

# Effects of the Globalization of Accounting Standards on International Capital Markets

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**Abstract** With IFRS covering 87 % of the world's biggest jurisdictions, it is considered the global set of accounting standards. This paper represents a summary of the research on how the globalization of accounting affects the development of international capital markets. Based on the hypothesis, that IFRS adoption enhances capital flows as the consequence of risk reduction of investments, we focused on IFRS adoption in different economic regions. The most space we devoted to the relation between IFRS and the US GAAP. Then we examined accounting harmonization in chosen developing countries and we also considered the accounting harmonization in China. After summarizing all the partial results, we conclude that the global adoption of IFRS lowers information asymmetry on the world market and it makes it easier for international investors to interpret financial reports and mitigate risks interrelated with their investments.

**Keywords** IFRS, international capital markets, US GAAP, accounting standards globalization

## 1. INTRODUCTION

Taking risks is an inseparable part of an investment decision-making process. One of the risks investors must undertake is the risk interrelated with the presentation of misleading accounting information in financial statements. While at the national level this risk is mitigated by obeying the legislation, at the international level this risk is mitigated by the adoption of the International Financial Reporting Standards (IFRS).

When entering new markets, investors encounter the difficulty of properly and comprehensively assessing accounting information in financial statements of targeted entities, especially when they are prepared in accordance with national accounting standards the investor does not comply with. In these circumstances, the profitability of an investment is reduced and the risk increases. The transformation of financial statements requires additional costs and to mitigate the uncertainty arising from the fact that accounting

information under different accounting standards may not be interpreted correctly or national legislation does not provide sufficient support for the true and fair view of the facts relevant to investment decisions. The less developed the country is, the more emphasis is placed on the reliability and comprehensibility of the information based on which investors make economic decisions.

In this context, IFRS serves as a tool to ensure the comparability of accounting information on the basis of which the information user makes decisions. The incorporation of IFRS into the national legislative framework increases the credibility of the national accounting model. Thereby the level of investment risk is reduced. The adoption of IFRS thus indirectly affects capital flows, especially those with long-term effects, on international markets.

The hypothesis of the impact of the implementation of IFRS on the increase in the volume of long-term capital investment flows was in recent years elaborated by several authors. Among the first, there were Chan, Corvig, and Ng in 2006 who found the relationship between FDI flow and accounting standards in a foreign country. Investors preferred home country investment portfolios because they considered the risk of reduced accounting information quality more significant than the risk of a non-diversified investment portfolio. Corvig with another two authors, Defond and Hung (2007) followed up this research and they found out that companies from the environment with lower level of quality of accounting information that voluntarily adopted IFRS subsequently reported higher volumes of investment in foreign mutual funds and vice versa mutual fund managers invested more in companies that implemented IFRS. This finding also assumes that the adoption of IFRS reduces the costs of processing and obtaining information for foreign investors. Yu (2009) confirmed that the implementation of IFRS is associated with lower costs of equity, which he considered a significant comparative advantage in assessing the attractiveness of investment for foreign investors.

An important contribution to the implementation of IFRS in relation to foreign direct investments (FDI) was the research of Chen, Ding, and Xu (2010). The results of their work led to three important

findings. Firstly, "FDI flows are positively linked to the convergence to IFRS on the assumption that the adoption of international accounting standards can support FDI by reducing the information barrier" (Chen, Ding & Xu, 2010). Secondly, the positive relationship is more intensive for pairs of countries with larger institutional differences, because there is a more intensive need to obtain comparable and understandable information for foreign investors' decision-making process. The third finding of this research was, based on the specific data, that the growth of foreign direct investment is positively linked to the degree of convergence from national accounting standards to IFRS over the period 2001-2005 (Chen, Ding & Xu, 2010).

The most recent research by Yousefinejada et al. (2018) aimed at identifying the relationship between the adoption of IFRS and the flow of FDI in ASEAN countries during the period from 2001 to 2016. The result of the research was confirmation of the existence of a relationship between IFRS and foreign direct investment, as well as the finding that this relationship is positive. Due to the IFRS adoption, FDI inflows increased by 10%. At the same time, this research pointed out that IFRS compliance is an important driver for foreign investors, even in Indonesia, which has not yet adopted IFRS but took steps to ensure the compliance of national accounting standards with IFRS in significant matters (Yousefinejada et al., 2018).

However, IFRS represents an investment risk mitigation tool not only because of the worldwide unification of accounting standards it provides but also because of the quality of IFRS's content. The main objective of IFRS is to provide relevant, reliable and comparable accounting information for both, internal and external users. The fulfillment of these characteristics is required by the IFRS Conceptual Framework and also by individual standards. The IFRS Conceptual Framework contains accounting principles and methods as well as basic items of financial statements and their definitions. The definitions and principles presented in the Conceptual Framework have a significant impact on the content of information disclosed in the financial statements. For this reason, even no other standards would be applied, the application of the Conceptual Framework would be sufficient to claim some level of accounting information quality and the unified approach to the preparation of financial statements.

## 2. METHODOLOGY AND DATA

The submitted paper represents the summary of partial results of research conducted under the internal grant project for young researchers of the Economic University in Bratislava (Faculty of Economic Informatics) no. I-19-107-00 called "Globalization of Accounting Standards in the context of the Development of Foreign Direct Investment".

The organization of the paper is as follows. The first part is meant to be an introduction to the discussed topic based on the literature overview of the relation between IFRS and international capital flows in different countries and economic regions. The second part presents the methodology on how this paper is structured and on which basis the presented information has been summarized.

By synthesis of the knowledge acquired throughout partial tasks and issues addressed in the project, we create a summary on how the globalization of accounting standards affects international markets. Focus is placed on three topics, including the US GAAP relation to the IFRS, Chinese accounting standards harmonization and quantitative effects of IFRS adoption on FDI in chosen developing countries. At the end of the paper, the final conclusions are

presented. We make statements about the final conclusions and give directions for further research possibilities.

## 3. RESULTS AND DISCUSSION

### 3.1 IFRS and the US GAAP harmonization

At the end of 2018, IFRS was, at least to some extent, required in 144 jurisdictions worldwide (IFRS Foundation, 2019). While in most of these jurisdictions a one-sided process of convergence of national accounting standards to the IFRS has been launched, the relationship between the US Generally Accepted Accounting Principles (US GAAP) and the IFRS differs. The US GAAP, as historically older and more extensive, were dominating the process of convergence first. (Zeff, 2005)

In September 2002, the Memorandum of Understanding, popularly known as the Norwalk Agreement, was signed between the IASB and the US Financial Accounting Standards Board (FASB), the main body responsible for issuing the US GAAP and there was an assumption that global accounting standards would be almost entirely derived from US GAAP. Over time, the assumption was proven to be wrong. The global financial and economic crisis between 2007 and 2009 brought up many new economic trends including two of them related to the development of global accounting standards:

- slowing down the process of globalization and cooperation in setting new global accounting standards (Zeff, 2007) - that was due to the US market failure to maintain its own stability. Therefore there has been growing distrust of standards' ability to ensure that financial statements provide true and fair view of the entities' financial position,
- expanding application of the IFRS on the world market – many countries started requiring IFRS domestic publicly accountable entities (listed companies and financial institutions) to ensure the unity of accounting, reporting, and presentation of financial information of those companies with the highest impact on capital market's stability.

We agree with the opinion of MacGregor Pelikánová and Cvik (2017, p. 158) that "currently, the US GAAP is overshadowed by the IFRS and only the future will ultimately answer whether the underlying economic philosophy and concepts of the IFRS will globally prevail and whether this will bring about the expected results, such as stability, transparency, fraud reduction, etc." Under these circumstances, there is a new requirement for investors in global markets. In our research, we refer to it as the need to be financially bilingual. The financial bilingualism was requested from both, from the US investors and also from the non-US capital markets participants. The argumentation is as follows:

The USA represents the most powerful and influencing capital market worldwide. It is also the country where most of the biggest transnational companies have their origin (UNCTAD, 2019) and for many of them, the US GAAP is the main set of accounting standards. Maintaining the stability of the world economy requires non-US capital market participants to have enough knowledge of the US GAAP provisions when entering international markets.

On the other hand, for US investors it has become a key success factor to master the IFRS when they look for any investment opportunities outside the US but often also at the national stock exchange. In December 2007 the SEC (The Security and Exchange Commission) decided to accept IFRS-compliant

financial statements for non-US companies on the US regulated market without the need to transform them, which made IFRS the internal part of the US financial market.

### 3.2 IFRS adoption in developing countries

The positive effects of convergence and subsequent adoption of IFRS, which are presented in the introductory literature review, are also confirmed by our FDI research in selected countries. We analyzed the development of foreign direct investment for each of the selected countries in six consecutive years R0 - R5, starting from the year when the IFRS was adopted and the next five consecutive years. The real period of time, therefore, varies from country to country. This distinguishes our research from several others that have been carried out in the last years. For example, Owusu et al. (2017) investigated the correlation of FDI and FDI on a sample of 116 countries, but with the same time horizon of 1996-2013 for each country for which data were available, although the time to implement IFRS in national legislation was different and therefore varied examined before and after implementation, although the synthesized results from the research set only partially reflected this.

We tested a sample of ten countries, which we created by deliberate selection based on common geopolitical and economic characteristics. The geographical proximity of the selected developing countries to the EU presupposes closer trade cooperation with the EU and thus a similar level of attractiveness of these countries in terms of FDI inflows. The adoption of IFRS before 2014 ensures that the development of FDI flows over a period of more than 5 years can be examined. We excluded the years 2007 to 2009 because, in times of economic recession, the primary determinant of FDI flows was economic instability and lack of resources. Examining the impact of adopting IFRSs over this period would not produce relevant, generally applicable results.

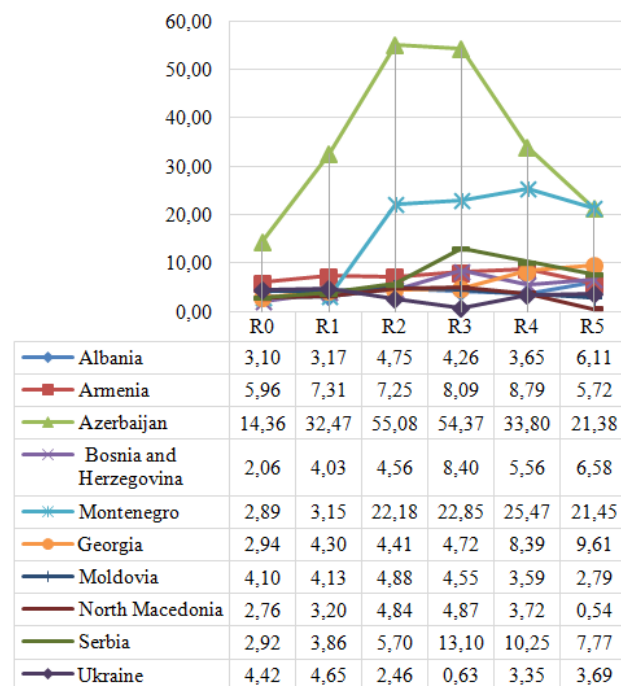
Given the different geographic, demographic and economic size parameters of the analyzed countries, we present the relative expression of FDI as a percentage of GDP. These values, as they are within a clearly defined range of 0-100%, can also be presented graphically. Even though we examined different periods of time, the development of FDI flows is similar for all countries. In some cases, for instance for Armenia, the relative values are higher, but the development is similar (see Fig. 1).

Subsequently, we analyzed the qualitative benefits of adopting IFRS. We have identified several common features in all countries (Deloitte, 2019). The adoption of IFRS has led to a reduction in the investment risk of FDI, in particular for the following reasons:

- The comparability of the accounting information presented in the financial statements has increased, allowing investors to evaluate the effectiveness of the investment more accurately and at a lower cost.
- The asymmetry of the accounting information between the investor country and the FDI recipient has been reduced, which has led to an improved investment environment and increased trade relations between the analyzed developing and developed countries.
- The English language has been extended as an economic and accounting language, thus contributing to facilitating communication between investors, accountants and local companies in selected countries.
- The investment risk of the countries analyzed has been reduced in terms of the stability and quality of accounting legislation, which has also reduced the personnel resources required to undertake investment in the country in the form of national

accounting legislation experts able to cooperate with investors in the international economic space.

Fig. 1: Development of FDI flows as% of GDP within five years after the adoption of IFRS



Source: Own arrangement based on the data from World Bank Open Data. (2019, September 27). Retrieved from <https://data.worldbank.org/>

### 3.3 Globalization of accounting standards in China

As one of the oldest civilizations in the world, accounting and auditing have a very long history and tradition in China. Our research was based on an analysis of the cultural, social, and political conditions in which accounting evolved, and then focused on the current level of harmonization of Chinese accounting standards and IFRS.

The origins of Chinese accounting date back to 2200 BC, to the reign of the Hsiu dynasty. Until the middle of the 20th century, however, Chinese accounting had no signs of the influence of internationalization. It has been first at the end of the 1970s, that China began to open up to international markets. So-called "open door" policy had emerged, and many reforms have been made, which has been reflected in the first attempts of internationalization of some principles and methods in Chinese accounting.

During the 1990s. the further expansion of the market economy in China caused, that Chinese accounting had to undergo significant changes. The Generally Accepted Accounting Standards of the People's Republic of China (PRC GAAP) were developed, in which the Accounting Standards for Business Enterprises (ASBE01) were introduced in 2001. It contains one basic standard called Chinese Accounting Standard (CAS) and 16 specific provisions. In 2006, the ASBE01 was amended to ASBE06, which in their content converged to IFRS to a more significant extent, but in practice, the version from 2001 remained to be used.

In terms of content, this process can be divided into four major phases:

1. *Accounting for companies with foreign capital participation (1985-1992)* - as foreign capital holdings differ significantly in organizational and capital structure from state-owned enterprises, the first phase of accounting reform began with the formulation of financial reporting requirements for the private sector of the economy.
2. *Accounting for public companies (1992)* – public companies and other similar forms of private ownership were established as independent legal entities with full autonomy. These companies have been classified into two categories. The first, internal companies, which the only issue shares to their employees and the second, public limited liability companies, which may invite the public to purchase their shares. Public companies were allowed to request to list their shares on stock exchanges. The possibility of setting up such a company brought about the need to reform accounting for the needs of this new type of ownership.
3. *Accounting standards and new accounting regulations based on industry (1993-2001)* - the Ministry of Finance issued the Corporate Accounting Standard, which came into effect on the 1st of July 1993. The Standard extended the traditional function of accounting in providing more information to entrepreneurs by underlining the needs of external users in assessing the company's financial situation and operating results. The standard replaced, in principle, all other accounting regulations previously in force.
4. *The complete set of new accounting standards (2001 – present)* – beginning with the ASBE01 issuing, developments in this area point to a significant shift towards the international financial reporting regulatory model.

Further convergence of IFRS and Chinese accounting is expected in the coming years, but the process itself is rather lengthy and the implementation of IFRS elements is delayed. When new IFRS updates are released, the Ministry of Finance of China review them to determine whether they fit for China and whether they will be included in CAS. As a result, the adoption of new IFRSs is often delayed or not made at all. In addition, the Ministry of Finance of China has not the same power and impact in all federal entities, so in many Chinese regions, the accounting system is still unreformed.

#### 4. CONCLUSION

The following conclusions can be drawn from these research results:

1. IFRS has gained a priority status as a set of standards recognized and enforced across international markets and has received worldwide recognition. Globalization of accounting standards towards IFRS reduces the asymmetry of accounting information on a regional and global scale, contributing to increasing the stability of international markets and ensuring faster and smoother capital flows around the world.
2. The harmonization of IFRS and US GAAP has triggered a new requirement that is imposed on investors - financial bilingualism. Despite the ongoing convergence process of IFRS and US GAAP, investors should continue to perceive the differences between the application of these two sets of standards in both the impact of accounting methods and disclosure requirements. Understanding these differences and their impact on key deal metrics will lead to a more informed decision-making process and a more accurate purchase price setting. On the other hand, the omission of relevant differences between US GAAP and IFRS may pose risks not only to the

transaction itself but when the market is widespread it may destabilize the entire financial market.

3. The harmonization of China's accounting standards has a different character than previously described IFRS and the US GAAP harmonization. Compared to the US, it is not a targeted and conscious convergence process, but rather a promotion of the natural demand of the international market. There is a pressure on the Chinese economy to converge and facilitate the penetration of international markets for both, the domestic and also foreign entities. However, for the sake of completeness, it has to be noted that China has made considerable efforts in the latest years to ensure that its accounting standards comply with internationally applicable standards, which would allow foreign firms to adapt more readily to the Chinese market conditions without changing accounting methods, but it still entails high additional costs for foreign companies to ensure a qualified approach to a correct interpretation of Chinese accounting outputs and the correct methodology of consolidating Chinese accounting entities in international structures.
4. The adoption of IFRS in developing countries has a positive effect on the volume of FDI inflows. We have expanded existing research in African, Asian or ASEAN countries to include a sample of countries geographically and commercially close to Europe and confirmed the established hypothesis that IFRS has a positive impact on capital inflows of the country. We are aware of the existence of other economic-geographical factors and do not consider IFRS to be the primary determinant of FDI inflows, but we emphasize their impact and consider this conclusion as a possible basis for further research in this field.

We do not consider these conclusions to be final. On the contrary, we consider them as a good starting point for further research. Relatively little space is devoted to the relationship between capital flows and the globalization of accounting standards, so there are many opportunities for further research and the application of the findings has such great potential.

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