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# Extraordinary Item Classification Eliminated from the Income Statement: Some Supportive Evidence

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## ABSTRACT

*Accounting Standards Update 2015-01 formally eliminated the reporting of "extraordinary items" in the income statement for fiscal years beginning after December 15, 2015. Gains and losses previously reported as extraordinary items and presented separately below income from continuing operations, are now reported as other gains and losses and included in income from continuing operations. The use of the extraordinary item classification fell sharply after 2002 when gains and losses from the early extinguishment of debt were no longer required to be reported as extraordinary items. By 2003 less than 100 publicly traded firms reported extraordinary items and in 2011 the number was only in the single digits. Finally, in 2013 and 2014 not a single firm in our sample, drawn from the Compustat database, reported an extraordinary item.*

## INTRODUCTION

In January 2015 the Financial Accounting Standards Board (FASB) published Accounting Standards Update (ASU) 2015-01 and formally eliminated the concept of extraordinary items from Generally Accepted Accounting Principles (GAAP). Thirteen years earlier in 2002, the International Accounting Standard Board (IASB) and International Financial Reporting Standards (IFRS) removed extraordinary items as a line item in the income statement. As stated in ASU 2015-01, the FASB concluded that costs will be reduced without reducing the availability of relevant information. The benefits of elimination include preparers no longer having to devote time and effort assessing whether an event qualifies as extraordinary. In addition, auditors and regulators will not have to spend time on the issue. Users will still have access to the information as companies will report material items that are unusual in nature or occur infrequently as separate line items. However, these items are now reported as part of continuing operations and on a pretax basis. The user will have to determine which special items provide useful information.

The extraordinary classification had been part of United States (U.S.) accounting for more than fifty years. In 1966 the Accounting Principles Board (APB) formally concluded in APB 9 that extraordinary items should be shown separately from other items in the income statement. This was based in part on the belief that the income statement is more informative if the effects of rare or unusual events are clearly separated from those that arise from continuing events or normal operations. It was generally agreed that management is in the best position to determine whether an item was extraordinary. APB 30 was released in 1973 to provide additional guidance and to improve consistency in application. This document introduced the joint requirements of “infrequent occurrence” and “unusual in nature” before any item could be treated as extraordinary. The standard also stated that a significant amount of judgment would be necessary on the part of management. In the ensuing years, questions were raised as to whether the extraordinary classification and its special treatment was useful to investors, whether the benefits of any usefulness outweighed the costs to companies in applying the standard and whether managers opportunistically used the extraordinary classification to suit their needs.

## DISAPPEARANCE OF EXTRAORDINARY ITEMS

The Compustat database of publicly traded firms was searched to identify all companies reporting an extraordinary item during the twenty-year period 1995 through 2014. The sample includes only U.S. firms listed on major stock exchanges that report a share price and sales greater than zero. The sample of firms was further screened to include only firms having financial statements reported under the industrial format (INDL) on Compustat. This restriction may have eliminated some financial services firms.

Table 1 displays the number of firms reporting extraordinary gains and losses from 1995 to 2014. From 1995 to 2002 the number of companies reporting an extraordinary gain or loss in a given year ranged from 317 to 526. In 2003 there was a sharp decline in the number of firms reporting extraordinary items, dropping from 317 in 2002 to 43 in 2003. In April 2002 the FASB released Financial Accounting Standard (FAS) 145 (now ASC 470-50-40-2) which eliminated the requirement of reporting gains and losses from early extinguishment of debt as an extraordinary item. This new treatment was applicable for fiscal years beginning after May 15, 2002. FAS 145 allowed that gains and losses from the early extinguishment of debt could still be reported as an extraordinary item, but such transactions now had to meet the restrictive criteria, “unusual in nature” and “infrequent occurrence”.

In 2009, FAS 141(R) became effective for business combinations. Prior to 2009, negative goodwill arising from an acquisition could result in an extraordinary gain being reported. FAS 141(R) eliminated that treatment and required that negative goodwill be reported as a gain and included as part of income from continuing operations.

After 2003 there is a gradual decline in the number of firms reporting extraordinary items. By 2013 there are no firms reporting extraordinary items. A noticeable trend is that from 2003 onward the number of gains per year is greater than or equal to the number of losses, whereas prior to 2003 the number of losses per year exceed the number of gains. By 2011 the annual number of extraordinary items reported in the Computstat database had declined to single digits.

Table 2 presents the number of firms reporting extraordinary items classified by historical SIC Industry codes. Consistent with the overall percentages, for the twenty-year period from

**Table 1**

**Companies Reporting Extraordinary Gains or Losses**
**(Fiscal years 1995 through 2014)**

| Fiscal Years | Firms Reporting Extraordinary Gains | Firms Reporting Extraordinary Losses | Total | Percentage |
|---|---|---|---|---|
| 1995 | 88 | 319 | 407 | 11.18 |
| 1996 | 53 | 379 | 432 | 11.86 |
| 1997 | 61 | 396 | 457 | 12.55 |
| 1998 | 75 | 382 | 457 | 12.55 |
| 1999 | 105 | 339 | 444 | 12.19 |
| 2000 | 125 | 254 | 379 | 10.41 |
| 2001 | 167 | 359 | 526 | 14.45 |
| 2002 | 91 | 226 | 317 | 8.71 |
| 2003 | 27 | 16 | 43 | 1.18 |
| 2004 | 32 | 5 | 37 | 1.02 |
| 2005 | 25 | 9 | 34 | 0.93 |
| 2006 | 26 | 5 | 31 | 0.85 |
| 2007 | 17 | 5 | 22 | 0.60 |
| 2008 | 16 | 4 | 20 | 0.55 |
| 2009 | 11 | 3 | 14 | 0.38 |
| 2010 | 6 | 4 | 10 | 0.27 |
| 2011 | 7 | 1 | 8 | 0.22 |
| 2012 | 3 | 0 | 3 | 0.08 |
| 2013 | 0 | 0 | 0 | 0.00 |
| 2014 | 0 | 0 | 0 | 0.00 |
| Total | 935 | 2,706 | 3,641 | |
| Percent | 25.68% | 74.32% | | 100.00% |

1995 to 2014, within each industry extraordinary losses were reported with greater frequency than were extraordinary gains. As expected, larger industries with more companies reported more extraordinary gains and losses. Companies in six of the sixteen classifications, Durable Manufacturers, Financial Institutions, Insurance and Real Estate, Retail, Services, and Transportation, collectively reported 72.29 percent of the extraordinary items during that period.

**Table 2**
**Companies Reporting Extraordinary Gains or Losses**
**By Industry (SIC Codes)**
**(Fiscal years 1995 through 2014)**

| **Industry** | **Firms Reporting Extraordinary Gains** | **Firms Reporting Extraordinary Losses** | **Total** | **Percentage** |
|---|---|---|---|---|
| Agriculture | 3 | 11 | 14 | 0.38 |
| Chemicals | 18 | 52 | 70 | 1.92 |
| Computers | 90 | 145 | 235 | 6.45 |
| Durable Manufacturers | 145 | 380 | 525 | 14.42 |
| Extractive Industries | 52 | 92 | 144 | 3.95 |
| Financial Institutions | 170 | 240 | 410 | 11.26 |
| Food | 20 | 63 | 83 | 2.28 |
| Insurance and Real Estate | 86 | 442 | 528 | 14.50 |
| Mining and Construction | 13 | 52 | 65 | 1.80 |
| Other | 3 | 5 | 8 | 0.22 |
| Pharmaceuticals | 24 | 50 | 74 | 2.03 |
| Retail | 88 | 264 | 352 | 9.67 |
| Services | 82 | 371 | 453 | 12.44 |
| Textiles and Printing | 20 | 118 | 138 | 3.79 |
| Transportation | 78 | 286 | 364 | 10.00 |
| Utilities | 43 | 135 | 178 | 4.89 |
| Total | 935 | 2,706 | 3,641 | |
| Percent | 25.68% | 74.32% | | 100.00% |

Table 3 classifies firms into one of four categories based on whether the firm reported a profit or loss on income from continuing operations and whether an extraordinary gain or loss was reported. The largest classification is firms reporting a profit on income from continuing operations and an extraordinary loss. This is 2,029 firms, or 55.7 percent, more than half of the total firms reporting extraordinary items. The second largest group is firms reporting a loss on income from continuing operations and an extraordinary loss, 677 companies or 18.6 percent of the total number of firms. Since fewer firms reported extraordinary gains than losses, those percentages are smaller with 10.2 percent reporting extraordinary gains and a loss on income from continuing operations and 15.5 percent reporting extraordinary gains and a profit on income from continuing operations.

**Table 3**
**Companies Reporting Extraordinary Gains or Losses**
**By Profit or Loss on Income from Continuing Operations**
**(Fiscal Years 1995 through 2014)**

| | **Firms** | **Firms** |
|---|---|---|

| Income from continuing operations | Reporting Extraordinary Gains | Reporting Extraordinary Losses | Total |
|---|---|---|---|
| **Profit** | 563 | 2,029 | 2,592 |
| Percentage | 15.5% | 55.7% | 71.2% |
| **Loss** | 372 | 677 | 1,049 |
| Percentage | 10.2% | 18.6% | 28.8% |
| **Total** | 935 | 2,706 | 3,641 |
| **Percentage** | 25.7% | 74.3% | 100% |

The financial statement impact of extraordinary gains and losses relative to income from continuing operations is presented in Table 4. The ratio or percentage of extraordinary gains and losses to both profit and loss on income from continuing operations is displayed in Table 4. Due to the significant influence of outliers, the means and standard deviations are not presented, only the quartile values are listed.

The largest median of an extraordinary item as a percentage of income is firms reporting extraordinary gains and a loss from continuing operations. For this group of firms the median amount was 15.8 percent. This means that half of the companies reported an extraordinary gain that was 15.8 percent or more than the reported loss from continuing operations. The next highest median value was 12.0 percent for firms reporting an extraordinary loss as a percentage of net loss from continuing operations. For firms reporting a profit on income from continuing operations, the median was 8.5 percent of income from continuing operations for extraordinary gains and 6.8 percent of income from continuing operations for extraordinary losses. If a reported amount is considered material at the five percent or greater level, then the percentage of the relationship between extraordinary items and the reported profit/loss from continuing operations would be material for over half of the firms.

An initial explanation for the majority of extraordinary items consisting of losses could be that those events that were infrequent and unusual tended to be events that were negative occurrences, such as physical damage to companies' assets or unanticipated business events that generated financial losses. However, one other potential partial explanation for the preponderance of losses reported as extraordinary items is that companies' management may have had a motive to do so. Previous research on discontinued operations, another special reporting line on the income statement treated the same as extraordinary items, provided evidence that management would favor reporting some operating losses as being from discontinued operations so that such losses would be excluded from core earnings, a number more closely followed than the earnings figure that include the results of discontinued operations (Barua et al. 2010). Thus, the core earnings of the company would be inflated by shifting operating losses into discontinued operations. This similarity of extraordinary items to discontinued operations raises the question as to whether management chose to categorize some losses as extraordinary that might have been more appropriately categorized as operating losses. Exploring this issue is beyond the scope of this paper

**Table 4**
**Extraordinary Gains or Losses as a Percentage of Positive or Negative Income from Continuing Operations (Fiscal Years 1995 through 2014)**

| **Extraordinary Item:**<br>**Income from Continuing Operations:** | **Gain**<br>**Profit** | **Loss**<br>**Profit** | **Gain**<br>**Loss** | **Loss**<br>**Loss** |
|---|---|---|---|---|
| N | 563 | 2,029 | 372 | 677 |
| 75% Q3 | 31.6% | 21.2% | 72.4% | 43.7% |
| 50% Median | 8.5% | 6.8% | 15.8% | 12.0% |
| 25% Q1 | 2.0% | 2.3% | 4.4% | 3.7% |

To the extent that companies were using the extraordinary item classification for the purpose of enhancing operating earnings, then it would provide support for the elimination of extraordinary items since it was facilitating manipulation of earning numbers and possibly undermining the usefulness of financial reporting.

## FUTURE RESEARCH

Whether the elimination of reporting some gains and losses as extraordinary items results in more valuable or higher quality information is an open question. The present study does not address whether companies were able to inappropriately shift gains and losses from operating income to the extraordinary classification. Future researchers could explore this issue by adopting the methodology that Barua et al. (2010) applied to their study of the reporting of discontinued operations.

As discussed earlier there were several significant changes to accounting for extraordinary items during the time-period examined in this study (e.g., reporting early extinguishment of debt in extraordinary items was eliminated as of 2003). Future research could examine whether the value relevance of the information reported changed as the reporting regimes changed.

## SUMMARY

The analysis in this article indicates that the reporting of extraordinary gains and losses had almost ceased to be reported by firms in recent years. In earlier years when it was more common, it arguably provided the opportunity, if not the intent, to classify some losses away from income from continuing operations and into extraordinary items, thus enhancing the amount of income from continuing operations, an amount widely followed by the investment community. Extraordinary losses were reported approximately three times as often as extraordinary gains.

In many cases, the gains and losses reported were of significant magnitude relative to the size of the company. More than one half of the firms reported extraordinary gains or losses that exceeded five percent of their profit or loss from continuing operations.

Prior to 2005, there were three items reported on the income statement after income from continuing operations: 1) discontinued operations; 2) extraordinary items; and 3) cumulative effect of change in accounting principle. In 2005, reporting the cumulative effect was eliminated and in 2015 reporting extraordinary items was eliminated. Recently, the scope of discontinued operations has been narrowed. More and more accounting information is being classified as part of income from continuing operations, core earnings, where it is up to the user of the financial statements to decide the usefulness of the information. Now there are fewer opportunities for management to classify items, especially losses, out of core earnings and into special reporting.

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