MEJORAMIENTO DE LA GOBERNANZA CORPORATIVA EN UN SISTEMA LEGAL DÉBIL: CONSEJO FISCAL DE BRASIL

CORPORATE GOVERNANCE IMPROVEMENT IN A WEAK LEGAL SYSTEM: BRAZILIAN FISCAL COUNCIL

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Abstract

The purpose of this paper is to test, even in a weak legal system, there is any legal mechanism to increase shareholders monitoring over the management and get better results for them. We used the T test to verify if the mean of each analyzed variable has presented significant difference between firms with and without Fiscal Council. We found that the existence of an active Fiscal Council is associated with higher ROE which it improves firm performance. We also found that firms with Fiscal Council engage significantly less in earnings management. The Fiscal Council is an important mechanism of shareholders protection and monitoring allowed by the Law. It a separate corporate body independent of the board of directors and management.

Keywords: Fiscal Council, Brazil, Corporate Governance, Emergent Market
JEL Classification: J28

Resumen

El propósito de este trabajo es evaluar, si en un sistema legal débil, existe algún mecanismo legal para aumentar la vigilancia accionistas sobre la gestión y obtener mejores resultados para ellos. Se utilizó la prueba T para verificar si la media de cada variable analizada presentó diferencias significativas entre empresas con y sin Consejo Fiscal. Encontramos que la existencia de un Consejo Fiscal activo se asocia con un mayor ROE. También se encontró que las empresas con el Consejo Fiscal se involucran mucho menos en earnings management. El Consejo Fiscal es un importante mecanismo de protección de los accionistas y el control permitido por la ley. Es una persona jurídica separada independiente del consejo de administración y de gestión.

Palabras claves: Consejo Fiscal, Brasil, Gobernanza Corporativa, Mercado Emergente
Clasificación JEL: J28

1. INTRODUCTION.

The relation among corporate governance, development of financial market, firm performance and value has been subject of intense research. According La Porta et al. (1998) the country legal system is fundamental to firm corporate governance.

La Porta et al. (1998) examined investor protection laws and the quality of enforcement in 49 countries. The authors identified four major legal regimes (Common, French, German and Scandinavian) and they found that, in general, legal protections for shareholders and creditors are stronger in English common law countries than in countries with French-style laws, such as Brazil, as extreme positions and German and Scandinavian systems located among them. Brazil is considered by La Porta et al. (1998) as a country with little legal protection for investors and all its consequences.

One of the recurring problems of corporate governance in Brazil is submitted to structure of ownership, in which the control can be separated from the property. Several studies suggest that the control of Brazilian companies is concentrated in the hands of few shareholders owning less than 50% of the total number of shares of the company and managing totally it (Standard & Poor's, 2004; Valadares and Leal, 2000; Monaco, 2000).

La Porta et al. (2002) considered that in this situation, the shareholders majority have the power to expropriate the minority. Saito (2001) has found that companies in Brazil with lower degree of separation of cash-flow and voting rights, and higher liquidity are less likely to have their minority shareholders expropriated.

According Silveira and Saito (2008), besides ownership structure and board of director composition, the access and content of public information is one of the main corporate governance problems in Brazil. Schiehll (2004) considers that in Brazil the most crucial issue would be how to offer protection to minority shareholders.

Earnings management is a strategy that can be used by managers of some firms to smooth earnings. The Fiscal Council has competence to improve shareholder protection and force companies to better disclosure for investors, reducing the earnings management. Viegas (2005) considers the fiscal council is a Brazilian specific legal provision to support the rights of minority shareholders.

Decourt, Martinewski and Pietro Neto (2007) analyzed the financial reports form Brazilian Listed Companies from 1995 to 2004 and they found strong evidence of earnings management. The results suggest that managers use earnings management to avoid report small losses.

Brazilian investors may take advantage of an important mechanism to improve shareholders protection allowed by the local Law. The Fiscal Council, as a way to increase monitoring, is one example of improvement that could be asked and easily installed by shareholders and it is not very common used to most listed Brazilian companies.

The Fiscal Council may be constituted by request of any shareholders holding, alone or in a group of shareholders together, at least 5% of the outstanding shares of the company. Holders of preferred, non-voting shares, are entitled to elect one member of the Fiscal Council. Non-controlling holders of voting shares representing at least 10% of all voting shares may also elect one member of the Fiscal Council.

The Fiscal Council set up in Brazilian companies should be composed of professionals nominated by the minority – non-controlling common and preferred stockholders – and majority shareholders and it has as main function to monitor the activities and financial statements of the company. Fiscal Council is not attached to the board of directors as the audit committee for the USA companies. It is nominated by the shareholders at any ordinary or extraordinary general assembly and its responsibilities are to the shareholders only.

The Fiscal Council can mitigate some important problems of corporate governance as the separation of cash-flow and voting rights and earning management. Levy Neto (2005) believes that the Fiscal Council, if properly used, according to the law, can be very positive for all shareholders.

The benefits of Fiscal Council to shareholders, it is not only the monitoring function. We believe that the Fiscal Council can reduce earning management and improve the firm performance. Based on these assumptions, the purpose of this research is to investigate the impact of the existence of Fiscal Council in the firm performance and quality of firm reports.

This research has focused on alternative governance mechanisms that might be better aligned with shareholders' interests and it contributes to show that there are good mechanisms to improve corporate governance even in countries with weak legal investor protection. The shareholders should exercise their power to have better firm corporate governance and consequently to improve the firm financial performance.

This article is structured as follows: section 1 is the introduction, section 2 is a review of Fiscal Council legal background by Brazilian Law, section 3 is our sample, section 4 is the method, section 5 is the results, section 6 is the concluding remarks and section 7 is references.

2. FISCAL COUNCIL.

According to Article 163 of Law Number 6.404/76 the Brazilian companies may constitute a Fiscal Council, which may be either permanent or appointed for a specific fiscal year, by request of shareholders holding at least 5% of the outstanding shares of the company.
The Fiscal Council of a Brazilian corporation is mainly charged with monitoring the financial management and reporting of a firm. It does not hire external auditing and it does not interfere on the financial reports.

The Fiscal Council is not equivalent to an audit committee as contemplated by the Securities Exchange Act and requirements of The Sarbanes-Oxley Act of 2002 (SOX). The Fiscal Council is totally independent of the firm, the board of directors, the management team and from external auditors. This is a very important characteristic, because it can act with more freedom than an audit committee, which it is attached, nominated by, some members are part of it and in some cases it may have other internal persons of the company, to the board of directors like in the USA. Bolton (2010) found that audit committee independence has no relation to firm performance or firm value. Klein (2002) has different view and found that audit committee independence is positively related to proxies for high quality financial reports.

According to the Brazilian law, the Fiscal Council has the following legal authorities:

- to supervise the acts of the officers and ensure that they comply with their legal and statutory duties;
- to give an opinion on the annual report of the management, including the supplementary information deemed necessary or useful for deliberation at a general meeting;
- to give an opinion on any proposals of the administrative bodies to be submitted to a general meeting, regarding an alteration in the capital, the issue of debentures or subscription bonuses, investment plans or capital budgets, dividend distribution, transformation, merger, consolidation or division;
- to report any error, fraud or criminal acts it may discover to the administrative bodies, and, if these fail to take the necessary steps to protect the corporation's interests, to a general meeting suggesting an appropriate course of action;
- to call the annual general meeting should the administrative bodies delay doing so for more than one month, and an extraordinary general meeting whenever serious or urgent matters occur, including in the agenda of the meeting such matters as it may deem necessary;
- to examine, at least every three months, the trial balance sheet and other financial statements periodically prepared by the corporation;
- to examine the accounts and financial statements for the fiscal year and to provide an opinion on them;
- to exercise such responsibilities during a liquidation, taking into account the special provisions which regulate liquidations.

The Fiscal Council is composed of a minimum of 3 and a maximum of 5 members, who are elected by a shareholder vote and, accordingly, the controlling shareholder typically elects a majority of its members. Holders of preferred, non-voting shares are entitled to elect one member of the Fiscal Council. Non-controlling holders of voting shares representing at least 10% of all voting shares may also elect one member of the Fiscal Council. The members of the Fiscal Council of a company may not be employees, directors, officers or affiliated with directors or officers of the company.

3. SAMPLE.

The sample was collected in the Bovespa site (www.bovespa.com.br) and Economatica database in August 2010. We have accessed the Publicly-held Companies Reports that listed companies sent to CVM regarding fiscal years of 2004, 2005, 2006, 2007, 2008 and 2009 to collect the information if the firm had Fiscal Council in that specific year.

The financial data came from Economatica database. We have included in our sample, only firms with positive net worth. The sample has information of 1,950 reports of 417 firms. It is divided in 281 reports from 2004, 294 reports from 2005, 323 reports from 2006, 351 reports from 2007, 352 reports from 2008 and 349 reports from 2009. The descriptive statistics of the companies in our sample are presented in Table 1.

Year	Listed Firms	Firms in Sample	Market value (billions R$) Bovespa	Sample	Firms with Fiscal Council		ROE	Tobin Q	Dividend Payout	Debt / Equity	Debt cost	Beta
2004	358	281	904.9	660.3	110	39.15%	14.61%	2.01	47.26%	108.8%	29.2%	0.88
2005	343	294	1,128.5	896.5	133	45.24%	12.85%	2.57	51.37%	113.2%	29.4%	0.77
2006	394	323	1,544.9	1,321.8	139	43.03%	13.64%	3.01	49.44%	96.2%	29.0%	0.90
2007	403	351	2,477.6	2,166.7	151	43.02%	15.62%	2.82	48.39%	86.0%	25.8%	0.96
2008	392	352	1,375.6	1,312.2	162	46.02%	10.71%	1.53	47.36%	112.2%	34.2%	0.97
2009	385	349	2,334.7	2,255.7	187	53.58%	13.51%	2.28	50.96%	98.1%	22.2%	0.97

Table 1: Descriptive statistics of the Sample

Our sample include 85.71% of firms listed in Bovespa and the market value of the firms in our sample represent 88.19% of market value of firms listed in Bovespa.

The absolute number of firms with Fiscal Council has increased all years from 2004 to 2009. The majority of newly listed companies have been on the Novo Mercado, the segment of BOVESPA that requires greater transparency, disclosure, stronger corporate governance practices and only voting shares are allowed.

The Brazilian Law allows that holders of preferred, non-voting shares are entitled to elect one member of the Fiscal Council. Most of the new listed firms in 2006 and 2007 do not have non-voting shares, thus, it became harder to minority shareholders to elect a Fiscal Council member, what was a disincentive to minority shareholders request the firm to constitute a Fiscal Council.

The CVM changed the understanding of the Law in 2008. Now, minorities of any firm that has at least 10% of voting shares in the market can elect a member one member of the Fiscal Council. This new understanding probably stimulated the increase of the number of firms with Fiscal Council.

4. METHOD.

It was analyzed if there was an active Fiscal Council in the company in each year. This data was collected in the Publicly-held Companies Reports sent to CVM.

We used the Tobin's q and ROE as a measure of value and profitability performance and Beta as a risk metric to analyze if the existence of Fiscal Council increase the company performance and reduce the firm risk.

We also test the effect of existence of an active Fiscal Council in the dividend payout, firm leverage, and firm debt cost. We use the debt to equity ratio (liabilities divided by total equity) to measure the company leverage.

We used the T test to verify if there is a significant difference between firms with and without Fiscal Council.

The existence of significant difference between both groups alone does not prove that the active Fiscal Council affects the observed variable. Maybe, the existence of the Fiscal Council could be a consequence of another factor too.

To increase our confidence that the existence of the Fiscal Council is relevant we tested the effect of the existence of Fiscal Council in other groups: firms without ADR, firms listed in one of the Special Levels of Corporate Governance of Bovespa, firms not listed in one of the Special Levels of Corporate Governance of Bovespa and we compare the evolution of the firm after and before the adoption of the Fiscal Council.

To test if the existence of Fiscal Council will reduce the earnings management we analyze the pattern of frequency distributions around the zero mean of standardized earnings. This model proposed by Burgstahler and Dichev (1997) assumes that differences in probability density between two neighbors close intervals in the histogram follows a normal distribution approximately.

The histograms were divided into strips of 5% in 5% and were considered for the purpose of this research, as small losses, losses of up to 5% of equity, while the small profits were considered as gains up to 5% of equity.

Thus, if there was no management of the results, the number of small profits of the entire sample should be close to the amount of small losses. For the annual samples, the number of years with small profits higher frequency of the frequency of small losses should be close to the number of years in which the ratio was reversed.

As a test of statistical significance was used statistic τ described by Degeorge, Patel and Zeckhauser (1999) which tests the discontinuity of an empirical distribution. This model assumes that differences in probability density between two neighbors close intervals in the histogram follows a normal distribution approximately.

We have applied the test in one group with firms without Fiscal Council and in another group with firms that have Fiscal Council.

5. RESULTS.

5.1 Firm Performance and Value

It was evaluated if firms with Fiscal Council perform better firms without Fiscal Council. The ROE, as expected, is much higher in firms with Fiscal Council and this difference is statistical significant. The results are shown in table 2.

	ROE			Tobin Q		
	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	1073	11.08%	0.0470	770	2.20	0.0402
Firms without Fiscal Council	909	-1.20%**		394	2.46**	

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 2: Firm performance and value

The Tobin Q is correlated with ROE, thus we expected to find that firms with Fiscal Council have higher Tobin Q too. However, in contrast to ROE, with Fiscal Council have lower Tobin Q. This difference is also statistical significant. This result suggests that the investors do not value the Fiscal Council.

Most firms with ADR have Fiscal Council too, because the Board of Auditors is mandatory for firms with ADR. The SEC allows that the Fiscal Council of Brazilian firms act as Board of Auditors. Consequently 91% of firms with ADR in our sample have Fiscal Council.

We made the same test only with firms without ADR to verify if the higher ROE is consequence of the ADR instead of Fiscal Council. The results are almost the same. This reinforces the hypothesis that Fiscal Council contribute to increase firm ROE and the investors do not value Fiscal Council. The results are presented in Table 3.

	ROE			Tobin Q		
	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	894	11.59%	0.0513	620	2.14	0.0201
Firms without Fiscal Council	896	-1.51%*		385	2.45**	

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 3: Firm performance and value – Group with forms without ADR

The fact of the firm have adhered to some Corporate Governance Level could induce to a false interpretation of the importance of the Fiscal Council in the analyzed variable, thus we also tested the value and performance differences between companies with and without Fiscal Council among firms that have adhered to some Corporate Governance Level and firms that have not adhered to some Corporate Governance Level. The results are presented in Table 4 and Table 5.

	ROE			Tobin Q		
	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	460	12.29%	0.0107	362	2.33	0.0018
Firms without Fiscal Council	298	-6.22%**		184	2.95***	

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 4: Firm performance and value – Group with firms listed in some Corporate Governance Level

	ROE			Tobin Q		
	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	613	10.17%	0.0124	408	2.09	0.3937
Firms without Fiscal Council	611	1.25%**		210	2.04	

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 5: Firm performance and value – Group with firms not listed in some Corporate Governance Level

The firms with Fiscal Council have greater ROE in both groups. The highest difference is between firms listed in some Corporate Governance Level. In this group there is the highest difference in Tobin Q too. This suggest investor value some mandatory Corporate Governance practices of these levels, however they are not so important as another non-mandatory as the Fiscal Council that has greater impact in firm ROE. Although all evidences that Fiscal Council increase firm ROE, we compared the ROE in the year after Fiscal Council adoption with the year before Fiscal Council adoption. The results are presented in Tables 6, 7, 8 and 9.

	N	ROE variation from 2004 to 2006	P-value
Firms with Fiscal Council adopted in 2005	21	-11.69%	
Firms with Fiscal Council adopted before 2005	80	-11.35%	0.48844
Firms with Fiscal Council adopted after 2006	25	-30.31%**	0.03643
Firms without Fiscal Council	92	-16.83%*	0.08606

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 6: ROE variation from 2004 to 2006

We can see that 2006 was a bad year to Brazilian firms, but firms with Fiscal Council were less affected, independently if the Fiscal Council was recent or not. Firms that would adopt Fiscal Council in the future had the worst performance.

	N	ROE variation from 2005 to 2007	P-value
Firms with Fiscal Council adopted in 2006	7	2.56%	
Firms with Fiscal Council adopted before 2006	110	0.08%	0.4588
Firms with Fiscal Council adopted after 2007	21	-2.60%	0.49949
Firms without Fiscal Council	94	-18.85%	0.18596

Table 7: ROE variation from 2005 to 2007

The firms with Fiscal Council have recovered their losses from 2006 and returned to 2005 level. The firms without Fiscal had a very poor result in the same period, however the firms that would adopt Fiscal Council in the future weren't so bad this year as 2006.

	N	ROE variation from 2006 to 2008	P-value
Firms with Fiscal Council adopted in 2007	8	22.88%	
Firms with Fiscal Council adopted before 2007	105	-0.65%	0.1248
Firms with Fiscal Council adopted after 2008	15	-11.10%*	0.08185
Firms without Fiscal Council	90	-3.76%	0.14156

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 8: ROE variation from 2006 to 2008

The firms that have adopted Fiscal Council in 2007 had an excellent result in 2008. In the same year firms without Fiscal Council had loses and the firms with Fiscal Council for more than one year were stable.

It is important to pay attention in the group of firms that hadn't adopted Fiscal Council in that year, but had adopted it until 2009. This group has a very poor ROE before the adoption the Fiscal Council, but after its adoption, they present a very good ROE.

	N	ROE variation from 2007 to 2009	P-value
Firms with Fiscal Council adopted in 2008	13	-2.34%	
Firms with Fiscal Council adopted before 2008	118	-17.01%	0.20448
Firms without Fiscal Council	119	-31.91%*	0.08375

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 9: ROE variation from 2007 to 2009

Year 2009 was a terrible year for companies, however, for those that had adopted the Fiscal Council in 2008 the loses were very small. These firms were part of the worst group before the adoption of Fiscal Council. Every year the group of firms that had adopted Fiscal Council had improved his ROE.

The group of firms with Fiscal Council for much time had bad results, but those firms were much better than firms without Fiscal Council.
These all results together suggest that, the Fiscal Council is not only an instrument of protection to minority shareholders. The Fiscal Council has an important contribution to increase the firm profitability.

5.2 Dividend Payout and Leverage

The dividend payout is similar to both groups. It seems that the Fiscal Council has not any effect in the dividend policy of Brazilian companies. It is responsibility of the Fiscal Council examine if the firm pays dividends according company's social statute or if it is silent about this topic, if the company pays the minimum dividend required by Brazilian Law.

Although dividends payment shall be examined by the Fiscal Council it is not its responsibility define the dividend policy. Decourt and Procianoy (2009) conducted a survey with CFO about dividend policy in Brazil and they identified that the decision about dividends is of the Board of Directors in most firms.

The leverage (debt / equity ratio) is higher in firms without Council Fiscal (90.66%) than firms with Council Fiscal (94.60%). That is not a great difference, and it is not significant.
Council Fiscal shall opine over management proposals for changes in investment plans, debt issuance, incorporation and M&A. These decisions may affect the company leverage. However, as occurs in dividend policy, the Council Fiscal responsibility is limited, and it has not any participation in the decision process.

Although the firm leverage does not be a Council Fiscal decision, it seems that the presence of the Fiscal Council in the company inhibits the indebtedness in excess. The results are shown in table 10. The segmented samples have not revealed any difference from the entire sample analyze.

	Dividend Payout			Leverage			Debt Cost		
	N	Mean	P-value	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	660	49.13%	0.4208	770	90.66%	0.2262	753	27.44%	0.0150
Firms without Fiscal Council	318	49.65%		587	94.60%		574	29.82%**	

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively
Table 10: Dividend payout, leverage and debt cost

We also find that firms with Fiscal Council are associated with a lower cost of debt financing. This difference is significant. This could be correlated to leverage. Firms with smaller debt / equity ratio should have smaller debt cost too.

We also may suppose that Fiscal Council could reduce the firm risk and higher ROE helps to reduce the debt cost of the firms with Fiscal Council. We find firms with Fiscal Council have lower debt cost in the group without firms with ADR and firms listed in some Special Governance Level. The results are presented in Table 11.

	Debt Cost					
	Firms without ADR			Firms listed in some Special Corporate Governance Level		
	N	Mean	P-value	N	Mean	P-value
Firms with Fiscal Council	609	28.43%		316	24.64%	
Firms without Fiscal Council	563	30.03%*	0.0869	174	28.13%**	0.0287

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 11: Debt cost – without ADR and listed in some Special Corporate Governance Level groups

These two groups reinforce the hypothesis that the Fiscal Council helps to reduce the cost of debt of the company.

5.3 Risk

The beta is a predictor of risk for a long-term investor. It is a measure of a stock's price volatility in relation to the rest of the market. The Fiscal Council does not affect the Beta firm. This result was expected, because the higher Tobin Q for firms without suggests that the Fiscal Council is not important for investor. The segmented samples have not revealed any difference from the entire sample analyze. The results are presented in table 12.

	Beta		
	N	Mean	P-value
Firms with Fiscal Council	744	68.64%	
Firms without Fiscal Council	368	65.38%	0.1979

Table 12: Risk

If the investors consider the Fiscal Council benefic to the company, the Beta of firms with Fiscal Council should be smaller than firms without Fiscal Council.

The Fiscal Council of a Brazilian corporation could be composed of professionals nominated by the minority and majority shareholders and should be truly independent. It is mainly charged with monitoring the financial management and reporting of a firm. Thus the Fiscal Council should reduce the firm risk. However, the Fiscal Council has not won the investor confidence.

5.4 Regression Model

We run a regression model where the dependent variable is if the firm has Fiscal Council or not and the other variable analyzed in this research are the independent variables.

Although the Fiscal Council is our dependent variable, this does not necessarily imply that the independent variables cause Fiscal Council. This regression can be a helpful tool in determining the strength of the relationship between the variables.

The independent variables of our model are firms with ADR, firm has adhered to some Corporate Governance Level, ROE, Leverage, Debt cost, Tobin-Q, Beta, Payout and Year. Most of them is statistical significant, only Payout and Year are not significant. The results are shown in Table 13.

The variable ADR has the highest coefficient. It was expected, because firms with ADR must have a Board of Auditors and SEC accepts that the Brazilian Fiscal Council act as a Board of Auditors.

The ROE has a high coefficient too, it reinforce our finds that the Fiscal Council contributes to increase the firm performance.

The variable firm has adhered to some Corporate Governance Level has the highest negative coefficient. We believe that is consequence of the firms in Novo Mercado do not have non-voting shares, thus, it was harder to minority shareholders to elect a Fiscal Council member before 2008 when CVM changed the understanding of the Law and allowed minorities of any firm that has at least 10% of voting shares in the market elect a member one member of the Fiscal Council.

The Beta also has a high negative coefficient what suggests that Fiscal Council reduce the firm risk.

The Tobin-Q is negative, and this is one more indicator that the investor does not value the Fiscal Council, although the important benefits to the company and shareholders.
The others statistical significant variable (leverage and debt cost) have very low coefficients.

Regression Statistics		
Multiple R	0.300136208	
R Square	0.090081743	
Adjusted R Square	0.075714613	
Standard Error	0.458428226	
Observations	580	
ANOVA		
	df	Significance F
Regression	9	0.0000
Residual	570	
Total	579	
	Coefficients	P-value
Intercept	-7.0545	0.7715
ADR***	0.2458	0.0000
CGL*	-0.0781	0.0545
ROE**	0.1821	0.0133
Leverage***	0.0008	0.0020
Debt cost**	-0.0038	0.0311
Tobin-Q**	-0.0297	0.0190
Beta**	-0.0671	0.0148
Payout	0.0046	0.8409
Year	0.0039	0.7482

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 13: Regression model

5.5 Earnings Management

For every firm without Fiscal Council that reported a small loss there were 5.22 firms that reported a small profit. This ratio of small profit to small loss firms with Fiscal Council is 2.36.

The results are shown in table 14. The histograms of both groups are presented in figures 1 and 2. This suggests that firms without Fiscal Council manage reported earnings to avoid small losses.

The companies with Fiscal Council also reports much more small profit than small loss, however, the ratio small profit to small loss is not significant and much smaller than the ratio of firms without Fiscal Council.

	Small loss	Small profit	Ratio	P-value
Firms with Fiscal Council	14	33	2.36	0.1174
Firms without Fiscal Council	9	47	5.22**	0.0482

***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively

Table 14: Ratio of small profit to small loss

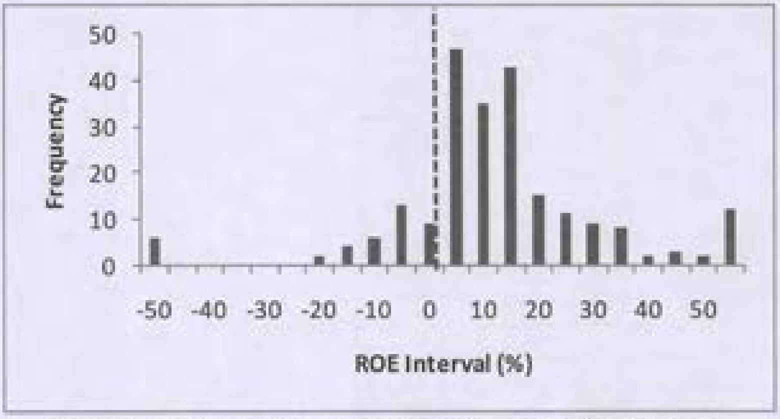

Figure 1. ROE histogram of firms without Fiscal Council

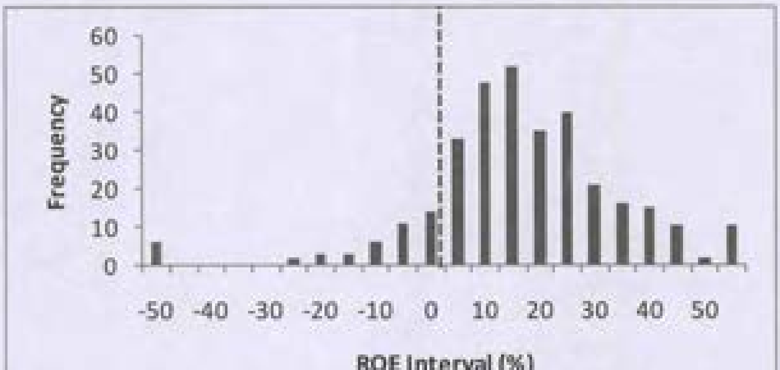

Figure 2. ROE histogram of firms with Fiscal Council

It is not possible affirm that the Fiscal Council eliminate the earnings management, however, our finds indicate that earnings management is less common in firms with Fiscal Council.

6. CONCLUDING REMARKS.

The Brazilian Fiscal Council has competence to improve shareholder protection and force companies to better disclosure for investors. Our research found real benefits to firms with Fiscal Council, as higher ROE, lower debt cost and less earning management. These benefits are meanly important to firms with less Corporate Governance.

This is an important mechanism that could be used by minority shareholders of all Brazilian listed firms. However, around 46% of listed companies do not have Fiscal Council.

It seems that Brazilian investors or do not the Law that allow them to require the Fiscal Council or they do not believe that the Fiscal Council could mitigate some important problems of corporate governance.
The investor indifference to Fiscal Council is evidenced by the lower Tobin Q and higher Beta of firms with Fiscal Council.

Brazil is considered as a country with little legal protection for investors. Despite this, Brazilian Law has created some important mechanism of shareholders protection that could be used, even, in more protected markets, but some Brazilian investors do not take advantage from these mechanisms allowed by the Law.

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