HURRICANE KATRINA'S IMPACT ON FINANCIAL STATEMENTS

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ABSTRACT

It is now clear that Katrina's economic impact is more severe and far reaching than first thought. The damage to many companies is beyond belief and those companies will suffer huge losses, some are covered by insurance policies and many are not covered. Are these considered recurring losses or extraordinary losses? The ruling was that these losses don't meet the criteria for the extraordinary items. The authors argue that the size of the losses and the great impact which Katrina left on many industries make these losses true extraordinary.

Extraordinary Items

An extraordinary item is an unusual, infrequent and material item that must be reported separately from the results of continuing operations. ABP Opinion #30 (Reporting the results of operations) [1] defines the three characteristics as follows:
Unusual: Possessing a high degree of abnormality and unrelated to the ordinary activities of the firm, taking into account the environment in which the firm operates.
Infrequent: not expected to recur in the foreseeable future, taking into the account the environment in which the firm operates
Material: large enough to make a difference in an investor's decision
All the three characteristics must be present for an item to be reported as extraordinary. On the income statement, extraordinary items are reported net of taxes.

While there is no doubt that Hurricane Katrina is an extraordinary tragedy, it does not meet the strict criteria that would allow companies to classify it as an extraordinary item on their income statement. The two criteria of being "unusual in nature," and "infrequent in occurrence" are not met. Unless companies can successfully argue that is unlikely that a similar loss will occur within the next two years, they will be unable to label them as non-recurring items. Under Regulation S-K and Regulation S-B, companies cannot eliminate or smooth items identified as non-recurring, infrequent or unusual from their non-GAAP Performance measures if these charges or gains have occurred in the last two years or if it is reasonably likely that these charges or gains will occur again in the next two years.

The Financial Accounting Standard Board (FASB) and the U.S. Securities and Exchange Commission (SEC) do not leave much room for interpretation on this issue for GAAP reporting. The SEC staff is quite explicit regarding its view on the treatment of hurricane damage in places that are considered high-risk areas. According to the SEC's Division of Corporation Finance in a March 2000 document titled "Accounting Disclosure Rules and Practices," the severity of a natural catastrophe ordinarily would not impact the determination of whether an item is extraordinary if such events occur with relative frequency, though with less severity. For example, losses incurred as a result of a hurricane in Florida would not qualify for extraordinary items no matter how severe the storm, since tropical storms and hurricanes occur in that region on a regular basis. Like their neighbors in Florida, the rest of the Gulf Coast has a long history of hurricanes.

[1] AICPA, *Reporting the results of operations*; Accounting Principle Board Opinion #30, N.Y. 1973

The EITF's decision to disallow extraordinary item treatment of the impacts of September 11th was not to discount the damage to the economy, but just the opposite. The EITF believed that the events were so extraordinary that they were pervasive. The information which companies will disclose will have a major impact on the stock market. Some firms already gave warnings to investors. These firms include Cendant, Belo, Knight Ridder, EnterCom Communications, Hearst-Argyle Television, Tyson Foods, Northrop Grummen, Yellow Roadway and Books-a-Million.