DETERMINANTS FOR PROVISION RECOGNITION:
A COMPARISON BETWEEN PORTUGAL AND BRAZIL

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ABSTRACT

We investigate if firms in Brazil tend to exhibit a greater preference for conservatism in financial reporting than firms in Portugal. For that purpose, we analyze the level of Provision reported in the Financial Position for firms publicly traded in these two Countries for the period from 2010 to 2012. Our results suggest that firms from Brazil tend to have higher level of Provisions scaled by Total Assets than the Portuguese firms, therefore the accounting system of Brazil is supposed to be more conservative. In spite of the Portuguese culture being a relevant determinant of external environment in Brazil, the geographical proximity and economic relevance with US may explain this result.

In addition to those external factors of accounting practice, we also investigate the influence of firm´s internal environment. We found evidence that while for Portuguese firms the Provisions are determined by firm's size and profitability for Brazilian firms it is the level of debt that affects the Provisions recognition.

KEY WORDS: Conservantism, Provisions, Internal and External factors, IAS 37.

RESUMEN:

En este artículo, se investiga si las empresas en Brasil tienden a mostrar una mayor preferencia por el conservadurismo en la información financiera en comparación con las empresas en Portugal. Para ello, analizamos el nivel de Provisiones reconocidas en la Posición Financiera por las empresas no financieras, emitentes de acciones, que se encuentran admitidas a negociación en el mercado de cotizaciones oficiales en esos dos países, en el período de 2010 a 2012. Nuestros resultados sugieren que las empresas en Brasil tienden a tener un mayor nivel de provisiones relativas a los activos totales en comparación con las empresas portuguesas. Esta evidencia empírica indica que el sistema contable brasileño tiende a ser más conservador, a pesar de la fuerte influencia cultural portuguesa. Sin embargo, la proximidad geográfica y la relevancia económica con los Estados Unidos pueden explicar este resultado.

Además de estos factores externos de la práctica contable, también investigamos la influencia del ambiente interno de la empresa. Así, encontramos evidencia en el caso portugués que las provisiones son determinadas por el tamaño y la rentabilidad de la empresa, mientras que en el caso de Brasil el factor determinante es el nivel de endeudamiento.

PALABRAS CLAVE: Conservadurismo, Provisiones, Sistema Contable, Factores Internos y Externos, NIC 37.

1. INTRODUCTION

In this study we investigate whether the level of conservatism is different between Portugal and Brazil. Although the firms included in this study are already following the International Financial Reporting Standards (IFRS), these standards are applied differently across countries Nobes (2006), Haller and Wehrfritz (2013).

In order to enhance the efficiency of international capital investment the International Accounting Harmonization has been a topical issue for regulators, academics, investors and creditors. This process aims to increase the financial reporting transparency and allows to compare financial information across Countries.

In spite of these efforts, there are still differences in financial information due to several environment factors, such as legal origin, fiscal influence on accounting, cultural differences, firms' financial sources (Nobes and Parker, 2012; Rodrigues and Pereira, 2007; Radebaugh and Gray, 1997).

While there is a strong Portuguese culture influence on Brazil the geographic and economic links between Brazil and United States (US) may lead the accounting system of Brazil being closer to the Anglo-Saxon accounting system, US General Accepted Accounting Principles (GAAP) than to the IFRS standards. In addition, the Portuguese firms adopted early the IFRS than Brazilian firms: 2005 for the former and 2010 for the later.

Regarding specifically the provision recognition, based on International Accounting Standard (IAS) 37 Provisions, Contingent Liabilities and Contingent Assets, provisions are associated with uncertainty and probability, which depends on personal expectations and may be used for earnings management purposes. Therefore, we further develop our work investigating which factors are likely to explain the level of provisions both for Portuguese firms and Brazilian firms.

The remainder of the article is organized as follows. Section 2 exhibits a brief literature review and develops the hypotheses analyzed in the study. Section 3 describes the research design, including sample selection procedures and the definition of regression model. Section 4 documents some descriptive statistics and reports the results of the empirical tests. Concluding remarks are provided in Section 5.

2. LITERATURE REVIEW AND HYPOTHESIS DEFINITION

The accounting standards flexibility is necessary in order to communicate private information to outsiders (Healy and Wahlen, 1999). Furthermore, the International Accounting Standards should be applied widely across Countries, therefore it is based on principles rather than in specific rules (Cerqueira and Pereira, 2017). However such flexibility may influence earnings quality, which is widely study in literature. Dechow *et al*. (2010) give detailed description of several measures used to assess earnings quality.

Even under IFRS adoption, there a number of reasons for existing differences in accounting practice. Nobes (2006) identified eight types, such as different versions of IFRS, different translations of IFRS, overt options in IFRS and estimations in IFRS. Tsakunis *et al*. (2009), emphasis the influence of the culture and the translation to the language of each Country that may cause difficulties to compare financial reporting across Countries.

The IFRS 37 *Provisions, Contingent Liabilities and Contingent Assets* was issued in 1998 and applied from 1999 and defines the recognition criteria and measurement bases, which are different from those establish by *Financial Accounting Standards Board* (FASB). As IFRS 37 is difficult to

apply and in order to enhance the convergence between the IFRS and US GAAP, IASB and FASB have been working together in this topic since 2005.

It is also important to notice that Portuguese and Brazilian Accounting Regulators have alter their local standards in order to be closer to the IFRS and to capture more international investment. In case of Portugal, the *Sistema de Normalização Contabilística* (SNC) was issued in 2009 to begin in 2010 and in Brasil in 2010.

The *Norma Contabilística de Relato Financeiro* (NCRF) 21 prescribes a similar accounting treatment for Provisions recognition, measurement and contingent liabilities and contingent assets as the IFRS 37. In case of Brasil it was issued the *"Pronunciamento Técnico CPC 25 – Provisões, Passivos Contingentes e Ativos Contingentes"* in 2009, which is based on IAS 37 as mentioned by Matias (2013).

In fact, one difficulty of IFRS 37 consists of the use of estimations, which are essential in provision measurement. This standard mentions 25 times the word "estimate" and once the word "estimation". Estimations imply managers' judgments and thus they may be an opportunity to earnings management (Healy and Wahlen, 1999).

Therefore, given the international accounting standard flexibility, the accounting practice depends on both external environment and firms' internal conditions.

In the case of the external environment, Nobes (1998) and Nobes and Parker (2012) describe in detail the environment factors that affect the accounting practice across Countries: legal system, culture, providers of finance, taxation, the profession, inflation and theory. We focus our investigation in the influence of culture and economic factors. Gray (1988) developed the study of the influence of social and cultural values on the accounting practice. For centuries, Portugal was present in Brazil leading to a strong cultural influence, with emphasis on the language. However, we also take into account the impact of the economic relations with other Countries in the accounting practices. Specifically, Brazil exhibits a commercial relationship with US considerably greater than with Portugal.

In case of internal conditions, we analyze the influence of a firm particular performance, concerning both economic and financial conditions. Chavent *et al*. (2006) study the association between financial sources and the level of provisions reported. For a sample of French firms listed in SBF 120 for the year 2001, they find evidence that provisions depends on firm size, leverage, profitability and industry.

Oliveira (2007) studied the compliance of the application of IFRS 37 by Portuguese firms for the 2000 year, namely regarding the disclosure and recognizing issues defined in IFRS 37. The author found evidence that the firms accounting practice do not meet the criteria establish in IFRS 37. A similar result was obtained by Fonteles *et al*. (2012), for a sample of firms from Brazil, listed in BM&FBovespa (São Paulo Stock Exchange). Investigating the compliance of the application of IFRS by firms listed in BM&Fbovespa for 2010, Oliveira (2011) did not find a firm that disclose the provisions, contingent liabilities and contingent assets as established in the standard. However, most of them disclose information from 50% to 70% according the standard.

Therefore, a number of studies investigate the factors that may influence the disclosure and the amount recognized of Provisions.

Firm's size is a widely studied factor that determines financial reporting. Watts and Zimmerman (1978) showed that larger firms have more political pressures because they are followed by analysts, government, and other stakeholders. In addition, larger firms have more detailed

information and workers with higher level of education (Guerreiro, 2006, Murcia and Santos, 2009, and Fekete, Matis and Lukács, 2008). Thus, we posit the first hypothesis:

H1: The level of provisions is higher for larger firms.

Other factor that affects financial reporting is the level of debt. Lopes *et al*. (2010) find evidence for a European sample of listed firms that firms tend to report financial information in order to exhibit better conditions in new debt contracts or to achieve the contractual clauses. Therefore firms with high debt ratios tend to have high financial reporting quality given by discretionary accruals. Guerreiro (2006) find evidence that firms with lower debt ratios tend to have higher levels financial reporting. By contrast, the results of Alves, Rodrigues and Canadas (2012), suggest that the level of debt are not significantly associated with financial reporting for a sample of Portuguese and Spanish firms. We based in these different evidences to define our second hypothesis:

H2: The level of provisions is associated with the firm's leverage.

The profitability is other determinant that we study the association with the level of provisions reported by firms. For a sample of firm from Brazil, Fonteles *et al*. (2012) find that profitability affects the level of provisions and contingent liabilities disclosure for firms from Brazil. Chavent *et al*. (2006), find the same evidence for French firms and Zourarakis (2009) for British firms.

H3: Profitability is positively associated with provisions reported by firms.

We also analyze if these two Countries is more conservative taking into account the level of provisions scaled by total assets. In spite of Portugal having a European Continental accounting system (Gernon and Bindon, 1992), this Country follow the IFRS earlier than Brazil. While the adoption of IFRS for Portugal is mandatory by the Regulation (EU) no. 1606/2002 for publicly traded companies for the preparation of their consolidated financial statements 2005 for Brazil it is mandatory since 2010. The IFRS are based in the Anglo-Saxon accounting system which is not as much conservative as European Continental. However, within Anglo-Saxon accounting system, Nobes (1998) distinguish the families: US; UK and IFRS. As Brazil exhibit a strong commercial relation with US the accounting system may have a considerable influence form US.

We can see in table 1 below, panel A that the exports from Portugal to Brazil are close to 1% of the total of the Portuguese exports with a slight increase during the period considered. The relative importance of imports to the total of Portuguese imports is greater than the exports, however they just represent 1,8% in 2010 and 2,4% in 2012.

From panel B of table 1, we observe that in the case of Brazil, the importance of Portugal in exports and imports is even smaller, always under 1% of the total of exports and imports. By contrast, the exports from Brazil to US are 10% of total exports in 2010 and 11% in 2012 and 15% for the Brazilian imports from US. Therefore, the economic influence of US is much stronger than the Portuguese influence.

Table 1: Imports and Exports from Portugal and Brazil

Panel A: Portugal exports and imports (Thousands Euros)					
	Exports			Imports		
	2010	**2011**	**2012**	**2010**	**2011**	**2012**
Total	37 268	42 828	45 213	58 647	59 551	56 374
Brazil	440	583	681	1 046	1 462	1 360
	(1,2%)	(1,4%)	(1,5%)	(1,8%)	(2,5%)	(2,4%)

Source: Prodata

Panel B: Brazil imports and exports (Thousands Euros)					
	Exports			Imports		
	2010	**2011**	**2012**	**2010**	**2011**	**2012**
Total	156 075	193 020	192 163	133 423	174 490	164 154
Portugal	1 273	1 567	1 008	460	678	747
	(0,82%)	(0,81%)	(0,53%)	(0,34%)	(0,39%)	(0,46%)
US	15 608	21 232	21 138	20 013	26 173	24 623
	(10%)	(11%)	(11%)	(15%)	(15%)	(15%)

Source: OEC (Observatory of Economic Complexity)

Considering that conservatism is lower for IFRS's family than for US GAAP, we formalize the following hypothesis:

H4: The provisions reported in Portugal are lower than in Brazil.

3. RESEARCH DESIGN

Sample selection

For the empirical tests we analyze a sample of 40 listed firms for a three-year period, from 2010 to 2012, thus we have 120 firm-year observations. We exclude financial institutions because of their specific regulation. From this sample, 20 firms are Portuguese, listed in *Euronext Lisbon* and 20 are Brazilian listed in BM&FBovespa. From 2010 the IFRS were mandatory for publicly firms with consolidated accounts in both Countries, therefore it is feasible to compare these financial information.

The data was collected from Financial Reporting available in *Comissão de Mercado de Valores Mobiliários* (CMVM) site for Portugal and in BM&FBovespa site for Brazil.

We take into account that the currency is different for the two Countries: the Portuguese financial Reports are in Euro and the Brazilian are in Real. Thus, we convert the amounts to Euro based on exchange rates disclosed by Banco de Portugal at 31st December of 2010, 2011 and 2012.

Regression Model

We estimated a multivariate regression model where the dependent variable is the amount of Provisions reported in the Financial Position Statement, specifically in the items of the Non-Current Liabilities. As the size of firms are heterogeneous, we scaled the Provisions by the Total Assets. In equation (1) we included four explanatory variables taking into to account the hypothesis mentioned in the previous section.

$$Provisions = \beta_\theta + \beta_1 Size + \beta_2 Debt + \beta_3\ ROA + \beta_4 Portugal + \in_i \qquad (1)$$

Where:

Provisions is obtained by Provisions/ Total Assets
Size is the Natural logarithm of Total Assets
Debt is the Liabilities/Total Assets
ROA is the Return on Assets which is Net income/Total Assets
Portugal is a dummy variable which is equal to one for Portuguese firms and is zero for Brazilian firms.

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In the empirical tests we apply panel data because combining time series with cross-section data increases the number of observations and may offer a solution to the problems caused by unobserved heterogeneity. In addition, we use both cross-sectional fixed effects at the firm level and time fixed effects.

4. EMPIRICAL RESULTS

Descriptive Statistics and Correlations

Table 2 reports the mean value of Provisions and the mean value of Provisions to Total Assets ratio. We see that both indicator are higher for Brazil than for Portugal. It is observable that the Provisions have increased in the three years for Brazil and increased from 2010 to 2011 for Portugal but it slightly decreased in 2012.

When we focus on the ratio of Provision to Total Assets, the evolution is similar: Brazil presents an increase in the three years and although for Portugal the ratio is higher in 2012 than in 2010 it is lower in 2012 than in 2011. Moreover, we see that the mean value of total Assets increase in the three years for both Countries but the increase of the level of Provisions reported is higher except for 2012 for Portugal.

Overall, the level Provisions as well as its relative value is higher for Brazil than for Portugal. This evidence suggest that Brazil accounting system is more conservative. This table also shows that the difference in this ration between the two Countries exhibit a small decrease: in 2010 the Brazilian ratio was more than 4 times the Portuguese ratio (4,53% versus 1,06%) but in 2012 it was less than 4 times (4,73% versus 1,35%).

Table 2 – Level of Provisions in Portugal and Brazil

	2010		2011		2012	
	Portugal	**Brazil**	**Portugal**	**Brazil**	**Portugal**	**Brazil**
Total Provisions (thousands Euro)	1.115.934	25.075.864	1.745.038	26.786.620	1.627.600	32.944.802
Total Provisions (thousands Euro)	105.577.704	553.071.477	116.182.137	595.168.676	120.621.105	695.980.429
Total Provisions/ Total Assets (%)	1,06	4,53	1,50	4,50	1,35	4,73

Source: Authors' calculations.

Table 3 contains the correlations between the variables included in this study. The correlation between Provisions and Size and Provisions and ROA are positive. This result is consistent with larger firms and more profitable firms exhibiting higher level of Provisions. By contrast, the correlation between Provisions and Debt is negative meaning that higher debt tends to be associated with lower Provisions reported in Financial Position.

Table 3 – Correlation Matrix

	Provisions	**Size**	**Debt**	**ROA**
Provisions	1			
Size	0,411385	1		
Debt	-0285916	-0,436879	1	
ROA	0,209774	0,260608	-0,305058	1

Source: Authors' calculations.
Variable definitions: Provisions: Provisions/ Total Assets; Size: Natural logarithm of Total; Debt: Liabilities/Total Assets; ROA: Net income/Total Assets; Portugal: One for Portuguese firms and zero for Brazilian firms.

Results from Regression Model

Table 4 reports the results of OLS estimations. The explanatory variable Size and the dummy Portugal are statistically significant at 5% level. The variables ROA and Debt are not statistically significant.

Furthermore, Size and Portugal have the expected sign: positive for Size, consistent with larger firms tend to report higher levels of Provisions; negative for Portugal suggesting that Portuguese firms are negatively associated with Provisions reported. These results are consistent with Chavent *et al*. (2006), Fonteles *et al*. (2012) and Alves *et al*. (2012) because they found that larger tend to disclose more information. The result for the dummy variable is also consistent with the IFRS being less conservative than the US GAAP that have a strong economic influence in Brazil.

Table 4 – Regression of Provisions on Size, Debt, ROA and Portugal

	Predicted Sign	Coef.	t-stat.
C		-2.790	-0.939
Size	+	0.363**	2.233
Debt	-	-0.004	-0.236
ROA	+	0.045	1.140
Portugal	-	-1.128**	-2.238
No.of Observations		120	
Adj.R-squa.		0,183	

**Indicates significance at the 5% level.
Source: Authors' calculations.
Variable definitions: Provisions: Provisions/ Total Assets; Size: Natural logarithm of Total; Debt: Liabilities/Total Assets; ROA: Net income/Total Assets; Portugal: One for Portuguese firms and zero for Brazilian firms.

Despite Debt is not statistically significant, it exhibits the expected negative sign. For example, Guerreiro (2006) found evidence that firms with lower levels of debt tend to have higher levels of information disclosure.

We further develop this study by analyzing which variables affects more the level of Provisions reported in the case of Portugal and Brazil. In table 5, we have the estimation results for the subsamples of Portuguese firms and Brazilian firms.

Our results shows that Size and ROA are statistically significant at 1% level for Portugal and these two variables are not significant for Brazil. By contrast, in Brazil the variable that is statistically significant is Debt, at 5% level and this is not significant to explain the level of Provisions in Portugal.

Regarding the signs of Size and ROA they are negative suggesting that the level of Provisions is likely to be smaller for larger firms and more profitable firms which is the opposite from expected. This result is obtained for both subsamples and may be due to the small size of the subsamples. However, Debt has a negative signed, as expected for both subsamples. This result suggest that for Brazilian firms the level of Provisions reported is higher for less leveraged firms.

Table 5 – Regression of Provisions for subsample of Portugal and Brazil

	Predicted Sign	Portugal		Brazil	
		Coef.	t-stat.	Coef.	t-stat.
C		42.255	3.549	14.972	1.820
Size	+	-2.648***	-3.297	-0.409	-0.821
Debt	-	-0.025	-1.484	-0.082**	-2.066
ROA	+	-0.081***	-4.381	-0059	-1.213
Num.Observ.		60		60	
Adj.R-squa.		0,823		0,899	

***, **Indicate significance at the 1% and 5% levels, respectively.
Source: Authors' calculations.

Variable definitions: Provisions: Provisions/ Total Assets; Size: Natural logarithm of Total; Debt: Liabilities/Total Assets; ROA: Net income/Total Assets; Portugal: One for Portuguese firms and zero for Brazilian firms.

Overall, based on the results of table 5 we find that the determinants of the level of Provisions for Portugal are different from that for Brazil.

5. CONCLUSIONS

Main conclusions

We find evidence that the level of Provisions reported is higher for Brazil than for Portugal. Although slightly less, this association remains when considering the ratio of Provisions on Total Assets. These results suggest that Brazil exhibit a more conservatism than Portugal, which is consistent with the fact of Portugal adopting IFRS for a longer time and with the economic influence of US in Brazil. However, we also find that this ratio decreased in the period considered, especially due the decrease of this ratio in Brazil.

Concerning external factors that determine the accounting systems, our results also suggest that the economic influence tends to be more significant than the culture factor. This conclusion is based on the evidence that in spite of Brazil relying on the Portuguese language and culture the adoption of IFRS 37 is more conservative, and this may be the result of the influence of US Anglo-Saxon Accounting Systems.

Regarding internal factors, our results provide evidence that the determinants of a firm to report Provisions are different in both Countries. While for Portugal the firm size and profitability are associated with the level of Provisions for Brazil is the level of leverage that determines the Provisions reported. In addition, for Portugal leverage is not significant and for Brazil size and probability do not affect the level of Provisions.

Finally, this study also emphasizes the importance of a more detailed standard to the accounting treatment of Provisions. For example, the recognition and measurement of Provisions is based on estimations which depend on managers' judgment. In order to reduce the manger discretionary in financial reporting it is important to stablish a more specific rule.

Investigation Limitations and Future Research

Our results may be affected by the small size of the sample used. Therefore, for future development we suggest to extent the number of both Portuguese and Brazilian firms. It also would be interesting to include other countries in the sample. This would also allow to investigate other external factors of the accounting systems.

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