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Structural changes in covenants through the adoption of IFRS in Brazil

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ABSTRACT

This study examines changes in the structure of covenants in debt agreements of companies issuing debentures during the adoption of International Financial Reporting Standards (IFRS) in Brazil. We investigate debt contracts of public and private companies that issued debentures before and after IFRS adoption in Brazil, between the years 2006–2008 and 2011–2014. We develop a database with all covenants from 126 contracts via hand-collected data, with 78 contracts from before IFRS adoption and 48 contracts afterward. We find high increases in covenants after adoption. However, this growth is observed only for restrictive security and non-accounting covenants, excluding clauses with accounting multiples. Our results show that IFRS adoption in Brazil shifted incentives and, as a result, shaped a new structure of debt contracts. Our findings complement and expand previous studies and can be useful to academics, regulators and practitioners by showing that the incentives to use accounting figures and ratios shifted in the credit market after IFRS adoption.

1. Introduction

We examine the effect of International Financial Reporting Standards (IFRS) on a set of covenants structured in debenture contracts of Brazilian public and private companies by studying changes in debt contracts near the time of mandatory adoption of IFRS.

The function of accounting figures and ratios in debt contract arrangements changes over time. One argument is that borrowers prefer to pay higher interest rates to maintain flexibility through accounting systems to avoid covenant violations (Beatty, Ramesh & Weber, 2002). Another is that accounting standard changes can affect lenders' decisions to use covenants based on accounting figures (Demerjian, 2011).

Prior research shows that debt agreements establishes covenants (Smith & Warner, 1979), and IFRS adoption has changed this relation (Ball, Li, & Shivakumar, 2015). The consequences are reduced information asymmetry as well as potential conflicts of interest. This study expand previous literature (Ball et al., 2015; Brüggemann, Hitz, & Sellhorn, 2013) and contributes to the understanding on how IFRS adoption in Brazil as an exogenous shock altered incentives in covenant development.

We posit that restrictive covenants are shaped by incentives in local accounting standards (BR-GAAP) that are strongly oriented to

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rules and based on historical costs of international accounting principles. Moreover, in this new information environment, market participants should exercise much more judgment regarding accounting figures and consequently the ratios established in debt covenants.

Debt covenants are defined as provisions to limit accounting and financial decisions (e.g., [Smith & Warner, 1979](#); [Leland, 1994](#)). Covenants are vulnerable to manipulation of financial statements so that the borrower appears to comply with pre-established accounting standards. A study by [DeFond and Jiambalvo \(1994\)](#) shows that the restrictions imposed by covenants affect accounting choices in the years before and during which the covenants are violated. However, the shift from local accounting standards to IFRS also changes incentives, which can impact contract structures.

In many local GAAPs the use of measurement basis is different from IFRS that uses fair value accounting, with different properties that can reduce the efficacy of the balance sheet information in debt contracts ([Ball et al., 2015](#)). Adoption of fair value can be considered a negative factor for the creditors, given their judgment bias, which leverages the company management's decisions in ways that are adverse to creditors. The authors find that the structure of debt contracts has changed due to changes in the financial indicators established in contracts, aspects of firms' liquidity and indebtedness and modifications of asset, liability and equity values.

[Brüggenmann et al. \(2013\)](#) highlight the importance of studying covenants after the adoption of IFRS since the changes caused by the adoption of international standards should cause corrective adjustments, modifications in the frequency of certain clauses and possible renegotiation of contracts.

Brazil is a code law country with low enforcement (e.g., [Almeida & Dalmácio, 2015](#); [Lopes & Walker, 2008](#)). As a result, it is reasonable to expect that debt agreements are well written to avoid court conflicts. However, IFRS adoption in Brazil was divided into two periods, the transition period in 2008–2009 and the full adoption period in 2010. These two shocks may have affected covenants before full adoption in 2010.

This paper adds to the prior literature by examining the effect of IFRS adoption on covenants in the Brazilian debt market. [Ball \(2006\)](#) argues that implementation of IFRS can benefit market participants by reducing information asymmetry among them. However, IFRS for debt contracts has generated doubts among credit market participants.

Our research design differs from those of previous studies of IFRS adoption in Brazil. We use empirical correspondence analysis to test our hypotheses and show our results. We develop a unique hand-collected sample from 126 debenture indentures available from the CVM¹ website, for a total of 78 and 48 observations before and after the IFRS adoption periods, respectively. We examine changes in covenant structure to classify them in accordance with [Ramsay and Sidhu \(1998\)](#) as follows: i) covenants based on security, ii) covenants based on financial data; and iii) covenants based on non-financial data. Our database includes all types of debenture contracts. However, the available data do not contain convertible bond contracts. We believe that Brazil's stock market volatility explain this characteristic.

Our main finding is a decrease in the use of covenants based on financial data in addition to an increase in the number of covenants in debt agreements. We also find that contracts have more security covenants. Our results have practical implications for practitioners and debtors when designing covenants, by showing a shift in covenant quantity and structure from the pre- to the post-IFRS adoption periods, marked by an increase in the number of security and non-financial data covenants but not the number of covenants based on financial data.

2. Background literature and hypotheses development

The importance of the relationship between covenants and financial contracts is based on the attempt to avoid nonpayment of debts or even bankruptcy, causing losses to creditors, which can hinder financial transactions. [Smith and Warner \(1979\)](#) note that covenants are inserted into loan agreements with the purpose of mitigating conflicts in donor-shareholder relationships, reducing the financial costs of the transaction and increasing the total amount lent.

The study of covenants in accounting has gained relevance because these clauses are present in most contracts through financial ratios. This assertion is highlighted in [Watts and Zimmerman \(1986\)](#), who show a strong relation between the covenants and financial information because covenants are frequently written in terms of accounting figures.

The relations that [Watts and Zimmerman \(1986\)](#) note between covenants and financial information are strengthened by the subdivision created by [Mather and Peirson \(2006\)](#), who state that the covenants can be divided into two main groups: 1) accounting and 2) non-accounting covenants. This subdivision, they suggest, shows that financial statements are highly relevant to future control when financial institutions and other creditors make decisions about providing resources to companies.

[Roberts and Sufi \(2009\)](#) indicate that 96% of private debt issues contain at least one financial/accounting covenant, among which the most common are covenants that aim to protect creditors against the risk of excess financial leverage of borrowers.

We use the covenant classification method employed by [Ramsay and Sidhu \(1998\)](#), which was based on the classification method previously proposed by [Smith and Warner \(1979\)](#) and [Whittred and Zimmer \(1986\)](#). Using this classification, we can separate covenants by their intention of company actuation or restriction. Thus, it is possible to capture the movements made by contractual parties to guarantee their debt payment.

[Ramsay and Sidhu \(1998\)](#) classify the covenants in debt contracts in the following categories, which we use here:

- Security covenants – restrictive clauses that mandate accelerated maturity in situations that cause uncertainty about the future

¹ Comissão de Valores Mobiliários (CVM), equivalent to the US Securities and Exchange Commission (SEC).

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