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Full length Article

Full adoption of IFRSs in Brazil: Earnings quality and the cost of equity capital

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A R T I C L E I N F O

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A B S T R A C T

The purpose of this paper is to investigate the impact of IFRS adoption on the earnings quality and the cost of equity capital of Brazilian companies. It is assumed that an increase in information contributes to a reduction in asymmetric information. A conjecture is that more efficient allocation of resources will result in a reduction in the cost of capital. The results show that the hypothesis of an increase in earnings quality after IFRS adoption holds true. The models used to analyze the equity cost of capital suggest a reduction in the cost of capital of around 7 basis points.

1. Introduction

The transition process from the Brazilian Generally Accepted Accounting Principles (BR GAAPs) to the International Financial Reporting Standards (IFRSs) occurred in two steps, in contrast to the process in the European Union countries that have adopted all the IFRSs since 2005. Since there are no reports about similar cases, the Brazilian convergence process can be characterized as unique, raising interest in investigating whether the economic consequences identified in other cases of IFRS adoption (Barth et al., 2008; Li, 2010) apply to Brazil.

In this context, the tax neutrality in accounting practices introduced by the IFRSs was achieved through a legal instrument, contributing to financial statements that are more useful to investors and creditors. Before adopting the IFRSs, financial accounting in Brazil was strongly influenced by the interests of tax rules to the detriment of other users of accounting information. Therefore, it is expected that users of accounting benefit from more informative accounting reports, which can assist them in making decisions regarding the allocation of resources in the capital market and contribute indirectly to reducing the cost of capital for public companies on the stock exchange. However, the extent to which such benefits may occur is not known, considering that the Brazilian convergence occurred in two stages, in addition to the institutional aspects that can influence the quality of financial statements.

Brazil is classified as a code law country, which provides less protection for investors, besides being a poorly developed capital market (La Porta et al., 1997). Furthermore, the Brazilian economy shows a weak institutional environment (Anderson, 1999) with corporate governance practices that do not ensure the shareholders' rights (Chong and Lopez-De-Silanes, 2012), representing a disincentive to attract foreign capital. In this context, accounting practices can serve opportunistic purposes rather than the informational needs of external users, as noted by Lopes and Walker (2012). Thus, IFRS adoption occurs in an unfavorable scenario to increase the quality of accounting information, necessitating an investigation of the benefits advertised by IFRS proponents.

Although these specific characteristics discourage the enhancement of financial information quality, the Brazilian market consists of heterogeneous companies with different economic incentives. To give an example, large companies with good investment projects

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can seek funding in the capital market at a competitive cost, provided that they are able to show transparency and protection of shareholder rights. Given the incipient nature of the Brazilian market and the need for greater funding, many Brazilian companies sought resources in the North American market through ADRs (American Depositary Receipts), and therefore had to adapt to strict corporate governance rules like the SOX (Sarbanes-Oxley Act). This group of companies also had to adapt to the USGAAP (United States Generally Accepted Accounting Principles), which can influence efforts towards the adoption of the IFRS, given the similarities between both GAAPs.

Although there is empirical evidence of an increase in the quality of accounting information due to the IFRSs (Alali and Foote, 2012; Armstrong et al., 2010; Barth et al., 2008; Chalmers et al., 2011; Cormier et al., 2009; Devalle et al., 2010; Gjerde et al., 2008; Horton and Serafeim, 2009) and a reduction in the cost of capital (Daske et al., 2008; Lee et al., 2010; Li, 2010), there are differences in the results when comparing countries of common law origin and countries of code law origin, due to the different incentives that influence the quality of financial statements (Ball et al., 2003; Soderstrom and Sun, 2007). Furthermore, other studies have shown, contrary to the results, increased information quality, such as Ahmed et al. (2013), who studied the mandatory adoption of the IFRSs in 20 countries.

Some research investigates the diverging results, including Christensen et al. (2013), according to whom there are some reasons to analyze the announced benefits of compulsory IFRS adoption cautiously: i) greater discretion in the application of the new standards, putting the announced transparency improvement at risk; ii) increasing heterogeneity among the adopting countries in the functioning of the legal system and the enforcement level; and iii) other factors that happened simultaneously, such as economic shocks and institutional and legal changes.

The findings of Armstrong et al. (2010) show that investors are concerned with the implementation of the IFRSs in code law countries. In this sense, considering that Brazil is a country of code law origin, the aim of this study is to investigate the impact of full IFRS adoption on the quality of financial statements and the cost of capital of Brazilian public companies.

This research stands out because it considers four dimensions in examining the quality of financial statements – earnings management, conditional conservatism, relevance, and timeliness – all of which are converging in terms of utility accounting. Moreover, the complete adoption period (2010 and 2011) of the IFRSs in Brazil has not been investigated. Further justification for studying this period lies in the financial statements disclosed, including economic transactions, which were not previously incorporated. Therefore, this research presents a diagnosis of full IFRS accounting information quality and its effect on the cost of capital of Brazilian public companies, concatenating two benefits associated with the IFRSs that have been intensively discussed in the literature separately but never jointly. These aspects, along with the others cited, constitute the research's originality.

In addition, it should be highlighted that the two-phased adoption by Brazil reveals yet another strategy in terms of convergence with the IFRS, offering evidence to complement studies on accounting globalization from the political viewpoint. The study by Ramanna (2013) presents important considerations in that sense, discussing the growth of the IASB's political power in recent years.

2. Motivation

2.1. Regulatory environment in Brazil and the IFRSs

Before the move from the Brazilian accounting standards to the IFRSs, financial accounting was influenced by the Federal Revenue Secretariat, regulators, and supervisory and professional associations. Thus, financial statements were not prepared in accordance with the most appropriate techniques, resulting in a loss of information quality. In this scenario, strong pressure arose from academics, market professionals, and other actors to centralize the accounting regulations in Brazil, seeking convergence with the International Accounting Standards Board (IASB). One major result was the creation of the *Comitê de Pronunciamentos Contábeis* (CPC), the main objective of which is to issue standards in consonance with the international standards. Nevertheless, the CPC's role was not only to translate the standards. More importantly, it was focused on the centralized issuing of accounting standards, representation and democratic processes. The centralization took place, as Brazilian accounting before the adoption of the IFRS was influenced by public and private entities, which caused difficulties to properly apply the standards. The centralization solved this problem, as the CPC is fully and completely independent in its deliberations.

What the democratic processes are concerned, the production of the financial standards involved six entities that enhance the strength of the adoption process of the IFRS. These are: i) CFC – Federal Accounting Council, the supreme representative of accountants; ii) APIMEC NACIONAL – Association of Capital Market Investment Analysts and Professionals; iii) BM & FBOVESPA – São Paulo Stock Exchange; iv) FIPECAFI – Foundation Institute for Accounting, Actuarial and Financial Research (affiliated with FEA/USP), representing the academy; v) IBRACON – Institute of Independent Auditors in Brazil; vi) ABRASCA – Brazilian Association of Publicly-Traded Companies. Therefore, the Brazilian model follows the model that has been most productive around the world: the financial information preparers, auditors, analysts, intermediaries and the academy joint to produce a single standard. Thus, we believe that the IFRS contributed to enhance the quality of the Brazilian information environment, as a result of the application of technical determinations acknowledged as superior in different countries that investigated the effects of the IFRS. In that sense, the investors, analysts and other information users benefit from this change. Nevertheless, empirical tests are needed to verify this expectation.

To understand the IFRS adoption process in Brazil better, it is necessary to describe the standards that were applied in two stages: i) partial adoption in 2008 and 2009; and ii) full adoption as of 2010.

There were 15 accounting standards in 2008 and 2009, and 3 were from Brazil: CPC 9, CPC 12, and CPC 13. In addition, IAS 32 and IAS 39 have not been fully adopted, allowing us to conclude that not all the financial instrument requirements were applied at