

The Impact of IFRS Adoption on the Cost of Capital: Evidence from Iraq

Miaad Abdulkadhim Jard AL-kefari^a, Ruqayah Abd ULkudhur Shneet^b, Gnan abed kachi^c, ^aComputer Science and Information Technology College University of Al-Qadisiyah, Iraq, ^bAl-Furat Al- Awsat Technical University Technical Institute of Samawah , Iraq, ^cCollege of Biotechnolog Dept medical University of Al-Qadisiyah, Iraq, Email: meaad.jard@qu.edu.iq, Arqahan90@gmail.com, gnan.abed@qu.edu.iq

This research investigates the impact of IFRS adoption and both the cost of capital and the error of analysts' forecasts in the listed Iraqi firms, using a sample covering the time period 2016 – 2017 consisting of 190 year observations. The findings found that IFRS adoption led to lower information asymmetry, lower cost of capital and lower errors on the analysts' forecasts; that is, IFRS adoption led to improving the informational Iraqi environment and an improvement of the vision of all stakeholders related to the firms.

Key words: *IFRS adoption, Cost of capital, Error of analysts' forecasts, Information asymmetric.*

Introduction

Many relationships between firms and stakeholders depend on the quality of information disclosed; the higher the quality of this information may lead to lower risks and lower returns required from shareholders. In this case, financial reporting is the main source of all financial information and its quality depends on the reliability and relevance that are achieved depending on the accounting standard used. Furthermore, higher comparability needs regulatory framework to determine a standard method for accounting and preparing financial reporting which leads to the reduction of information asymmetry (Li, 2010; Bova & Pereira, 2012; Combs, et al., 2013; Kim et al., 2014; Turki, et al., 2017).

In this regard, the IFRS adoption may have a great effect on the quality and quantity of accounting information contained in financial reporting which improves the information content of financial statements by limiting discretionary accounting choices that enable firms to enter the international capital markets (Covrig et al. 2007; Barth et al. 2008; Kim et al.

2011). On the other hand, this limiting of discretionary accounting choices may reduce the information content of financial statements because it ignores some important accounting policies (Dicko & Khemakhem, 2010).

This controversy about the effects of IFRS adoption leads to the importance of investigating the impact of IFRS adoption on the cost of equity capital, because the cost of equity capital is one of the most important financial terms. This term refers to the funds that must be paid to both bondholders and stockholders. The cost of equity capital variations must be interpreted as a reflection of the information content presented in financial statements, that is, better information means a lower return demanded by bondholders and stockholders and therefore a lower cost of equity capital (Munteanu, 2011).

From this point of view, the relationship direction between IFRS adoption and the cost of equity capital depends on the ability of IFRS adoption to provide the suitable information content. In this regard, according to Ball (2006), the IFRS adoption provides greater reliability for investors, which means financial information will become easier to understand for analysts, which leads to information asymmetry reduction.

Indeed, the adoption of IFRS has improved the information quality in many countries (Barth, et al., 2008; Jiao, et al., 2011). In another vein, this improvement in the information content of financial reporting refers to more relevant information and less information asymmetry, hence reducing risk related to the investors, which leads to decreasing the required returns from investors and thus happens the reduction on the cost of equity capital (Lee, et al., 2010). But it is not possible to deal with this direction of relationship as postulated by Li (2010), who found this relationship in European countries for the listed companies, while Daske, et al. (2008) confirm that the accuracy of this relationship depends on the institutional differences between the countries. In other words, country differences may affect the direction of the relationship between IFRS and the cost of equity capital. In addition, Gao (2010) points out that the information content improvement is not evidenced on the decrease of capital cost, because this improvement may affect the investment decisions as it may alter the investment assessment related to shareholders and bondholders.

Contrarily, the analysts' forecast accuracy may be improved after IFRS adoption because of the increased quantity and quality of disclosures and more restricted accounting choices which make the forecasting task easier and thus improve the accuracy of analysts' forecasts (Hope, 2003).

This current study concludes that research gap represented by analysing this relationship in a new environment, being the Iraqi accounting environment. In addition, this study is conducted through two stages; the first stage analyses the impact of IFRS adoption on the

accuracy of analysts' forecasts, the second analyses the impact of IFRS adoption on the cost of equity capital.

Literature Review

There are many positive effects of IFRS adoption in many capital markets, such as better information content, more transparency, less information asymmetry and easier forecast tasks (Tendeloo & Vanstraelen, 2005; Armstrong, et al., 2010; Zeghal, et al., 2012). In this regard, a lot of researchers found that the IFRS adoption leads to numerous benefits on the information quality because of increased value relevance for the information content of financial statements, which means the enhancement of the efficiency of capital markets. Other studies have found a positive effect of IFRS adoption on analysts' forecasting performance in many countries (Ernstberger, et al., 2008; Cheong et al., 2010; Ionascu, 2012; Martinez & Dumer, 2014; Kim et al., 2014; Turki, et al., 2017; Masoud, 2017). However there are another stream of researches who have pointed out a negative or no effect of IFRS adoption on analysts' forecasting performance in many countries (Cheong et al., 2010; Cheng, 2012; Cotter, et al., 2012; Garrido-Miralles & Sanabria-García, 2014; Rhee, et al., 2016; Ding, et al., 2017).

In addition, there are numerous studies that have analysed the relationship between IFRS adoption and the capital cost in many countries; Armstrong, et al. (2010) analyse this relationship in Europe, Boya & Pereira (2012) examine it in Kenya, Castillo-Merino, et al. (2014) observe it in Spain, and Kim, et al. (2014) analysed it in 34 countries, and all of them agree that IFRS adoption leads to a reduction on the cost of equity capital.

Although several studies agreed (e.g. Leuz & Verrecchia 2000; Cuijpers & Buijink 2005; Lambert, et al., 2007; Hail, et al., 2010; Li 2010; Mihai, et al., 2012; Barth, et al., 2013; Horton, et al., 2013) about the negative relationship between financial reporting quality and the cost of equity capital, while the financial reporting quality depend on the quality of accounting standards used, Daske (2006) found a positive relationship between IFRS adoption and the cost of capital. In addition, Gatsios, et al. (2016) found no relationship.

It could be assumed that these asymmetric results among researches related to the difference in environment of research. Therefore, this study contributes to the accounting literature in two ways. First, it can examine the impact of IFRS adoption on the cost of equity and analysts forecasts in a new accounting environment, which is Iraq. Second, this article tries to measure the analysts' forecasts in one of the emerging capital markets, such as Iraq.

Theory and Hypotheses Development

IFRS became the accounting standards most applied around the world and has a lot of positive effects on the financial information content, because it is more rigorous and transparent (Turki, et al., 2017) – even as Turki, et al. (2016) found negative effects for IFRS adoption on the comparability which makes the analysts' task more difficult. In addition, several studies, such as those by Ashbaugh and Pincus (2002) and Gois, et al. (2018), found a positive relationship between IFRS adoption and the dispersion level of financial analysts' forecasts.

In another vein, Hodgdon et al., (2008) and Jiao, et al. (2012) point out higher analysts' forecasts accuracy by the adoption of IFRS. Yet on the contrary, Jonsson, et al. (2012) and Tan, et al. (2011) found no relationship between IFRS adoption and analysts' forecasts accuracy. Thus, the first hypothesis can be developed:

H1: There is no relationship between of IFRS adoption on the analysts' forecasts accuracy in the listed firms in Iraq.

According to Tweedie (2006), IFRS adoption helps to reduce the information asymmetry, which means less expected risks from investors and less required returns and decreased cost of capital. Even though other studies like those by Cuijpers and Buijink, (2005) and Daske (2006) found insignificant effect of IFRS adoption on the cost of equity capital, this insignificant relationship can be explained by a non-commitment application of IFRS, that is, voluntary IFRS adoption is the main cause of this insignificant relationship, where the firms don't apply all of the rigorous accounting choices of IFRS (Daske, et al., 2012).

Kim et al., (2014) reject these results, finding instead that the country may want to support their local standards and its effect on the financial reporting quality, and thus voluntary adoption of IFRS will achieve the significant relationship between the IFRS adoption and the cost of equity capital. Thus, the second hypothesis can be developed:

H2: There is no relationship between IFRS adoption on the cost of equity capital in the listed firms in Iraq.

Variables Measurement

This section shows how to measure study variables for developing the empirical models needed to test hypotheses, as follows:

The Independent Variable: IFRS Adoption

In Iraq, the adoption of IFRS is not mandatory to all firms, so a majority of firms in Iraq adopt IFRS voluntarily. This study therefore measures the IFRS adoption using a dummy variable, which is taken as 1 if the firm adopt IFRS in preparing financial reporting and 0 if otherwise (Daske, 2006; Munteanu, 2011; Kim, et al., 2014; Gatsios, et al., 2016).

The First Dependent Variable: Cost of Capital

The cost of equity refers to the required returns by investors, and it is often measured using the capital asset pricing model (CAPM) as follows (Yee, 2000):

Cost of equity = Risk free rate of return + Beta × (market rate of return – risk free rate of return)

Where beta refers to sensitivity movements related to the market.

The Second Dependent Variable: The Accuracy of Analysts' Forecasts

The dependent variable is the error by financial analysts related to the forecasting companies' future earnings. The variable $ERROR_{i,t+1}$ refers to the deviation between $EPS_{i,t+1}$ consensus forecast and the realised $EPS_{i,t+1}$ after taking the absolute value, scaled with the median of the stock price in year $t + 1$:

$$Error_{i,t+1} = \frac{|EPS_{i,t+1} - Forecast\ EPS_{i,t+1}|}{Share\ price_{i,t+1}}$$

This follows Hope (2003) and Glaum, et al., (2013) and other previous studies that use this measuring tool.

Control Variables

There is a control for earnings predictability and firm level factors that may affect the accuracy of analysts' forecasts and the cost of capital (e.g. Daske, 2006; Munteanu, 2011; Kim, et al., 2014; Gatsios, et al., 2016; Turki, et al., 2016). Control variables are shown as follows:

Variable	Definition
EC	The absolute value of the difference between current earnings and the previous year's earnings divided by the previous year's earnings.
Loss	Dummy variable which is taken as 1 in the case of realised loss and as 0 otherwise.
Size	Natural logarithm of total Market value of equity.
Lev	Financial leverage of the firm.
Roa	Return on assets of the firm.

Empirical Research Models

The first hypothesis of this article predicts that no relationship between IFRS adoption and the cost of capital on the Iraqi accounting environment. The first hypothesis can be tested using this model below:

$$\text{COE} = \beta_0 + \beta_1 \text{IFRS} + \beta_2 \text{EC} + \beta_3 \text{Loss} + \beta_4 \text{Size} + \beta_5 \text{Lev} + \beta_5 \text{Roa} + \varepsilon.$$

Where:

COE = Cost of equity capital measured by the CAPM model shown above;

IFRS = dummy variable, which is taken as 1 if the firm adopts IFRS in preparing financial reporting and as 0 otherwise

Other control variables shown in the model are explained above.

The second hypothesis of this article predicts that no relationship between IFRS adoption and the error in the analysts' forecasts. The second hypothesis can be tested using this model below:

$$\text{Error} = \beta_0 + \beta_1 \text{IFRS} + \beta_2 \text{EC} + \beta_3 \text{Loss} + \beta_4 \text{Size} + \beta_5 \text{Lev} + \beta_5 \text{Roa} + \varepsilon.$$

Where:

Error = Error in analysts' forecasts by earnings;

All of other variables have shown above.

Data Sampling

The sample period starts from 2016 and goes through to 2018 because the IFRS adoption didn't start in Iraq before the end of 2016, due to the new committed published laws about the importance of IFRS adoption. The primary data source is the Iraq Stock Market, which contains 268 year observations during the sample period; by excluding 78 observations

belonging to extreme values and missed data related to the variables of the study, the final sample of the study becomes 190 observations. These observations are shown in table No. 1, distributed over the years and different industries on the Iraq stock market.

Table 1: Sample distribution on the different sectors in Iraq Stock Market

Sector	2016	2017	2018	Total
Banks	9	30	23	62
Insurance	2	6	2	10
Financial services	3	4	6	13
Services	3	4	10	17
Industries	6	15	15	36
Hotels and tourism	0	2	12	14
Agriculture	1	4	5	10
Communications	0	1	3	4
Financial Transfer	3	6	15	24
Total	27	72	91	190

Table 1 shows that the sample concentrated in the last two years of the sample period because of the awareness about the importance of IFRS adoption on the Iraq stock Market after new laws.

Results

Descriptive Statistics

Descriptive statistics of numeric variables inserted on the model shown in table No. 2, after eliminating all extreme values and observations related to a single financial analyst.

Table 2: Descriptive Statistics

Variable	Obs	Median	Mean	Std. Dev.	Min	Max
COC	190	0.5755	0.5337	0.2796	0.3812	0.9974
Error	190	0.1125	0.3002	1.0099	1.0000	8.2727
EC	190	1.4150	4.6611	16.5336	0.0500	2.103
Loss	190	0.0000	0.2500	0.4336	0.0000	1.0000
Log Size	190	5.8609	5.9271	0.8322	4.2233	8.0556
LEV	190	0.5133	0.5558	0.4422	0.0140	6.0703
ROA	190	0.0864	0.1831	0.2660	-0.9472	0.8353

As shown in table 2, the mean of Cost of capital is 0.53, which is near to its counterpart in other studies, which are 0.492 and 0.439, respectively. The mean of Error is 0.30, which is close to other studies, which are 0.440 and 0.436, respectively (e.g. Kim, et al., 2014; Turki, et al., 2016, 2017).

Conversely, the mean of Loss indicator is 0.25, which means a decline in the number of losing firms in the sample, that is, the majority of the sample firms paid interest to the present and prospective investors. In addition, the mean of EC, Lev, and ROA are 4.66, 5.92 and 0.18, which is near to other studies (for example, Leuz & Verrecchia 2000; Cuijpers & Buijink 2005; Lambert, et al., 2007; Hail, et al., 2010; Li 2010; Mihai, et al., 2012; Barth, et al., 2013; Horton, et al., 2013). Based on the above results, it can be concluded that these study results can be compared with other studies related to this study.

Correlation Matrix

This section presents the correlation matrix among variables inserted in the model to identify the nature of relationships among variables and identify initial opinion about the multicollinearity among variables. So, the table No. 3 presents the correlation matrix among research variables.

Table 3: Correlation matrix

	COC	Error	IFRS	LOSS	Log Size	EC	LEV	ROA
COC	1.00							
Error	0.61	1.00						
IFRS	-0.79	-0.52	1.00					
LOSS	0.48	0.41	0.55	1.00				
Log Size	0.07	0.07	0.06	-0.05	1.00			
EC	-0.13	0.08	0.10	0.14	-0.01	1.00		
LEV	-0.09	-0.05	0.02	0.03	-0.06	-0.02	1.00	
ROA	-0.54	-0.48	0.49	0.50	-0.07	0.21	-0.04	1.00

As shown in table 3, there is no significant relationship among dependent and independent variables, there is a negative relationship between IFRS adoption and cost of equity capital, and there is a negative relationship between IFRS adoption and the error in the analysts' forecasts. Although these results can't be depended on as final, they represent the initial results concerning the direction of these relationships, and the results of regression analysis will confirm or deny these results.

Regression Results

Table 4 shows the results of regression analysis among variables inserted in the model on Iraq as follows:

Table 4: Results of regression analysis

Variables	Panel A: Dependent Variable COC		Panel B: Dependent Variable Error	
	Coef. T-Stat.	VIF	Coef. T-Stat.	VIF
Constant	0.80*** (46.54)		24.64*** (12.16)	
IFRS	-0.39*** (-19.64)	1.33	-17.72*** (-7.53)	1.3 3
Log Size	1.40*** (2.19)	1.01	1.40 (1.85)	1.0 1
EC	-0.00 (-0.38)	1.05	0.05 (0.60)	1.0 5
LEV	-0.05*** (-2.62)	1.02	-2.98 (-1.27)	1.0 2
ROA	-0.20*** (-5.28)	1.39	-26.25*** (-5.83)	1.3 9
LOSS	0.01 (0.66)	1.03	0.14 (0.14)	1.0 3
Industry Dummies	<i>Included</i>		<i>Included</i>	
N	190		190	
Adj. R ²	66.13%		33.21%	
F-Value	117.80		30.76	
F.Sig.	0.0000		0.0000	

The first hypothesis of the research predicts that there is no relationship between IFRS adoption and the error of analysts' forecasts, where the results shown in panel B confirm a significant negative effect of IFRS adoption on the analysts' forecasts error, that is, the IFRS adoption led to the decrease in the error of analysts' forecasts for the Iraqi listed firms. This result agrees with the results of numerous studies and the explanatory power of the model is 33.21%, which is greater than its counterpart in these studies by Tendeloo and Vanstraelen (2005), Armstrong, et al. (2010) and Zeghal, et al. (2012).

In addition, there is a significant negative relationship between ROA and the error of analysts' forecasts, which means that the increase in the ROA led to a decrease in the error of analysts' forecasts.

The second hypothesis of the research predicts that there is no relationship between IFRS adoption and the cost of capital, where the results shown in panel A confirm that there is a

significant negative relationship between IFRS adoption and the cost of capital, that is, the IFRS adoption led to the decrease in the cost of capital for the Iraqi listed firms. This result agrees with the results of numerous studies such as those by Armstrong, et al. (2010), Boya and Pereira (2012), Castillo-Merino, et al. (2014) and Kim, et al. (2014). In addition, the explanatory power of the model is 66.13%, which is greater than its counterpart in numerous studies, including Leuz and Verrecchia (2000), Cuijpers and Buijink (2005), Lambert, et al. (2007), Hail, et al. (2010), Li (2010), Mihai, et al. (2012), Barth, et al. (2013), Horton, et al. (2013) and Turki (2016, 2017).

In addition there is a significant negative relationship between leverage and the cost of capital and between ROA and the cost of capital, and a significant positive relationship between size and the cost of capital, which means that the increase in the leverage and ROA led to a decrease on the cost of capital, while the increase in the firm size led to increasing the cost of capital.

Consequently, the null hypotheses of the research can be refused and the alternative hypotheses accepted, because of the significant negative effect of IFRS adoption on the analysts' forecasts error and the cost of capital.

To ensure the results in table 4, the ANOVA analysis was used, which presents its results in table 5 as follows:

Table 5: ANOVA Results

Panel A: ANOVA Results for dependent Variable COC						
Variable		Sum of Squares (SS)	Df	Mean Square	F	Sig.
IFRS	Between Groups	17.77	1	17.77	606.92	0.0000
	Within Groups	10.59	362	0.03		
	Total	28.37	363	0.78		
Panel B: ANOVA Results for dependent Variable Error						
Variable		Sum of Squares (SS)	Df	Mean Square	F	Sig.
IFRS	Between Groups	53360.78	1	53360.78	130.79	0.0000
	Within Groups	147693.94	362	407.99		
	Total	201054.725	363	553.869765		

The results of this table confirm the results conducted by regression analysis in table 4, which means accepting the alternative hypotheses of the study.



Conclusions

This research investigated the impact of IFRS adoption and both the cost of capital and the error of analysts' forecasts in the listed Iraqi firms, using a sample covering the time period 2016 – 2017 and consisting of 190 year observations.

The findings found that IFRS adoption led to lower information asymmetry and a lower cost of capital, plus lower errors on the analysts' forecasts on the Iraqi listed firms, that is, IFRS adoption led to improving the informational Iraqi environment and an improvement to the vision of all stakeholders related to the firms.

These results confirm that the adoption of the international financial reporting standards leads to increasing the quality of financial information content in financial reporting. This quality leads to a decrease in the information asymmetry and an improvement in the analysts' forecasts and decreasing error and risks, so investors will require lower returns, hence reducing the cost of capital.

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