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Effects of the Adoption of IFRS on the Credit Market: Evidence from Brazil

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ABSTRACT

Based on a sample of approximately 6500 credit ratings and 137,000 loan contracts, this paper analyzes the effects of mandatory IFRS adoption on the Brazilian credit market. We find that the IFRS adoption effects were limited to firms displaying improved accounting information quality at the time of transition, lending support to the notion that economic benefits do not necessarily flow from the publication of financial reports in IFRS but, rather, depend on how earnestly firms adopt the recommended disclosure practices.

1. Introduction

Accounting information plays two primary roles in credit contract relationships (Beatty, 2008). First, it helps banks and other lenders evaluate credit risk (*ex ante*, mitigating the problem of adverse selection). Second, it helps monitor credit risk over the life of the debt contract through financial covenants (*ex post*, mitigating the problem of moral risk). The purpose of this study is to examine the impact of mandatory IFRS adoption in Brazil on the relevance of accounting information to credit risk assessment and on loan contract terms.

Over 120 jurisdictions—including developed, emerging, and developing economies—either permit or require the use of IFRS in financial reporting. Recent studies document a number of positive consequences to the equity markets associated with the introduction of IFRS, such as increased market liquidity, reduced equity cost, increased inflow of foreign investment, improvements in analyst forecast accuracy, and reduced insider information asymmetry (Brochet, Jagolinzer, & Riedl, 2013; Byard, Li, & Yu, 2011; Daske, Hail, Leuz, & Verdi, 2008; DeFond, Hu, Hung, & Li, 2011; Li, 2010; Lima, 2011; Tan, Wang, & Welker, 2011). However, prior research has primarily focused on the usefulness of IFRS to investors, with limited research examining the usefulness of IFRS to creditors.

As an example, several studies have analyzed the effect of IFRS adoption in the Brazilian capital market instead of the credit market. Considering the informational aspect, Lima, Lima, Carvalho, and Lima (2010) investigated whether underlying firm-level incentives influence firms' compliance with International Financial Reporting Standards (IFRS) convergence practices and whether this adoption impacts firms' cost of equity capital and market liquidity in Brazil—a setting with a poor institutional environment but high growth opportunities—using a sample of 54 companies from the São Paulo Stock Exchange. The results indicate that firm-level incentives are important drivers of compliance with IFRS convergence practices. The results suggest that firms that (a) are larger, (b) are more exposed to international markets, and (c) have greater financing needs are more likely to adopt IFRS practices by

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implementing material changes in their accounting policies. The economic consequence analysis shows that cost of capital does not seem to be related to any of the convergence measures used. However, there is a statistically significant relationship between all the market liquidity variables and the IASCI, indicating that companies that best meet the convergence requirements have lower trading costs and greater liquidity, and their share price is less susceptible to the influence of individual investors. Following the same results, Santos and Cavalcante (2014) state that the adoption of IFRS in Brazil contributed to an increase in the information relevance of accounting profits of publicly traded companies.

In the same sense, Almeida and Rodrigues (2017) examined the effects of interactions among IFRS adoption, analyst coverage, and cross-listings in the United States on the voluntary disclosure of Brazilian public companies. They found a significant positive shift on voluntary disclosure incentives among cross-listed firms from the IFRS pre-adoption period to the post-adoption period. They also found that analyst coverage has a positive association with voluntary disclosure over the IFRS adoption process; however, the interaction between IFRS adoption and analysts affects only environmental and social disclosure positively.

In turn, considering the value aspect, Sampaio, Gallucci Netto, and Silva (2017) verify that there is a positive impact on Tobin's q and market-to-book for firms that adopt IFRS in Brazil; thus, after IFRS adoption, the firm value increased. Malaquias, Cardoso, and Martins (2016) show that after IFRS adoption, the accounting numbers present a significant effect in the Brazilian financial market, because after IFRS adoption, company information reported in the financial statements seems to more adequately represent the financial position of the company and inform external users of accounting numbers, since the adjustments made in the value of stocks are lower, decreasing the volatility of stock returns.

Investigating the effects of IFRS adoption on the credit market is important for several reasons. First, debt financing is a major resource for companies worldwide; indeed, for the vast majority, it is a more important source than the capital market. Using Brazil as an example, businesses obtained approximately BRL 15.7 trillion through the National Financial System (SFN) in total financing over the period from 2005 to 2014, of which 93% was bank credit, 4% was public issuance of debt, and only 3% was issuance of equity. Even though a significant part of the loans may have been substitution for already-existing debts, firms unquestionably access debt financing more frequently than equity financing.

Second, creditors are potentially sensitive to changes in accounting regulations due to their impacts on performance evaluation and contracting. The adoption of IFRS brings with it many changes in financial reporting that potentially impact the interpretation of financial information by creditors. The credit market provides a unique opportunity for investigating the effects of IFRS adoption. In addition, if financial reports are influenced primarily by the credit market rather than the capital market, as claimed by Ball, Robin, and Sadka (2008), it is important to understand how creditors react to changes in accounting regulations.

Third, creditors and shareholders have different information needs. Accounting information is used in one way by creditors (e.g., for performance evaluation and contracting) and in another by investors (e.g. for evaluation of shares, Holthausen & Watts, 2001; Watts, 2003, 2006). Therefore, the effects of IFRS adoption on the stock market cannot be automatically applied to the credit market. Holthausen and Watts (2001) conclude that financial information may be relevant to certain types of users only and criticize what they consider a virtually exclusive reliance on equity investors. Hail and Leuz (2007) call for more research into the consequences of IFRS adoption for the credit market.

Accounting scholars have long discussed whether the IASB puts too much emphasis on investors' information demands to the detriment of creditors' performance evaluation and contractual needs (Ball, Xi, & Shivakumar, 2015; Beneish, Miller, & Yohn, 2012; Benston et al., 2007). Two schools of thought have emerged from the debate on the usefulness of IFRS to the credit market. On one hand, the adoption of IFRS can increase the usefulness of accounting information to creditors. The benefits gained from improved accounting information quality under IFRS make accounting information more relevant to assessing credit risk, resulting in a positive economic impact on the credit market. This view derives mainly from the fact that the IFRS framework is principles-based (Barth, Landsman, & Lang, 2008), with an emphasis on fair value and favoring more timely recognition of economic gains and losses. From the informational perspective, such mechanisms can help reduce the cost of monitoring and renegotiating contract terms. On the other hand, the adoption of IFRS could also hinder the usefulness of accounting information to creditors. Gains and losses in market value can include transient impacts on cash flows, thus hindering the usefulness of net income for the purpose of contracting, especially when long-term loans are involved (Christensen & Nikolaev, 2012; Li, 2010). Furthermore, fair value is not necessarily the result of transactions in high-liquidity markets but may be based on subjective evaluations, which can lead to greater agency costs and earnings management. Critics question the adequacy of IFRS for contractual purposes due to substantial differences in accounting methods allowed by IFRS and uncertainties regarding future board decisions, raising the risk of covenant violations due solely to normative changes (Deloitte, 2011). Viewed from this perspective, IFRS can reduce the reliability of accounting information, compromising its value for credit decisions.

Overall, the few studies to evaluate the relation between mandatory IFRS adoption and loan contracts yielded inconsistent results (e.g., Chen, Chin, Wang, & Yao, 2013; Florou, Kosi, & Pope, 2013; Ling-Ching, Hsu, & Lee, 2013; Wu & Zhang, 2014). Ling-Ching et al. (2013), Florou et al. (2013), and Wu and Zhang (2014) find IFRS adoption to be associated with greater sensitivity of credit ratings to accounting information, suggesting IFRS standards produce more relevant information for creditors. In contrast, Chen et al. (2013) report that IFRS adoption led to higher interest rates, greater likelihood of demand for collateral, and shorter maturities. These inconsistencies may be explained by differences in country-specific and firm-specific incentives (Ball, Robin, & Wu, 2003; Daske, Hail, Leuz, & Verdi, 2013).

Prior studies are limited in several ways: (a) they focus on the comparison of average country measures, (b) the influence of firm-level incentives is not discussed, (c) the analysis is restricted to credit operations, and (d) only generic controls are used for the institutional aspects of each jurisdiction. In our study, by focusing on a single country (Brazil), the effect of institutional incentives remains constant. Using a comprehensive sample of bank credit contracts and bonds issued by Brazilian firms, our study extends prior

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