Chapter 5

Do IFRS Matter in Emerging Countries?
An Exploratory Analysis of Brazilian Firms

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ABSTRACT

This study analyzes the impact of the process of IFRS adoption on earnings management in the emerging country that is probably the most important in the world economy that has adopted in full the IFRS, Brazil. We examine earnings distributions for discontinuities around thresholds before and after IFRS adoption for a sample of Brazilian listed firms for the period 2004-2011. The findings of this study reveal that discontinuities exist, both before and after IFRS implementation, and that there is a decrease in discontinuity. The results of our study suggest that mandatory adoption of IFRS by Brazilian companies is associated with a decrease in earnings management, in particular during the period of full adoption of IFRS (post-2010).

INTRODUCTION

Among the benefits sought from IFRS adoption are the elimination of barriers to international investing, the enhancement of the reliability, transparency and comparability of financial reports; the augmentation of market liquidity, and the decrease of the cost of capital (Brown, 2011; Brown, 2013). As empirical research on the consequences of IFRS adoption worldwide develops, the context-specificity of the effects of said adoption becomes increasingly clear (Soderstrom & Sun, 2007; Brown, 2011; Pope & McLeay, 2011; Brüggemann, Hitz, & Sellhorn, 2013; Palea, 2013; Brown, 2013). The realization of the expected

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benefits of IFRS adoption seems to depend heavily on a panoply of factors, including the nature of the local standards in place prior to the adoption, the regulatory support and the degree of compliance monitoring and enforcement (Brown, 2011).

One of the areas regarding which the adoption of IFRS is expected to have an impact is that of earnings management. Earnings management is said to occur “when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (Healy & Wahlen, 1999, p. 368). One may distinguish between accounting earnings management, when the intervention of managers is on how the transactions and events are accounted for, and real earnings management, when it occurs via decisions on the timing or structuring of real transactions (Ewert & Wagenhofer, 2005). Graham, Harvey and Raigopal (2005) conclude that the most surprising finding in their study was that most earnings management was achieved via real actions rather than accounting manipulations.

A wide diversity of behaviours may be encompassed within the notion of earnings management, ranging from those which comply with the accounting standards in place to those that violate said standards. In this perspective, Dechow and Skinner (2000) distinguish between behaviours that clearly demonstrate intent to deceive, which can be considered under the umbrella of fraudulent accounting, and behaviours that, although being aggressive, are acceptable ways for managers to exercise their discretion. According to Healy and Whalen (1999, p. 380) earnings management may occur for a variety of reasons, including “to influence stock market perceptions, to increase management’s compensation, to reduce the likelihood of violating lending agreements, and to avoid regulatory interventions”. Graham et al. (2005) found that managers want to meet or beat earnings benchmarks to build credibility with the capital market, maintain or increase stock price, improve the external reputation of the management team, and convey future growth prospects. A recent paper by Dichev, Graham, Harvey and Rajgopal (2013) estimated that about 20% of public firms manage their earnings figures, and that the typical management is about 10% of the earnings per share.

It is usually claimed that tighter accounting standards reduce earnings management and provide more relevant information to the capital market (Ewert & Wagenhofer, 2005). Arguments have been presented in support both of positive and negative effects of IFRS adoption on earnings management (Ahmed, Neel, & Wang, 2013).

Research on earnings management has a long history (Healy & Whalen, 1999; Dechow & Skinner, 2000; Walker, 2013). Empirical studies on earnings management are legion, and there are already many studies published and more are in progress analyzing the effect of IFRS adoption on such practices. However, the majority of them focus on developed countries, either analyzing the effects of IFRS adoption in European Union countries and/or other developed countries such as Australia (Callao & Jarne, 2010; Chen, Tang, Jiang, & Lin, 2010; Iatridis, 2010; Iatridis & Rouvolis, 2010; Jeanjean & Stolowy, 2008; Paananen & Lin, 2009; Van Tendeloo & Vanstraelen, 2005; Zéghal, Chtourou, & Sellami, 2011). There are also some studies analyzing samples which include developed and developing countries (Barth, Landsman, & Lang, 2008; Houqe, van Zijl, Dunstan, & Karim, 2012; Ahmed et al., 2013). Research on the effect of IFRS adoption on earnings management in developing countries and in particular in BRIC countries (Brazil, Russia, India and China) is scarcer and tends to concentrate in China (Vieira,