope (2009) also observe that the trading activity of individual investors increases following mandatory adoption of IFRS, and Beneish, Miller & Yohn (2009) found that IFRS adoption positively impacts cross-border debt investment especially in countries with less developed investor protection and greater financial risk.

Subsequently, the need for this research in Africa is fueled by the research of Gordon, et al. (2012), who studied the difference in the impact of the IFRS adoption on the FDI inflows between developed and developing countries, using ordinary least squares approach and found that the most sensible to this influence are developing countries, while the results for developed countries were statistically insignificant. While Henock & Oktay (2012) examined the effect of IFRS on foreign direct investments and found that IFRS adoption led to a significant increase in FDI using cross border acquisitions of listed target from the adopting countries, this study uses FDI inflows of sampled sub-Saharan African countries. Also, Márquez-Ramos (2008) concluded

that the adoption of IFRS enforces mutual trade in goods and FDI between countries, using the gravity model. The aim of our study is not only to examine the effect of IFRS adoption on FDI inflows but also to examine whether the causality goes both ways.

2.2. Eclectic theory and hypothesis development

An important determinant of FDI is the eclectic paradigm also known as OLI framework was developed by Dunning in 1977. The OLI framework which stands for Ownership, Location and Internationalization, was established with the motive of identifying the reasons why corporations become multinationals. According to Denisia (2010) Ownership refers to intangible assets, which are, at least for a while exclusive possessions of the company and may be transferred within transnational companies at low costs, leading either to higher incomes or reduced costs; Location on the other hand refers to where the company is situated with the intention to minimize costs; and Stoian & Filippaios (2008) described Internalization to explain why MNC is going to engage in FDI rather than to sell license to a foreign firm or to contract a franchising arrangement. Past researchers have been able to improve on the OLI framework to include other important determinants of FDI, consequently our present study provide the link with accounting framework as a key determinant of FDI. IFRS in particular affords multinationals lower cost of preparing their consolidated financial statements and it also encourages FDI in a particular location since there is ease of information.

As observed by Young & Guenter (2003), countries where financial accounting environments lead to lower information asymmetries among investors are more likely to have higher international capital mobility. Also, in line with Bushman & Smith's (2001) argument that reduction of information asymmetries between investors is an important channel through which financial reporting information affects economic performance. Assidi & Omsi (2012) confirmed in their research that IFRS contribute improved quality information to diffuse it with the public and to increase transparency, which makes it possible to attenuate asymmetries of information and the costs of agency. Therefore, countries that have adopted IFRS ought to have increased FDI inflow, which leads to the following hypothesis:

H_{01}: Adoption of IFRS has no significant effect on FDI inflows in Selected African countries.

3. Methodology and analysis of empirical results

Our study uses data from six African countries of Egypt, Nigeria, Kenya, Morocco, Tunisia, and South Africa for the period 1980-2015. Periodic exchange rates, FDI inflows, GDP, Inflation rates utilized in this study with relation to IFRS adoption of the countries sampled, were gotten from United Nations, Department of Economic and Social Affairs, Population Division, World Population Prospects. The pre-estimation analysis was done in three-folds: the first provides descriptive statistics for all the variables employed in this study; the second shows the causal relationships/interaction of the variables and the third testing the hypothesis of this study through empirical analysis by running the step-wise Regression models developed in this study.

The step-wise regression models were carried out by running regression analysis for the dependent variable (FDI inflows) and the independent variable (IFRS) alone and further introducing control variables. The control variables introduced include: Exchange rate (EX), Inflation (INF) and GDP. These were selected in line with the work of Amadi (2002) that

concluded that macroeconomic variables such as GDP per capita, inflation rate and exchange rate had significant influence on FDI.

Step-wise Regression Model

$$LOG(FDI)_{it} = \alpha_1 + \beta_1 IFRS_{it} + \mu_1 ....I$$

$$LOG(FDI)_{it} = \alpha_2 + \beta_2 IFRS_{it} + \beta_3 EX_{it} + \beta_4 INF_{it} + \beta_5 LOG(GDP)_{it} + \mu_2 .... II$$

From the step-wise regression models above:

$LOG(FDI)_{it}$ is the natural Logarithm of FDI inflows in Million USD of country i in time t

$IFRS_{it}$ is an indicator variable taking the value of 1 for no defined standards, 2 for local standards different from IAS/IFRS, 3 represents the use of both local standards and IAS/IFRS, and 4 represents full adoption of IFRS. All in country i in time t.

EX_{it} is country i's currency in relation to dollars in time t.

INF_{it} is the annual inflation rate of country i in time t

$LOG(GDP)_{it}$ is the Natural Logarithm of annual GDP of country i in time t

3.1 Descriptive statistics

The data of LOG(FDI), IFRS, LOG(GDP), Inflation and Exchange rate are described in this section. From Table 1, there seems to be evidence of significant variations in the trends of the domestic currency rates to dollar exchange rates, LOG(FDI), LOG(GDP) and inflation over the years covered in this study. This is indicated by the wide range of their minimum and maximum values, except for IFRS with values ranging from 1 to 4. Also, the standard deviation values indicate a high degree of dispersion from the mean of exchange rates and inflation rates of sampled countries over the years under study.

Table 1: Descriptive Statistics

	EXCHANGE	LOG(FDI)	LOG(GDP)	IFRS	INFLATION
Mean	22.39900	1.848111	3.885853	2.009804	10.27146
Median	6.635800	1.252717	4.117000	2.000000	7.927316
Maximum	158.2670	9.424577	21.17700	4.000000	83.62289
Minimum	0.544455	-1.150856	-10.75200	1.000000	-5.550901
Std. Dev.	37.88072	1.858372	3.773525	1.073598	10.55359
Observations	216	216	216	216	216

Source: computed by the authors

3.2 Causality Test

Table 2 is the result of the granger causality test for all the variables in the model, showing the ability of one variable to predict (and therefore cause) the other variable. The causality result reveals that exchange rate granger causes GDP, exchange rate and GDP granger causes inflation rate, while inflation granger causes FDI. The null hypothesis were rejected at 5% as indicated by the probability value of 0.0005, 0.0004, 0.0011 and 0.0358 respectively, this is confirmed by their relative F-stat value of 4.73617, 4.80821, 4.28924 and 2.45105 respectively. Specifically, IFRS does not granger cause FDI and FDI does not granger IFRS, indicating that IFRS singularly cannot be used to predict FDI and Vice versa.

Table 2: Pairwise Granger Causality Tests
Date: 07/17/15   Time: 13:30
Sample: 1980 2013
Lags: 5

Null Hypothesis:	Obs	F-Statistic	Prob.
IFRS does not Granger Cause EXCHANGE	186	0.19525	0.9640
EXCHANGE does not Granger Cause IFRS		1.54754	0.1782
LOG(FDI) does not Granger Cause EXCHANGE	186	1.67988	0.1425
EXCHANGE does not Granger Cause LOG(FDI)		0.29233	0.9166
LOG(GDP) does not Granger Cause EXCHANGE	186	0.25138	0.9386
EXCHANGE does not Granger Cause LOG(GDP)		4.73617	0.0005
INFLATION does not Granger Cause EXCHANGE	186	8.24231	6.E-07
EXCHANGE does not Granger Cause INFLATION		4.80821	0.0004
LOG(FDI) does not Granger Cause IFRS	186	1.23411	0.2957
IFRS does not Granger Cause LOG(FDI)		0.54772	0.7399
LOG(GDP) does not Granger Cause IFRS	186	0.53852	0.7469
IFRS does not Granger Cause LOG(GDP)		0.27633	0.9255
INFLATION does not Granger Cause DIFRS	186	1.41094	0.2232
DIFRS does not Granger Cause INFLATION		0.34599	0.8842
LOG(GDP) does not Granger Cause LOG(FDI)	186	0.50601	0.7714
LOG(FDI) does not Granger Cause LOG(GDP)		0.55958	0.7309
INFLATION does not Granger Cause LOG(FDI)	186	2.45105	0.0358
LOG(FDI) does not Granger Cause INFLATION		0.82769	0.5317
INFLATION does not Granger Cause LOG(GDP)	186	2.12902	0.0645
LOG(GDP) does not Granger Cause INFLATION		4.28924	0.0011

3.4 Regression Analysis

Table 3 shows the regression analysis of the two models of this study. This indicates clearly the extent to which IFRS adoption influence FDI inflows in isolation, and in combination with other control variables of Exchange rate, GDP and Inflation.

Table 3. Regression analysis

Variables	MODEL 1				MODEL II			
	Coefficient	Std Error	t-Stat.	Prob.	Coefficient	Std Error	t-Stat.	Prob.
C	0.657032	0.513590	1.279294	0.2023	0.174611	0.310632	0.562117	0.5747
IFRS	0.592634	0.109265	5.423820	0.0000	0.652646	0.121534	5.370062	0.0000
EXCHANGE	-	-	-	-	-0.002127	0.004331	-0.491085	0.6239
INFLATION	-	-		-	0.024790	0.011815	2.098301	0.0372
LOG(GDP)	-	-	-	-	0.039840	0.029805	1.336717	0.1829
R^2	0.127348				0.370640			
Adj. R^2	0.123028				0.341442			
S.E of Reg	1.517624				1.508098			
F-Statistic	29.47835				12.69438			
Prob.(F-Stat)	0.00000*				0.00000*			
Obs	216				216			
Cross-Sections	6				6			

Dependent Variable: LOG(FDI)   *significance at 5%

$$LOG(FDI)_{it} = \alpha_1 + \beta_1 IFRS_{it} + \mu_1 \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots I$$

$$LOG(FDI)_{it} = 0.657032 + 0.592634 IFRS_{it}$$

$$LOG(FDI)_{it} = \alpha_2 + \beta_2 IFRS_{it} + \beta_3 EX_{it} + \beta_4 INF_{it} + \beta_5 LOG(GDP)_{it} + \mu_2 \ldots\ldots\ldots\ldots\ldots II$$
$$LOG(FDI)_{it} = 0.17461 + 0.65265 IFRS_{it} - 0.002127 EX_{it} + 0.024790 INF_{it} + 0.039840 LOG(GDP)_{it}$$

Interpretation

The result from table 3 shows that the adoption of IFRS has a positive effect on FDI inflows (measured by LOG(FDI)). This is shown by the sign of the coefficients (β_1 and β_2) in both models, however model II further indicates that inflation rate (INF) and Gross Domestic Product (LOG(GDP)) have positive effects on LOG(FDI), Exchange rate (EX) has a negative effect on LOG(FDI). The size of the coefficient of model I (β_1) shows that a unit increase in the measure of accounting standards (IFRS) will lead to 59% increase in FDI inflows while β_2 in model II suggests that a unit increase in the measure of accounting standards (IFRS) will lead to 65% increase in FDI inflows. The influence of adoption of IFRS is of more magnitude when other control variables are introduced in this model; this is further confirmed by the R- square of about 13% in model I and adjusted R- square of 34% in model II. Implying that for model I about 13% variations in FDI inflows are caused by IFRS adoption alone, while the remaining 87% variations in FDI inflows are caused by other factors. In model II, about 34% variations in FDI inflows are attributed to IFRS and the control variables of Exchange Rate, Inflation, and GDP, while the remaining 66% variations are caused by other factors not considered in this study. This

further indicates that changes in accounting standard especially by adopting IFRS alone does not guarantee increased FDI inflows.

Also, the P- value of both the T- statistics in model I and F- statistics in model II of 0.000, shows that both models are statistically significant. Thus, the null hypothesis that the Adoption of IFRS has no significant effect on FDI inflows in Selected African countries may not be accepted.

4. Conclusion and Recommendation

The regression results indicate that adoption of IFRS has a positive effect on FDI inflows in the sampled Sub-Saharan African countries for the period 1980-2013. The model one shows that separately IFRS has a significant positive effect on FDI Inflows although, the explanatory power of the model is low at 12.7%, indicating that only 12.7% variations in FDI inflow is explained by IFRS, subsequently, model two inculcates other control variables. The result shows that IFRS, Inflation and GDP have significant positive effect on FDI while Exchange rate has a negative effect. Also, the R^2 is at 37% which implies that all the variables introduced in the model cause 37% variation in FDI inflows which is higher than the 12.7% for model one. Therefore, our study is consistent with the works of Young & Guenter (2003); Bushman & Smith's (2001); Assidi & Omri (2012).

This study has been able to identify that IFRS cannot singularly be used to predict FDI inflows and also FDI inflows singularly cannot be used to predict the adoption of IFRS, this is further shown by the R^2 of the regression estimates, we therefore conclude that adoption of IFRS alone cannot guarantee increased FDI inflows to selected African countries and care must be taken as to policies developed to attract FDI. We recommend that right policies should be set to aim at making African countries economically stable to be able to attract foreign direct investment. Although, the Organization for Economic Co-Operation and Development (OECD, 2003) gave a checklist for foreign direct investment incentive policies, this paper suggests the following policies in addition to those in the checklist:

i. Presence of transparency in Government and political stability.
ii. Presence of basic infrastructure of electricity, good road network and other social amenities.
iii. Tax incentives tailored towards attracting FDI.
iv. Stable and secured macroeconomic environment
v. Reduction of corruption and corrupt practices in public offices.

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