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Convergence of accounting standards and foreign direct investment

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Abstract

Since the development of the eclectic paradigm by Dunning (1977, 1988, 1993), many studies have investigated different forms of location advantages that attract foreign direct investment (FDI). In this study, we consider accounting standards as a component of the institutional infrastructure of a location and hypothesize that the convergence of domestic and International Financial Reporting Standards (IFRS) promotes FDI as it reduces information processing costs for foreign investors.[2] We also hypothesize that the effect of reduced information costs is stronger for partner countries whose accounting systems showed greater pre-convergence differences because they magnify the facilitating role of accounting standard convergence for FDI. Using bilateral FDI data from 30 OECD countries between 2000 and 2005, we find evidence generally consistent with these hypotheses.

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[2] For simplicity, we refer to both International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) as IFRS throughout.

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1. Introduction

The eclectic paradigm developed by Dunning (1977, 1988, 1993), known as the Ownership-Location-Internalization (OLI) paradigm, provides a framework for understanding foreign direct investment (FDI) activities. Many scholars have since investigated the different forms of location advantages that countries possess and their effects on FDI. These location advantages can include physical infrastructure such as highways and airports (Loree & Guisginer, 1995) or institutional infrastructure such as political stability and rule of law (Globerman & Shapiro, 2003). In his most recent works, Dunning (2005, 2006) emphasizes that the institutional infrastructure should be central to any study of the determinants of international business activities. In this study, we consider accounting standards as a component of the institutional infrastructure and examine whether similarities in accounting standards between partner countries are conducive to bilateral FDI, and whether convergence to international accounting standards increases FDI traffic.

Discrepancies between national accounting standards and practices have been recognized as important informational barriers to cross-border investment (Ahearne et al., 2004; Pagano et al., 2002). Previous studies have found that foreign investors prefer markets with high-quality information that enables them to assess investment prospects at a lower cost (Portes & Rey, 2005). Thanks to its verifiability, accounting information has been widely employed as one of the key inputs to reduce information asymmetries in investment decisions. After the European Union's adoption of IFRS in 2005, the leaders of the G-20 in September 2009 called on "*international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard-setting process, and complete their convergence project by June 2011*."[3] As more countries adopt or converge to IFRS, researchers, regulators and users of financial statements have all become increasingly interested in understanding the consequences of using a set of uniform financial reporting standards across countries. The debate concerns even more American academics and professionals these days because the U.S. is the only remaining major economy in the world not yet adopting IFRS.[4] Though some have raised the question of the cost of IFRS adoption,[5] one of the most frequently cited benefits of switching from local reporting standards to IFRS is that reducing or eliminating differences in accounting standards can allay information processing costs and increase cross-border economic transactions. European Commissioner McCreevy, for example, claims that widespread adoption of IFRS "*should lead to more efficient capital allocation and greater cross-border investment, thereby promoting growth and employment in Europe*" (McCreevy, 2005). A large number of recent studies have

[3] www.journalofaccountancy.com/Web/20092188.htm.

[4] See Hail et al. (2010) for the most recent analysis on this potential adoption of IFRS by the U.S.

[5] According to the survey by consultancy Accenture, depending on company size, U.S. executives estimate that they will spend between 0.1% and 0.7% of annual revenue to move from U.S. GAAP to international standards, an endeavor publicly traded companies in Europe undertook four years ago at an average cost of 0.05% of revenue (www.cfo.com/article.cfm/13399306).

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