THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

Performance Measures in Earnings-Based Financial Covenants in Debt Contracts*

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Abstract

This paper examines how performance measures are defined in the three most common earnings-based financial covenants in debt contracts: interest coverage, fixed charges coverage, and debt to cash flows covenants. I first provide stronger evidence than in Li [2010] regarding the use of transitory earnings and conservative adjustment in performance measures in debt contracts, and then examine the use of accounting accruals in covenant measurement. The primary findings for accruals are as follows. First, depreciation and amortization expenses are generally excluded from the performance measures (with capital expenditure also subtracted sometimes), while working capital accruals are generally included (with non-cash income or non-cash expense excluded sometimes), indicating working capital accruals are generally useful, and more useful than long-term accruals, in measuring credit risk. Second, firms with higher agency costs of debt are more likely to exclude long-term accruals, non-cash income, and other non-cash expense from the performance measures, suggesting that accrual reliability is one primary concern in covenant measurement. Finally, the likelihood of using “free cash flows” (adding back depreciation and amortization expense and subtracting capital expenditure) in the performance measure decreases with the variability of investments in fixed assets.