



Asset revaluations, future firm performance and firm-level corporate governance arrangements: New evidence from Brazil

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ARTICLE INFO

Article history:

Received 19 March 2011

Received in revised form 27 May 2011

Accepted 8 June 2011

Keywords:

Revaluation

Brazil

Fair value

IFRS adoption

ABSTRACT

Using a sample of Brazilian listed firms for the period 1998–2004 we find evidence that revaluations of fixed assets are negatively related to future firm performance, prices and returns. We also find that the decision to revalue is negatively associated with scores on a Brazilian Corporate Governance Index (BCGI) and positively associated with indebtedness and illiquidity. Our results suggest that revaluations of fixed assets in Brazil are not designed to convey information to external users of financial statements but rather to improve equity positions – opportunistic motivations. Our evidence also corroborates the idea that firms that adopt superior voluntary governance arrangements are less likely to engage in actions designed to manipulate their financial statements. These results lend support to the recent amendment to the Company law which eliminated the revaluation option for Brazilian firms despite the current process of IFRS convergence.

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“Accounting is a language and as any language it can be used to write fiction”²

1. Introduction

In the process of global convergence to IFRS one of the most controversial topics is the revaluation of fixed assets. Revaluations are allowed under IFRS but not under US GAAP. As IFRS allows firms the option to revalue their fixed assets the desirability of this accounting treatment comes into question. The question turns on the use of historical cost figures which are considered to be more reliable than fair values, which are potentially more relevant (if managers have superior current information that they report truthfully). Related to this question is the applicability of IFRS over a large range of countries with distinct corporate financial reporting models and incentives – does allowing the revaluation of fixed assets provide relevant information in all countries independent of their institutional features?

If strong investor protection helps to control accounting manipulation then it is logically possible that a permissive approach to revaluations will work well in countries where the institutional arrangements for external investor protection are strong, but poorly in countries where external investors are less well protected. If this is the case then it may make sense for

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² Sir David Tweedie speaking in January 2010 at the São Paulo Stock Exchange.

some countries that have adopted IFRS or are thinking of adopting IFRS to impose local restrictions on revaluations in the interest of external investors.

In order to show that the outcome of permitting revaluations may depend on national context we investigate whether revaluations of fixed assets provides information about future firm performance using both *ex-post* realised operating earnings (as proxies for future firm performance) and market-related variables (returns and prices) in the context of Brazil. We do not expect revaluations in Brazil to be related to future firm performance but rather to be motivated by opportunistic reasons. This expectation is grounded on prior research (Anderson, 1999; Lopes & Walker, 2010) which shows that the Brazilian financial reporting system (at least during the years covered in this study) was not designed to inform external parties as is often the case in insider model countries (Leuz & Wustemann, 2004 or a Class B country Nobes, 1998). Another consideration underlying this expectation is that equity depletion (Lin & Peasnell, 2000b) is unlikely to be a driver of the revaluation of fixed assets in Brazil because Brazilian GAAP did not require write-offs of goodwill and assets with doubtful recoverability and also was very lenient in terms of allowing capitalisation of research and development costs and also of deferred assets.

Brazil provides an interesting setting to investigate revaluations for two main reasons. First it is interesting to investigate the informativeness of revaluations in a setting distinct from the high quality information environments where past research has been performed (UK and Australia). The Brazilian financial reporting environment during the period covered in this study could be characterised as inimical to the production of high quality accounting reports. The strong influence of tax rules on financial reports, the low participation of the private sector and of the accounting profession in standard setting, and highly concentrated insider share ownership are the main examples of factors which reduced the informativeness of accounting reports. Thus, during most of the sample period, there was a perception in Brazil that financial statements were not prepared to provide information to external parties but only to comply with tax rules. The ready acceptance of the recent adoption of IFRS (Lopes, 2011) is further evidence of the general perception that the quality of the financial reporting environment in Brazil should be improved.

Second, as explained in more detail below, the Brazilian experience of revaluations was generally perceived to be disappointing. As a result Brazilian accounting policy makers have adopted a negative stance towards revaluations in spite of them being allowed by IFRS. In 2007, Brazilian Company Law was amended in order to provide the legal background for full IFRS convergence by the end of 2010.³ However, this new law does not permit asset revaluations despite them being permitted under IFRS. Thus, unlike many other countries (e.g. Germany), Brazil moved from a local GAAP which allowed fixed asset revaluations to an IFRS model which eliminated them. The reason for this unusual restriction (generally moves to IFRS increase the use of fair value especially in code law countries – Christensen & Nikolaev, 2009) was a general disbelief in the relevance of revaluations in Brazil which were viewed as instruments to manipulate reports and thus to be eliminated in the interest of achieving higher quality accounting standards (Costa, 1993; Schvirck, 2006).⁴ This perception is interesting because IFRS standards are normally perceived to be of high quality. Correct or not this view is grounded on the perception that the properties of published financial statements do not depend solely on the accounting standards (as IFRS allows for revaluations and are supposedly high quality standards), but also on the incentives firms face to account for transactions in a certain way, which in turn depend on macro-institutional factors and also on firm-level features.

Using a sample of 849 firm-year observations for firms listed in the São Paulo Stock Exchange for the period 1998–2004 we find evidence that revaluations of fixed assets are negatively related to future firm performance, prices and returns. This evidence suggests that revaluations are not informative about firm performance and consequently are implemented for alternative reasons, or perhaps are based on a misconception by managers that they may be value relevant.

In addition to the analysis of the relation between revaluations and future performance, we also study the drivers of the decision to revalue, focussing in particular on the quality of corporate governance. We find that the decision to revalue is negatively associated with scores on a Brazilian Corporate Governance Index (BCGI) – a measure of governance quality – and positively associated with indebtedness and illiquidity. Our results suggest that revaluations of fixed assets in Brazil are not designed to convey information to external users of financial statements but rather to improve reported equity positions to avoid covenant violations, i.e. opportunistic motivations. Our evidence also corroborates the idea that firms that adopt superior voluntary governance arrangements are less likely to engage in actions designed to manipulate their financial statements. These results lend support to the recent amendment to the company law which eliminated the revaluation option for Brazilian firms despite the current process of IFRS convergence.

We contribute to the literature in several ways. First we add to the literature on asset revaluations by producing evidence on Brazil, and more importantly, evidence on the relation between firm-level corporate governance and the revaluation of fixed assets in the context of a significant emerging market. Furthermore we contribute to a growing literature which aims to uncover the influence of firm incentives and imperfect enforcement mechanisms on the properties of published accounting reports. We corroborate the view (e.g. Ball & Shivakumar, 2008) that contractual motivations (in our case to avoid covenant violations and also to improve the book value of net assets) exert a significant influence over accounting choice. Our results show that the actual properties of accounting reports depend not only on accounting standards but also on the information environment in which firms are immersed and their incentives to provide informative reports. These findings improve our

³ Companies could adopt full IFRS earlier for the year ended in 2009.

⁴ It is interesting to observe the comment on the main (bestselling) financial accounting textbook used in Brazil (Manual de Contabilidade Societária by Martins, Iudícibus, Gelbcke and Santos, 2010; p. 380 – our translation) “Summarizing, revaluation of fixed assets, despite being the product of good intentions, ended up being a procedure which brought more difficulty than utility to external users;”.

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