Should Extraordinary Items Be Reinstated?

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Given the complexity accountants face in identifying and reporting extraordinary items, the FASB decided to eliminate the reporting requirement in 2015. This decision has merely shifted the burden from the internal accountants to the outside investors. This change adds little value to the financial community and should be reconsidered. A main argument against reinstating the reporting requirement, perhaps, is the tendency of managers to deploy extraordinary items for earnings management purposes. This paper investigates the earnings management issue using a logit regression and a panel regression model. The findings do not point towards earnings management being a motive behind reporting extraordinary items.

Keywords: extraordinary items, Accounting Standards Update 2015-01, earnings management, logit regression, panel data regression

INTRODUCTION

In the interest of aligning the US GAAP with the International Financial Reporting Standards (IFRS), the reporting requirement of extraordinary items in financial statements have been eliminated in 2015 (Accounting Standards Update 2015-01). Regulators also cite more simplicity in complying with the US GAAP when extraordinary items are eliminated given the complexity of determining whether an item meets the criteria to be classified as extraordinary. Instead of exerting more efforts in simplifying the criteria to make the process of classification smoother for accountants, regulators chose to simply eliminate it. While this may be the easier route for accountants, it could perhaps create new challenges to security analysts and investors who may not be able to disentangle the regular income generated by the usual business operations from that generated by non-recurring events. As such, the elimination of the required reporting of the extraordinary items, while may have made it simpler for accountants, it may cause more confusion to the public stakeholders. This change may be regarded by many, as a zero-sum game, where the complexity of classifying events as extraordinary is shifted from one group (managers and accountants) to another group (financial analysts and public investors). Other observers may view the change as a negative-sum game given the fact that managers who know more about the nature of the business operations, may be more qualified than outsider analysts to classify an item as extraordinary or not. As outsiders, security analysts already face numerous challenges in examining the financial statements to capture the relevant information and throw out the "noise". This change in the accounting standards would add another layer of confusion. It would be more appropriate for the insiders to classify and report extraordinary items as they see fit, in compliance with accounting standards. Security analysts and investors can then decide whether that classification is appropriate or whether it is motivated by earnings management purposes.

While the elimination of the extraordinary items reporting requirements may have been initiated on a good faith, it perhaps failed to consider consequences regarding proper valuation of the firm's performance. A recent critique of this change comes from Yu-Ho (2021) who finds that eliminating extraordinary items from the income statement hampers the ability to explain variations in the P/E ratio across different firms. The less informative P/E ratio would then impact its usefulness in the valuation process. In addition, Gamble, Noland, Ranasinghe, and Dhole (2012) state that "Used properly, the classification should improve financial reporting by providing investors and creditors with financial data that is not distorted by the underlying anomaly." As such, the elimination of the extraordinary reporting requirements adds little value to the financial community taken together (managers, accountants, security analysts and the public). This calls for reinstating the reporting requirement of extraordinary items. While the two main reasons why the reporting requirement of extraordinary items have been eliminated from financial statements (difficulty of identifying them and alignment with the IFRS) are not fully convincing, a main argument against reinstating them perhaps, is the tendency of managers to deploy them for earnings management purposes.

Earnings management has been well documented in the accounting and finance literature [see for instance, Chen, Cheng, and Wang (2015), Chih, Shen, and Kang, (2008), Dechow and Skinner (2000), Dechow (1994), Dechow, Sloan, and Sweeney (1995), Kim and Luo (2021)]. Manipulating the firm's earnings overtime may be driven by various reasons. First, to make an impression on investors that the earnings stream of the firm is relatively stable with no major volatility thereby giving the impression of less risk. Second, earnings management may serve the purpose of reducing the tax bill of the firm. Third, earnings management may be in line with the overall business strategy where the firm could raise its expenses (on payroll, bonuses, etc.) in good times and reduce them in bad times, keeping the earnings stable over time. Various legal (and perhaps illegal) techniques have been used by accountants to smooth earnings. These techniques include delaying the recognition of revenue to the next fiscal period in anticipation of lower overall business activity in the future. On the other hand, the recognition of certain expenses may be delayed to the following accounting period when the firm is currently struggling and anticipates better times ahead. These manipulations may not easily be detected by investors who don't possess insider information. However, what is clearly visible to investors are the "extraordinary items" in the income statement that could be positive (income) or negative (expense). These items fall outside the normal course of business activities and therefore don't occur frequently. However, certain firms tend to report such extraordinary items more frequently than investors anticipate. There could be two explanations for this. Either extraordinary items are used for the purpose of earnings management or their existence on financial statements are purely random. This paper investigates the extent to which firms report extraordinary items over time and whether they are mainly used for the purpose of earnings management. If earnings management is not found to be a major reason firms report extraordinary items, then they should be reinstated given the lack of added value from their elimination, and the extra burden imposed on security analysts and the public investors.

LITERATURE REVIEW

Researchers have long called for the termination of the reporting requirements of extraordinary items. For instance, Massoud, Raiborn, and Humphrey (2007) argue that the restrictions imposed on classifying certain events as extraordinary by the Accounting Principles Board Opinion 30 resulted in only two percent of firms reporting them in 2003. These very narrow definitions of extraordinary items along with the desire to unify the US GAAP with the IFRS are the bases for why the authors call for the elimination of extraordinary items. The authors further note that the decision by the Financial Accounting Standards Board's (FASB) Emerging Issues Task Forces to not report the effects of the September 11, 2001, terrorist attacks as well as those from the 2005 Hurricane Katrina as extraordinary makes this classification questionable. If these two major extraordinary events cannot be classified as such for financial reporting purposes, then what qualifies? Hoyle, Paik, and Shi (2017) report that only 1.5 percent of firms reported extraordinary items in 2014. They also offer a complete historical background on the modifications that the reporting requirements of extraordinary items have experienced over the years, and the factors that led to

the decline in its use before its ultimate elimination. A recent trend that lessened the importance of the income statement classifications of events is the publication of the pro-forma income statements that focus on core earnings and disregard any events that management deems non-recurring. Such pro-forma core earnings statements are non-GAAP statements but published along side the GAAP statements (see for instance, Bhattacharya, Black, Christensen, and Larson 2003). However, Black and Christensen (2009) show that managers manipulate this non-GAAP earnings statement to reach certain desired targets by ignoring certain routine expenses. This is in contrast with the mandate of the Sarbanes-Oxley Act that the pro-forma statements be reconciled with the GAAP statements in order to improve information quality provided by these pro-forma statements.

DATA AND METHODOLOGY

The sample used in this paper includes all active U.S. firms with available data in CompuStat Research Insight over the years 1998-2017. Annual data is obtained for 7098 firms resulting in 90,585 firm-year observations. Data for the following three variables are obtained: Extraordinary Items *XI*, Total Income (Loss) *NI*, and total Taxes *TAX*. This paper explores whether extraordinary items tend to occur randomly in the normal course of business activities, or whether it is intentionally manipulated by accountants for the purpose of earnings management. In the case of earnings management, extraordinary items tend to be positive (that is, extraordinary income) when the overall business activity is down in the current year compared to the previous year. That is, $XI_t > 0$ *when* the following inequality holds:

$$(NI - XI + TAX)_t < (NI - XI + TAX)_{t-1} \tag{1}$$

where $(NI - XI + TAX)_t$ represents the total net income before tax and before extraordinary items for the current year *t*. On the other hand, extraordinary items tend to be negative (that is, extraordinary loss) when the overall business activity is better in the current year compared to the previous year. That is, managers may have delayed the recognition of an expense from last year (when business activity was relatively slow) to this year when business activity has picked up. Therefore, it is expected that $XI_t < 0$ *when* the following inequality holds:

$$(NI - XI + TAX)_t > (NI - XI + TAX)_{t-1} \tag{2}$$

Consider the following variable denoted by $dINC_t$ and defined as the difference between the income before extraordinary items and tax in the current period *t* and that from the prior period *t*-1 as follows:

$$dINC_t = (NI - XI + TAX)_t - (NI - XI + TAX)_{t-1} \tag{3}$$

Also, consider the following dummy variable denoted by *DUMXI*, where:

$$DUMXI = \begin{cases} 1, & if \ XI_t < 0 \\ 0, & otherwise \end{cases} \tag{4}$$

and the following dummy variable denoted by *DUMINC*, where:

$$DUMINC = \begin{cases} 1, & if \ dINC_t \geq 0 \\ 0, & otherwise \end{cases} \tag{5}$$

A logit regression model is then employed where *DUMXI* is regressed on *DUMINC*. If extraordinary items are being used by firms for earnings management purposes, then the coefficient estimate of the following logit regression model is expected to be positive and significant:

$$log \left(\frac{p_{xi}}{1-p_{xi}} \right) = b_0 + b_1 \ DUMINC \qquad (6)$$

where: p_{xi} = the probability of the extraordinary item being negative ($XI_t < 0$)

FINDINGS

Descriptive Statistics

Panel data spanning the years 1998 to 2017 on all active U.S. firms is obtained from CompuStat Research Insight. Information on the "Extraordinary Items" is missing for the years prior to 1998 and after the year 2017. The total number of firms is 7526. Firms with no consecutive data (with missing data in between these years) is dropped. This reduced the total number of firms studied to 7098. The following Table 1 provides the descriptive statistics where *XI* is the Extraordinary Items, *TAX* is the total income taxes and *NI* is the Net Income (loss).

TABLE 1
DESCRIPTIVE STATISTICS

Panel 1.A. All Firms (7098 firms)

	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
XI	-$1.71	$195.09	-$54,235.00	$5,097.00	-244.42	66,554.17
NI	$275.52	$1,798.95	-$99,289.00	$104,821.00	5.93	663.53

Panel 1.B. Firms who report XI at least once in the study period (1579 firms)

	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
XI	-$5.23	$341.07	-$54,235.00	$5,097.00	-139.80	21,772.65
NI	$425.30	$2,485.47	-$99,289.00	$104,821.00	2.09	438.05

Panel 1.C. Firms who did not report XI during the study period (5519 firms)

|	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
XI	-	-	-	-	-	-
NI	$202.71	$1,337.97	-$38,118.50	$98,806.05	14.51	681.46

The data comes from Compustat Research Insight database. The sample includes 7098 firms over the period 1998-2017 with a total of 90,585 firm-year observations. *XI* and *NI* refer to the Extraordinary Items and the Net Income, respectively.

Percent of Firms Who Report Extraordinary Items

The cross section of firms is examined to identify to what extent they report extraordinary items. The results show that 1579 firms (22.25% of all firms) reported extraordinary items at least once over the study period. That is, more than 77% of all firms do not report extraordinary items at all in the 20-year period examined. It seems, therefore, that extraordinary items, overall, are seldom used and truly extraordinary in nature. Now let us turn the focus on those 1579 firms that did report extraordinary items at least once in the

past 20 years and investigate the frequency by which they report these items. Figure 1 provides a graphical illustration of the frequency of reporting *XI* among the firms who did report them at least once over the study period. The findings show that, 739 firms (47% of the 1579 firms) did report *XI* at least 10% of the time. In addition, those firms who reported *XI* at least 15% of the time is about 24% of the firms.
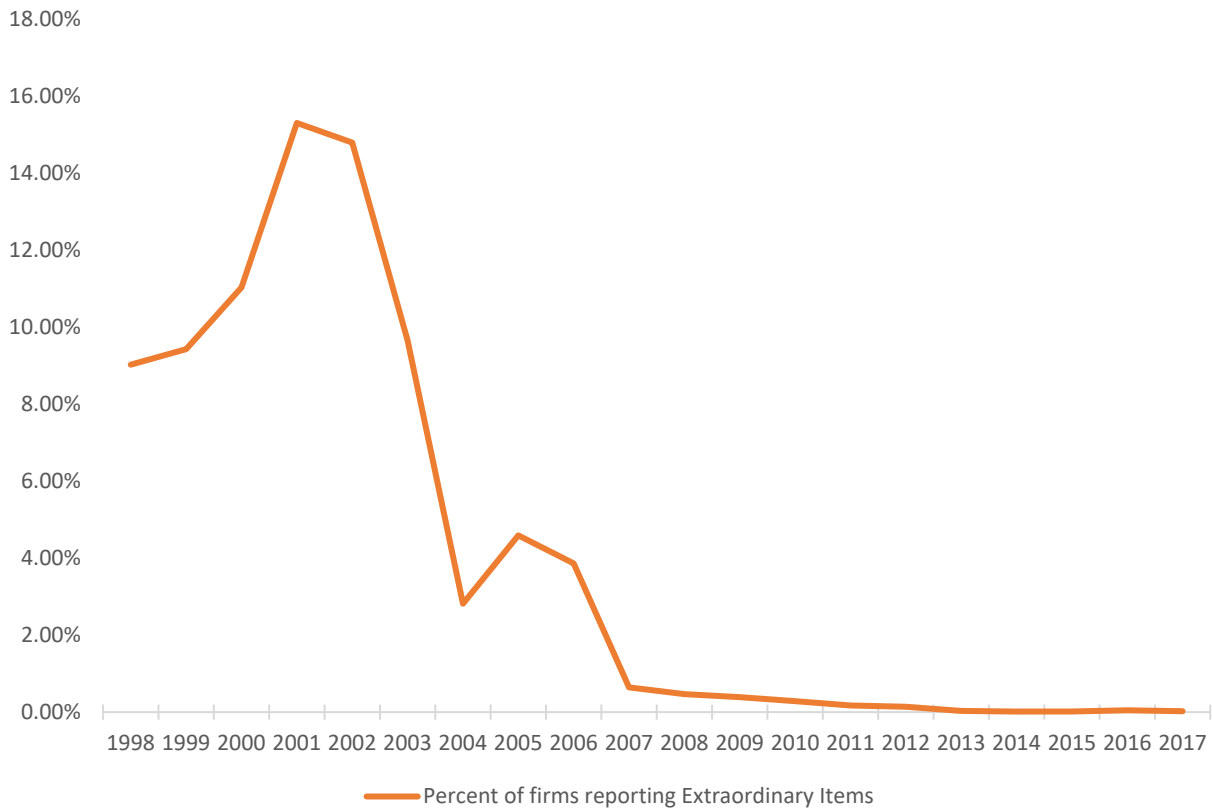
FIGURE 1
FREQUENCY OF REPORTING EXTRAORDINARY ITEMS AMONG FIRMS WHO REPORT THEM AT LEAST ONCE DURING THE 1998-2017 STUDY PERIOD
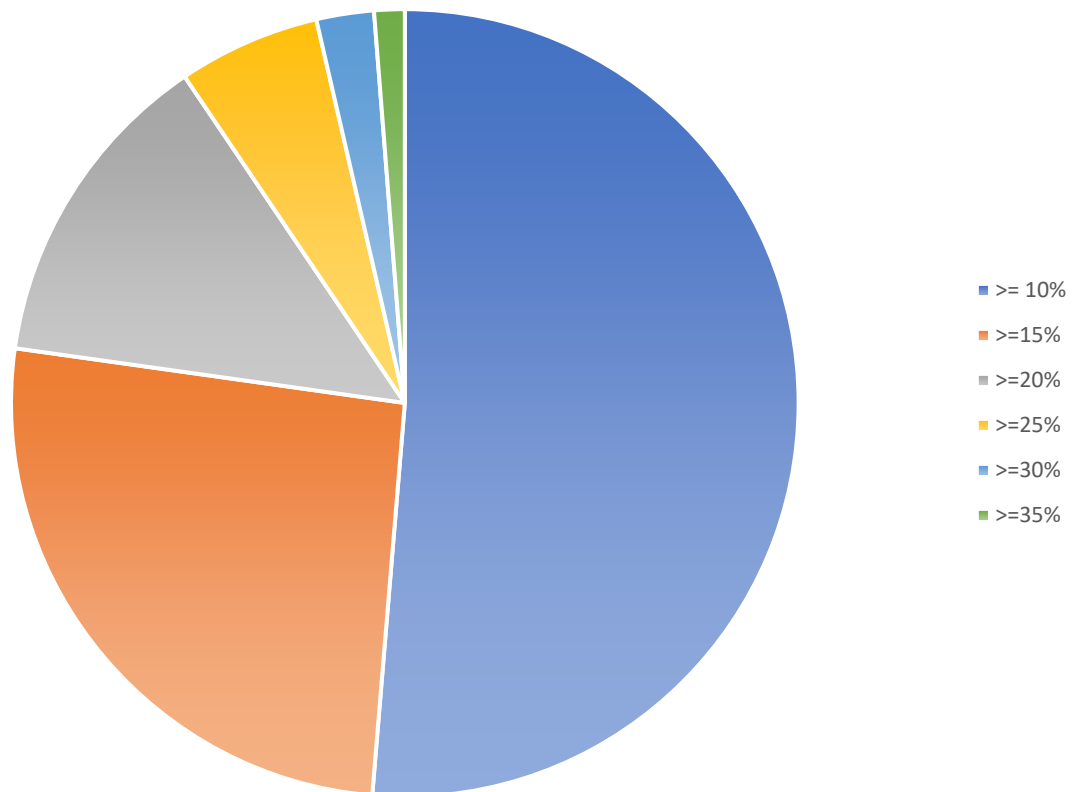
The figure shows that few firms report extraordinary items more than 35% of the time. Please note the chart does not include those firms who did not report extraordinary items during the study period.

Moreover, the frequency of *XI* reporting by firms is further investigated over time to detect any possible trends. Figure 2 tracks the number of firms who reported *XI* in each year over the 20-year period of study. The figure shows that in 1998, there are 261 firms (9% of the 2890 firms with available data this same year) reported *XI*. This percentage has steadily increased over time to reach a peak in the year 2001 when 537 firms (15% of the 3507 firms with available data this same year) reported *XI*. This percentage has retracted overtime to reach less than 1% in 2007 and less than 0.1% in the years 2013 and beyond. Overall, it seems that firms are reporting *XI* less frequently overtime with the peak recorded in 2001 possibly due to the extraordinary nature of the events that occurred that year (Sept 11 terrorist attacks).
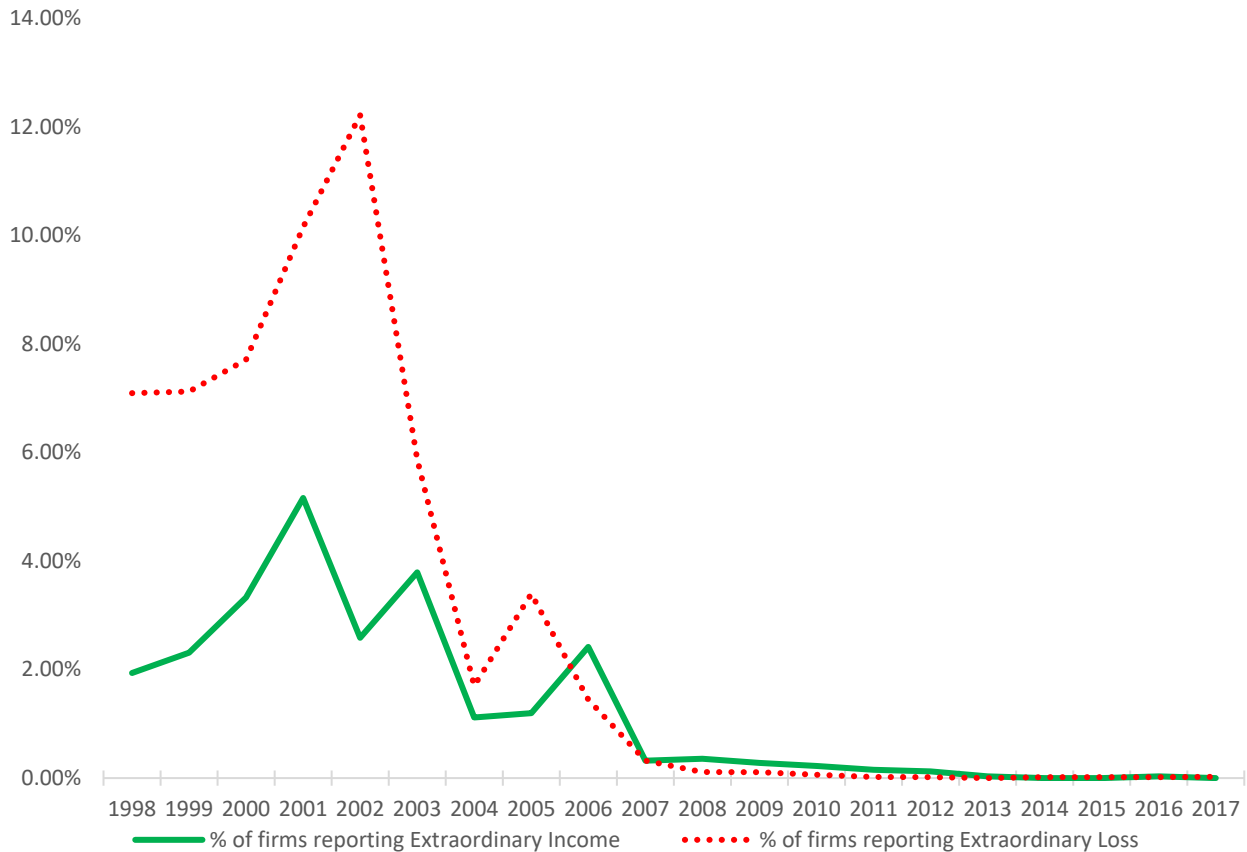
FIGURE 2
PERCENT OF FIRMS REPORTING EXTRAORDINARY ITEMS FOR EACH YEAR

The figure shows that reporting extraordinary items by firms steadily increased since 1998, reaching a peak in the year 2001. Subsequently, reporting extraordinary items has steadily declined to marginal percentages by the year 2007 and beyond.

Figure 3 shows that reporting extraordinary losses by firms are more common than reporting extraordinary income until the year 2007. Starting with the financial crisis in 2008 and beyond, extraordinary income becomes slightly more common albeit the fact that both are marginal.

FIGURE 3
EXTRAORDINARY INCOME V.S. EXTRAORDINARY LOSS FOR EACH YEAR

The figure shows that reporting extraordinary losses by firms are more common than reporting extraordinary income until the year 2007. Starting with the financial crises in 2008 and beyond, extraordinary income becomes slightly more common.

Extraordinary items are also measured as a percentage of the total firm's net income. The mean percentages are displayed in Figure 4 by year. It is noteworthy that extraordinary items as a percent of net income before extraordinary items and tax reached a peak of -84% in the year 2002. This coincides with the two peaks reported in Figure 1 (frequency of reporting *XI*) and Figure 2 (frequency of reporting negative *XI* (extraordinary losses)).

FIGURE 4
EXTRAORDINARY ITEMS AS A PERCENT OF NET INCOME
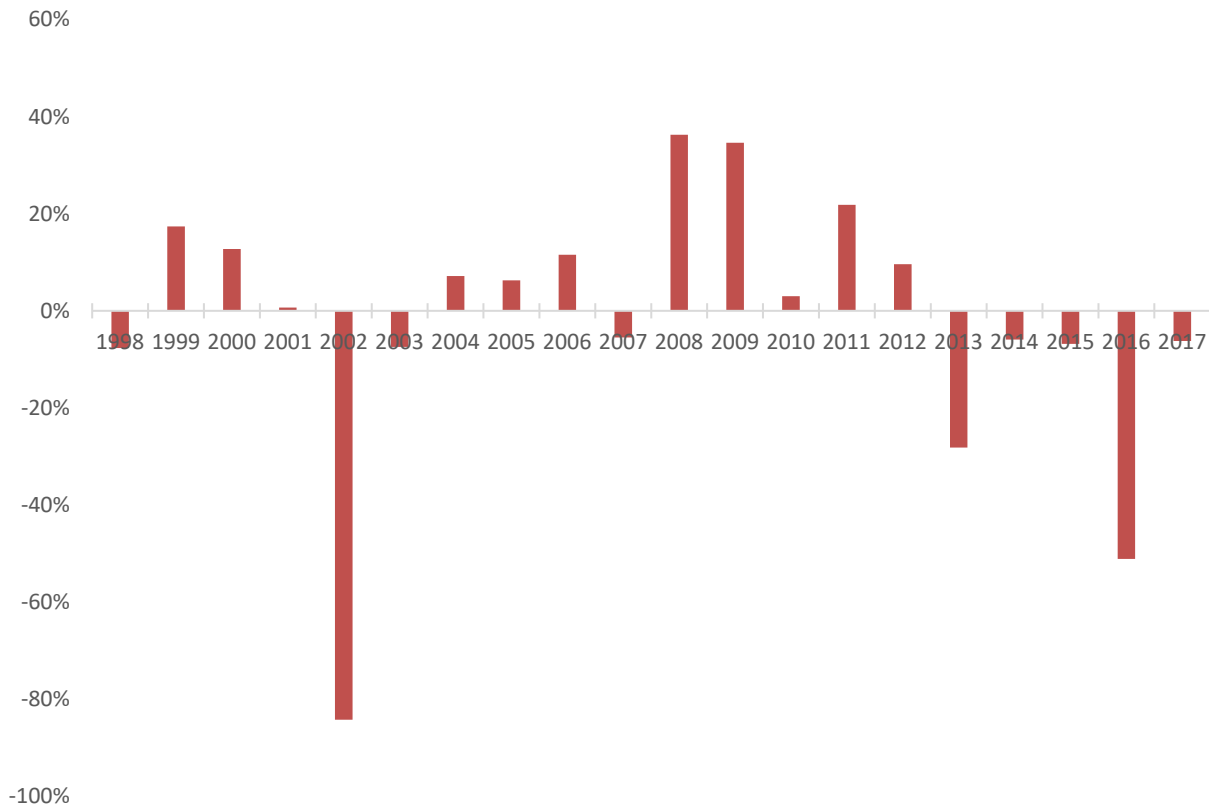
Do Firms Use Extraordinary Items for Earnings Management?

Despite the infrequent reporting of extraordinary items on the firms' books, it is important to examine whether those firms who report them do so for earnings management purposes. As such, we run the logit regression model (equation 6). If extraordinary items are being used by firms for earnings management purposes, then the coefficient estimate of the dummy variable *DUMINC* is expected to be positive and significant. Table 2 shows that this coefficient estimate is 0.135 and is highly significant. This implies that higher income before extraordinary items and before tax this period as compared to the prior period is associated with increased probability of reporting an extraordinary loss. In addition, the *dP/dX* ratio is 0.003 and shows the impact of a change in the value of the dummy variable on the probability to report an extraordinary loss. While the log likelihood ratio test of zero slopes is statistically significant at the 5% level, implying that the coefficient estimates are significantly different than zero, the scaled R^2 is unusually small raising concern about the explanatory power of the model. As such, an alternative model is also considered. This model associates past changes in income before extraordinary items and tax to current levels of extraordinary items and is presented as follows:

$$dXI_t = b_0 + b_1 dXI_{t-1} + b_2 dINC_{t-1} \tag{7}$$

TABLE 2
LOGISTIC REGRESSIONS

	Coefficient	*dP/dX*
Dependent Variable: DUMXI		
Constant	-3.984***	-0.077
	(-96.692)	
DUMINC	0.135**	0.003
	(2.543)	
LR (zero slopes)	6.521**	
Log Likelihood	-7437.7	
Scaled R^2	0.85E-4	
Correct Prediction	98%	

The following logistic regression model examines the association between changes in income before extraordinary items and before tax ($DUMINC$) on one hand and the tendency to report extraordinary items on the other hand.

$$Log\left[\frac{p_{XI}}{1-p_{XI}}\right] = b_0 + b_1\,DUMINC \qquad (6)$$

A positive sign implies that higher income before extraordinary items and before tax this period as compared to the prior period is associated with increased probability of reporting an extraordinary loss. The marginal effects (*dP/dX*) show the impact of a change in one independent variable while keeping other variables unchanged, at their mean levels. *** and ** represent significance at the 1% and the 5% levels of significance, respectively where *d* denotes the first difference operator, and the variables as previously defined. If extraordinary items are being used for earnings management purposes, then the coefficient estimate b_2 would be expected to be negative and significant. That is, higher income in the previous period would be smoothed out during the current period by reporting a lower extraordinary item (either a lower extraordinary income or an outright extraordinary loss). Table 3.a presents the findings for the pooled ordinary least squares regressions. The regression model has an R^2 equal to 26% with an insignificant Durbin_Watson statistic implying no autocorrelation present. In addition, the standard errors are heteroskedastic consistent. It is evident that the coefficient estimate b_2 is statistically insignificant implying no relationship between past changes in income and current changes in extraordinary items. That is, firms do not use extraordinary items for earnings management purposes. Panel 2.b reports the findings for the fixed effects model. The R^2 is roughly the same as in the pooled model and the coefficient estimate b_2 is again insignificant implying similar findings that extraordinary items are not being used for management earnings purposes. However, different results are obtained for the random effects model presented in panel 2.c. The coefficient estimate b_2 is positive and significant implying that higher income levels are associated with increased (not lower) extraordinary items. This finding is in contrast with the expectation of a negative relationship between the two if earnings management is present. It is important to note that the Hausman test static is insignificant. This means the random effects model is to be chosen over the fixed effects model. In summary, the pooled regression model and the random effects model paint two different pictures regarding the relationship between past income and current changes in extraordinary items. Overall, while extraordinary items are not frequently reported by firms, their use does not seem to be linked to earnings management. While the results of the regression models do not point towards earnings management, it is safe to say that investors should not be preoccupied with the reporting of extraordinary items as they may be random in nature. Forensic investors who are looking to detect possible earnings management being undertaken by firms, should be looking elsewhere in the financial statements for clues. Thus, given that reporting extraordinary items is infrequent, may not be motivated by earnings management, little value is added by eliminating them from financial statements. The burden of identifying extraordinary items is

simply being shifted from managers (insiders) to security analysts (outsiders). Thus, the decision to eliminate the required reporting of extraordinary items should be reconsidered by the FASB.

TABLE 3
PANEL DATA REGRESSIONS

Panel A	Dependent Variable	Independent Variables				
		Constant	dXI_{t-1}	$dINC_{t-1}$	Adj. R^2	DW
Pooled Regression	dXI_t	-0.401 (-1.255)	-0.515 *** (-39.749)	0.005 (1.115)	0.264	2.318

Panel B	Dependent Variable	Independent Variables				
		Constant	dXI_{t-1}	$dINC_{t-1}$	Adj. R^2	DW
Fixed Effects	dXI_t	--	-0.515 *** (-39.708)	0.005 (1.119)	0.215	2.319

Panel C	Dependent Variable	Independent Variables				
		Constant	dXI_{t-1}	$dINC_{t-1}$	Adj. R^2	DW
Random Effects	dXI_t	-0.401 (-0.141)	-0.515 *** (-93.947)	0.005*** (4.458)	0.264	2.318

This tables provides results from pooled regressions, fixed effects, and random effects. The regression models employ unbalanced panel data with 1577 firms that report extraordinary items at least once over the period 1998-2017 with a total of 24,895 firm-year observations. The model is as follows: $dXI_t = b_0 + b_1 dXI_{t-1} + b_2 dINC_{t-1}$ where XI refers to the Extraordinary Items, INC refers to the Income before Extraordinary Items and before Tax. The standard errors are heteroskedastic-consistent. The Hausman test yields a Chi-square statistic of 0.0003 that is insignificant. This implies that the random effects model is to be used. A positive sign implies that positive changes in income before extraordinary items and before tax in prior periods is associated with a positive change in extraordinary income in the current period. Taken together, the findings in this table, along with those in Table 2, regarding the effect of income in prior years on the extraordinary items in current periods do not point towards earnings management. *** represent significance at the 1% level of significance.

CONCLUSION

The Financial Accounting Standards Board (FASB) has eliminated the reporting requirements of extraordinary items on the income statement as approved by the Accounting Standards Update 2015-01. Two main reasons motivated such a change. The first is the complexity accountants face in classifying certain events as extraordinary according to set criteria. The second reason is the desire to merge the U.S. Generally Accepted Accounting Principles (GAAP) with the International Financial Reporting Standards (IFRS). While this decision is made in good faith, the FASB may have failed to consider the impact of this change on the ability of the public (investors and security analysts) to disentangle the core earnings from the non-recurrent ones. Internal accountants and managers have access to insider information not accessible to outsiders (investors and security analysts). Thus, despite the difficulty they encounter in identifying extraordinary items, they are in better positions than the outsiders to make those decisions. Regulators, instead of simplifying the criteria of identifying an item as extraordinary, they simply chose to throw the problem under the rug by eliminating this requirement. The burden, however, merely shifted from the internal accountants and managers to the outside investors and security analysts. As such, the elimination of the extraordinary reporting requirements adds little value to the financial community taken together (managers, accountants, security analysts and the public). This calls for reinstating the reporting requirement of extraordinary items. While the two main reasons why the reporting requirement of

extraordinary items have been eliminated from financial statements are not fully convincing, a main argument against reinstating them perhaps, is the tendency of managers to deploy them for earnings management purposes. This paper investigates the earnings management issue related to the use of extraordinary items using a logit regression model and a panel data regression model. The findings do not point towards earnings management being a motive behind reporting extraordinary items. As such, while the extraordinary items are found to be rarely used by firms, and are unlikely being used for earnings management purposes, the decision by the FASB to eliminate their reporting requirement should be reconsidered.

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