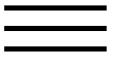


Has the balance sheet approach led to a decline in the use of balance sheet covenants.

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Accounting standards and debt covenants: Has the balance sheet approach led to a decline in the use of balance sheet covenants?

Peter R. Demerjian

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Abstract

Recent years have seen a sharp decline in the use of balance sheet-based covenants in private debt contracts. I hypothesize that changes in accounting standards can explain part of this decline. Standard setting has shifted towards a balance sheet approach, which I predict has made the balance sheet less useful for contracting. I measure the effect of the balance sheet approach on specific borrowers using a volatility ratio. I find that borrowers with greater volatility ratios are less likely to have balance sheet-based covenants. This evidence is consistent with reductions in the contracting usefulness of the balance sheet being associated with reductions in balance sheet covenants.

Highlights

In recent years, balance sheet covenants are used less frequently in debt agreements. I consider the role of accounting standards in this decline. Specifically, I examine whether the shift to the “balance sheet approach” has influenced covenants. I find that accounting standards are associated with balance sheet covenant use. The same is not true of income statement covenant use, which has not changed.



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JEL classification

G21; G28; M41; M48

Keywords

Debt contracting; Covenants; Accounting standards; Balance sheet

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