Foreign Direct Investment Inflow in the Context of IFRS Adoption: Evidence from Slovakia

Radoslav Tusan

1 Department of Finance, Faculty of Economics, Technical University of Košice, Nemcovej 32, 042 00 Košice, Slovak Republic

Received: February 27, 2023
Accepted: March 21, 2023
Published: June 30, 2023

Abstract: IFRS can be considered a global accounting standard; by accepting it, the country can help increase the transparency of financial statements. Increased transparency will subsequently attract new foreign investors who prefer markets with high-quality information and provide them with the opportunity to assess investments at low costs and low risk. The adoption of IFRS can bring positive macroeconomic effects to countries, from which they can subsequently benefit and improve their overall economy. The article analyzes the impact of the adoption of IFRS on FDI in the Slovak Republic for the period from 1995 to 2020 through the correlation coefficients of various related variables. Two research objectives were specified in the article: 1) the adoption of IFRS does not have a significant effect on the inflow of FDI; 2) the adoption of IFRS has a significant impact on the inflow of FDI. The comparison of correlation coefficients showed interesting results in the mentioned context.

1. INTRODUCTION

As part of the developing uniformity of the financial and accounting sphere, several countries have adopted International Financial Reporting Standards (IFRS) in recent years. The Slovak Republic adopted IFRS in 2005. These standards not only improve the clarity of accounting and reporting in a given country but also support the economic field and have the potential to have a positive effect on foreign direct investment (FDI). Foreign Direct Investment (FDI) represents a direct form of investment by an investor in companies or businesses from another country. Basically, they are an investment by the given investor in a certain selected company. FDI is an investment of at least 10% of a share in a business, for example in the form of buying shares or another business share. The investor acquires significant decision-making power in the selected invested company. From the approach of the system of national accounts, FDI is a component of the balance of payments statistics, specifically the financial account of the balance of payments. FDI is an investment where its essence is a long-term relationship and where an entity based in one country has a permanent interest in an entity based in another country. We can simply characterize FDI as financial transactions in an investment relationship, where the parties involved can be two parties, persons, or nations (the investor and the person invested). It is usual for an investor to take into account the determinants of its environment when placing FDI. The question that many investors may ask, why it is good or why it would be worthwhile to invest in the Slovak Republic (SR), offers several answers. Slovak Investment and Trade Development Agency (SARIO, 2020) list ten interesting reasons why an investor could decide to locate his FDI in the Slovak Republic: location in the center of Europe, security, membership in the Eurozone, qualified workforce, the openness of the economy, developed infrastructure, investment incentives. Part of the business environment in Slovakia is the application of IFRS by several groups of entities. As a framework, IFRS in Slovakia is used by entities of public interest and those that have exceeded the size criteria.
2. LITERATURE REVIEW

Since the beginning of the nineties, researchers have been studying the impact of IFRS adoption on the economic growth of companies and countries. The results of studies from that period were ambiguous (Zaidi & Huerta, 2014). Gordon et al. (2012) assessed the impact of the adoption of IFRS on the total inflow of FDI into the country and at the same time determined whether this impact differs according to the country with a developing or developed economy. The authors analyzed 124 countries of the world with the finding that the adoption of IFRS has a higher impact on the inflow of FDI in developing countries than in developed economies (p. 393). Nejad et al. (2018) observed the relationship between IFRS adoption and FDI inflows in ASEAN (South East Asian Nations) countries. They found that the levels of FDI inflows increased significantly after the adoption of IFRS in these countries, also that the countries' Gross domestic product (GDP) is positively correlated with FDI inflows (p. 318, 323). These authors also found a positive relationship between IFRS adoption, FDI inflow, openness of the economy and education of the population (p. 319). Gu and Prah (2020) conducted research between FDI inflows, IFRS adoption, GDP growth, openness of the economy, perceptions of trust in the country's compliance agents, and political instability. The result of the research carried out in 12 African countries pointed to the interaction between FDI, IFRS adoption, and the perception of confidence in compliance with the rules in the country (p. 27). The variable "political instability" proved to have an inhibit effect on the inflow of FDI (p. 28). Research on the impact of IFRS adoption on FDI was carried out by Lungu et al. (2017). In the model, they set the dependent variable FDI, and independent variables such as: GDP, IFRS adoption, economic freedom, investment freedom, credit interest rate, exchange rate, financial freedom, political stability, tertiary education, and EU membership. The analysis sample was composed of 26 developing countries of Central and Eastern Europe as well as EU member states. The authors found the fact that countries that accepted IFRS are more likely to benefit from a higher increase in FDI than those countries that ultimately did not adopt IFRS (p. 15). The results characterized a higher increase in FDI inflows after the adoption of IFRS in the case of non-EU countries compared to EU countries. Non-EU countries benefit greatly from the adoption of IFRS through listed and unlisted companies. Conversely, the impact of IFRS adoption is not significant for EU countries when considering IFRS adoption by listed firms (p. 19). Efobi and Nnadi (2015) investigated the connection between foreign aid, IFRS adoption and FDI. Their research aimed to determine to what extent the adoption of IFRS can attract FDI in the presence of foreign aid. This foreign aid is a form of foreign finance that can directly compete or complement FDI. Foreign aid consists of financial flows, technical assistance and commodities that support welfare and economic development and is a significant source of foreign capital inflows. Using the example of 92 countries, they pointed to the fact that IFRS adoption increases FDI, but with the conditional acceptance of foreign aid (p. 16). Zaidi and Huerta (2014) examined IFRS adoption and enforcement as antecedents of economic growth. They hypothesized that there is a relationship between IFRS adoption and economic growth in a country. They took into account the so-called Level of Enforcement defined by Kaufmann et al., (2008, p. 7) as a set of measures for compliance with social and property standards. At the same time, they were based on the assumption that IFRS provides a more unified framework for reporting financial statements than the previous International Accounting Standards (IAS). In addition to the level of enforcement, they used variables such as: IFRS adoption, level of corruption, level of education, FDI, level of economic development of the country, political stability, and EU membership. Based two-staged least regression analysis, they confirmed the hypothesis on a sample of 51 countries that require IFRS for listed companies, thereby confirming the positive impact of IFRS adoption on the country's economic growth (p. 21).
3. METHODOLOGY AND DATA

The research aims to determine the strength (tightness) of the relationship between two quantities. The standardized measure of mutual linear dependence between the values of two variables is the correlation coefficient. The basic method in the article is correlation analysis to determine the strength of the relationship between variables. Data tightness was measured by Pearson's correlation coefficient. The data of the variables were obtained from the websites of the National Bank of Slovakia and the Statistical Office of the Slovak Republic, for the years 1995 – 2020. The variables used in the analysis were: FDI, IFRS dummies (0 = non-adoption, 1 = adoption), GDP, export, import, average nominal wage, prime interest rate, and current account balance of payments.

Figure 1 shows the development of FDI inflows to the Slovak Republic in the years 1995 - 2020. There was a constant inflow of FDI until 2003. After a decline in FDI in 2004, there was renewed growth in 2005. In 2005, the Slovak Republic adopted IFRS for selected entities. The development of FDI inflow changed in the following years, when in 2015 FDI recorded a decrease. The development since the mentioned year already shows a slight increase.

4. RESULTS

The research questions were whether IFRS adoption has no significant effect on the FDI inflow, or whether IFRS adoption has a significant impact on the FDI inflow. The research was carried out through correlation analysis using the Pearson correlation coefficient. The variables of the model used were FDI, IFRS dummy variable, GDP, Export, Import, Average nominal wage, Prime interest rate, and Balance of payments current account, for the years 1995 - 2020. The results of correlations are arranged in the correlation Table no. 1. The most watched dependency is the relationship between IFRS and FDI. This showed a strong (significant) dependence of 0,7528. The relationships between FDI and GDP (0,6728); FDI and Export (0,6321); and FDI and Import (0,6330) demonstrated high dependence. A strong dependence was demonstrated by the variables IFRS and GDP (0,8895); IFRS and Export (0,8702); and IFRS and Import (0,8726). A very tight dependence was shown by the variables GDP and Export (0,9917); GDP and Import (0,9931); and Export and Import (0,9990). This very close mutual dependence between the variables Export and Import can be excluded from the analysis due to mutual influence. The dependence between the Prime interest rate and other variables is very low (from...
0.0247 to 0.3297). High negative dependence is shown by the variable Average nominal wage concerning other variables. This means that the growing development of average nominal wages is negatively correlated with other variables. The variable Balance of payments current account has low negative to no dependence concerning other variables.

<table>
<thead>
<tr>
<th></th>
<th>FDI</th>
<th>IFRS Dummy</th>
<th>GDP</th>
<th>Export</th>
<th>Import</th>
<th>Average nominal wage</th>
<th>Prime interest rate</th>
<th>Balance of payments current account</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IFRS Dummy</td>
<td>0.7528</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.6728</td>
<td>0.8895</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Export</td>
<td>0.6321</td>
<td>0.8702</td>
<td>0.9917</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Import</td>
<td>0.6330</td>
<td>0.8726</td>
<td>0.9931</td>
<td>0.9990</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average nominal wage</td>
<td>-0.6394</td>
<td>-0.6875</td>
<td>-0.7411</td>
<td>-0.7099</td>
<td>-0.6971</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prime interest rate</td>
<td>0.0247</td>
<td>0.2311</td>
<td>0.2812</td>
<td>0.3268</td>
<td>0.3297</td>
<td>-0.2327</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Balance of payments CA</td>
<td>-0.3335</td>
<td>-0.2287</td>
<td>-0.0140</td>
<td>0.0361</td>
<td>0.0031</td>
<td>-0.1462</td>
<td>-0.0326</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Own calculation

The high value of the correlation coefficient of 0.7528 answers the question of whether or not there is a dependency between the IFRS and FDI variables. The significant dependence between the variables IFRS and GDP, IFRS and Export, IFRS and Import is also interesting.

5. FUTURE RESEARCH DIRECTIONS

Strong dependencies between the variables IFRS and GDP, IFRS and Export, and IFRS and Import, give impulses for possible future research directions. It is an interesting phenomenon; the growing development of average nominal wages is negatively correlated with other variables. Also, the analyzed correlation relationship could be investigated in the future, from the point of view of FDI inflow and inflation, unemployment, economic sentiment indicator, and membership of the country in the European Union.

6. CONCLUSION

The purpose of the article Foreign direct investment inflow in the context of IFRS adoption: evidence from Slovakia was to find out, based on established research questions, whether IFRS adoption has or does not have a significant effect on FDI inflow. Efobi and Nnadi (2015), Gordon et al. (2012), Nejad et al. (2018), and Lungu et al. (2017), dealt with the researched area of the impact of IFRS on FDI in different countries. Gu and Prah (2020), and Zaidi and Huerta (2014) contributed by expanding the research on the impact of IFRS adoption on FDI and GDP growth. In principle, the authors confirmed the positive impact of IFRS adoption on FDI inflow, respectively on GDP growth. In this article, additional variables were used to analyze the impact of IFRS adoption on FDI inflow, such as: GDP, Export, Import, Average nominal wage, Prime interest rate, and Balance of payments current account. From the analysis of correlation coefficients, it was found that IFRS and FDI have a strong correlation. The research question was confirmed in the sense that IFRS adoption has a positive effect on FDI inflow. It can be concluded that the adoption of IFRS increases the credibility of financial statements and thus contributes to increased FDI inflow.
Acknowledgment

This research was supported by the Science Grant Agency [VEGA 1/0444/23]: Network Analysis and Modelling of Interrelationships on International Financial Markets.

References


