Chapter 3
Has IFRS Improved Comparability Regarding Earnings Management in Latin America?

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ABSTRACT

The adoption of IFRS as a unique set of accounting standards is claimed to have the potential to enhance cross-border financial statements comparability, due to a reduction of information costs and information asymmetry. IFRS is a recent issue in Latin America and there is a lack of knowledge about its application in the region, with countries beginning to completely converge to international accounting standards around 2010. This chapter compares the level of earnings management in the first three Latin American IFRS adopters, Brazil, Chile and Peru, considering the periods before and after IFRS adoption. The results show that firms from each country evidence different levels of earnings management before IFRS adoption, and that those differences no longer remain after the adoption of IFRS. The results indicate that IFRS has made financial information more homogeneous and, therefore, enhanced information comparability in Latin America.

INTRODUCTION

The adoption of the International Financial Reporting Standards (IFRS) by several countries worldwide has the potential to enhance cross-border comparability, highly because of the decrease of information costs and the reduction of information asymmetry. The importance of “comparability” regarding financial statements across firms ultimately lies on the efficiency of capital allocation. De Franco et al (2011)
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cites the views of the SEC and of the FASB, both in the United States, that investors judge the merit of each investment possibility in order to efficiently allocate their resources. If information about these investments is not comparable, their choice cannot be rationally made.

A number of studies examined different perspectives of information comparability related to IFRS adoption. These results evidence a general improvement in the financial statements comparability following IFRS adoption (Tan et al, 2011; De Fond et al, 2011; Brochet et al, 2013, Horton et al, 2013). The measures of accounting comparability in these studies are diverse. This variety is due to the difficulty to define a specific proxy for accounting comparability. The general notion is that comparability is reached when similar events are recorded similarly and dissimilar events are recorded dissimilarly (Lang et al, 2010). Finding a measure that captures this effect is quite difficult, once an outsider is not able to identify similarities and differences of events in various firms. Therefore, the literature has not yet provided a definite proxy for accounting comparability. Callao et al (2007), for example, examines financial ratios and rules for recognition and valuation, while De Franco et al (2011) state comparability as a function of the underlying economic events, comparing the expected earnings according to the firms’ stock returns. Lang et al (2010) relate accounting comparability to earnings comovement, and Archer et al (1995) use an index built by van der Tas (1988) that measures the proportion of pairwise comparisons that are feasible given the alternative accounting methods adopted by different firms. DeFond et al (2011) defines an improvement in comparability as an increase in uniformity, which is defined as an increase in the number of industry peers that use the same accounting standards. De Franco et al (2011) have recognized this lack of definition and have proposed a measure that captures the idea that accounting translate economic events into financial statements; therefore, given a set of economic events, two firms have comparable accounting systems if their financial statements are comparable. Brochet et al (2013) also examine accounting comparability and rely on the measures of De Franco et al (2011) and De Fond et al (2011).

Most would agree that true comparability (recording similar events similarly and dissimilar events dissimilarly) is desirable because accounting data become more useful for rational decisions related to capital allocation. If sharing accounting standards result in dissimilar events being treated similarly, information may be destroyed (Lang et al, 2010).

Considering the troubles to find a measure that truly reflects the sense of accounting comparability, in order to assess if accounting comparability has been affected by the adoption of IFRS in Latin America, this study seeks for an indirect way to assess comparability, based on the level of earnings management. The idea behind this choice is: if financial information in different countries have similar levels of accounting quality (earnings management being considered a feature of accounting quality), it is more comparable if one country present more reliable information than the other ones. If investors cannot equally trust on financial statements from different countries, they are not able to compare them. Therefore, if financial statements present similar levels of earnings management, they are likely to be more comparable.

The current literature about the effects of IFRS on the level of earning management is fruitful. In general, evidences show that IFRS limits earnings management and improves accounting quality (Barth et al, 2008; Jeanjean and Stolowy, 2008; Aharony et al, 2010). However, studies concerning Latin America are still incipient. Latin America’s importance to global economy has been growing since a significant recovery from late 2008 world economic instability (International Monetary Fund, 2013). From the