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The Impact of In-Substance Defeasance on Bondholder and Shareholder Wealth

JAMES M. JOHNSON, ROBERT A. PARI, and LEONARD ROSENTHAL*

ABSTRACT

This paper hypothesizes and tests the argument that a defeasance transaction initiates a wealth transfer from stockholders to bondholders. Our empirical tests provide compelling evidence of bondholder gains, but no support for shareholder losses when a firm defeases debt. We speculate that the insignificance of the loss to shareholders is primarily due to the size disparity between the value of defeased debt and the market value of outstanding equity, since the suggested economic merits of defeasance appear unfounded. Although we cannot prove an agency motivation for defeasance, we find a very high correlation between compensation tied to earnings and defeasing debt at a book gain.

DURING THE PAST SEVERAL years, a transaction known as an “in-substance defeasance” (ISD) has been used by managers as a device to extinguish debt. Through an ISD, a firm can remove debt from its financial statements by using U.S. government securities to service the firm’s debt.¹ If the amount paid for the government securities is less than the book value of the defeased debt, the difference is reported as income. Better-known examples include Exxon (1982), Marine Midland (1984), and USX (1985), which reported ISD accounting gains of \$132 million, \$30 million, and \$51 million, respectively.

Since the cost of riskless (i.e., default-free) government securities sufficient to service a risky corporate debt issue must be greater than the market value of the defeased risky debt, the direct effect of an ISD is a wealth transfer from stockholders to owners of a defeased debt issue.² Several articles have discussed

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¹ Defeasement is accomplished by establishing and funding an irrevocable trust for the sole purpose of servicing a defeased debt. The defeasing firm purchases a portfolio of U.S. government securities (or equivalent, as defined in FASB 76) sufficient to service the defeased debt’s interest and principal on a timely basis. Upon establishment of the trust, the defeasing firm is permitted to remove the defeased debt from its balance sheet, along with the trust securities acquired. The balancing entry is to retained earnings (and sometimes to deferred taxes as well).

² There may also be a wealth transfer from other claimholders of the firm to owners of defeased issues.

the general attributes of and motivations for defeasing debt.³ The authors are not aware, however, of any published research which estimates the *value impact* of this transaction.⁴ The purpose of this paper is to examine empirically the wealth transfer hypothesis.

Our analysis provides evidence of a significant gain to bondholders in the month of defeasance. We do not find evidence of a significant loss to shareholders, however. We speculate that the shareholder result may be attributable to the size disparity between the value of defeased debt and the value of equity⁵ rather than to a lack of shareholder costs, since the economic rationales given for defeasance appear to be unjustified.⁶

Although we cannot find a motive for defeasance which is in the interests of shareholders, it is possible that incentive compensation arrangements motivate management. Of the issues defeased by firms which tie management compensation to book earnings, ninety-one percent were defeased at a book gain.

I. The Defeasement Process and Its Wealth Transfer Implications

In November 1983, the Financial Accounting Standard Board (FASB) issued Standard No. 76, "Extinguishment of Debt," which gave accounting sanction to ISD transactions. An ISD is a procedure by which a firm can remove a debt issue from its books even though it is not legally released "from being the primary obligor"⁷ under the terms and conditions of the debt agreement.

To execute an ISD, financial assets must be placed in an irrevocable trust the sole purpose of which is servicing the defeased debt. Permissible trust assets include securities issued or guaranteed by the U.S. government. In addition, the trust assets must generate cash flows sufficient to service the interest and principal payments on the defeased debt on a timely basis, before taxes. In short, an ISD is permitted only if the defeased debt's required cash obligations will be met with virtual certainty.⁸

It is clear that investors will consider a defeased issue more valuable, since it

³ See, for example, Petersen, Petersen, and Ang (1985) for a comprehensive discussion of the defeasement process.

⁴ Although Hughes and Sefcik (1986) discuss this in their working paper, the authors requested that their manuscript not be quoted.

⁵ We are suggesting a size disparity problem here which is conceptually similar to that found in the merger and acquisition literature: it is much easier to detect the effects of a merger or tender offer on the target firm (defeased bondholders) than on the acquiring firm (defeased firm stockholders).

⁶ The questionable benefits to shareholders arising from defeasance are discussed in Section I.

⁷ See FASB 76, footnote, p. 2.

⁸ The authors uncovered ISD transactions dating as far back as 1980, but they went largely unnoticed due to their considerably smaller size relative to Exxon. At the time, both the FASB and SEC were opposed to ISD accounting, and this resulted in the SEC banning ISD in August 1982 until the FASB made a final decision. Due to the controversy generated by ISD, however, final approval was delayed until November 1983. The SEC somewhat reluctantly lifted its ban the following month, with one commissioner stating that he had reservations about it "because the debt is still legally debt and the creation of earnings appears to be a charade" (*The Wall Street Journal*, November 30, 1983, "FASB Adopts Rule That Critics Assert Allows 'Instant' Profit").

has U.S. government-guaranteed securities as collateral in addition to the firm's assets. The establishment of the trust, in effect, renders previously risky corporate debt riskless, and this risk decrease is responsible for the hypothesized increase in the market value of defeased debt. Therefore, our first testable hypothesis is that bondholders of a defeased issue experience a positive excess return (wealth transfer) when the defeasance is announced publicly. This hypothesis was proposed first by Weil (1983). Other authors, including Petersen, Petersen, and Ang (1985) and Hughes and Sefcik (1986), have offered similar hypotheses regarding the wealth effects of an ISD.

If bondholders gain from an ISD, who finances this windfall? Since an accounting transaction cannot increase the value of the firm, one possibility is that the shareholders (or other claimants) are financing the bondholder gains, with shareholder losses approximating bondholder gains.

Some argue that there may be economic incentives to defease a risky debt issue. Two of the more plausible incentives advanced are the elimination of restrictive bond covenants and the avoidance of premiums demanded by bond trading "syndicates" that attempt to hold treasurers hostage by purchasing large blocks of bonds due for a sinking fund payment. Arguably, these incentives are more apparent than real. Discussions with bond indenture experts at major investment banks reveal that defeasance does not release the obligor from any covenant or requirement unless the indenture made specific provision for such an eventuality. Although a legal⁹ defeasance, by definition, releases the obligor from the covenants of a debt, none of the issues in our sample is a legal defeasance. In the absence of a legal defeasance, it would be necessary for the obligor (or its agent) to acquire the permission of all bondholders to facilitate the change of, or release from, an indenture provision.¹⁰ We have been unable to find any instance of attempted indenture modification by the firms in our sample. Our second testable hypothesis, then, is that shareholders experience a wealth loss due to defeasance.

If there is an absence of shareholder-motivated reasons to defease, what is management's incentive? We suggest that management is motivated by incentive compensation agreements. Proxy statements for all twenty-eight firms in our sample were examined to determine the extent to which management compensation may be tied to earnings. Statements for three firms (four defeased issues) did not mention having such plans. Of the twenty-five firms which indicated having incentive compensation, the language in three cases (three defeased issues) was too vague to determine whether compensation was tied to earnings. The remaining twenty-two firms (thirty-five defeased issues) indicated that management compensation was determined, at least in part, by earnings. We then

⁹ A debt issue defeased in accordance with the terms stated in its indenture is referred to as a "legal" defeasance. Legal defeasances began in the 1970s and related exclusively to state and municipal bonds. In a legal defeasance, the indenture covering an issue specifically allows the debtor to be released from its obligation and, therefore, from the covenants in the agreement as well. Issues which are extinguished *in-substance* lack an indenture provision for defeasement.

¹⁰ It might seem that the defeasing firm could negotiate directly with the trustee of the bond issue. However, as an agent of the bondholder, the trustee lacks both the power and authority to alter the provisions of the bond indenture without the expressed permission of the bondholders.

estimated whether each defeasance would likely produce a gain or loss for reporting purposes, regardless of whether such a gain or loss was reported.¹¹ According to our estimates, thirty-two of the thirty-five issues (ninety-one percent) defeased by firms which tie compensation to earnings did so at a gain for financial reporting purposes.

II. Data and Sample

Due to the reporting requirements of FASB 76, the NAARS (National Association of Accountants Research System) financial statement database was employed to search for defeased issues. NAARS contains annual reports—including footnotes—for more than 4,200 publicly traded firms. This initial NAARS search produced a total of 101 firms.

A search of trade journals, business newspapers, DIALOG (a database of Dialog Information Services which includes Standard and Poor's Corporate Reports), and the Dow Jones News Retrieval System produced an additional three defeasance transactions. These 104 firms were then analyzed on a case-by-case basis to determine which were usable; only firms that defease publicly traded debt are included. A total of fifty-five issues were excluded for one of the following reasons: (1) the debt was not a marketable security (defeasances of pension funds, capital leases, Federal Home Loan Bank borrowings, and revolving credit agreements); (2) market data was not obtainable (defeasance of foreign obligations); or (3) the issue was a legal defeasance. Instantaneous defeasances¹² are excluded since they are not ISDs.

Imposing these filters reduces our sample to forty-nine firms. An additional eighteen firms were excluded for having unlisted debt. Three more were excluded since they defeased debt within one to three months of maturity. Our final sample¹³ thus consists of twenty-eight firms that defeased at least one publicly traded bond issue each, for a total of forty-two issues.

Table I contains descriptive statistics on size, maturity, ratings, and the number of defeasances by year for the final sample of defeased bonds. These figures

¹¹ Nine of the firms in the sample (thirty-two percent) were silent with respect to the effect of defeasance on earnings, while another five firms (eighteen percent) indicated that the effect was not "material." The remaining fourteen firms indicated that they defeased at a gain. Even though a gain may not be material for a firm on a consolidated basis, it is entirely possible that it would be material for compensation purposes at the cost or profit center level. Thus, we estimate the likelihood of defeasance having a favorable effect on earnings by estimating the difference between a defeased issue's coupon and the yield on a government bond of the same term to maturity available during the month of defeasance. Such a government bond rate comparison should be a good proxy since it would be a likely candidate to defease the debt. Defeased issues which had a coupon rate lower than the comparable government bond rate were assumed to be defeased at a book gain. Of the thirty-five issues defeased by firms which tie compensation to earnings, thirty-two (ninety-one percent) were defeased at a gain according to our methodology.

¹² An instantaneous defeasance is one in which the defeasing firm issues debt and places assets in trust to defease the debt issue simultaneously. Such transactions amount to an arbitrage play and are motivated by the ability of U.S. firms to (sometimes) issue debt in Europe at a rate that is less than the return on U.S. government securities. In Technical Bulletin 84-4, the FASB disallowed ISD accounting treatment for instantaneous defeasances.

¹³ The list of firms is available upon request from the authors.

Table I
Descriptive Statistics of Defeasance Sample

<u>Term to maturity of issue when defeased (in years)</u>							
	<u>minimum</u>		<u>maximum</u>		<u>median</u>	<u>mean</u>	
	0.7		23.8		7.2	8.5	
<u>Size of defeased issue (in millions)</u>							
	<u>minimum</u>		<u>maximum</u>		<u>median</u>	<u>mean</u>	
	\$2.3		\$400.0		\$39.5	\$58.9	
<u>Rating (Moody's) of defeased issues</u>							
	<u>Aaa</u>	<u>Aa</u>	<u>A</u>	<u>Baa</u>	<u>Ba</u>	<u>Unrated</u>	<u>Total</u>
	6	10	10	6	5	5	42
<u>Number of issues defeased by year</u>							
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>Total</u>
	1	2	2	5	20	12	42

indicate that the bonds have a mean maturity of 8.5 years, with an average par value of approximately \$59 million. The majority of bonds are high-quality, investment-grade issues (A-AAA). Finally, the distribution of defeasances by year of occurrence indicates a significant increase in ISD transactions after FASB 76 sanctioned them in November 1983.

Stock rates of return are obtained from the CRSP daily returns file, and bond price data are from Merrill Lynch, Moody's, and Standard & Poor's. Nunn, Hill, and Schneeweis (1986) (hereafter NHS) note that many bonds do not trade with sufficient frequency to produce hard sale prices, and NHS demonstrate the superior quality of Merrill Lynch price data, which is a matrix pricing system where bonds are priced relative to one another.¹⁴ In the absence of a trade, Merrill Lynch adjusts prices daily to reflect changes in the yield curve. This adjustment, which is not provided by Moody's or Standard & Poor's, is important because many bonds do not trade on (or near) the last day of the month. Since our market indexes (the Moody's Corporate Bond Index and the Merrill Lynch Corporate Bond Index) reflect changes in the yield curve, we need a time series of individual bond returns that reflects interest rate shifts in a timely manner. Empirical support for this need is provided by NHS, who demonstrate dramatic differences in market model parameter estimates when Merrill Lynch prices were substituted for Moody's prices (e.g., the mean beta estimate almost doubled and the average R^2 tripled).¹⁵

Due to the superiority of the Merrill Lynch system, we use their data for the twenty-nine defeased issues available in their database; for the remaining thirteen issues, we use Moody's prices. Since the corporate bond data source can affect the results, we report our results for both the full sample and the Merrill Lynch subsample.

Monthly holding-period returns rather than daily returns are calculated for each bond for two reasons. First, the actual event day is not known in many

¹⁴ See Nunn et al. (1986) for a more complete description of the Merrill Lynch pricing system.

¹⁵ These results are based on the Merrill Lynch index. When Moody's index was used, the average beta estimate increased approximately sixty percent, and R^2 nearly tripled when Merrill Lynch prices were substituted for Moody's prices.

cases, although the event month is known. Second, bonds tend to be much more thinly traded than common stocks, making their precise market value on any given day somewhat uncertain.

The closing price for each issue in each month $t(P_t)$ is adjusted to include accrued interest (A_t) for the appropriate number of days. Thus, for each debt issue the return (R_t) for month t is

$$R_t = ((P_t + A_t) - (P_{t-1} + A_{t-1})) / (P_{t-1} + A_{t-1}). \quad (1)$$

We use a “first public information” procedure to define the event month in testing our wealth transfer hypothesis. The earliest month from the following was employed: (1) date of a story in the financial press or corporate news release disclosing the defeasance (eighteen cases), (2) month in which the first quarterly report disclosing a defeasance was mailed to shareholders (two cases), (3) month in which the first 10Q report disclosing a defeasance was filed with the SEC (four cases), or (4) month in which the first annual report disclosing a defeasance was mailed to shareholders (eighteen cases).

III. Bond Methodology and Results

To test the hypothesis of no abnormal performance during the announcement month (month zero), we use the market model approach described by Brown and Warner (1980). Months $t - 39$ to $t - 4$ and the Merrill Lynch Long-Term Corporate Bond Index are used to estimate the parameters of the “market” model.

Next, the excess or abnormal return during month t is defined as

$$\bar{A}_t = (1/N_t) \sum_{i=1}^{N_t} AR_{it}, \quad (2)$$

where

$$AR_{it} = R_{it} - \hat{\alpha}_i - \hat{\beta}_i R_{Mt},$$

R_{it} = monthly returns on security i in period t ,

$\hat{\alpha}_i, \hat{\beta}_i$ = estimated parameters of the market model, (3)

R_{Mt} = the Merrill Lynch Bond Index return in month t , and

N_t = number of bonds with excess returns in month t .

The null hypothesis of zero abnormal performance in month t is tested with the t -statistic given by

$$t = \bar{A}_t / [\hat{s}^2(\bar{A}_t)]^{1/2}, \quad (4)$$

where

$$\hat{s}^2(\bar{A}_t) = \sum_{t=-39}^{t=-4} (\bar{A}_t - \bar{\bar{A}})^2 / 35, \quad (5)$$

$$\bar{\bar{A}} = (1/36) \sum_{t=-39}^{t=-4} \bar{A}_t. \quad (6)$$

Panel A in Table II presents the excess returns and corresponding t -statistics

Table II
Bondholder Excess Returns

Bond excess returns are calculated using the Brown and Warner (1980) market model procedure. Market model parameters are estimated using months $t - 39$ to $t - 4$ and the Merrill Lynch Long-Term Corporate Bond Index. The event date is the first public information date described in Section II. The full sample consists of all forty-two bond issues defeased by twenty-eight firms. The Merrill Lynch subsample consists of twenty-nine bond issues defeased by seventeen firms. All issues were defeased during the 1980–1985 time period.

	Month	Excess Return (%)	<i>t</i> -Statistic
<u>Panel A</u>			
Full sample	–2	0.038	0.100
(42 issues)	–1	0.119	0.314
	0	0.582	1.540
	1	–0.410	–1.084
	2	–0.046	–0.121
<u>Panel B</u>			
Merrill Lynch	–2	0.013	0.042
subsample	–1	0.308	0.965
(29 issues)	0	0.734	2.301*
	1	–0.260	–0.815
	2	0.427	1.338

* Significant at the two percent level.

for the full sample, and Panel B presents the Merrill Lynch subsample results. Although the full sample excess return in the month of defeasance is positive (0.582 percent), it is not significantly different from zero. In contrast, the results based on the Merrill Lynch price series show a positive excess return (0.737) that is significant. The positive excess return for the Merrill Lynch subsample is consistent with our hypothesis of an increase in defeased bondholder wealth.¹⁶

IV. Equity Methodology and Results

Average daily excess returns are calculated with the following two-step procedure. First, we estimate the parameters of the market model for each firm using the Scholes-Williams (1977) method and the CRSP value-weighted index.¹⁷ The returns from days $t - 105$ through $t - 44$ are used to obtain the required leading, lagging, and coincident beta coefficients for each firm. Second, the average excess return on day t is defined as

$$\bar{A}_t = (1/N_t) \sum_{i=1}^{N_t} AR_{it}, \quad (7)$$

¹⁶ Since most of the bonds in our sample were rated A or higher by Moody's, the bondholder risk reduction and the corresponding excess return caused by defeasance are relatively small.

¹⁷ The CRSP equally weighted index (with dividends) was also used, and the qualitative results were the same.

where

$$\begin{aligned}
 AR_{it} &= R_{it} - \hat{\alpha}_i - \hat{\beta}_i R_{Mt}, \\
 R_{it} &= \text{daily returns on security } i \text{ in period } t, \\
 \hat{\alpha}_i, \hat{\beta}_i &= \text{the estimated parameters of the market model,} \\
 R_{Mt} &= \text{daily return on the CRSP value-weighted index, and} \\
 N_t &= \text{number of firms with excess returns on day } t.
 \end{aligned} \tag{8}$$

Since the exact day of disclosure is unknown for many firms, and since we wish to maintain consistency with bond event dates, we aggregate the daily excess returns to form multiday (twenty-two-day) excess returns that correspond to the monthly bond intervals. For each return interval, the test statistic¹⁸ is the ratio of the cumulative mean excess return to its estimated standard error and is given by

$$t = \sum_{t=1}^{22} \bar{A}_t / \left[\sum_{t=1}^{22} \hat{s}^2(\bar{A}_t) \right]^{1/2}, \tag{9}$$

where

$$\hat{s}^2(\bar{A}_t) = \sum_{t=-105}^{t=-44} (\bar{A}_t - \bar{\bar{A}})^2 / 61, \tag{10}$$

$$\bar{\bar{A}} = (1/62) \sum_{t=-105}^{t=-44} \bar{A}_t, \tag{11}$$

and the remaining terms are as defined previously. An exact announcement date is known for eleven firms which defeased debt. For these issues, we determine the two-day announcement effect.

Panel A in Table III presents the average multiday (i.e., monthly) excess returns and corresponding *t*-statistics for the full sample. For comparative purposes, we also present the Merrill Lynch sample results in Panel B. As hypothesized, the excess return to shareholders is negative for both the full sample and the Merrill Lynch subsample, but it is not significantly different from zero during the event month. The two-day announcement effect for the eleven firms for which exact announcement dates are known produces similar results. Although the excess return for the exact announcement subsample was a negative 0.767 percent, the *t*-statistic (−1.352) remained insignificant.

One possible explanation for the observed insignificance is that the dollar value of defeased debt is relatively small compared to the dollar market value of outstanding equity. In fact, the dollar amount of defeased debt divided by the dollar value of equity is only 0.067 for the full sample and 0.037 for the Merrill Lynch sample. Therefore, even though bondholders gain significantly from defeasance, the corresponding loss to shareholders could be miniscule. A second explanation is the greater volatility of equities relative to bonds.

¹⁸ Since several of our event dates are clustered in time, we use a test statistic that assumes dependence in our sample. If the observations are independent, however, our results are biased downward (i.e., there is a bias in favor of the null hypothesis of no “abnormal return”). See Brown and Warner (1985).

Table III
Shareholder Excess Returns: CRSP Value-Weighted Index Results

Equally weighted results are virtually the same and are available upon request. The full sample consists of thirty-one equity issues explained as follows: seventeen firms each defeased one bond issue; nine firms defeased more than one bond issue on the same date; one firm defeased two bond issues on different dates, and one firm defeased three bond issues on different dates.

	Month	Excess Return (%)	t-Statistic
Panel A			
Full sample	-2	-0.655	-0.505
(31 issues)	-1	-0.362	-0.279
	0	-1.432	-1.103
	1	0.240	0.185
	2	1.528	1.176
Panel B			
Merrill Lynch	-2	-0.738	-0.458
subsample	-1	0.941	0.585
(20 issues)	0	-0.156	-0.097
	1	1.052	0.653
	2	1.816	1.128

V. Summary and Conclusions

This paper examined the impact of in-substance defeasance transactions on bondholders and stockholders. It was hypothesized that such transactions could cause a wealth transfer from shareholders to bondholders since defeasance causes a firm to extinguish a debt issue at a premium. Although our results support the hypothesis of bondholder gains, we find no evidence that shareholders finance this gain since the negative equity excess returns were not statistically distinguishable from zero.

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