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

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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.

JEL classification
G21; G28; M41; M48

Keywords
Debt contracting; Covenants; Accounting standards; Balance sheet

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