1992

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Publication Details

This working paper was originally published as Shannon, RP, and McCartney, B, Abnormal and Extraordinary Items - Time for Another Change?, Accounting & Finance Working Paper 92/39, School of Accounting & Finance, University of Wollongong, 1992.

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by

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November 1992

WORKING PAPER NO. 39

ABNORMAL AND EXTRAORDINARY ITEMS - TIME FOR ANOTHER CHANGE?

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This paper highlights some major problems which have arisen with the recent introduction in Australia of new definitions of abnormal and extraordinary items in AASB 1018 "Profit and Loss Accounts", which have brought our definitions more in line with international definitions in U.K., U.S.A. and Canada.

Evidence exists from an examination of the disclosures of these items by the top 150 listed Australian holding companies, over the period from 1987-1990, that the new definitions are still subjective and inappropriately allow the inclusion of ordinary operations items which are of a non-recurring nature in the operating profit before abnormal items figure and the abnormal items figure, thus posing a problem for any user wishing to estimate operating profit in subsequent period(s). In the light of these findings, the paper suggests an alternative approach to the treatment of currently defined abnormal and extraordinary items.

INTRODUCTION

The Australian Approved Accounting Standard AASB1018 "Profit and Loss Accounts" became effective for financial statement periods that ended on or after 31 December 1989.

The standard differs from the old AAS1 "Profit and Loss Statement" (previously applicable from 1 December 1974) in several respects, however two of these differences are of particular interest.

Firstly, the purpose of the standard seems to be more ambitious. Rather than merely attempting to facilitate evaluation of the profit or loss (old AAS1 para.1), the new standard requires disclosure of information about the profit or loss, so that users are provided with information which is necessary for an understanding of the financial position, performance, and financing and investing activities of the company or group of companies (AASB1018 para..03).

Secondly, the new standard includes new definitions of abnormal and extraordinary items. Abnormal items no longer need be only attributable to events or transactions of a type that are ordinary operations of a business entity, but can now be also attributable to events or transactions of a type that are outside ordinary operations. Extraordinary items must now not only be attributable to events or transactions of a type that are outside ordinary operations, but also not of "a recurring nature".

It would seem that arguments for the changes include greater consistency with international definitions in the U.K., U.S.A. and Canada (CF Wygal, Stout and Volpi [1987] and Baghel [1990]) and some reduction in choice in using alternative accounting treatments for similar items.

However, it can also be counter argued that the new standard has not done enough to address the core problem of the subjectivity surrounding the classification of an item as abnormal or extraordinary (See Loveday [1987], Pizzey [1987], Greener [1988] and

Hyndman and Kirk [1989] for criticisms of recent revisions to SSAP6 "Accounting for Extraordinary Items and Prior Year Adjustments" in U.K. and Herring and Jacobs [1987] and Chakravarty [1987] for criticisms of APB Opinion 30 in U.S.A.) and little to address what several studies have shown is information of "great importance" to most users -- the disclosure of information about the future economic outlook/prospects of companies. (Refer Kent Baker and Haslem [1973], Lee and Tweedie [1975] and Chenhall and Juchau [1976]). Users should not have to look beyond the profit figures to determine what profits are really attributable to the ongoing operations of a company.

The purpose of this paper is to critically examine the effects of the changes in the definitions of abnormal and extraordinary items. Evidence is presented which suggests the changes in definitions have not improved disclosure to users. In the light of this evidence an alternative approach for the treatment of currently defined abnormal and extraordinary items is recommended which focuses on a recurring items operating profit figure with any non-recurring items being shown separately, as "non-recurring items".

THE DECISION PROCESS PRE AND POST AASB1018.

The decision process for distinguishing abnormal and extraordinary items under pre-AASB1018 and post-AASB1018 are depicted in Figures 1 and 2 respectively.

Figure 1 shows that under the old AAS1 standard, the decision process was a relatively simple one requiring accountants to distinguish between ordinary and outside ordinary operations revenue and expense and other gains and losses. Ordinary operations items were required to be included in operating profit (loss) and any items which were abnormal by reason of their size and effect on the results were shown as abnormal items, usually in a separate note. Items outside of ordinary operations were required to be shown as extraordinary items and were usually disclosed separately on the statement itself in total (before tax, tax effect and after tax) and in detail in a note.

(Figure 1 about here)

Figure 2 shows the current decision process under the new AAS1 and AASB1018 standards. The process again requires accountants to distinguish between ordinary and outside of ordinary operations revenue and expense items. (No reference is now made to other gains and losses). Both ordinary operations items and those outside ordinary operations and of a recurring nature which are not abnormal by reason of their size and effect on results are now required to be included in operating profit (loss) before abnormal items. Items which by reason of their size and effect on results related to both ordinary operations and outside ordinary operations and of a recurring nature are required to be shown as abnormal items and are now usually separately disclosed on the statement itself in total (before income tax) and in detail in a note. Items which are outside ordinary operations and not of a recurring nature are required to be shown as extraordinary items and usually disclosed on the statement itself in total (before tax, tax effect and after tax) and in detail in a note.

(Figure 2 about here)

The effect of the change in definitions on instances and amounts of abnormal and extraordinary items actually disclosed by the top 150 listed Australian holding companies' consolidated accounts (selected on the basis of market capitalisation) is depicted in Tables 1 to 4 respectively. 1987 to 1989 figures relate to pre-AASB1018 definitions and 1990 figures are compiled (with a few exceptions only) under post-AASB1018 definitions.

Tables 1 and 2 show how abnormal items have significantly increased in number and amount in 1990. Tables 3 and 4 show how extraordinary items have significantly decreased in number and amount in 1990. Indeed, as Shannon and Wijewardena, in Ryan

et al [1991,p.194] highlighted, the new definitions have resulted in many items which were previously classified as extraordinary items now being disclosed as abnormal.
It would appear from analysis of figures from 1990 abnormal and extraordinary item disclosures (including disclosure reclassifications by many companies of 1989 comparative figures) that this reclassification has been substantially in the areas of gains/losses (g/l) realised on discontinued operations, g/l realised on sale of investments, g/l realised on sale of non-current assets and provisions for losses on investments.
Other interesting observations from the tables can also be made.
Firstly, the tables show that 1990 disclosures of extraordinary items are not as "rare" as the new AASB1018 presupposed (See Commentary, para.(vi)).
Table 3 shows that 94 (63 debit and 31 credit) extraordinary items were still disclosed in the 1990 consolidated accounts of the top 150 holding companies.
Table 4 shows that these extraordinary items still totalled to a substantial debit amount ($2,238,742,000), but a relatively minor credit amount ($325,126,000).
Compared with the previous three years total instances and amounts, debit extraordinary items have decreased substantially more in terms of instances than in dollar terms. In 1990, the instances of debit extraordinary items have decreased to approximately one quarter of previous instances, but in dollar terms they have less than halved their previous levels.
Secondly, and perhaps more importantly, reclassification does not appear to have affected the dominance of debit extraordinary item amounts over credit balances which traditionally existed, nor the relatively equal balance of abnormal item debit and credit amounts which previously existed. In 1990, the total abnormal item debit amount ($1,698,507,000) is only marginally greater than the total credit amount ($1,560,668,000), consistent with previous years.

PROBLEMS

In view of the above observations, it would appear that not enough has been done to address the core problem of subjectivity surrounding the classification of an item as abnormal or extraordinary.

The types of items listed above which have been reclassified to abnormal, would normally be expected to be outside ordinary operations and not of a recurring nature (ie extraordinary) assuming it is not usual to be in the business of discontinuing operations or selling long-term investments or non-current assets.

It would appear that many companies have opted to classify these items as abnormal on the grounds that the items do not equate with the wording used for one of the examples of extraordinary items in AASB1018 Commentary para (vi) (ie result from "the sale or abandonment of a significant business or all the assets associated with such a business").

In addition, the prediction that extraordinary items would become "rare" is not borne out by the facts, and the continued dominance of extraordinary item debit over credit balances, with no change to the relative equality of debit and credit abnormal item balances is evidence of possible manipulation of operating profit before extraordinary items results with a consequent effect on EPS calculations, particularly if compensating credit balances are not available.

In addition to the problem of subjectivity, the new definitions have done little to address the disclosure of profit figures which can help:

1) resource providers assessment of future profitability and hence "assist them in determining whether continued support of the entity's activities is warranted" (SAC2 Para 21).

2. recipients of goods and services assessment of the ability of a reporting entity "to continue to provide goods and services in the future, the likely level at which the goods

and services will be provided and the likely cost of the goods and services" (SAC2 Para 22).

A profit figure attributable to the ongoing operations of an entity is lacking as the new definitions still allow the inclusion of ordinary operations items which are of a non-recurring nature in the operating profit before abnormal items figure and in the abnormal items figure. Only outside ordinary operations items which are of a non-recurring nature are required to be distinguished.

The inclusion of these ordinary operations items which are of a non-recurring nature poses a major problem for any user wishing to estimate operating profit before abnormal items and abnormal items in subsequent period(s), unless other sections of the annual report (ie The Chairman's Address) covers this topic.

In summary, it would appear that the new definitions have resulted in the continuation of unreliable profit figures which have little relevance for decision makers. The two major qualitative characteristics of information detailed in SAC3 (relevance and reliability) are not being met.

SUGGESTED ALTERNATIVE DECISION PROCESS

Figure 3 shows a suggested alternative decision process.

(Figure 3 about here)

The alternative decision process would abandon the present subjective categorisation of abnormal and extraordinary items and omit ordinary operation items which are of a non-recurring nature from the operating profit before abnormal items figure and from the abnormal items figure. The operating profit figure would only include revenue and expense items which by their nature, are expected to recur in subsequent period(s).

Items currently shown as abnormal items, including those listed in AASB1018 Commentary para (ii) would be either included in operating profit, if they are expected to recur, or more likely shown as non-recurring items. Any recurring items which are abnormal by reason of their size and effect on the results would be shown as abnormal items in a separate note. Similarly, items currently shown as extraordinary items, including those listed in AASB1018 Commentary (vi), would continue to be separately shown on the statement itself in total (before tax; tax effect and after tax), but now as non-recurring items.

Revenue and expense items earned or incurred during the year related to any discontinued activities (eg dividend income received prior to the realization of investments) would still be regarded as recurring if the proceeds of the realization of such activities are used in ongoing operations.

The resulting operating profit figure would be more reliable, because simplifying the decision process would tend to reduce opportunities for bias, and be a figure which is more relevant to decision makers as it would more closely depict the future outlook/prospects of the company or group of companies and be a useful figure to compare with results in subsequent periods. Information which the studies detailed above as of "great importance" would be disclosed.

PROCEDURE TO IMPLEMENT SUGGESTED ALTERNATIVE DECISION PROCESS

In order to implement the suggested alternative decision process, certain changes to the definitions section of AASB1018 would be necessary.

The current definitions of abnormal and extraordinary items would be replaced by a new definition of abnormal items and a definition of non- recurring items.

The following are suggested:

"Abnormal items" means items of revenue and expense, brought to account in the period, which by their nature are expected to recur in subsequent period(s), but are considered abnormal by reason of their size and effect on the results for the financial period.

"Non-recurring items" means items of revenue and expense, which by their nature are not expected to recur in subsequent period(s).

The definitions of "operating profit or loss after income tax" and "operating profit or loss before income tax" would be replaced by:

"Operating profit or loss after income tax" means the profit or loss for the financial period before non-recurring items and after applicable income tax expense.

"Operating profit or loss before income tax" means the profit or loss for the financial period before non-recurring items and before applicable income tax expense.

The definition of "ordinary operations" would become obsolete.

CONCLUSION AND SUGGESTIONS FOR FURTHER RESEARCH

This paper has highlighted some major problems which have arisen following the recent changes in definitions of abnormal and extraordinary items in Australia.

Evidence exists:

1. that the new definitions are still subjective and that this problem is compounded by examples given in the Commentary section of the standard;

2. that the new definitions have done little to address potential manipulation of operating profit before extraordinary items figures and hence EPS calculations;

3. that the new definitions inappropriately allow the inclusion of ordinary operations items which are of a non-recurring nature in the operating profit before abnormal items figure and in the abnormal items figure, thus posing a problem for any user wishing to estimate both operating profit before abnormal items and abnormal items in subsequent period(s).

In the light of these findings, the paper suggests an alternative approach to the treatment of currently defined abnormal and extraordinary items which would abandon the subjective categorisation of abnormal and extraordinary items and focus on a recurring items operating profit figure, with any non-recurring items being shown separately as "non-recurring" items.

It is envisaged that this operating profit figure would be more reliable and be a figure which is more relevant to decision makers as it would more closely predict the future outlook/prospects of the company or group of companies and be a useful figure to compare with results in subsequent period(s). Information which studies have described as of "great importance" to most users would be disclosed.

Further research could be carried out in the following areas:

Firstly, the acceptability of this suggested approach to both users and preparers could be surveyed.

Secondly, knowledge of the incidence and value of non- recurring items in current operating profits before abnormal items and abnormal items could also be sought from companies.

Finally, studies could also test whether the proposed recurring operating profit figure has marginal information content and greater predictive power than current operating profit figures.

1 OLD DECISION PROCESS PRE-AASB1018

Revenue and expense items and other gains and losses attributable to events or transactions of a type that are:

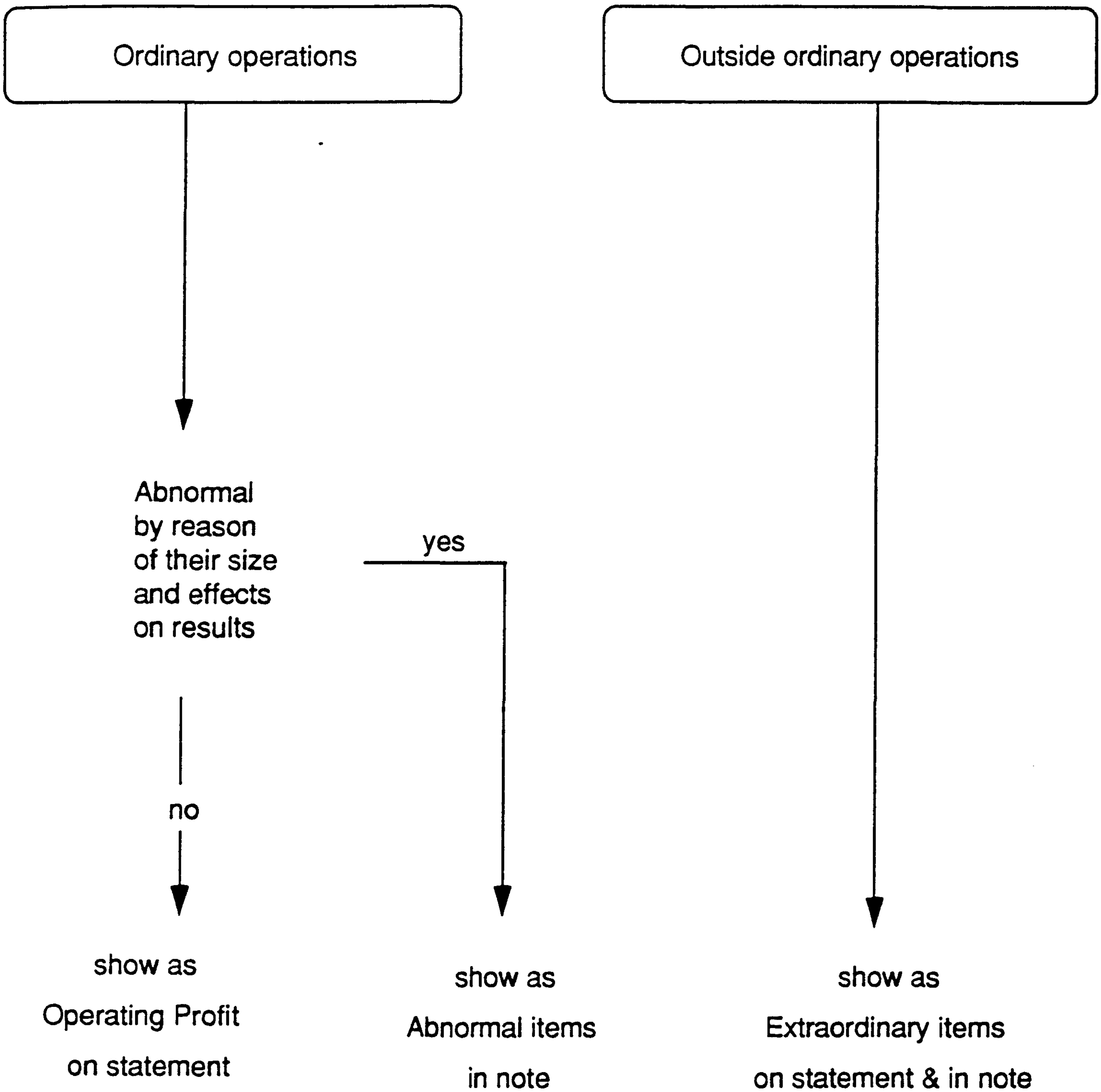
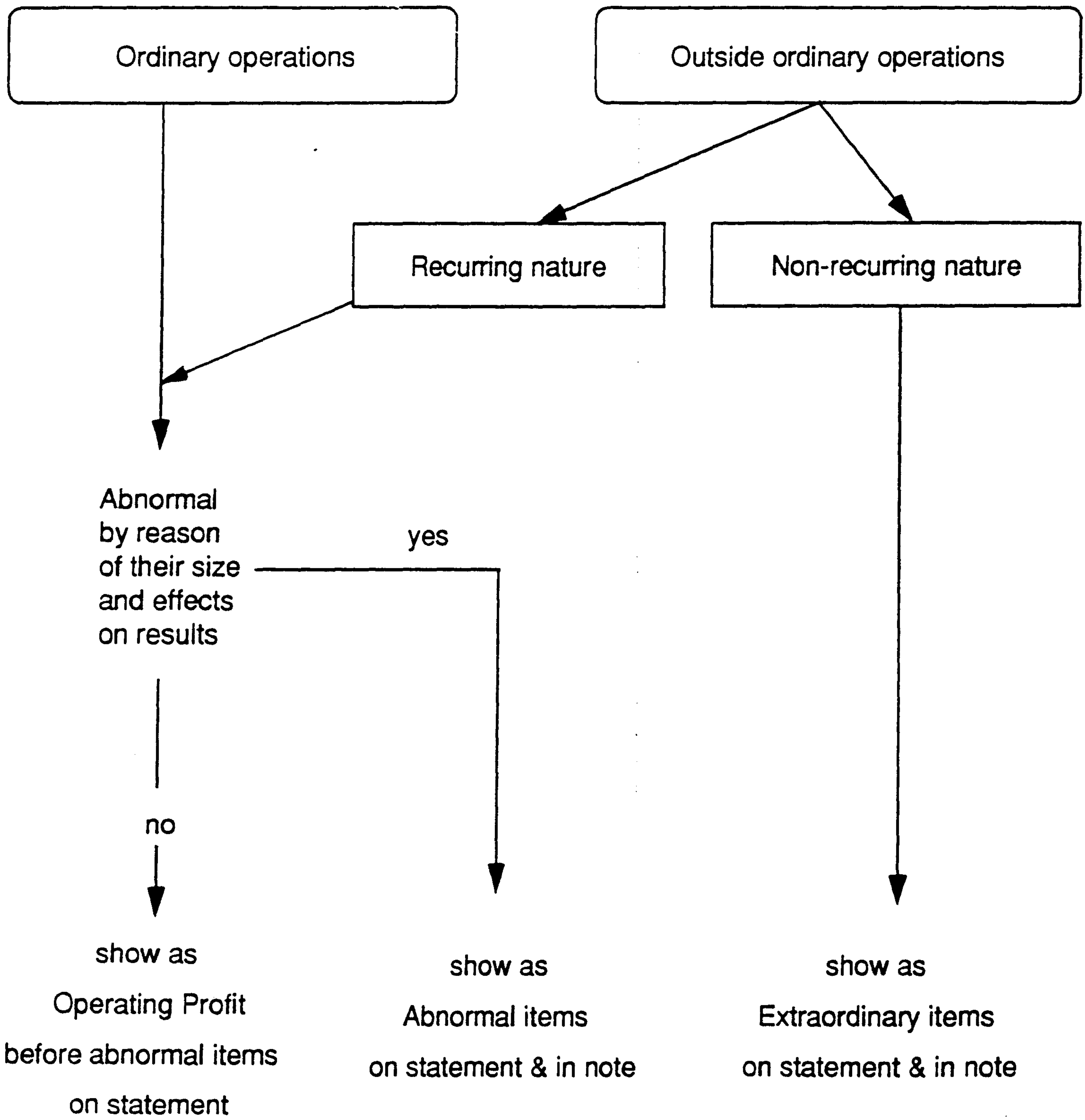


FIGURE 2 CURRENT DECISION PROCESS POST-AASB1018

Revenue and expense items attributable to events or transactions of a type that are:



3 SUGGESTED ALTERNATIVE DECISION PROCESS

Revenue and expense items attributable to events or transactions of a type that are:

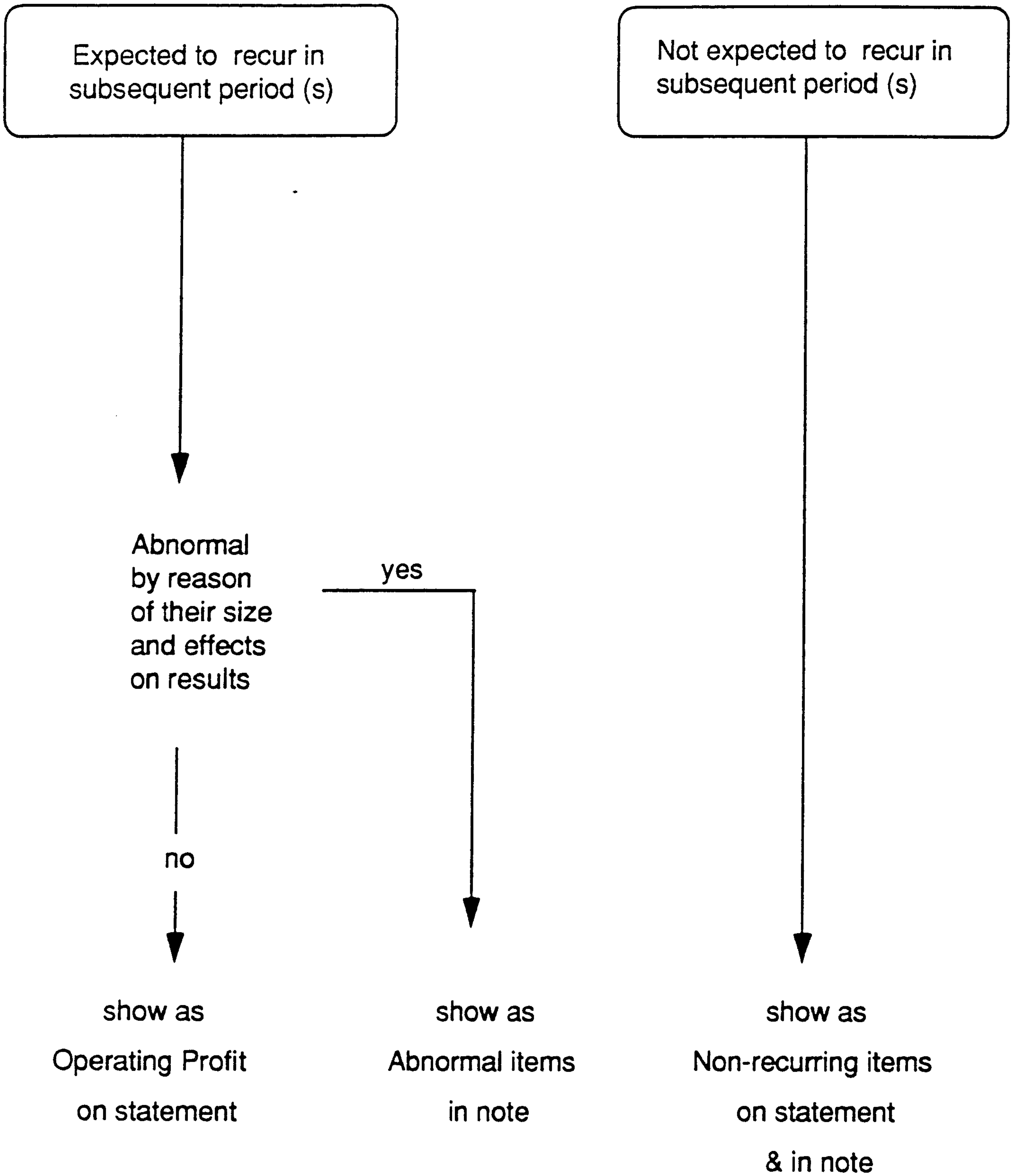


TABLE 1 ABNORMAL ITEMS								
	INSTANCES							
	1987		1988		1989		1990	
	DR	CR	DR	CR	DR	CR	DR	CR
Bad/doubtful debts expense		1			3		4	
Bonus or new share issue expenses	1						2	
Borrowing expenses	1						2	1
Change of accounting policy (method)		1				1		
Currency fluctuations	1	1		2	3	6	4	2
Depreciation adjustments			2		1	1	1	
Dividend from associated companies		1				1		
Employee benefits adjustments		1			1	1	4	2
Exploration &prospecting costs w/o	5		4	2	1		3	
G/L realised on discontinued ops	2		2	1	3	2	20	12
G/L realised on sale of investments		4	1	3	3	10	7	17
G/L realised on sale of n-c assets		3	1	7	2	11	5	12
G/L on revaluation of investments			2		2	1	4	2
G/L on revaluation of n-c assets					3		6	2
Goodwill w/o	2		2		1		8	
Insurance adjustments	1	1						1
Interest/holding costs on investments	1				2		1	
Inventories	2	1	2		3	2	2	
Lease income/transfers/sales					1	3		1
Legal expenses	1						2	
Preliminary expenses w/o	1						3	
Provision for losses on guarantees			2		3		1	
Provision for losses on investments	1		4		7		13	
Provisions w/back or no longer req.		1				4	1	4
Research expenses w/o	1				3		1	1
Sundry, other					1		2	1
Taxation adjustments		2					2	
Other	3	3	6	2	6	2	11	6
Total instances	23	20	28	17	49	45	109	64

TABLE 2 ABNORMAL ITEMS								
	AMOUNTS							
	1987		1988		1989		1990	
	DR	CR	DR	CR	DR	CR	DR	CR
	$000	$000	$000	$000	$000	$000	$000	$000
Bad/doubtful debts expense		24			141426		24085	
Bonus or new share issue expenses	696						2607	
Borrowing expenses	3000						22765	1184
Change of accounting policy (method)		1229				518		
Currency fluctuations	49751	6400		40082	113727	227394	38661	39889
Depreciation adjustments			6401		2437	5700	11496	
Dividend from associated companies		4500				18810		
Employee benefits adjustments		2585			10047	7528	53888	28262
Exploration &prospecting costs w/o	165550		54085	46183	33269		42682	
G/L realised on discontinued ops	43302		5831	8530	46988	25255	179618	187609
G/L realised on sale of investments		62143	169717	167707	8199	294977	86677	278720
G/L realised on sale of n-c assets		219520	160721	115250	1152	191310	14094	841776
G/L on revaluation of investments			407608		16025	1452	67162	11170
G/L on revaluation of n-c assets					100619		32889	9302
Goodwill w/o	42060		23855		1795		74587	
Insurance adjustments	1243	995						2750
Interest/holding costs on investments	2460				107417		47058	
Inventories	630	3513	1414		155602	6485	43069	
Lease income/transfers/sales					557	6104		19700
Legal expenses	20						2580	
Preliminary expenses w/o	166						65729	
Provision for losses on guarantees			5365		18845		7944	
Provision for losses on investments	10564		114039		55951		434003	
Provisions w/back or no longer req.		1333				51988	34939	36532
Research expenses w/o	89				39887		7735	6237
Sundry, other					19194		5410	74
Taxation adjustments		7456					48673	
Other	5596	6317	57277	226926	116967	4177	350156	97463
Total amount	325127	316015	1006313	604678	990104	841698	1698507	1560668

TABLE 3	EXTRAORDINARY ITEMS							
				INSTANCES				
	1987		1988		1989		1990	
	DR	CR	DR	CR	DR	CR	DR	CR
Bad/doubtful debts expense	1	1	3		5		1	
Bonus or new share issue expenses	5		5		7		1	
Borrowing expenses	5	4	2	1	2	1	2	
Consolidation adjustments	1	1	1		1		1	
Currency fluctuations	22	15	4	4	4	4		
Dividend from associated companies		2				1		
Employee benefitsadjustments	2	3	5	1			2	1
Environmental costs and compensat	1				1			
Exploration &prospecting costs w/o	3		1					
G/L realised on discontinued ops	49	7	48	26	52	11	28	9
G/L realised on sale of investments	15	61	10	29	17	37	4	16
G/L realised on sale of n-c assets	20	59	12	51	10	30	2	4
G/L on revaluation of investments	9	3	16	2	19	1	2	
G/L on revaluation of n-c assets	13		5		11	1	2	
Goodwill w/o	35		37	6	25	2	3	
Insurance adjustments			1			1		
Intangible assets w/o	5		4	1	9		2	
Inventories		2		1	1	1		
Lease income/transfers/sales		1		1	1	1		
Legal expenses	6		2		5		3	
Option fees		2						
Preliminary expenses w/o	4		4		1		1	
Provision for losses on guarantees			2		3		1	
Provision for losses on investments	14		11		11		2	
Provision for losses on l/t loans	2				3			
Provisions w/back or no longer req.		6		4		4		
Research expenses w/o	1		2		1			
Sundry, other	14	3	17	5	12	7	2	1
Taxation adjustments	22	24	33	37	21	21	3	
Other	7	3	10	4	5	1	1	
Total instances	256	197	235	173	227	124	63	31

TABLE 4 EXTRAORDINARY ITEMS								
		AMOUNTS						
	1987		1988		1989		1990	
	DR	CR	DR	CR	DR	CR	DR	CR
	$000	$000	$000	$000	$000	$000	$000	$000
Bad/doubtful debts expense	3049	1075	52213		30792		105000	
Bonus or new share issue expenses	1719		2217		10550		623	
Borrowing expenses	19918	1654	15488	157	2010	237	58634	
Consolidation adjustments	13504	740	5005		652		85977	
Currency fluctuations	743869	50186	6596	25703	23095	85780		
Dividend from associated companies		98802				150		
Employee benefitsadjustments	2623	7541	30554	19667			9328	2100
Environmental costs and compensat	1210				7493			
Exploration &prospecting costs w/o	1695		3550					
G/L realised on discontinued ops	331502	145270	631156	792735	676966	424143	986302	105625
G/L realised on sale of investments	99116	686674	41257	727534	84616	889684	776096	193109
G/L realised on sale of n-c assets	16189	1179067	18823	354498	37283	1112067	6313	24289
G/L on revaluation of investments	106407	1695	316047	386	569398	3634	13033	
G/L on revaluation of n-c assets	578429		92275		787177	1479	80873	
Goodwill w/o	847662		1725625	6825	620430	122	10785	
Insurance adjustments			4823			1509		
Intangible assets w/o	4398		244029	54516	369279		68961	
Inventories		2436		5633	200	3128		
Lease income/transfers/sales		1495		13960	1031	5900		
Legal expenses	8114		5432		47567		14093	
Option fees		5040						
Preliminary expenses w/o	2378		8279		1272		1868	
Provision for losses on guarantees			13892		40200		6100	
Provision for losses on investments	26663		58458		159309		12198	
Provision for losses on l/t loans	262				9818			
Provisions w/back or no longer req.		4118		25017		1770		
Research expenses w/o	27585		2527		816			
Sundry, other	10722	240	30847	604	37520	4819	1388	3
Taxation adjustments	71037	68641	111952	161387	182724	161590	470	
Other	123961	2993	409689	100552	42710	113	700	
Total amount	3042012	2257667	3830734	2289174	3742908	2696125	2238742	325126

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