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ASC 842 and the Interest Cost of Debt

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This paper examines whether lease accounting under *ASC 842 - Leases*, which requires capitalization of operating leases, affects a retail firm's effective interest cost of debt. We hypothesize that greater transparency into leasing activities under ASC 842 could decrease a merchant's credit worthiness, thereby increasing the interest rates charged by creditors on it's borrowed funds. Our research employs a combination of Logistic Regression and Discriminant Analysis to evaluate the change in probability of factors associated with an increase in borrowing costs. By examining a sample of 71 apparel, home improvement, diversified, and specialty retailers before and after ASC 842 implementation, we find evidence that firms demonstrated a greater degree of balance sheet leverage, offset by lower non-lease asset fixity and lower earnings. The changes in borrower characteristics were associated with an incrementally higher effective cost of debt post ASC 842 adoption, but, contrary to expectations, the incremental change was not statistically significant. Possible explanations for these results are (a) retail leases may be less relevant in credit risk assessment decisions than assumed, (b) the capitalization of operating leases was already factored into creditors' lending decisions prior to ASC 842, or (c) firms have delayed acquiring new debt during the study frame (i.e., during Covid-19 economic uncertainty) and therefore continue to operate under existing credit facilities.

Keywords: *ASC 842, Operating Leases, Cost of Debt*