The Effect of Financial Reporting on Bank Loan Contracting in Global Markets after Mandatory IFRS Adoption

By

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Discussant

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Purpose of Study

- This study examines the effect of mandatory adoption of IFRS on the contracting terms of bank loans using international data.
Data and Research Method

- **Data**
  - Worldwide bank loan data from DealScan during the 2000-2011 period
    - 31 countries (17 treatment and 14 benchmark countries)
  - Accounting data from Worldscope (non-US firms) and Compustat (US firms)
  - 26,474 bank loans

- **Method**
  - Difference-in-differences (DID) analysis
Summary of Empirical Finding

- After IFRS adoption in 2005, borrowers experienced
  - Increase in interest rate, collateral provision, and the fraction of a loan retained by lead arrangers
  - Reduction in the use of accounting-based financial covenants and loan maturity
These results are more pronounced among borrowers with

- Greater accounting differences between local GAAP and IFRS
- Decreased accounting quality, measured by variance of abnormal accruals

Results are robust after conducting comprehensive sensitivity analyses including removing financial crisis period
Implication

- Evidence supports that worldwide adoption of IFRS
  - Increases information asymmetry, presumably due to
    - A new accounting/reporting system
    - More complex and subjective estimates because of the use of fair value accounting
  - Triggers restrictive contracting terms trade-off
    - Reducing the use of debt covenants
    - Shortening debt maturity
    - Increasing interest rate, collateral provision, and fraction of the loan retained by the lead arrangers
Contributions

- Among the first studies to investigate the effect of IFRS adoption on credit markets worldwide
  - Evidence on the effect of IFRS adoption on the contracting terms of bank loans
  - Evidence suggesting that mandatory IFRS adoption may not be beneficial for borrowers
Question 1

- Does IFRS adoption increase information asymmetry?
  - Benefits of mandatory IFRS adoption
    - Better accounting quality (e.g. Barth et al., 2008)
    - More accurate forecasts from foreign analysts and analyst following (Tan et al. 2011)
    - Lower cost of capital (Li, 2010)
    - More comparable financial statements (Yip and Young, 2012, Barth et al. 2012)
Cost of IFRS adoption
- Increased audit fee (Kim et al., 2012)
- Greater flexibility and discretion for earnings management (Ahmed et al., 2013)

Net benefit of IFRS adoption
- Positive market reaction to potential adoption of IFRS in the E.U. (Armstrong et al. 2010) and U.S. (Joos and Leung, 2012)

There is no consistent evidence suggesting that IFRS adoption has increased information asymmetry
Suggestion

• More discussion about the reasons underlying the findings
  
  ◦ Different effect between mandatory and voluntary IFRS adoption
    • Borrowers experience lower interest rates, less restrictive covenants, longer debt maturity following voluntary IFRS adoption (Kim et al., 2011)
    • The opposite findings for mandatory IFRS adoption (Ball et al., 2013)
  
  ◦ Fair value accounting adds transitory shocks to earnings that make it an inferior variable in the context of long term debt agreements (Li, 2010; Ball et al. 2013); refer to Dermerjian et al. (2014)
Question 2

- Increase in average interest rate for the treatment countries/firms is very high
  - Treatment firms: 74% (from 97 to 169 basis points)
  - Control firms: 14% (from 179 to 204)
  - DID: 60%

- Difference in interest rate before IFRS adoption is very high
  - 97 vs. 179
• Decrease in the average number of financial covenants for treatment countries/firms is high
  ◦ Treatment sample: 60% (from 0.154 to 0.061)
  ◦ Control sample: 30% (from 1.15 to 0.803)
  ◦ DID: -30%

• Difference in average number of financial covenants before IFRS adoption is high
  ◦ 0.154 vs. 1.15
Increase in collateral provision for treatment countries/firms is very high

- Treatment sample: 125% (from 0.083 to 0.351)
- Control sample: -6% (from 0.351 to 0.330)
- DID: 131%

Difference in collateral provision before IFRS adoption is very high

- 0.083 vs. 0.351
Have the authors effectively controlled for the differences in debt market and economic development between two groups of countries/firms?
Suggestion

• Time series analysis may help
  ◦ Provide regression results by year to detect
    • Pattern of interest rate / number of covenants/collateral provision changes during the examination period
    • when (which years) these items significantly increased
    • any observation of learning effect after first adoption of IFRS
Not all countries have the same intensity of using accounting-based debt covenants

- Comparing countries with similar intensity
- Comparing countries with similar debt market (e.g. similar legal system/environment, creditor protection and right)
- Comparing countries with similar economic development (e.g. E.U. vs. US)
- Separate common law (English speaking countries) from codified law countries
  - US vs. UK and other English speaking countries
  - Codified law countries in the E.U. vs. non IFRS adoption codified law countries
  - Any real examples to confirm descriptive statistics?
Question 3

- Managers’ incentives (e.g. Christensen et al. 2008; Daske et al., 2008, 2013; Armstrong et al. 2010; Kim et al. 2011) and enforcement mechanism (Christensen et al. 2013) matter

  - Hong et al. (2011) find that bank loan covenants are more prevalent in countries with higher financial reporting quality

  - IFRS improves liquidity only in countries with substantive enforcement change (Christensen et al. 2013)

  - Lower interest rate, less restrictive covenants, longer maturity after voluntarily adopt IFRS (Kim et al. 2011)

- Are firms with higher accounting quality pre IFRS adoption different from those with lower accounting quality pre IFRS adoption in terms of use of debt covenants, interest rate, and collateral provision after IFRS adoption?
Suggestion

- Control for
  - Country enforcement change after IFRS adoption
  - Accounting quality pre-IFRS adoption
    - The authors have considered the change in accounting quality, measured by variance of abnormal accruals.
    - To be consistent with most previous studies, the authors may consider using abnormal accruals.

- Consider replicating Kim et al. (2011) for voluntary adoption firms
Other Questions/suggestions

- Contract terms are simultaneously determined. Consider using simultaneous regressions
  - Robustness test

- Underlying reasons for the trade-off between accounting and non-accounting based debt covenants are unknown
  - Future research
• Content of debt covenant is more important than the number of covenant
  ◦ Data limitation

• Why use the number (score) of restated items instead of amount of restatement as a proxy for accounting differences between local GAAP and IFRS?
  ◦ Restatements include errors and change in accounting policies
Concluding Remarks

- Interesting
- Well motivated, executed, and written
- Best of luck with the paper