

# An Examination of The Reporting & Disclosure of Early Debt Extinguishments

Brian W. Carpenter, (bwc352@tiger.uofs.edu), University of Scranton

## Abstract

*The accounting treatment of early extinguishments of debt has long been a source of problems for the accounting profession. Due to differences between book and market values of debt, early retirements of debt frequently lead to the following paradox: economically good decisions can be reported as accounting losses and, conversely, economically bad decisions can be reported as accounting gains. This study analyzed auditor attitudes toward possible disclosure modifications which could mitigate the negative influences arising from current accounting practice. The results reveal support for the inclusion of cash flow analyses to improve the resulting disclosure for these transactions.*

## Introduction

The accounting treatment of early retirements of debt has long been a source of concern for the accounting profession. Due to differences between historical and market valuations of debt, companies can, under certain circumstances, misuse the accounting treatment given debt transactions to artificially inflate their reported profits. Furthermore, the management of some companies may be willing to jeopardize the economic health of their companies to attain these illusory profits. Concern about this potential for abuse has been expressed by many parties, including members of the Accounting Principles Board (APB) and the Financial Accounting Standards Board (FASB). The dissention of these Board members is a matter of public record and is contained in the minority positions of APB *Opinion No. 26*, "Early Extinguishment of Debt"

(APB, 1972), *Statement of Financial Accounting Standards (SFAS) No. 4*, "Reporting Gains and Losses from Extinguishment of Debt" (FASB, 1975), and *SFAS No. 76*, "Extinguishment of Debt" (FASB, 1983), which are the primary sources of accounting guidance for these transactions. The concern expressed by these dissenting Board members proved to be well-founded. The passage of these accounting regulations did little to stem problems associated with early debt extinguishments. In fact, the problem was exacerbated by the creative misuse of in-substance defeasances which introduced additional concerns regarding possibly misleading assertions about the retirement of the debt itself.

Criticism of this area of accounting has come from not only the dissenting members of the APB and the FASB, but also from the public at large and the U.S. Congress. Unfortunately, the paradoxical incentives and disincentives re-

---

*Comments and Questions concerning this article should be sent directly to the authors via e-mail.*

sulting from the current accounting treatment of these transactions are not widely recognized or understood. It is for precisely this reason that it is of paramount importance that the reporting and disclosure of these transactions be thorough and complete. While the misuse of debt transactions has a long history, regulatory attention to this matter is primarily limited to inflationary periods, when the ingredients are most likely to be present to favorably manipulate reported income. Unfortunately, when the inflationary period ebbs, the attention devoted to this problem similarly fades. While the abuse of these transactions to artificially boost income attracts widespread attention, there exists an equally important problem during periods of decreasing interest rates. During periods of decreasing interest rates, the existing reporting requirements provide a strong disincentive to refinancing high rate debt with lower rate debt. This latter problem generally fails to attract public or regulatory attention. However, it should clearly be noted that problems stemming from the existing reporting and disclosure requirements for the early retirement of debt are not limited to periods of rising interest rates.

In *SFAS No. 4*, the FASB noted the dissatisfaction associated with *APB Opinion No. 26* and indicated that the related issues require additional attention (paragraphs 4 and 5). The Board stipulated in *SFAS No. 4* that the disclosure for these transactions be "sufficient to enable users of financial statements to evaluate [the significance of the resulting gains or losses]" (paragraph 9). Furthermore, three out of the seven Board members dissented to the passage of *SFAS No. 76*; a fraction which would prevent the passage of the Statement under current voting rules. It is contended that the original concerns expressed by the dissenting Board members during the passage of these regulations are still valid, and the current disclosures for these transactions fail to enable users to fully comprehend the significance of the resulting gains or losses.

This study investigated these issues by assessing auditor attitudes toward two possible disclosure modifications for these transactions.

Auditors were chosen for the study since they were presumed to have a superior knowledge of the standards related to early debt extinguishments. The specific disclosure modifications addressed in this investigation were the amortization of the resulting gains or losses (as repeatedly recommended by those who expressed dissatisfaction with *APB Opinion No. 26*) and the inclusion of cash flow analyses which would more clearly reveal the discrepancies that exist between the economic and accounting measures for these transactions. The auditors' attitudes toward these suggested disclosure modifications were also evaluated to determine whether these attitudes were affected by the auditors' opinions regarding the motivation for these transactions or by their concern for "information overload". The existence of any such correlations could possibly indicate a need for a future extension of this study to financial statement users, whose attitudes might not be as strongly affected by these related considerations.

### **Gains and Losses Resulting from Early Debt Extinguishments**

The potential for income manipulation through debt transactions arises because of differentials between historical and market valuations of debt. Book values of debt are, of course, based upon historical cost valuations. These historical cost valuations are not meant to reflect market valuations and, accordingly, rarely coincide with market valuations of debt. While there are several complexities involved in recording the debt transaction, this aforementioned difference between market and book valuations determines the ultimate accounting gain or loss recorded for the transaction. In effect, if the market value of the retired debt is greater than its book value the transaction results in an accounting loss, and if the market value of the retired debt is less than its book value the transaction results in an accounting gain. However, since market valuations of debt react in inverse relation to changes in market rates of interest, market values of debt decrease when interest rates rise, and increase when interest rates fall. Because of this relationship, when interest rates rise

above the contract rate of the debt, the potential may exist for management to reap an accounting gain by retiring the old, lower rate debt. This paradox has long been a source of potential abuse by companies desiring to artificially inflate their reported profitability. Conversely, during periods of decreasing interest rates, disincentives arise which may prevent managers from undertaking economically beneficial debt transactions. Unfortunately, this latter paradox does not receive nearly the same attention.

### Debt-Extinguishment Techniques

Two of the most controversial techniques used to execute the early extinguishment of debt have been low-to-high interest bond refundings and in-substance defeasances. Low-to-high bond refundings allow a company to reap the accounting gain associated with the retirement of low-rate debt when the company may not have the existing assets to retire the outstanding debt. A bond refunding basically replaces the old bond issue with a new bond issue. Paradoxically, the accounting gains result from the replacement of low-rate debt with newer higher-rate debt. Similarly, the replacement of high-rate debt with newer lower-rate debt reaps accounting losses.

In-substance defeasances allowed companies to reap the accounting gains that arose from the retirement of old rate debt when the companies may not have been able to execute an actual retirement of the debt. In-substance defeasances allowed companies to remove the debt from their financial statements and record gains or losses as though the debt had actually been retired.

### Relevant Accounting Guidance

The reporting of gains and losses resulting from the early retirement of debt falls under the disclosure requirements of *SFAS No. 4*, "Reporting Gains and Losses from Extinguishment of Debt" (FASB, 1975) and *APB Opinion No. 26*, "Early Extinguishment of Debt" (APB, 1972). *APB Opinion No. 26* served primarily to limit the alternatives available for reporting gains

or losses from the early retirement of debt. Prior to the enactment of this Opinion, there existed several methods of reporting these gains, each of which had been "supported in court decisions, in rulings of regulatory agencies, and in accounting literature" (paragraph 5). Paragraph 19 of this Opinion, entitled "Reduction of Alternatives" indicated the majority conclusion that "all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment." Several years later, *SFAS No. 4* was enacted. This Statement appended the guidance found within *APB Opinion No. 26*. The primary additions implemented by *SFAS No. 4* were clarifications of when the gains or losses were required to be reported as extraordinary and a requirement that these gains or losses be described "sufficiently to enable users of financial statements to evaluate their significance" (paragraph 9). The Statement's reference to the disclosure of the gains or losses indicates that "Gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated, and, if material, classified as an extraordinary item, net of related income tax effect" (paragraph 8). The Statement's reference to adequate disclosure indicated that the following items shall be disclosed: (a) A description of the extinguishment transactions, including the sources of funds used to extinguish the debt if it is practicable to identify the sources; (b) The income tax effect in the period of extinguishment; and (c) The per share amount of the aggregate gain or loss net of related income tax effect. (paragraph 9)

These regulations did not stop the misuse of early extinguishments. In fact, some of the largest and most controversial gains were recorded after the enactment of these regulations. In the inflationary period of the early 1980's, many large companies began to misuse a method, referred to as in-substance defeasances, even though the method's use was, at the time, intended only for certain non-profit organizations. This misuse sparked yet another round of intense public scrutiny of this problem area of

accounting. This activity ultimately led to *Statement of Financial Accounting Standard No. 76, "Extinguishment of Debt"* (FASB, 1983). Much to the surprise of many observers, the issuance of this Standard did not curb what they saw as the misuse of the method. It instead ratified the use of the method, which sparked intense criticism of the self-regulatory nature of the accounting profession. The primary impact of *SFAS No. 76* was to create guidelines meant to curb some of the most egregious abuses of in-substance defeasances, and to address certain disclosure issues brought about by the unusual nature of these defeasances. However, the overall accounting requirements for disclosing the gains or losses resulting from early extinguishments of debt remained unchanged.

### **Bond Refundings**

If a company has an outstanding debt issue and the interest rates that a company must pay to borrow money rises, an opportunity may arise to reap an accounting profit through a bond refunding. The key to such an opportunity is that the company's borrowing rate must exceed the rate paid upon the issuance of the old bond issue. For example, if the old bond issue was issued at seven percent and the company now faces a borrowing rate of ten percent, an opportunity may exist to reap an accounting gain through a bond refunding. If these older low interest rate bonds were replaced with the new higher interest rate bonds, the difference between the purchase price of the old bonds (their market value) and their book value--less expenses--is treated as income. Such a bond refunding will result in an instantaneous increase in current earnings while committing the corporation to higher future interest payments. Joy (1977) discussed this motive for bond refunding and concluded that "this reason for refunding is highly suspect... In such instances refunding may be merely a method of artificially increasing current earnings."

Such a low-to-high rate bond refunding by Pan Am in 1976 resulted in an after tax gain of \$102,915,000. Because of this extraordinary

gain, Pan Am reported a positive net income of \$94,593,000 rather than a loss of \$8,322,000 (Pan Am, 1976). This positive net income figure reversed a trend of seven consecutive years of net losses. However, this one-time accounting gain did not come without an associated cost; the bond swap increased Pan Am's annual pre-tax interest expense by approximately \$2,100,000. From an accounting perspective, Pan Am's action resulted in a substantial accounting gain. However, from an economic perspective, Pan Am's action had negative tax consequences and obligated the firm to substantially higher interest payments.

### **In-Substance Defeasances of Debt**

The in-substance defeasance of debt allowed companies to account for debt as though it had been extinguished when, in fact, the debt had not been extinguished. The in-substance defeasance required that the borrower deposit government securities or other qualifying funds with a trustee. The amount of these funds were to be sufficient to satisfy the scheduled payments of both the interest and principal of the specific obligations. Upon meeting the aforementioned requirements, the borrower was allowed to remove the debt as though the debt had actually been retired. Accordingly, when interest rates increased, this method could have been used to secure a desired boost to a company's reported profitability. It is important to note that even though the debt was considered extinguished and was removed from the balance sheet, the borrower was still legally liable for the payment of the debt.

This transaction evoked the same concerns about managerial motives as did many of the bond refundings. In 1982, Exxon offset \$515 million of its debt by purchasing \$312 million of a Treasury securities and placing these securities with a trustee to meet the interest and principal obligations of the debt. The transaction increased their after-tax earnings by \$132 million. Public concern about the managerial motives behind many of these defeasances was illustrated in an article which appeared in *Forbes* a few weeks

after Exxon's announcement (Green, 1982):

*Just a few weeks ago Exxon picked up some \$130 million in second-quarter earnings without selling a single gallon of gasoline. There's a fancy name for what the oil company did--"defeasance"--and it's wholly legal. But it can also be a way to persuade your shareholders that things are better for the company than they really are.*

*A couple of major companies "defeased" recently. Among them was the Kellogg Co. of breakfast food fame. In Exxon's case, doing so enabled it to claim some \$200 million in pretax profit simply by shuffling pieces of paper in a kind of arbitrage between current high interest rates and older, lower rates... The treasurer's office certainly earned its keep that day.*

### Congressional Expressions of Concern

The concern over defeasances was not limited to the public. The Securities and Exchange Commission's agreement to allow these transactions was cited as a major reason why Representative John D. Dingell initiated the "Dingell hearings" into how the accounting profession sets and enforces accounting standards. About a year after Exxon's defeasance the *Wall Street Journal* (Berton, 1984) reported:

*A House subcommittee has begun an investigation into the Securities and Exchange Commission's accounting oversight role....The panel, the Oversight and Investigation arm of the House Commerce Committee, alleges that the SEC has not been tough enough on establishers of accounting standards.*

In a letter to SEC Chairman, John Shad, Representative John Dingel (Dem., Mich.), who was chairman of the subcommittee, cited "...debt defeasance and off-balance-sheet financing as areas the SEC should have taken a stronger stand" (Dingell, 1984). Michael Barrett, who was chief counsel and staff director of the subcommittee, stated that they were "not terribly happy with the way the SEC has exercised oversight on all the

regulatory agencies with respect to accounting disclosures" (Berton, 1984). In his letter to SEC Chairman John Shad (1984), Representative Dingell stated:

*This communication is in reference to the Commission's adoption of Securities Act Release No. 33-6501, rescinding Financial Reporting Release (FFR) No. 3, relating to extinguishment of debt through "insubstance defeasance" arrangements. Pursuant to the Rules of the House of Representatives, the Subcommittee has initiated an inquiry into the accounting profession, including the supervision and promulgation of accounting standards by the Securities and Exchange Commission ("SEC" or "Commission"). The investigation is being pursued in connection with the responsibility of the Subcommittee to review the Commission's performance of two of its major missions: the protection of investors and full and fair disclosure of the character of securities sold in interstate and foreign commerce....*

*...the FASB issued Statement of Financial Accounting Standards (SFAS) No. 76 which provides that, in addition to the traditional criteria (payment of the debt and legal release as primary obligor), debt may also be extinguished when eligible assets are placed in trust to be used for satisfying scheduled payments on the debt. By this technique, large companies can wipe large chunks of debt off their balance sheets without having to buy back bonds they previously sold to investors.*

*In rubber-stamp fashion, the Commission accepted the FASB standards... How does the new standard contribute to meaningful corporate disclosure? ...Defeasance is criticized by some analysts as merely cosmetic accounting, which increases income without improving cash flow.*

Representative Dingell's letter echoed many of the concerns which were expressed in the minority position of APB *Opinion No. 26*. While the FASB required additional disclosure regarding the legal liability of the defeased debt and restricted the types of funds that could be used to fund defeasances, the overall accounting techniques used to disclose the profitability of

early debt extinguishments were relatively unaffected by the controversy and ultimate issuance of SFAS No. 76.

### Expressions of Concern within the Profession

The accounting literature makes frequent references to the need to assess the "quality" of earnings. The quality of gains reaped, for example, through the borrowing of higher rate debt to retire lower rate debt, would presumably be different than other reported gains. This presumption would especially seem to be true for accounting gains that are, in reality, economic losses. Accordingly, the gains or losses resulting from early debt retirements would seemingly be of special interest to the creditors and stockholders of such a company. Consequently, the accounting treatment of these gains and losses would seemingly benefit from additional, or at least revised, disclosure which would better convey the special circumstances related to such transactions. The FASB, itself, in SFAS No. 4 (FASB, 1975) called for a level of disclosure that would allow financial statement users to fully evaluate the significance of gains or losses resulting from the early extinguishment of debt:

*Gains or losses from extinguishment items should be described sufficiently to enable users of financial statements to evaluate their significance (paragraph 9).*

However, the recommended disclosures of SFAS No 4 fail to convey the paradoxical nature of gains or losses resulting from the early retirement of debt. This inadequacy has been cited by members of both the APB and the FASB. The text of APB Opinion No. 26 (APB, 1972) noted the opposition to the Opinion due to concern over the treatment of the resulting gains or losses:

*Some accountants...believe that recognizing the difference [between market and book values] as gains or losses may induce a company to report income by borrowing money at high rates of interest to pay off discounted low-rate debt. Conversely, a large potential charge to income may*

*discourage refunding even though it is economically desirable; the replacement of high cost debt with low cost debt may result in having to recognize a large loss. Thus, a company may show higher current income in the year of extinguishment while increasing its economic cost of debt and lower current income while decreasing its economic cost of debt. For these reasons, these accountants favor deferral (paragraph 10).*

Three of the members of the APB voted against passage of Opinion No. 26. An additional three members assented with qualification. Of these six members who expressed concern over the Opinion, four indicated that their dissatisfaction was due to the sentiment expressed in Paragraph 10 (cited above). In the words of Mr. Defliese, the dissention was due to the failure "to require the recognition of the economic effects associated with an early extinguishment of debt designed to yield a profit". Mr. Defliese and his three concerned board members must have felt prophetic when, in the years to come, a great number of firms did, indeed, design extinguishments to yield a profit.

As noted in the Opinion, many of those who disagreed with the recognition of the entire gain in the period of retirement suggested that these gains or losses be amortized over what would have been the remaining life of the old debt issue. This call for the amortization of the resulting gain or loss was meant to reduce the potential incentive associated with the misuse of debt extinguishments. In effect, the amortization of a possible gain would have reduced the gain reported in the year of retirement to some fraction of what it would otherwise be. While this recommendation would not entirely eliminate the incentives for abuse, it would greatly diminish such incentives.

Dissatisfaction with the provisions of APB No. 26 were re-expressed years later when the FASB supplanted the APB as the primary source of authoritative accounting guidance. When the FASB took over from the APB it was decided to seek input regarding the existing guidance in place at that time. Opinion No. 26

was a frequently cited source of concern. Despite this expression of concern, the FASB decided to defer action on this matter to a later date, a date that still has not apparently taken place. Statement No. 4 (FASB, 1975) referenced this call for reassessment of APB *Opinion No. 26* as follows:

*Many respondents to the Board's July 12, 1973 request for views concerning APB Opinions and Accounting Research Bulletins suggested that the conclusions of APB Opinion No. 26 relating to early extinguishments of debt be reconsidered. ...The Board considered carefully the suggestions that APB Opinion No. 26 be reconsidered and concluded that the issues extend beyond APB No. 26... The Board concluded that the pervasiveness of [these] issues makes broad reconsideration...a more comprehensive undertaking than can be accomplished in the near future. ...Prior to the issuance of the Exposure Draft of this Statement, the Board had been considering an Interpretation of APB Opinion No. 26 that would have specified disclosure requirements regarding gains and losses from extinguishment of debt but that course of action was changed when it became clear to the Board that the income statement classification of gains or losses on extinguishment of debt also required attention (paragraphs 3 through 5).*

The summary of SFAS No. 4's letters of comment noted that the expression of concern over *Opinion No. 26* affected the support for SFAS No. 4. Specifically, it was noted that "For a variety of reasons, many respondents recommended that the FASB not adopt the Exposure Draft (of SFAS No. 4) as a final Statement. Some respondents recommended that APB *Opinion No. 26* and related issues be reconsidered" (paragraph 14).

As was previously noted, the misuse on these transactions has continued since the issuance of these standards. In fact, the creativity displayed in seeking such gains led to the use of the more sophisticated in-substance defeasance, which exacerbated the prior concerns by adding yet another concern -- the removal of debt from

an issuer's balance sheet while the issuer remained legally liable for its payment. SFAS No. 76 (FASB, 1983), which in effect ratified the use of in-substance defeasances, passed by a four to three vote. The three dissenting FASB members dissented from this Statement because:

*...they do not believe that extinguishment of debt accounting and resultant gain or loss recognition should be extended to situations wherein the "debtor is not legally released from being the primary obligor under the debt obligation. They believe such accounting should be limited to situations... that are more consistent with both present practice and the concept in paragraph 143 of FASB Concepts Statement No. 3, Elements of Financial Statements of Business Enterprises, that "a liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise." In their opinion, the setting aside of assets in trust does not, in and of itself, constitute either the disposition of assets with potential gain or loss recognition or the satisfaction of a liability with potential gain or loss recognition (paragraph 12).*

### **The Need for Additional Research**

Research is needed in this area to assess whether the disclosure of early debt extinguishments provides users with a satisfactory understanding of the effects of the transactions. The profession's current lack of assessment within this area runs contrary to the spirit of the SFAS No. 4, which specifically calls for such a level of disclosure. This study provides a first step in determining whether certain disclosure modifications would improve users' understanding of the impact of early debt retirements.

### **Research Methodology**

In this study, auditors representing all ranks (i.e. partners, managers, and seniors) and all major auditing firms, responded to a list of statements related to the early extinguishment of debt. These statements dealt with the perceived motivations for bond refundings and in-substance

defeasances, and reporting issues related to their proper disclosure. A total of 198 usable responses were obtained out of 304 distributed instruments, for a response rate of over 65 percent.

The participants were asked to respond to a list of statements by indicating their level of agreement or disagreement with the statements. Their responses were recorded on a 7-point Likert scale which had the endpoints marked as "Strongly Agree" and "Strongly Disagree". The five points within the endpoints were denoted as "moderately disagree", "mildly disagree", "neutral", "mildly agree", and "moderately agree". The responses were then tabulated to assess the overall sentiment toward the statements. Several of the statements were used to assess whether tangentially related issues such as concern over "information overload" affected the participants' views regarding possible disclosure modifications.

### **The Results**

The statements, mean responses (based on the 7-point Likert scales), percentage of participants indicating agreement with the statement, and percentage of participants indicating disagreement with the statements were as follows:

1. Bond-refundings are frequently nothing more than an attempt by management to make themselves look good by artificially increasing the firm's net income with a "paper profit."

Mean Response: 3.067  
 Percent Disagreeing: 62.6%  
 Percent Agreeing: 16.4%

2. Other factors such as debt covenants, conversion features, and falling interest rates are more likely to be the driving forces behind a bond refunding than is the possibility of reaping a "paper profit."

Mean Response: 5.660  
 Percent Disagreeing: 6.2%  
 Percent Agreeing: 89.1%

3. In-substance defeasances are frequently nothing more than an attempt by management to make themselves look good by artificially increasing the firm's net income with a "paper profit."

Mean Response: 3.139  
 Percent Disagreeing: 61.4%  
 Percent Agreeing: 21.2%

4. In-substance defeasances are nothing more than a method of overcoming a shortcoming of historical cost accounting, that is, the valuation of debt at its original rather than current value.

Mean Response: 3.479  
 Percent Disagreeing: 51.0%  
 Percent Agreeing: 29.9%

5. Gains or losses resulting from the early extinguishment of debt would be disclosed better if they were amortized rather than recognized wholly in the period of the transaction.

Mean Response: 3.052  
 Percent Disagreeing: 66.5%  
 Percent Agreeing: 25.1%

6. The inclusion of some form of a cash flow analysis for bond refundings in the footnotes of the related financial statements would decrease the possibility of management trying to use bond refundings to artificially increase their firm's net income.

Mean Response: 3.751  
 Percent Disagreeing: 48.2%  
 Percent Agreeing: 41.4%

7. The inclusion of some form of a cash flow analysis for bond refundings in the footnotes of the related financial statements would help readers of such financial statements better understand the actual impact of bond refundings.

Mean Response: 4.482



Percent Disagreeing: 30.1%

Percent Agreeing: 59.5%

8. The amount of disclosure already appearing in financial statements -- and the opinion of some accountants that users of financial statements are overloaded by the amount of current disclosure -- should be considered carefully before requiring any additional disclosure.

Mean Response: 4.866

Percent Disagreeing: 25.8%

Percent Agreeing: 67.5%

9. Regardless of whether it is a correct perception, many people believe that auditors are giving an opinion about not only the fairness of the financial statements, but also the quality of the management's decisions during the accounting period.

Mean Response: 4.505

Percent Disagreeing: 33.0%

Percent Agreeing: 61.8%

The majority of auditors clearly believed that the motivations for most debt retirement transactions were for reasons other than the manipulation of income. This finding was not unexpected. In fact, the inclusion of these statements regarding the motivation of debt retirements was to assess whether auditor sentiment for possible disclosure modification was affected by their beliefs regarding managerial motives. Later analysis proved that such correlations did, indeed, exist. Generally, the auditors did not believe that amortization of retirement gains or losses would improve the disclosure of these transactions. However, the majority of auditors did believe that inclusion of cash flow analyses would help financial statement users better understand the actual impact of early debt retirements.

It was hypothesized that there would be a relation between the participants' views about the motivation of early debt extinguishments (represented by statements 1 through 4) and their

views regarding the amortization of any resulting gains or losses.

**H<sub>1</sub>:** The perceived desirability of amortizing early-debt-extinguishment gains or losses is correlated to the perceived motivations for such transactions.

The analysis of the data indicated strong support for the hypothesized relationship. Specifically, participants indicating that income manipulation was a primary motivating factor of early debt extinguishments (indicated by statements 1 and 3) also tended to be more likely to favor the amortization of the resulting gains or losses from these transactions (indicated by statement 5). Conversely, participants indicating that these transactions were more likely motivated by less circumspect circumstances (indicated by statements 2 and 4) tended to be less likely to favor the amortization the resulting gains or losses. These results parallel the expressed attitudes of the members of the APB. The statistical correlations for these statements are tabulated in Table 1.

It was also hypothesized that the participants' feelings toward enhancing the disclosure of these transactions would be affected by their attitudes about information overload.

**H<sub>2</sub>:** The perceived desirability of enhancing the disclosure of early debt extinguishments is correlated to the participants' concerns about "information overload".

This hypothesized relationship was strongly supported by the ensuing analysis. Statement 8 expressed the view that information overload was, indeed, a concern. Statements 6 and 7 expressed support for the inclusion of cash flow analyses in debt retirement disclosure. The resulting statistical correlations between these statements are listed in Table 2.

The negative correlation between these statements indicated that the participants' support for the inclusion of cash flow analyses was negatively correlated with their concern about infor-

**Table 1**  
Correlations between Perceived Motivations for Early Debt Retirements  
and Support for Amortization.

Statements	Direction of Relationship	Statistical Strength of Correlation
Statements 1 and 5	Positive	0.0004
Statements 2 and 5	Negative	0.0958
Statements 3 and 5	Positive	0.0001
Statements 4 and 5	Negative	0.0687

**Table 2**  
Correlations between Support for Cash Flow Analyses  
and Concern about "Information Overload".

Statements	Direction of Relationship	Statistical Strength of Correlation
Statements 8 and 6	Negative	0.0001
Statements 8 and 7	Negative	0.0001

**Table 3**  
Correlation between Concern about "Information Overload"  
and Support for the Amortization of Early Retirement Gains and Losses.

Statements	Direction of Relationship	Statistical Strength of Correlation
Statements 8 and 5	Negative	0.0004

**Table 4**  
Correlations Between Attitudes Toward Debt Transactions and Support  
for Amortization of Gain/Loss and Inclusion of Cash Flow Analyses.

Statements	Direction of Relationship	Statistical Strength of Correlation
Statements 1 and 7	Negative	0.0057
Statements 1 and 5	Positive	0.0004
Statements 2 and 7	Positive	0.0001
Statements 2 and 5	Negative	0.0958
Statements 3 and 7	Negative	0.0110
Statements 3 and 5	Positive	0.0001
Statements 4 and 7	Positive	0.0001
Statements 4 and 5	Negative	0.0687

mation overload. The statistical strength of this relationship was extremely strong.

It was also surmised that those participants concerned about information overload may tend to disfavor even the small increases in disclosure complexity that would result from the amortization of these gains or losses. The resulting statistical correlation between these statements is listed in Table 3.

Statement 5 expressed support for the amortization of the retirement gains or losses. Statement 8 expressed concern about "information overload". The analysis of the data confirmed the hypothesized relationship between these two statements. More specifically, the analysis indicated that as the participants' support for the amortization of the gains/losses was negatively correlated with their concern for information overload. Once again, the statistical strength of this relationship was extremely strong.

An unexpected finding was that those who tended to view early debt extinguishments as being relatively benign, tended to favor the inclusion of a cash flow analysis (as indicated from the correlation of statements 1, 2, 3, and 4 to statement 7). This was in direct opposition to the participants' attitudes toward the amortization of the gains (as indicated by the correlation of statements 1, 2, 3, and 4 to statement 5). These correlations are listed in Table 4.

The correlations listed in Table 4 indicate that participants who view the debt transactions as being relatively benign (as indicated by positive responses to statements 2 and 4) tend to favor the inclusions of cash flow analyses (as indicated by statement 7) and disfavor the amortization of the resulting gains or losses (as indicated by statement 5). Conversely, those participants who tend to view the transactions as being motivated largely by the desire to manipulate income (as indicated by statements 1 and 3) tend to favor the amortization of the gain (as indicated by statement 5) and disfavor the inclusion of cash flow analyses (as indicated by statement 7). The

participants' views on the amortization issue was hypothesized, and therefore not unexpected. However, the participants' correlated attitudes toward the cash flow analyses was neither hypothesized or readily explainable.

Finally, the participants were asked whether they felt as though there was a tendency for users of financial information to misread their opinions as somehow indicating the quality of management decisions. The participants indicated that they did feel as though their opinions were misread by financial statement users, with 61.8% of the respondents indicating agreement with this statement.

### **Conclusion**

The paradoxical accounting treatment of early debt extinguishments has long been a source of trouble for the accounting profession. However, attention to the matter is primarily limited to inflationary periods, when the ingredients are present for the area to be misused to artificially boost reported earnings. Unfortunately, the problems associated with these transactions are not limited to periods of increasing interest rates. During periods of decreasing interest rates, current accounting regulations provide disincentives to the execution of many economically beneficial debt transactions. Problems associated with this area of accounting was predicted in the minority opinion of APB No. 26. In that opinion, APB Board members Defliese, Watt, Wear, and Gellein not only expressed their concern about the problems that could ensue from this accounting treatment, but also called for the amortization of these gains or losses to alleviate the incentives and disincentives that cause many of these problems.

This study investigated the perceptions of auditors to the motivations behind these transactions and their attitudes toward two possible disclosure modifications. The most important revelation of this analysis was that a majority of the participants believed that the inclusion of a cash flow analysis would improve the disclosure of early debt extinguishments. Perhaps the in-

clusion of a such a cash flow analysis would address many of the shortcomings cited by critics of APB *Opinion No. 26* and *Statement of Financial Accounting Standards No. 4*. Cash flow analyses would certainly help fulfill the goal expressed in *SFAS No. 4* of disclosing information which would "sufficiently enable users of financial statements to evaluate [the gain or loss's] significance". The attractiveness of using cash flow analyses is further bolstered by the general lack of enthusiasm by the participants for the amortization of the debt retirement gains or losses.

### Suggestions For Future Research

As was previously noted, the participants' support for either disclosure modification (amortization or cash flow analyses) was strongly correlated to their opinions regarding the motivation for these transactions. Similarly, the participants' support was also strongly influenced by their concern for information overload. Given these correlations, the generalizability of these results need to be more fully assessed. It may very well be that users of financial information, for example, do not share the auditors' concerns for these other influencing factors. Hence, user support for the amortization of the transactions' results or for the inclusion of cash flow analyses could differ from that expressed by auditors. Accordingly, there is a need for a similar investigation of the attitudes of users and preparers of financial information. However, even without such an extension of this study, the study's results clearly indicate that this issue has not yet been satisfactorily resolved. □

### References

1. Accounting Principles Board, *Opinion of the Accounting Principles Board No. 26*, "Early Extinguishment of Debt.: (October 1972).
2. Berton, Lee, "House Unit Probing SEC's Monitoring of Accounting Rules," *Wall Street Journal*, (January 31, 1984) p. 14.
3. *Business Week*, "Debenture Swaps that Trim Debt." (July 4, 1977), p. 54.
4. \_\_\_\_\_, "Pan Am: In the Black--For Now." (September 5, 1977), p. 53.
5. Dingell, John D., Letter from Congressman Dingell, Chair of the U.S. House of Representatives Subcommittee on Oversight and Investigations, to John S.R. Shad, Chairman of the Securities and Exchange Commission, January 17, 1984.
6. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 4*, "Reporting Gains and Losses from Extinguishment of Debt." (March 1975).
7. \_\_\_\_\_, *Statement of Financial Accounting Standards No. 76*, "Extinguishment of Debt." (November 1983).
8. Green, Richard. "Games Companies Play,:" *Forbes*, (August 30, 1982), p. 43.
9. Hertzberg, Daniel, "Exxon Completes Big Debt Restructuring, Raising Second Quarter Profit \$130 Million," *Wall Street Journal*, (July 7, 1982), p. 4.
10. Johnson, Rodney, and Richard Klein, "Corporate Motives in Repurchases of Discounted Bonds," *Financial Management* (Autumn 1974), pp. 44-49.
11. Joy, O. Maurice, *Introduction to Financial Management*. (Homewood, IL: Richard D. Irwin, Inc., 1977).
12. Peterson, P., D. Peterson, and J. Ang, "The Extinguishment of Debt Through In-substance Defeasance," *Financial Management* (Spring 1985), pp. 59-67.
13. Saunders, Laura, "Too Little is Not Enough," *Forbes* (November 7, 1983), p. 106.