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Abstract


This study uses ex ante cost-of-equity capital models to assess the risk relevance of off-balance sheet operating lease capitalization. Operating lease on-balance sheet capitalization has changed in recent years when off-balance sheet transactions in general and operating leases in particular have been facing increased regulatory and investor scrutiny. This study finds that a firm's ex ante cost-of-equity capital is positively associated with adjustments in its financial leverage (financial risk) and operating leverage (operating risk) resulting from capitalized off-balance sheet operating leases and that the positive association between the ex ante cost of capital and the impact of operating leases on a firm's financial leverage is weaker for the operating leases compared with the capital leases. This study also finds that the positive association between the ex ante cost of capital and the impact of operating leases on a firm's financial leverage has decreased considerably in recent years, since regulators issued interpretation letters clarifying controversial lease accounting issues.

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