Extraordinary Items

23.1 APPLICABLE AUTHORITATIVE PRONOUNCEMENTS

FASB Codification Sections: **FASB ASC 225-20-15**; **FASB ASC 225-20-50**; **FASB ASC 815-30-35**; **FASB ASC 225-30-50**

23.2 OVERVIEW

Extraordinary items are those that are both unusual and infrequent. An extraordinary item should be presented on the face of the income statement net of any income tax effect.

23.3 MEASUREMENT PRINCIPLES

23.3.1 Criteria for Extraordinary Status

To qualify as an extraordinary item, *both* of the following criteria must exist:

- It must be unusual in nature (the underlying event or transaction must be abnormal and unrelated, or incidentally related, to the ordinary activities of the business); and
- It must occur infrequently (the underlying event or transaction would not reasonably be expected to occur in the foreseeable future).

Generally, an event or transaction is presumed to be an ordinary and usual activity of the company unless the evidence clearly supports it as extraordinary and it meets both of the above criteria.

23.3.2 Unusual Nature

In determining whether an item is extraordinary, the following factors should be considered:

- Type of business
- Scope of operations
- Operating policies
- Lines of business

The environment in which the company operates is a primary consideration in determining the status of the underlying event or transaction. The environment includes characteristics of the industry, geographical location, and the nature and extent of government regulation. It is possible, therefore, that the same item may be ordinary for one company yet extraordinary for another. For example, a tornado may be considered ordinary for a company that operates in Kansas but extraordinary for one that operates in Florida. Note that "unusual nature" is not established by the fact that an event or transaction is beyond management's control.

As a further example, a gain or loss on the extinguishment of debt should not be considered unusual if the underlying transaction is part of the entity's ongoing activities to manage interest rate risk. Conversely, in other circumstances, a debt extinguishment can be deemed an extraordinary event (with any resulting gain or loss reported as an extraordinary item) if the transaction qualified as both unusual in nature and infrequent in expected occurrence.

23.3.3 Infrequent Occurrence

The environment in which a company operates must be considered in determining the probability of recurrence of a specific event or transaction. As with "unusual nature," the same item may be considered ordinary to one company but extraordinary to another. The past provides some evidence for the future. In the case of a tornado in Kansas, the past indicates that one may be likely to occur relatively frequently (if not regularly), and thus the financial effects of a tornado would ordinarily not be considered an extraordinary item.

23.3.4 Judgment

Judgment is necessary, of course, in determining the status of an item. It is therefore possible that the financial effects of an event might be reported as ordinary by one company and extraordinary by another company operating in the same or a similar environment. The importance of making a "correct" assessment of the circumstances lies solely in the placement of the item in reporting the economic impact of the underlying event. If it is deemed to be ordinary, it is reported above the caption in the income statement "Income from operations." If considered extraordinary, it is reported below that caption.

23.3.5 Items Not to Be Considered Extraordinary

The following items should not be reported as extraordinary because, by definition, they are usual in nature and may be expected to recur in the normal course of operations:

- Write-down or write-off of receivables, inventories, equipment leased to others, or intangible assets
- Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations
- Gains or losses on disposal of a component of an entity
- Other gains or losses from the sale or abandonment of property, plant, and equipment
- Effects of a strike, including those against competitors and major suppliers
- Adjustment of accruals on long-term contracts
- Costs in defense of a takeover attempt and costs incurred as part of a standstill agreement

There may be rare situations in which an event that meets both criteria for extraordinary status gives rise to a gain or loss that includes one or more of the items above that are not to be reported as extraordinary. In these cases, the gain or loss may be reported as extraordinary if it is a direct result of a *major* casualty (e.g., a flood in a location where the occurrence of a flood is not considered likely), an expropriation, or a prohibition under a newly enacted law. However, any related gain or loss that would have occurred if there were no major casualty should be considered ordinary.

23.3.6 Exceptions to Meeting Both Criteria

Even though they do not meet both criteria, the following items should be reported as extraordinary:

- Gains and losses that would otherwise not qualify as extraordinary (e.g., write-down of receivables or inventories, foreign exchange gains or losses, or gains or losses on disposal of a business segment) if the event that gave rise to such gains or losses is itself considered extraordinary.
- The investor's share of an investee's extraordinary items (This should be reported as part of the investor's extraordinary items.)
- Adjustments made in the current period of items classified as extraordinary in prior periods.
- The net effect of discontinuing the application of FASB ASC 980-10.
- The remaining excess of fair value of net assets acquired over cost in a business combination.

The EITF has reached a consensus regarding the classification of gain or loss resulting from the previous hedge of debt that is ultimately extinguished. The Task Force concluded that the amount reclassified from accumulated other comprehensive income to current earnings resulting from a cash flow hedge of debt (or of a forecasted debt transaction) should not be classified as an extraordinary item when the debt is extinguished.

The following examples illustrate application of the EITF consensus.

Example 1. Extinguished Debt Previously Subject to a Fair Value Hedge

FACTS

Assume that, on January 1, 20x1, Client Company, Inc. issues $10 million of debt with a coupon rate of 10%. The debt is payable on December 31, 20x7 and is callable at par beginning on January 1, 20x4. On January 1, 20x3, Client Company enters into a contract with EMW, Inc. to hedge the debt's embedded call feature. Under the terms of the contract, Client Company will pay EMW an amount equal to the fair value change in the debt resulting from a decrease in interest rates, and EMW will pay Client Company an amount equal to the change in the debt's fair value caused by an increase in interest rates. Also assume that interest rates have increased during 20x3 such that Client Company has a gain on the hedging instrument in the amount of $500,000 and a corresponding loss on the embedded call option.

Note that to be classified as extraordinary, the gain must meet both criteria for extraordinary status.

SOLUTION

Pursuant to FASB ASC 815-10, the carrying value of the debt is increased by $500,000, and current earnings for 20x3 is charged in the same amount. On January 1, 20x4, when Client Company calls the debt (early extinguishment), the $500,000 gain will be recognized.

Example 2. Extinguished Debt Previously Subject to a Cash Flow Hedge

FACTS

Assume that Client Company, Inc. issues $10 million of debt payable on January 1, 20x1. The interest rate is variable based on three-month LIBOR. The debt is payable on December 31, 20x5 but is callable at par beginning on January 1, 20x2. When the debt was issued, Client Company entered into a transaction with TGBT, Inc. qualifying as a cash flow hedge of interest payments. Also assume that LIBOR increases during 20x1 resulting in a $100,000 gain on the hedging instrument, which is recognized in other comprehensive income. Finally, assume that Client Company calls the debt on January 1, 20x2.

SOLUTION

In accordance with FASB ASC 815-10, the $100,000 gain is credited to other comprehensive income. When the debt is extinguished on January 1, 20x2, FASB ASC 815-10 requires that the $100,000 gain be transferred to current earnings from accumulated other comprehensive income. Pursuant to the EITF consensus, that amount should not be classified as extraordinary (i.e., it is thus excluded from the computation of extinguishment gain or loss).

Example 3. Extinguished Debt Previously Subject to a Cash Flow Hedge of a Forecasted Transaction

FACTS

Assume that, on January 1, 20x1, Client Company, Inc. plans to issue $10 million of fixed rate debt one year hence. To lock in a rate of 8%, Client Company enters into a cash flow hedge with GL, Inc. against future interest payments. Assume that rates have increased between January 1, 20x1 and January 1, 20x2 such that Client Company has a $200,000 gain on the hedging contract. Also assume that one year after the increase, on January 1, 20x3, the debt is extinguished.

SOLUTION

In accordance with FASB ASC 815-10, in 20x1, the $200,000 gain is recognized as other comprehensive income. When the debt is extinguished, on January 1, 20x3, the $200,000 gain is transferred to current earnings and, pursuant to the EITF consensus, it is not included in the computation of the gain or loss on extinguishment and it is not classified as an extraordinary item.

23.4 DISCLOSURES

23.4.1 In General

The following information should be disclosed on the face of the income statement:

The amount of income or loss before extraordinary items. (This caption will require modification if there are discontinued operations of a business segment and/or accounting changes.)

The amount of each significant item. Each item should be appropriately described under the general caption “Extraordinary items.”

The amount of income tax attributable to each item. This disclosure may be made in a note (Customarily, the amount of income tax is parenthetically noted on the face of the income statement.).

The amount of net income.

Earnings per share amounts before extraordinary items, and net income (Often, the per-share amounts of extraordinary items, either individually or in the aggregate, are also disclosed, although GAAP does not require such disclosure.).

In addition, the nature of each significant item should be described in a footnote.

23.4.2 Unusual or Infrequent Item

Virtually any significant transaction or event that is *either* unusual *or* infrequent (but not both) may be presented as a separate line item either in a multi-step or single-step income statement. Its position depends on the degree of emphasis desired, as long as it is a component of income from operations.

Regarding the impact of the terrorist attacks of September 11, 2001, the following information should be disclosed:

- A description of the circumstances of the losses and the amounts of such losses (and related insurance recoveries) that have been recognized in the financial statements.
- A description of contingencies not yet recorded that are reasonably expected to have an impact on the financial statements (e.g., future losses and/or probable future insurance recoveries).
- Applicable information pursuant to **SOP No. 94-6**, Disclosure of Risks and Uncertainties, and pursuant to **SOP No. 96-1**, Environmental Remediation Liabilities (see Section 33, CONTINGENCIES).

23.4.3 Examples

Thermodynetics, Inc. (2010 Form 10-K)

Example .

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 19 – DISCONTINUED OPERATIONS:

In August 2005, the Company discontinued the operations of Vulcan. From that date through March 31, 2007 the Company liquidated Vulcan's remaining assets and settled all secured liabilities. During the fiscal quarter ended September 30. 2010, the Company extinguished debts totaling $2,782,195, which reflected liabilities from Vulcan. Vulcan was closed during 2005 and all secured creditors were satisfied. The remaining liabilities were payable by Vulcan alone to unsecured creditors, and with the passing of their statutory rights, those liabilities were written off resulting in a gain, net of taxes of $1,582,195, which has been reflected as an extraordinary item.