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# Signaling Firm Performance Through Financial Statement Presentation: An Analysis Using Special Items

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**ABSTRACT:** This paper investigates whether managers' presentation of special items within the financial statements reflects economic performance or opportunism. Specifically, we assess special items presented as a separate line item on the income statement (income statement presentation) to those aggregated within another line item with disclosure only in the footnotes (footnote presentation). Our study is motivated by standard-setting interest in performance reporting and financial statement presentation, as well as prior research investigating managers' presentation choices in other contexts. Empirical results reveal that special items receiving income statement presentation are less persistent relative to those receiving footnote presentation. These results are consistent across numerous alternative specifications. Overall, the findings are consistent with managers using the income statement versus footnote presentation to assist users in identifying those special items most likely to differ from other components of earnings—that is, for informational, as opposed to opportunistic, motivations.

**Keywords:** *special items, strategic reporting, presentation, voluntary disclosure, pro forma*

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## **ABSTRACT**

This paper investigates whether managers' presentation of special items within the financial statements reflects economic performance or opportunism. Specifically, we assess special items presented as a separate line item on the income statement (income statement presentation) to those aggregated within another line item with disclosure only in the footnotes (footnote presentation). Our study is motivated by standard-setting interest in performance reporting and financial statement presentation, as well as prior research investigating managers' presentation choices in other contexts. Empirical results reveal that special items receiving income statement presentation are less persistent relative to those receiving footnote presentation. These results are consistent across numerous alternative specifications. Overall, the findings are consistent with managers using the income statement versus footnote presentation to assist users in identifying those special items most likely to differ from other components of earnings—that is, for informational, as opposed to opportunistic, motivations.

# **Signaling Firm Performance Through Financial Statement Presentation: An Analysis Using Special Items**

## **1. Introduction**

This paper investigates whether managers' presentation of special items within the financial statements reflects informational versus opportunistic motivations. The presentation decision we examine is whether management disaggregates special items as a separate line item on the income statement (income statement presentation) or aggregates them into another line item with identification only via footnote disclosure (footnote presentation). Under both presentation choices, the special item is recognized, i.e., reflected in net income. By informational motivations, we suggest managers use the income statement versus footnote presentation as a mechanism to assist users in better understanding the economic implications of the reported special items. By opportunistic motivations, we suggest managers use this presentation decision to bias perceptions of the firm's performance.

To distinguish between these motivations, we follow prior research and examine the mapping of special items into the firm's future performance: that is, the persistence of reported special items (Burgstahler, Jiambalvo, and Shevlin 2002). We predict that informational motivations are revealed by correspondence between the reporting signal (i.e., the presentation choice) and the economic signal (i.e., the economic performance of the reported special items). That is, informational motivations suggest that those special items receiving income statement presentation are less persistent relative to those receiving footnote presentation. In contrast, we predict that opportunistic motivations are revealed by a lack of correspondence between the presentation choice and economic performance of the reported special items. That is, opportunistic motivations suggest that those special items receiving income statement presentation are more persistent compared to those receiving footnote presentation.

Our study is motivated by academic interest in manager disclosure decisions generally (e.g., Healy and Palepu 2001), as well as literature examining disaggregation (Dye and Sridhar 2004) and the characteristics of permanent versus transitory components of earnings (e.g., Brooks and Buckmaster 1976; Elliott and Hanna 1996). These papers provide evidence that disaggregation of elements with differing implications for firm performance improves the information set about the firm. In addition, our paper is motivated by standard-setter interest in financial statement presentation, which arises from the flexibility managers have in these reporting choices and the potential implications of these choices for financial statement users (FASB 2006; IASB 2006). Consistent with this perspective, our study is also motivated by experimental evidence that financial statement presentation choices can affect user judgments (e.g., Hirst and Hopkins 1998; Maines and McDaniel 2000).

We choose managers' presentation of special items on the income statement as our experimental setting for the following reasons. First, special items have been shown to have differing properties relative to other components of income (e.g., Lipe 1986), suggesting differential presentation in the financial statements may assist users in understanding their properties. Second, special items have been increasing in frequency and magnitude over time (e.g., Elliott and Hanna 1996; see also Appendix A), suggesting they are economically significant reporting elements. Further, financial reporting standards have recently incorporated additional reporting elements—particularly those relating to fair value accounting—likely to have similar attributes to the special items we examine.<sup>1</sup> Third, prior research demonstrates that special items are heterogeneous across a number of characteristics (e.g., Francis, Hanna, and Vincent 1996; Burgstahler, Jiambalvo, and Shevlin 2002), providing cross-sectional variation that we exploit in

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<sup>1</sup> For example, special items tend to have lower serial correlation than other components of earnings. Similarly, changes in fair value have (in expectation) low or zero serial correlation.

our empirical examination. Finally, we conjecture that special items provide a strong setting for examining motivations underlying managers' financial statement presentation choices, as the reporting of special items typically reflects substantial inherent uncertainty (e.g., the success of a restructuring) and measurement error (e.g., estimation of impaired goodwill).

Our empirical tests use hand-collected data spanning 1993-2002 for a sample of 500 U.S. firms within the S&P 1500. Data are collected to enable measurement of both the specific composition of the reported special items as well as the related financial statement presentation choice. We observe considerable variation in the income statement versus footnote presentation of special items—both across and within firms. Overall, empirical results reveal that special items receiving income statement presentation are less persistent relative to those receiving footnote presentation. These results are consistent across a number of alternative specifications. More detailed analysis reveals that the lower persistence of special items receiving income statement presentation occurs primarily within negative (i.e., income-decreasing) special items, and particularly within restructuring and merger and acquisition charges. If income statement presentation is a mechanism for managers to signal earnings components having differential properties, and if persistence provides a reasonable measure to capture economic implications of reported special items' for the firm's future performance, then the relatively lower persistence of special items receiving income statement presentation is consistent with managers (on average) using the presentation decision for informational, versus opportunistic, motivations.

Our paper contributes to the accounting literature in three primary ways. First, we build on prior research examining managers' reporting behavior in other types of financial reporting presentation choices, particularly that investigating pro forma reporting (e.g., Schrand and Walther 2000; Bhattacharya et al. 2003). A number of these studies conclude that managers act

opportunistically in their reporting decisions. In contrast, our results focusing on a different presentation decision—that *within* the primary financial statements—suggest that managers use this presentation consistent with informational motivations. Second, we build on prior research documenting differential properties across special items (e.g., Francis, Hanna, and Vincent 1996; Burgstahler, Jiambalvo, and Shevlin 2002) by showing that the properties of special items also differ across their presentation within the primary financial statements. Finally, we provide evidence that managers’ presentation decisions for this subset of reporting elements does capture differing economic qualities, consistent with observed user behaviors surrounding such decisions in experimental settings (e.g., Hirst and Hopkins 1998; Bhattacharya et al. 2007).

The remainder of this paper is organized as follows. Section 2 discusses related prior research, motivation, and our hypothesis development. Section 3 presents the research design. Section 4 discusses our sample selection and descriptive data. Section 5 presents our empirical results. Section 6 provides sensitivity analyses. Section 7 provides preliminary evidence on the market response to this presentation choice. Section 8 concludes.

## **2. Prior Research, Motivation, and Hypothesis Development**

Theory on management disclosure (see Healy and Palepu 2001 for a review) suggests that disclosure decisions reflect both informational motivations (that is, managers use these decisions to inform financial statement users about the underlying economics of their firms) and opportunistic motivations (that is, managers use these decisions to bias users’ perspectives). Applying this theoretical framework, the literature examining pro forma reporting suggests that managers use discretion for both informational and opportunistic reasons (Bradshaw and Sloan 2002). Several papers provide empirical evidence consistent with opportunism. Schrand and

Walther (2000) examines earnings press releases, and documents that managers are more likely to separately announce a prior-period gain from the sale of assets than a loss, consistent with managers opportunistically selecting the prior-period earnings amount used as a benchmark to evaluate current-period earnings. Similarly, Doyle, Lundholm, and Soliman (2003) finds that pro forma items have predictive ability for future cash flows; such predictive power is inconsistent with their exclusion from GAAP earnings, and suggestive of opportunistic reporting choices. Finally, McVay (2006) documents that managers opportunistically shift reported expenses from core expenses (such as cost of goods sold) to special items, thereby overstating “core” earnings. Other papers provide evidence supporting both informational and opportunistic motivations underlying pro forma reporting choices. Lougee and Marquardt (2004) finds that firms with low GAAP earnings informativeness are more likely to disclose pro forma earnings consistent with motivations to accurately reflect the firm’s performance; however, the direction of the GAAP earnings surprise is also an important determinant of this decision, consistent with opportunistic motivations. Similarly, Bowen, Davis, and Matsumoto (2005) provides evidence that managers emphasize metrics that portray more favorable firm performance; however, these same metrics are also more value relevant.

We build upon this literature by examining an alternative presentation decision. Specifically, we examine a presentation choice *within* the primary financial statements: namely, that of disaggregation versus aggregation within the income statement. Despite significant interest by standards setters (FASB 2006; IASB 2006), this presentation decision has received scant empirical investigation. Thus, we build upon notions of disaggregation (e.g., Dye and Sridhar 2004) to examine managers’ choice to present separately certain elements within the financial statements. Similar to the pro forma literature, our analysis is motivated, in part, by prior



experimental research that presentation choices can affect the costs to users to identify, interpret, and weigh the implications of reported items for the firm (e.g., Hirst and Hopkins 1998; Maines and McDaniel 2000; Elliott 2006).

Related, we build upon prior research documenting the heterogeneous nature of special items. These papers reveal that special items vary in the bias affecting their recognition (Francis, Hanna, and Vincent 1996; Riedl 2004) and in their persistence (Burgstahler, Jiambalvo, and Shevlin 2002). Thus, we combine the voluntary disclosure literature, which generally has not examined presentation choices within the financial statements, with the special items literature, which documents variation across types of special items, to examine whether special items systematically differ across their presentation within the financial statements.

Our choice of special items is intuitive as an empirical setting for the following reasons.<sup>2</sup> First, proper identification and labeling of this type of charge is likely relevant for financial statement users, as these items typically have differing properties from other components of earnings (e.g., Lipe 1986; Elliott and Hanna 1996; Fairfield, Sweeney, and Yohn 1996; Burgstahler, Jiambalvo, and Shevlin 2002). Second, special items have increased dramatically in frequency and magnitude over recent years (see Appendix A), suggesting these are economically significant items for many firms. Further, special items represent reporting events where opportunities to inform or bias perceptions through presentation choice are likely exacerbated, owing to the high uncertainty (such as the success of a restructuring endeavor) and challenging measurement issues (such as estimating an impairment) typically surrounding them. Finally, there are no rigid guidelines regarding the presentation of such items, except that they must be included

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<sup>2</sup> *Accounting Principles Board 30 – Reporting the Results of Operations* defines special items as charges that are infrequent or unusual in nature. Related, our analysis excludes discontinued operations, extraordinary items, and effects of changes in accounting principle. All three qualify for specific treatment under US GAAP: each must be disclosed separately, net of applicable taxes, on the income statement below income from continuing operations.

in operating income. Thus, managers have significant discretion over how to present special items within the financial statements.<sup>3</sup> In particular, managers may present special items in one of two ways: disaggregated as a separate line item on the income statement with likely discussion in the footnotes (i.e., *income statement presentation*), or aggregated within another line item on the income statement with identification and discussion only via the footnotes (i.e., *footnote presentation*). In both cases the special items are recognized, i.e., reflected in net income. The manager choice is the mechanism to reveal this: either via the income statement or the footnotes. This reporting choice allows managers to signal the economic properties of the special item (e.g., whether it is more or less persistent), thus potentially assisting users in determining the implications—i.e., the correct weighting—to place on the special item.

Motivated by theory underlying manager disclosure and presentation choices, our analyses examine whether presentation of special items within the financial statements (on average) reflects informational versus opportunistic motivations. The analyses distinguish between these motivations by examining the correspondence between the reporting signal for special items and their economic characteristics. Thus, empirically disentangling these motivations requires proxies for the reporting and economic signals. The reporting signal is easily observed: it is the income statement versus footnote presentation of the special items. To capture the economic signal, we follow prior research examining properties of special items, which documents that special items have lower persistence relative to other income statement reporting elements (Burgstahler,

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<sup>3</sup> While we explicitly incorporate the magnitude of the special item into our research design, we are unaware of any rules imposing an income statement presentation requirement based on materiality. Firms are required to “identify” (i.e., disclose) all material events; however, they have discretion in the presentation decision as it relates to the financial statements, including the income statement. As an example, the SEC raised questions to IBM regarding its 1999 annual report, in which IBM aggregated a \$4.06 billion gain from the sale of a subsidiary, which was identified in the footnotes but presented as an offsetting item within SG&A on the income statement. However, the matter was subsequently dropped, and IBM was not required to amend its filings (Bulkely 2002).

Jiambalvo, and Shevlin 2002; Doyle, Lundholm, and Soliman 2003). Accordingly, we employ persistence of the special items as the economic signal.<sup>4</sup>

Thus, our primary empirical tests compare the persistence of special items receiving income statement presentation to that for special items receiving footnote presentation. We make the following two competing predictions. First, under the informational hypothesis, managers will use the presentation decision as a mechanism to signal the economic properties of reported special items. Accordingly, we predict that special items receiving income statement presentation will have lower persistence (on average) relative to special items receiving footnote presentation. For example, if managers use income statement presentation to signal differing properties relative to other income statement components, then negative special items receiving income statement presentation will have lower persistence relative to those receiving footnote presentation. Thus, under the informational hypothesis, we expect to observe correspondence between the reporting signal (the presentation choice for the special items) and the economic signal (the persistence of the special items).

Second, under the opportunistic hypothesis, managers will use the presentation decision to misrepresent the economic properties of reported special items. Incentives underlying this opportunism may be characterized in two ways. First, managers have incentives to inflate reporting heuristics such as “core earnings” (e.g., due to capital market pressures). Second,

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<sup>4</sup> The persistence of special items—i.e., their effect on the firm’s future performance—can manifest in two primary ways. First, additional special items may be reported in the future, consistent with the serial correlation of special items documented in prior research (e.g., Elliott and Hanna 1996). For example, a firm reporting a restructuring may incur additional restructuring charges in the future conditional on the success of the initial restructuring; or a firm reporting an impairment may require a restructuring of the associated business segment in the future due to underperformance. Second, reported special items may be indicative of generally depressed future economic performance, consistent with the underperformance of firms reporting special items (e.g., Elliott and Shaw 1988). For example, a firm reporting a substantial impairment may have reduced future revenue and/or depressed margins, owing to a shift in the competitiveness of the operations in which the impairment occurred. These situations can result in special items not being (completely) transitory, both with respect to future additional special items, as well as future performance generally.

managers have incentives to lower such heuristics (e.g., due to political costs for reporting excessive earnings). Restated, incentives to inflate “core earnings” will lead a manager to behave opportunistically by mischaracterizing non-persistent positive special items (i.e., gains) as persistent via footnote presentation, and to mischaracterize persistent negative special items (i.e., losses) as non-persistent via income statement presentation.<sup>5</sup> Similarly, incentives to reduce “core earnings” will lead a manager to behave opportunistically by mischaracterizing persistent positive special items as non-persistent via income statement presentation, and to mischaracterize non-persistent negative special items as persistent via footnote presentation. In both instances, this leads to a lack of correspondence between the reporting signal and the economic signal. Accordingly, under the opportunistic hypothesis, we predict that special items receiving income statement presentation will have higher persistence (on average) relative to those receiving footnote presentation.<sup>6</sup>

We note a potential confound that can affect our inferences. For a particular subset of observations—namely “big bath” observations—opportunism can affect both the presentation *and* recognition of special items. With regards to our predictions, this subset of observations will have a competing inference that our analyses cannot distinguish. Specifically, under “big bath” reporting, managers recognize “excessive” (that is, non-economic) negative special items (e.g., Francis, Hanna, and Vincent 1996; Riedl 2004). These special items are likely to both receive income statement presentation (as managers likely wish to frame such charges as non-recurring) and be transitory (due to bias introduced in the recognition of these items). Thus, for the subset of “big bath” special items, observed lower persistence for those receiving income statement

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<sup>5</sup> Note that there are no opportunistic incentives to present persistent positive special items in the footnotes. Similarly, there are no opportunistic incentives to present a non-persistent loss on the face of the income statement. These cases are “null sets” under opportunistic incentives to inflate core earnings.

<sup>6</sup> Underlying both hypotheses is an assumption that managers perceive that users differentially weigh special items across this presentation choice: i.e., that this presentation choice can affect user decisions.

presentation cannot distinguish between informational motivations (that is, managers providing income statement presentation to alert users to economically more transitory components) versus opportunistic motivations (that is, managers providing income statement presentation for special items that are biased or non-economic).<sup>7</sup> Thus, we first conduct our analyses using all available observations; however, due to the above confound, we then exclude “big bath” observations and focus our analyses on “non-big bath” observations, which allows cleaner inferences regarding informational versus opportunistic motivations.

### **3. Research Design**

We test the above hypotheses as follows. First, we model the determinants of the presentation of special items and test if persistence is a significant determinant. Second, we examine whether the persistence of special items varies across the presentation decision. We use two tests for the following reasons. The first estimation allows us to model managers’ presentation of special items directly using an *ex ante* measure of managers’ expectation of special items’ persistence to distinguish between informational versus opportunistic motivations. In contrast, the second estimation uses an *ex post* measure of persistence to assess the mapping of firm level special items conditional on their presentation into future performance. Thus, we view the two analyses as complementary.

#### ***Determinants of Financial Statement Presentation of Special Items***

First, we employ the following regression model to examine the determinants of management’s presentation of special items separately on the income statement (income statement

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<sup>7</sup> Other common earnings management incentives to recognize special items (such as income smoothing) do not lead to competing explanations regarding our persistence measure; accordingly, we focus only on the “big bath” notion.

presentation) versus aggregated into another line item with identification only via footnote disclosure (footnote presentation):

$$SI\_Sep_{it} = \delta_0 + \delta_1 YEAR_t + \delta_2 SIZE_{it} + \delta_3 INST_{it} + \delta_4 SI\_MAG_{it} + \delta_5 IS\_DISAGG_i + \delta_6 SI\_PERSIST_{it} + \delta_7 NSI_{it} + \delta_8 MISS\_BENCH_{it} + \delta_9 BEAT\_BENCH_{it} + \phi_{it} \quad (1)$$

*SI\_Sep* is the percentage of special items reported within a separate line item on the income statement for firm *i* in fiscal year *t*. This is measured as the absolute amount of special items receiving income statement presentation, divided by the absolute amount of total reported special items; thus, the variable ranges in value from 0 to 1, inclusive. Note that positive (i.e., income-increasing) and negative (i.e., income-decreasing) special items are not netted in this calculation.<sup>8</sup>

The model includes five control variables. First, we include *YEAR* (year) as the likelihood of presenting special items separately on the income statement may be changing over time; for example, pro forma reporting increased over our sample period (e.g., Bradshaw and Sloan 2002). Second, we include *SIZE* (the log of firm *i*'s year *t* sales) to control for differing investing and information environments across variously sized firms on the presentation decision. Third, we include *INST* (the percentage of firm *i*'s common shares outstanding owned by institutions at the end of year *t*, measured using Spectrum), with institutional owners representing sophisticated users, which may affect this presentation decision. However, the effects of *YEAR*, *SIZE* and *INST* on this presentation are unclear *ex ante*; accordingly, we do not predict a sign for  $\delta_1$ ,  $\delta_2$ , or  $\delta_3$ . We also include *SI\_MAG* (firm *i*'s total reported special items for year *t* divided by beginning market value of equity), as the likelihood of reporting special items as a separate line item should be

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<sup>8</sup> For example, consider a firm having a \$40 write-off and \$10 gain. If the firm reports both items separately on the income statement, then *SI\_Sep* = 1.00 (50/50). If the firm reports only the write-off separately, with the gain aggregated within another line item, then *SI\_Sep* = 0.80 (40/50). If the firm reports only the gain separately, with the write-off aggregated, then *SI\_Sep* = 0.20 (10/50). If the firm aggregates both items within other line items, then *SI\_Sep* = 0 (0/50). Thus, we consider all special items as absolute amounts individually to define *SI\_Sep*, as netting may obscure presentation differences.

increasing in the magnitude of the special item, consistent with materiality affecting management presentation decisions.<sup>9</sup> Thus, the predicted sign for  $\delta_4$  is positive. Finally, we control for the firm's propensity to disaggregate financial information by inclusion of *IS\_DISAGG*, or firm *i*'s income statement disaggregation. This variable is coded from hand-collected data as follows. We identify all fiscal years within our sample period in which firm *i* has no reported special items in the current or previous two fiscal years. We then hand-collect the number of line items provided on the income statement (excluding sub-totals), and average this for the available years for the firm.<sup>10</sup> This provides a "base level" of income statement disaggregation by the firm. If firms providing more disaggregated data in general are more likely to provide income statement presentation for special items, the predicted sign for  $\delta_5$  is positive.

The model includes four experimental variables. Of primary interest, we examine if the economic characteristics of the reported special items affect the presentation decision. To measure this attribute, we follow prior literature (Burgstahler, Jiambalvo, and Shevlin 2002; Doyle, Lundholm, and Soliman 2003) and use the special items' ability to predict the firm's future performance: *SI\_PERSIST*, the special items' persistence. This seems warranted, as standard-setter interest regarding the presentation of financial statement reporting elements in part surrounds the correct weighting users should apply with respect to predicting future performance (FASB 1980).

We create an *ex ante* measure of the managers' expectation of the persistence of the special item by estimating persistence of special items by sign and magnitude at the industry level. Since

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<sup>9</sup> Alternatively scaling *SI\_MAG* by lagged total assets or sales does not change the inferences.

<sup>10</sup> The intent of *IS\_DISAGG* is to control for firms' "normal" level of income statement disaggregation, in the absence of reporting special items. For this reason, we exclude years in which special items are reported to avoid confounds that may arise due to the firm choosing a greater level of disaggregation coincident with the reporting of the special item. Similarly, we exclude firm-years in which the firm reported special items up to two years previously, owing to the required presentation of three years of income statements for comparative purposes.

the reporting of special items tends to cluster within industries, we believe an industry level measure is a good proxy for *ex ante* expectations. Estimating the model by distinguishing special items by sign and magnitude allows the persistence measure to take different values for positive versus negative and for small versus large special items. Thus, empirical implementation of *SI\_PERSIST* occurs in the following three steps. First, we estimate the following model:

$$E^*_{it+1} = \lambda_{0j} + \lambda_{1j}E^*_{it} + \lambda_{2j}NSI\_Large_{it} + \lambda_{3j}NSI\_Small_{it} + \lambda_{4j}PSI\_Large_{it} + \lambda_{5j}PSI\_Small_{it} + v_{it} \quad (1a)$$

where  $E^*$  is firm  $i$ 's net income less any reported special items;<sup>11</sup>  $NSI\_Large$  ( $NSI\_Small$ ) are firm  $i$ 's reported income-decreasing special items that are above (below) 5% of lagged total assets; and  $PSI\_Large$  ( $PSI\_Small$ ) are firm  $i$ 's reported income-increasing special items that are above (below) 5% of lagged total assets. All variables are scaled by market value of equity at the beginning of year  $t$ . This model is estimated by 2-digit SIC industry  $j$  using all available Compustat observations within our sample period; the within-industry estimation allows the model to capture the economics of similar types of firms. Thus, this model examines the ability of current period's earnings before special items and special items to predict one period-ahead earnings within a given industry. Second, we assign the corresponding industry level estimate of the  $\lambda_2$ ,  $\lambda_3$ ,  $\lambda_4$ , or  $\lambda_5$  coefficient by matching on the sign (positive versus negative) and magnitude (large versus small, as defined above) of the sample firm's reported special items. Third, we scale the matched  $\lambda$  by the sample firm's core earnings persistence parameter, obtained from firm-specific estimation of net income before special items for year  $t+1$  upon net income before special items and special items for year  $t$  for each of our sample firms over the sample period. In this

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<sup>11</sup> We present the primary analyses using special items absent any tax effect, owing to various tax treatments that are applied across reported special items (e.g., restructuring charges for severance typically are tax-deductible, while goodwill impairments typically are not). However, inferences are unchanged when we apply a standard tax rate to reported special items.



way, *SI\_PERSIST* captures the persistence of special items for similar firms with similar size and signed special items, and also controls for the sample firm's core earnings persistence. Thus, *SI\_PERSIST* is used to proxy for managers' expectations regarding the persistence of their reported special items.<sup>12</sup>

We use *SI\_PERSIST* to identify whether the presentation decision reflects (on average) informational versus opportunistic motivations. Specifically, informational motivations are reflected when special items receiving income statement presentation are less persistent than special items receiving footnote presentation. This is because informational motivations result in the correspondence between the presentation decision and the economic performance of the reported special items. Thus, informational motivations lead to a predicted negative sign for  $\delta_6$ . Alternatively, opportunistic motivations suggest that incentives (such as capital market pressures to meet particular benchmarks) lead managers to present special items inconsistent with their underlying economic content. Accordingly, opportunistic motivations are reflected when special items receiving income statement presentation are more persistent than those receiving footnote presentation. Thus, opportunistic motivations lead to a predicted positive sign for  $\delta_6$ .

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<sup>12</sup> As a key variable within equation (1), several research design choices regarding *SI\_PERSIST* warrant discussion. First, we could estimate a firm-level model, versus the chosen industry-level model. We choose not to do so, due to limitations in the variation of reported special items within firms (e.g., not all firms report large and small, or positive and negative, special items within our sample period), which would limit our ability to derive firm-specific estimates of  $\lambda_2$ ,  $\lambda_3$ ,  $\lambda_4$ , and  $\lambda_5$ . Second, in allowing the special items parameters to vary, we choose to focus on two characteristics: the size and sign of special items, which have been examined in prior research. We also could allow the special items parameters (i.e.,  $\lambda$ ) to vary by the category of special item (e.g., restructuring, write-off, other). However, this would require use of our limited sample of 500 firms, as the categorical decomposition of special items across all firms is unavailable electronically for our sample period. Thus, we trade-off having broader firm representation with having more detailed decomposition of special items to derive a proxy of manager expectations of special items' persistence. Finally, we choose to assess performance through analysis of one-year ahead net income. We choose net income, due to its key role as a performance measure; and we choose the one-year ahead window as any future implications for special items likely manifest most materially in the immediately subsequent fiscal year.

We note that results are unchanged using alternative specifications to obtain *SI\_PERSIST*. These include: defining the dependent variable in equation (1a) as net income versus net income before special items; obtaining coefficients at the 3-digit SIC level; not scaling *SI\_PERSIST* by the sample firm's core earnings persistence; and winsorizing the distribution of special items parameters.

Next, we argue that the presentation of special items also reflects their directional impact on net income: that is, whether the special items are income-increasing versus income-decreasing. Accordingly, we include *NSI*, an indicator variable equal to 1 if the firm has negative special items, and 0 otherwise. Prior research suggests negative special items are more transitory than positive special items (Burgstahler, Jiambalvo, and Shevlin 2002), and are more likely to be separately presented on the income statement (Kinney and Trezevant 1997) and in press releases (Weiss 2001), suggesting a positive predicted sign for  $\delta_7$ . However, management may wish to downplay income-decreasing special items (i.e., “bad news” such as write-offs), suggesting a predicted negative sign for  $\delta_7$ . Thus, we do not predict the sign for the coefficient on *NSI*.

Finally, we include two alternative proxies to examine opportunistic motivations underlying the presentation decision. Both focus on whether the special item causes the firm to miss or beat critical benchmarks, as prior research documents that benchmarks affect the recognition of special items (e.g., Moehrle 2002; Riedl 2004) and their presentation in press releases (e.g., Schrand and Walther 2000; Lougee and Marquardt 2004), and because managers care about meeting benchmarks (Mergenthaler, Rajgopal, and Srinivasan, 2009). Accordingly, we include *MISS\_BENCH*, an indicator variable equal to 1 if the reported special items cause operating earnings to fall below any of three benchmarks (prior year operating earnings, analysts’ consensus earnings forecasts, or zero earnings), and 0 otherwise. The predicted sign for  $\delta_8$  is positive, as management would wish to signal that such an item is transitory, and thus should not be considered a part of current year’s “core earnings.” We then include *BEAT\_BENCH*, an indicator variable equal to 1 if the reported special items cause operating earnings to be above any of the three benchmarks (again, prior year operating earnings, analysts’ consensus earnings forecasts, or zero earnings), and 0 otherwise. The predicted sign for  $\delta_9$  is negative, as management

would wish to de-emphasize that beating a benchmark is attributable to a current year special item (similar to Schrand and Walther 2000). Note that each variable captures specific distributions of the net negative and positive special items, respectively. For example, while all negative special items reduce earnings by definition, only a subset will cause the firm to miss any of the indicated benchmarks.<sup>13</sup>

### ***Relative Persistence of Special Items Across Their Presentation in the Financial Statements***

The analysis above uses an *ex ante* measure of persistence of the reported special item. In the next analysis we use an *ex post* measure that allows us to examine persistence at the firm level. We examine the relative persistence of special items across their presentation in the financial statements, using the following regression similar to Burgstahler, Jiambalvo, and Shevlin (2002):

$$E_{it+1} = \alpha_0 + \alpha_1 E^*_{it} + \alpha_2 SI\_IS_{it} + \alpha_3 SI\_FN_{it} + \gamma_{it} \quad (2)$$

where  $E_{it+1}$  is net income for firm  $i$  for year  $t+1$ ;  $E^*_{it}$  is net income less special items for firm  $i$  for year  $t$ ; and  $SI\_IS_{it}$  ( $SI\_FN_{it}$ ) is reported special items for firm  $i$  for year  $t$  receiving income statement presentation (footnote presentation). For this analysis we use signed (versus absolute) special item amounts.<sup>14</sup> All variables are scaled by market value of equity at the beginning of year  $t$ . Thus, this analysis examines the predictive content of current period net income and special items for future (one-period ahead) net income, conditional on the special items' presentation. If managers correctly identify *ex ante* those special items that are economically more transitory, and emphasize them via income statement presentation, informational motivations predict  $\alpha_2 < \alpha_3$ . That is, special items receiving income statement presentation will have lower persistence relative

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<sup>13</sup> We do not examine particular contracting incentives (e.g., bonus thresholds for compensation, or debt restrictions like covenants) as presentation is unlikely to affect calculations embedded in such contracts.

<sup>14</sup> Equation (1) uses absolute special items to avoid netting in the context of the presentation decision. The current analysis of Equation (2) uses signed special items, which better reflects their mapping into future performance.

to those receiving footnote presentation. Alternatively, opportunistic motivations predict  $\alpha_2 > \alpha_3$ . Thus, this analysis uses the *ex post* mapping of special items into one-year ahead performance to disentangle the informational versus opportunistic motivations underlying the presentation decision.

Prior research also suggests that special items, and their mapping into performance such as future earnings, vary on a number of dimensions. To investigate this possibility, we examine the following regressions, which further decompose the special items:

$$E_{it+1} = \beta_0 + \beta_1 E^*_{it} + \beta_2 LARGE\_IS_{it} + \beta_3 LARGE\_FN_{it} + \beta_4 SMALL\_IS_{it} + \beta_5 SMALL\_FN_{it} + \psi_{it} \quad (2a)$$

$$E_{it+1} = \chi_0 + \chi_1 E^*_{it} + \chi_2 NSI\_IS_{it} + \chi_3 NSI\_FN_{it} + \chi_4 PSI\_IS_{it} + \chi_5 PSI\_FN_{it} + \xi_{it} \quad (2b)$$

$$E_{it+1} = \varphi_0 + \varphi_1 E^*_{it} + \varphi_2 RESTR\_IS_{it} + \varphi_3 RESTR\_FN_{it} + \varphi_4 WO\_IS_{it} + \varphi_5 WO\_FN_{it} \\ + \varphi_6 ONEG\_IS_{it} + \varphi_7 ONEG\_FN_{it} + \varphi_8 OPOS\_IS_{it} + \varphi_9 OPOS\_FN_{it} + \omega_{it} \quad (2c)$$

where  $E$  and  $E^*$  are as defined above. We provide three additional partitions of special items to systematically evaluate whether the presentation varies within the indicated partitions. Within each partition, all variables are scaled by beginning market value of equity. First, we partition based on the magnitude of special item in equation (2a). Thus,  $LARGE\_IS$  ( $LARGE\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation when firm  $i$ 's non-netted special items divided by beginning market value of equity are above the sample median.  $SMALL\_IS$  ( $SMALL\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation when firm  $i$ 's non-netted special items divided by beginning market value of equity are below the sample median. This allows us to examine whether the persistence of special items varies across the presentation decision *within* larger special items ( $\beta_2 \neq \beta_3$ ), and *within* smaller special items ( $\beta_4 \neq \beta_5$ ).

Next, we partition on the special items' directional impact on reported net income in equation (2b), following Burgstahler, Jiambalvo, and Shevlin (2002). Thus,  $NSI\_IS$  ( $NSI\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that are income-decreasing (i.e., negative).  $PSI\_IS$  ( $PSI\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that are income-increasing (i.e., positive). This allows us to examine whether the persistence of special items varies across the presentation decision *within* negative special items ( $\chi_2 \neq \chi_3$ ), and *within* positive special items ( $\chi_4 \neq \chi_5$ ).

Finally, we partition on the special items' category in equation (2c), following Francis, Hanna, and Vincent (1996). Thus,  $RESTR\_IS$  ( $RESTR\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to restructuring charges.  $WO\_IS$  ( $WO\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to asset write-offs.  $ONEG\_IS$  ( $ONEG\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to other special items charges that are income-decreasing (that is, neither restructuring nor write-offs); principally, these include losses on sales of assets, merger and acquisition charges, and write-offs of acquired in-process R&D.  $OPOS\_IS$  ( $OPOS\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to other special items charges that are income-increasing; principally, these include gains on the sale of assets. This allows examination of special items' persistence across the presentation decision *within* restructuring charges ( $\varphi_2 \neq \varphi_3$ ), *within* write-offs ( $\varphi_4 \neq \varphi_5$ ), *within* other negative special items ( $\varphi_6 \neq \varphi_7$ ), and *within* other positive special items ( $\varphi_8 \neq \varphi_9$ ).

To summarize, the comparison of persistence of special items receiving income statement to that for special items receiving footnote presentation enables us to disentangle whether the presentation decision reflects informational versus opportunistic motivations. Under

informational motivations, special items receiving income statement presentation (conditional on their size, sign, or category) will be less persistent relative to those receiving footnote presentation, suggesting  $\_IS$  coefficients  $< \_FN$  coefficients (e.g.,  $\beta_2 < \beta_3$ ,  $\beta_4 < \beta_5$ , etc.). Alternatively, under opportunistic motivations, special items receiving income statement presentation (again, conditional on their size, sign, or category) will be more persistent relative to those receiving footnote presentation, suggesting  $\_IS$  coefficients  $> \_FN$  coefficients (e.g.,  $\beta_2 > \beta_3$ ,  $\beta_4 > \beta_5$ , etc.). Thus, we compare the persistence of special items receiving income statement versus footnote presentation, holding constant the nature (size, sign, category) of the special items.

We view the two primary analyses as complementary in the following way. Equation (1) takes persistence as given, and estimates the “persistence” parameter (i.e., estimates the effect of persistence on the presentation decision). In contrast, equation (2) and the related partitions take the presentation of special items as given (since this is directly observable), and estimates the “presentation” parameter (i.e., it estimates the effect of presentation on persistence). Use of both methods should provide additional robustness to our inferences.

#### **4. Sample Selection and Descriptive Data**

Table 1 outlines our sample selection process, in which we randomly select firms to hand-collect the composition and presentation of special items. We begin with all U.S. firm-years designated within the S&P 1500 during the period 1993 – 2002. Our restriction to this subset enables us to capture a broad cross-section of firms while focusing our analysis on a relatively large proportion of U.S. market capitalization.<sup>15</sup> Due to the cost of hand-collection of data, we randomly choose 500 firms from among all firms that fall within the S&P 1500 during our sample

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<sup>15</sup> However, use of larger firms will, by definition, limit our ability to generalize to the broader population of firms.

period. For these 500 firms, we include all available firm-years within the sample period, resulting in a sample of 4,695 firm-years.<sup>16</sup>

We then hand-collect and categorize all special items, including whether they receive income statement versus footnote presentation, using the firm's 10-Ks, annual reports, and/or 10-Qs. Our collection includes performing key word searches within electronic source documents, as well as scanning management discussion and analysis, the financial statements, and footnotes for indications of special items, regardless of whether Compustat reports that the firm has a special item. We hand-collect this data for the following reasons: during this period, major electronic sources of special items data (particularly Compustat) do not identify the category of special items, they net income-increasing and income-decreasing special items into an aggregate amount, and they do not provide information regarding their presentation within the financial statements.<sup>17</sup>

Table 2 provides descriptive data for our sample. The average firm-year has total assets of \$8.4 billion, consistent with our self-selection into S&P 1500 firms. Over half of the observations report special items (2,412 out of 4,695, or 51%). Of the 2,412 reporting special items, 1,279 or 53% report special items exceeding 1% of lagged total assets—a commonly used threshold to define “significant” special items in prior literature. 1,452 or 60% report only negative special items, consistent with special items tending to be income-decreasing. Special items are distributed widely across the three primary categories of restructuring charges (46% of observations reporting special items), write-offs (34%), and other (71%).<sup>18</sup> Finally, there is substantial variation in firms' presentation of special items, with 1,335 or 55% presenting all special items as separate line items

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<sup>16</sup> Various analyses use a subset of the 4,695 observations; these are noted where appropriate.

<sup>17</sup> We categorize reported special items into three major categories: restructuring, write-offs, and other special items. *Restructuring* subcategories include employee severance, facility closing, other, and restructuring reversals. *Write-offs* subcategories include write-offs of goodwill, intangibles, PP&E, investments, oil and gas properties, software, leases, inventory, and other. *Other* subcategories include gains on settlements, losses on settlements, in-process R&D, gains on sales of assets, losses on sales of assets, merger related costs, and other.

<sup>18</sup> The percentages do not sum to 100%, as a firm may report multiple categories of special items in any given year.

on the income statement, 733 or 30% aggregating all special items in other line items on the income statement with identification only via footnote disclosure, and 344 or 15% adopting mixed presentation. Interestingly, the average magnitude of special items for observations having only footnote presentation is 1.6% of lagged total assets, which again exceeds the above-mentioned threshold to define “significant” special items used in prior research. Finally, note that our analyses focus on the variation in the presentation decision, as reflected in the bottom three rows and last two columns of Table 2.

## 5. Empirical Results

### *Descriptive Statistics and Univariate Results*

Table 3 presents descriptive statistics for the sample used to examine the determinants of income statement versus footnote presentation of special items. This sample focuses on those observations reporting special items and having available data for Equation (1) ( $N = 2,228$ ). Panel A presents means and medians for the regression variables. Special items are typically reported as a separate line item on the income statement (mean of  $SI\_Sep = 0.646$ ), with  $SI\_MAG$  revealing an average magnitude of 4.1% of beginning market value of equity. Firms on average present almost fifteen line items on their income statements ( $IS\_DISAGG = 14.659$ ). Special items have an average persistence ( $SI\_PERSIST$ ) of 0.102, and 86% of observations reporting special items report a negative special item ( $NSI = 0.859$ ). Almost 29% of observations report negative special items that result in the firm missing a benchmark ( $MISS\_BENCH = 0.289$ ), while only 5% report positive special items that result in the firm beating a benchmark ( $BEAT\_BENCH = 0.051$ ). This latter is consistent with the generally conservative nature of how special items are reported, leading to a higher frequency (and concurrent greater impact on benchmarks) of negative than



positive special items. Panel B presents Pearson correlations, with univariate associations generally consistent with our previously discussed predictions. Of note, *SI\_PERSIST* is significantly negatively correlated with *SI\_Sep* (correlation = -0.044).

Table 4 presents univariate comparisons of observations reporting special items under income statement versus footnote presentation; for expositional convenience, we present results only for the magnitude of special items (*SI\_MAG*) and our key construct for economic performance, the persistence of special items (*SI\_PERSIST*). We provide statistics for two sets of observations. First, Panel A includes all observations with necessary data ( $N = 2,228$ ), and reveals that special items receiving income statement presentation are significantly larger in magnitude (e.g., *SI\_MAG* mean of 0.051 versus 0.018) and less persistent (*SI\_PERSIST* of 0.068 versus 0.180) than those receiving footnote presentation. In Panel B, we focus only on “non-big bath” observations, to avoid the confounding interpretations relating to “big bath” observations as previously discussed. To empirically identify the “big bath” observations for exclusion ( $N = 216$ ), we impose three criteria: the net special items are income-decreasing; total negative special items exceed 5% of lagged total assets; and the firm reports negative net income before special items.<sup>19</sup> The univariate results for the non-big bath observations ( $N = 2,012$ ) are consistent with those presented in Panel A: special items receiving income statement presentation remain larger (*SI\_MAG* mean of 0.040 versus 0.016) and less persistent (*SI\_PERSIST* mean of 0.066 versus 0.182) than those receiving footnote presentation. We now turn to the multivariate analysis for further evidence.

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<sup>19</sup> Our univariate and multivariate inferences are unaffected by alternative definitions to identify “big bath” observations for exclusion from our primary analyses. These include: alternative magnitude thresholds to define “big bath” special items (e.g., greater than 1% or 2% of beginning market value of equity); alternative scalars to assess magnitude (e.g., scaling by total assets or sales); and alternative benchmarks (e.g., requiring that the special item causes the firm to miss prior year’s earnings).

### ***Determinants of Financial Statement Presentation of Special Items***

Table 5 presents results from OLS regressions examining the determinants of management's decision to provide income statement versus footnote presentation of reported special items. All standard errors are clustered by firm and control for heteroskedasticity. Column (1) presents results for all observations having the necessary data ( $N = 2,228$ ). Of the control variables, the coefficient on *YEAR* is significantly negative ( $-0.009$ ,  $t$ -statistic  $= -2.54$ ), suggesting a decrease in the likelihood of special items receiving income statement presentation over the sample period. The coefficient on *SIZE* is negative and significant ( $-0.022$ ,  $t$ -statistic  $= -3.86$ ), consistent with larger firms being less likely to separately present special items. In addition, the coefficient on *INST* is significantly positive ( $0.179$ ,  $t$ -statistic  $= 3.99$ ), consistent with managers being more likely to separately present special items as institutional ownership increases. Finally, *SI\_MAG* is positively associated with this decision ( $0.668$ ,  $t$ -statistic  $= 5.28$ ), consistent with materiality affecting the presentation decision, as larger special items are more likely to receive income statement presentation. *IS\_DISAGG* is insignificant.

Regarding our experimental variables, *SI\_PERSIST* is negative and significant as predicted (coefficient  $= -0.009$ ,  $t$ -statistic  $= -2.19$ ), indicating managers are more likely to provide income statement presentation for those special items having lower persistence. This is consistent with managers being able to identify more transitory special items *ex ante*, and using income statement presentation to signal those special items that are more likely to be transitory (i.e., for informational motivations). In addition, *NSI* is positive and significant (coefficient  $= 0.122$ ,  $t$ -statistic  $= 4.24$ ), indicating that *ceteris paribus* managers are more likely to present negative special items separately on the income statement than positive special items (e.g., Kinney and Trezevant 1997). Of the reporting incentive variables, only *MISS\_BENCH* is significantly

positive as predicted (coefficient = 0.100,  $t$ -statistic = 4.45), indicating that managers are more likely to provide income statement presentation for special items that cause current year's earnings to fall below previous year's earnings, analysts' consensus forecasts, or zero earnings (e.g., Schrand and Walther 2000). This is consistent with managers using income statement presentation to signal negative special items that affect relevant benchmarks (i.e., for opportunistic motivations).<sup>20</sup> However, *BEAT\_BENCH* is insignificant and obtains the opposite to predicted sign (coefficient = 0.077,  $t$ -statistic = 1.53).

The above results reveal that special items presented on the income statement are less persistent than those presented in the footnotes. This is consistent with the presentation choice reflecting informational motivations: that is, it reflects a correspondence between the presentation of the special items and their economic content. However, as previously discussed, observations reflecting “big bath” reporting incentives have two competing explanations. Thus, for the subset of “big bath” observations, the documented lower persistence of special items receiving income statement presentation cannot disentangle the opportunistic motivation (that of highlighting non-economic transitory charges) from the informational motivation (that of highlighting economic transitory charges). However, “non-big bath” observations should not be affected by this confound. Accordingly, to minimize ambiguous inferences underlying this presentation decision, we apply a screen to eliminate observations likely to reflect “big bath” incentives, and thus focus the analysis on “non-big bath” observations. Similar to Table 4, the eliminated “big bath” observations satisfy the following three criteria: the net special items are income-decreasing; total negative special items exceed 5% of lagged total assets; and the firm reports negative net income before special items. Column (2) of Table 5 presents the OLS results for the subset of “non-big

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<sup>20</sup> We alternatively estimate three separate regressions, sequentially defining *MISS\_BENCH* to equal 1 if the reported special items cause the firm's net income to be below prior year's net income, analysts' consensus earnings forecasts, and zero net income (e.g., Doyle and Soliman 2002). Inferences are unchanged.

bath” observations ( $N = 2,012$ ). Results for the control variables are similar to those reported above: the coefficients for *YEAR* and *SIZE* are significantly negative, significantly positive for *INST* and *SI\_MAG*; and insignificant for *IS\_DISAGG*. Similarly, results for the experimental variables are unchanged: *SI\_PERSIST* (coefficient =  $-0.012$ ,  $t$ -statistic =  $-2.77$ ), *NSI* ( $0.107$ ,  $t$ -statistic =  $3.64$ ), and *MISS\_BENCH* ( $0.127$ ,  $t$ -statistic =  $5.03$ ) are significant as above. Since this subsample reasonably identifies observations unlikely to be affected by “big bath” reporting incentives, the results regarding *SI\_PERSIST* are consistent with the presentation decision reflecting informational motivations, without a confounding interpretation of opportunistic reporting and presentation that may underlie “big bath” special items.

### ***Relative Persistence of Special Items Across Their Presentation in the Financial Statements***

Table 6 presents results from analyses examining special items’ ability to predict future earnings, conditioned on their presentation in the financial statements; that is, the relative persistence of special items receiving income statement versus footnote presentation. Column (1) provides a base regression, revealing that special items (*SI*, coefficient =  $0.177$ ) have significantly lower persistence than earnings before special items ( $E^*$ ,  $0.910$ ) in predicting one-year ahead earnings, consistent with prior research (e.g., Burgstahler, Jiambalvo, and Shevlin 2002) (untabulated difference is significant at the less than 1% level).

Columns (2) through (5) then provide results from the systematic decomposition of special items by their presentation as well as other common characteristics of special items examined in prior research. First, column (2) reveals that special items receiving income statement presentation (*SI\_IS*, coefficient =  $0.163$ ) are significantly less persistent than those presented in the footnotes (*SI\_FN*,  $0.296$ ) ( $F$ -value on difference =  $5.06$ ). This is consistent with the presentation

decision reflecting informational motivations: that is, special items receiving income statement presentation are less persistent than those receiving footnote presentation, as reflected in their *ex post* mapping into the subsequent year's earnings.

Next, column (3) presents results partitioning special items on both their presentation and magnitude. Within larger special items (i.e., defined as above the sample median), those receiving income statement presentation (*LARGE\_IS*, coefficient = 0.166) are significantly less persistent than those receiving footnote presentation (*LARGE\_FN*, 0.282) (*F*-value on difference = 3.58). Similarly, within smaller special items (i.e., defined as below the sample median), those receiving income statement presentation (*SMALL\_IS*, -0.021) are significantly less persistent than those presented in the footnotes (*SMALL\_FN*, 0.401) (*F*-value on difference = 3.38). Thus, differences in persistence appear robust across sizes of special items.

Column (4) then presents results partitioning special items on both their presentation and sign; that is, whether the special items are income-decreasing or income-increasing. For negative (i.e., income-decreasing) special items, those receiving income statement presentation (*NSI\_IS*, 0.145) are significantly less persistent than those receiving footnote presentation (*NSI\_FN*, 0.311) (*F*-value on difference = 6.85). However, for positive (i.e., income-increasing) special items, those receiving income statement presentation (*PSI\_IS*, 0.311) are less persistent than those presented in the footnotes (*PSI\_FN*, 0.410), but the difference is insignificant (*F*-value = 0.38). Thus, it appears differences in persistence are driven primarily by negative special items.

Finally, column (5) presents results partitioning special items based on both their presentation and category. For this analysis, categories are defined as restructuring, write-offs, other negative special items, and other positive special items. Within restructuring charges, those receiving income statement presentation (*RESTR\_IS*, 0.142) are significantly less persistent than

those receiving footnote presentation (*RESTR\_FN*, 0.436) ( $F$ -value on difference = 2.62). For special items that are write-offs, those presented on the income statement (*WO\_IS*, 0.123) appear slightly more persistent than those receiving footnote presentation (*WO\_FN*, 0.111), though the difference is insignificant ( $F$ -value = 0.01). Within other special items that are negative (i.e., income-decreasing), those receiving income statement presentation (*ONEG\_IS*, 0.209) are significantly less persistent relative to those presented in the footnotes (*ONEG\_FN*, 0.643) ( $F$ -value = 5.62). Finally, among other special items that are positive (i.e., income-increasing), those receiving income statement presentation (*OPOS\_IS*, 0.333) appear less persistent than those receiving footnote presentation (*OPOS\_FN*, 0.447), but the difference is insignificant ( $F$ -value = 0.48). Overall, results from the categorical decomposition suggest that differences in persistence are driven primarily by restructuring charges and other special items that are income-decreasing, where the latter include primarily losses on sales of assets, and merger and acquisition charges (including write-offs of acquired in-process R&D).

Our primary tabulation of Table 6 includes all observations with available data to maintain the full distribution of observations.<sup>21</sup> However, because of the previously discussed concerns on inferences surrounding “big bath” observations, we similarly verify the robustness of our results by re-estimating all Table 6 regressions excluding “big bath” observations, employing the same definition as within Table 5. Untabulated results are unchanged from those reported in Table 6 with three exceptions: differences for small special items in column (3) and for restructuring charges in column (5) remain negative as presented, but are now insignificant; and the difference for positive special items in column (4) remains negative, but now attains significance.

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<sup>21</sup> Note also that Table 6 includes firm-years reporting no special items. Such observations are excluded in the Table 5 analyses as there is no value for the dependent variable, *SI\_Sep*.

## 6. Sensitivity Analyses

In this section, we perform a number of sensitivity analyses. First, we estimate logistic regressions to examine whether results are sensitive to specification of the dependent variable. Second, we examine the robustness of the results to additional partitions on the magnitude of special items. Third, we examine the impact of monitoring on the presentation of special items. Fourth, we investigate alternative specifications to accommodate potential changes in sample characteristics over the time period of the study. Fifth, we examine a further decomposition of special items into sub-categories.

### *Logistic Regressions*

The dependent variable from equation (1), *SI\_Sep*, has significant clustering at the end points of its distribution. To accommodate this distribution, we alternatively examine a logistic specification. Using equation (1), we re-define *SI\_Sep* to be an indicator variable equal to 1 when *any* reported special items receive income statement presentation, and 0 when all reported special items receive footnote presentation. This is akin to suggesting that the highlighting of any special item on the income statement may be a mechanism employed by managers to signal a “red flag” for users to look for other related items. All other variables are unchanged from their previous definitions. Table 7 Panel A presents the results. Column (1), focusing on non-big bath observations ( $N = 2,012$ ), reveals similar inferences to those of Table 5. In particular, *SI\_PERSIST* remains significantly negative (coefficient =  $-0.048$ , Wald-statistic =  $-4.55$ ).

We then estimate a second logistic regression, wherein we eliminate observations having mixed presentation; that is, we exclude observations wherein some special items receive income statement presentation and some receive footnote presentation ( $N = 311$ ). This exclusion is

justified, as attributing observations with mixed presentation to either the 1 condition (i.e., income statement presentation) or the 0 condition (i.e., footnote presentation) for the logistic regression can result in measurement error in the dependent variable. Results are presented in column (2) of Table 7, and remain unchanged. The primary experimental variable, *SI\_PERSIST*, is again negative and significant (coefficient =  $-0.058$ , Wald-statistic =  $-6.28$ ). Overall, Panel A of Table 7 suggests inferences are robust to alternative specifications of the dependent variable.

### ***Partitions on the Magnitude of Special Items***

We next consider whether our results are robust across various size partitions of special items.<sup>22</sup> Our primary regressions control for the magnitude of special items in two ways: first, via inclusion of the magnitude of special items as a control variable (*SI\_MAG*); second, by allowing the expected persistence parameter, *SI\_PERSIST*, to vary by the size of the special items (see related discussion in section 3). However, it is possible these research designs do not fully control for differences in the magnitude of special items; and, accordingly, the association between *SI\_PERSIST* can vary further depending on the magnitude of special items. To investigate this possibility, we partition the sample observations into two equal size groups: those with special items (scaled by market value of equity) above versus below the sample median. We then re-estimate the OLS regressions of equation (1) on each subsample. The results are presented in Panel B of Table 7, with column (3) reflecting observations above the sample median, and column

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<sup>22</sup> We also split our “non-big bath” sample ( $N = 2,012$ ) into three groups of observations: those in which the special item causes the firm to beat prior year’s earnings ( $N = 88$ ); those in which the special item causes the firm to miss prior year’s earnings ( $N = 247$ ); and those having no benchmark effect ( $N = 1,677$ ). We then re-estimate equation (1) separately for each sub-sample. For the beat benchmark sample, *SI\_PERSIST* is negative but insignificant ( $t$ -statistic =  $-0.92$ ). For the miss benchmark sample, *SI\_PERSIST* is negative but insignificant ( $t$ -statistic =  $-0.18$ ). We note that the smaller sample sizes for these two tests make inferences difficult due to possible lack of power. For the no benchmark sample, *SI\_PERSIST* is negative and significant ( $t$ -statistic =  $-2.44$ ). Of note, the latter provides corroborating support for our informational motivation inference, as the no benchmark sample removes those observations most likely to have opportunistic incentives to present special items coinciding with missing or beating particular benchmarks.



(4) observations below the median. The results are robust across both partitions. Of primary interest, *SI\_PERSIST* is marginally significantly negative for special items above the median (coefficient =  $-0.011$ ,  $t$ -statistic =  $-1.78$ ), and significantly negative for special items below the median ( $-0.013$ ,  $t$ -statistic =  $-2.57$ ). Further, the average magnitude of special items is 4% (1%) of beginning market value of equity for special items above (below) the sample median, suggesting both groups reflect economically significant special items. Overall, these results further suggest inferences are robust across various size partitions of special items.<sup>23</sup>

### ***Alternative Measures of Monitoring***

We next consider whether the type of monitoring influences the presentation decision. Specifically, we consider two common measures of monitoring: a measure of corporate governance, and auditor type. Regarding the governance measure, we include in equation (1) the variable *GINDEX*. This variable is obtained from Gompers, Ishii, and Metrick (2003); larger values correspond to weaker governance. We partition the sample observations into those above versus those below the median value of *GINDEX*, and estimate equation (1) as a stacked regression model to compare the associations across the two subsets of observations. Untabulated results reveal *SI\_PERSIST* is negative and significant for the subsample having stronger monitoring (i.e., below median value *GINDEX*); is negative but insignificant for the subsample with weaker monitoring; and the difference between the two is insignificant. However, we note that *GINDEX* is unavailable for approximately 25% of the overall sample, limiting the power of the analyses. Regarding auditor type, we also examine whether type of auditor affects the

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<sup>23</sup> We conduct two alternative specifications to examine the robustness of our results to the size of special items. First, we employ terciles based on the magnitude of special items. Second, we incorporate into equation (1) an interaction between *SI\_PERSIST* with an indicator variable equal to 1 for special items above the median. Inferences are unchanged across these alternative specifications.

motivations underlying the presentation of special items. However, consistent with our self-selection into larger firms, we observe little variance in this construct: 98.4% of our sample are audited by large (i.e., “Big 4” or “Big 6”) auditors. These results provide limited evidence that the presentation of special items reflects informational motivations for those firms with stronger monitoring; results for firms having weaker monitoring are inconclusive.

### ***Alternative Specifications to Accommodate Changes over the Sample Period***

Equation (1) includes the variable *YEAR* to control for changes in the presentation of special items over time. However, this variable controls for slope effects. We consider three alternative specifications to accommodate other potential shifts that may occur over the sample period. First, we estimate a fixed effects model, including indicator variables for each year to capture mean differences in managers’ presentation of special items over the sample period. Untabulated results are unchanged from those reported. Second, we investigate a random effects model. Untabulated results comparing coefficients and significance levels across the fixed versus random effects models reveal minimal differences; a related Hausman test (Kennedy 1998) comparing the two sets of coefficients produces a highly insignificant Chi-square, consistent with results being invariant to the fixed versus random effects specification. Finally, we estimate Fama and MacBeth (1973) annual regressions; again inferences are unaffected. These analyses suggest that time-varying effects are not driving the reported results.<sup>24</sup>

### ***Decomposition of Special Items into Sub-Categories***

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<sup>24</sup> To isolate the initial presentation decision, we re-estimate equation (1) on the sub-sample of firms reporting special items for the first time during our sample period. To identify “first time” reporters, we require either (1) that the firm did not exist prior to 1993, or (2) if it did exist prior to 1993, it did not report a special item in the five year period 1988-1992. Results for this subset of firms, using the first year reporting a special item ( $N = 200$ ), are unchanged from the primary results; in particular, *SI\_PERSIST* is negative and significant ( $t$ -statistic =  $-1.86$ ).

The results presented in column (5) of Table 6 decompose special items into the major categories of restructuring, write-offs, other negative special items, and other positive special items. These results suggest that the lower persistence of special items receiving income statement versus footnote presentation are attributable to two of these categories: restructuring charges and other negative special items. However, additional analysis is possible to exploit further differences that may exist within these categories. Accordingly, we further decompose reported special items as follows. We partition restructuring charges into negative (i.e., income-decreasing) and positive (i.e., income-increasing) charges, where the latter relate to restructuring reversals. We partition write-offs into those relating to goodwill, PPE, inventory, and other. Finally, we partition other special items into gains on sales of assets, losses on sales of assets, in-process R&D, and merger and acquisition. We re-estimate equation (2), comparing coefficients for special items receiving income statement versus footnote presentation within each of the now ten sub-categories. Untabulated results reveal that negative restructuring charges, in-process R&D, and merger and acquisition charges presented on the income statement have significantly lower persistence relative to those presented in the footnotes. Differences on the remaining subcategories are insignificant. We note, however, that several subcategories have relatively few observations, which may limit power to detect statistical differences.<sup>25</sup> Overall, this provides additional insights into the type of charges that are driving the results.

## **7. Preliminary Evidence on the Market Response to the Presentation of Special Items**

The focus of the previous analyses is managers' presentation of special items on the income statement versus footnotes; that is, the causes of this presentation decision. The

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<sup>25</sup> For example,  $N = 20$  for restructuring reversals receiving footnote presentation,  $N = 50$  for losses on sale receiving income statement presentation, etc.

consequences of this decision warrant investigation as well. For brevity, we present preliminary evidence on whether a key user (equity market participants) differentially values special items receiving income statement versus footnote presentation. We employ the following regression:

$$RET_{it} = \theta_0 + \theta_1 E^*_{it} + \theta_2 SI\_IS_{it} + \theta_3 SI\_FN_{it} + \tau_{it} \quad (3)$$

The dependent variable,  $RET$ , is firm  $i$ 's 12-month market-adjusted stock return ending three months following the fiscal year end  $t$ .<sup>26</sup>  $E^*$  is firm  $i$ 's year  $t$  net income less reported special items.  $SI\_IS$  ( $SI\_FN$ ) is firm  $i$ 's year  $t$  special items receiving income statement presentation (footnote presentation). All independent variables are scaled by beginning market value of equity. If market participants perceive special items receiving income statement presentation as having lower persistence, the valuation multiplier for these special items will be less than that for special items receiving footnote presentation; that is,  $\theta_2 < \theta_3$ .

Untabulated results reveal that while the coefficient for  $SI\_IS$  ( $\theta_2 = 0.89$ ) appears less than that for  $SI\_FN$  ( $\theta_3 = 1.31$ ), the difference is insignificant ( $p$ -value = 0.199). Additional partitions by the sign of special items reveal that income-decreasing (i.e., “negative”) special items receiving income statement presentation have a significantly lower coefficient relative to those receiving footnote presentation ( $p$ -value for difference = 0.001); however, this difference is insignificant for income-increasing (i.e., “positive”) special items ( $p$ -value = 0.570). These results provide limited evidence of special items receiving income statement presentation having a lower response

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<sup>26</sup> We do not employ a short-window event study design for the following reason. The presentation we consider requires the full income statement (for those special items receiving income statement presentation) and full footnotes (for those special items receiving footnote presentation). Prior research (e.g., on pro forma earnings) has used events such as earnings announcements and/or press releases. Of note, these events tend to include release of the primary financial statements (including the income statement); however, there is generally limited or no provision of the footnotes. Thus, the event in which the full footnotes are provided likely coincides with the filing of the 10-K or the annual report release. This suggests that a short-window analysis would likely compare events based on earnings announcement dates (for those special items receiving income statement presentation) to events based on 10-K filing dates (for those special items receiving footnote presentation). Because significantly different levels of information are released across these two events, and because our key experimental variable (the presentation of special items) correlates directly across these events as well, we do not conduct a short-window research design.

coefficient relative to those receiving footnote presentation, and some consistency with our tabulated results regarding presentation and persistence.

## **8. Conclusion**

This paper examines whether managers' presentation of special items within the financial statements reflects informational motivations (that is, revealing the underlying economics of the reported special items) or opportunistic motivations (that is, attempts to bias perceptions). Specifically, we examine the disaggregation of special items as a separate line item on the income statement (income statement presentation) as compared to aggregation of special items within other line items with disclosure only in the footnotes (footnote presentation). This analysis is motivated by prior research on management disclosures (such as pro forma reporting), prior experimental evidence regarding the capacity of managers' presentation decisions to affect user judgments, and standard-setter interest in financial statement presentation.

Overall, the empirical results reveal that special items receiving income statement presentation are less persistent than those receiving footnote presentation. These findings are consistent across a number of alternative specifications and variable definitions. Since income statement presentation provides a mechanism to signal components of income having differing properties, our results are consistent with a correspondence between the presentation of the special items and the economic properties of those special items. That is, our results are consistent with the presentation reflecting informational, as opposed to opportunistic, motivations. Overall, these results extend prior research by examining manager presentation choices made within the primary financial statements, and providing evidence that managers use the flexibility afforded in this presentation to assist users in understanding the underlying economics of reported special items.

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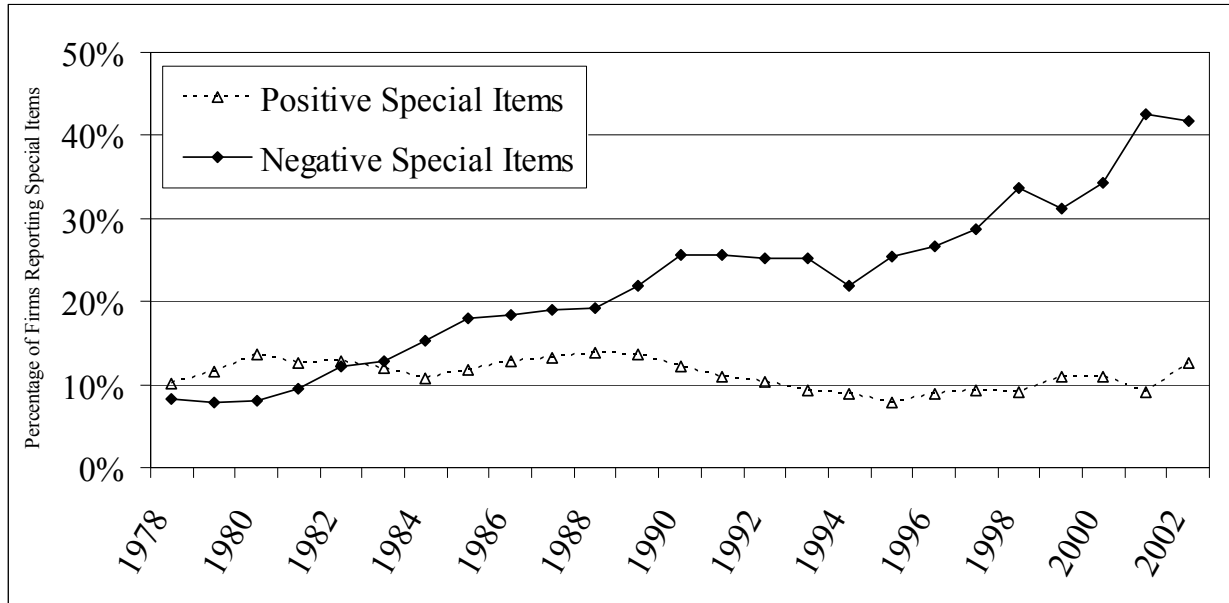
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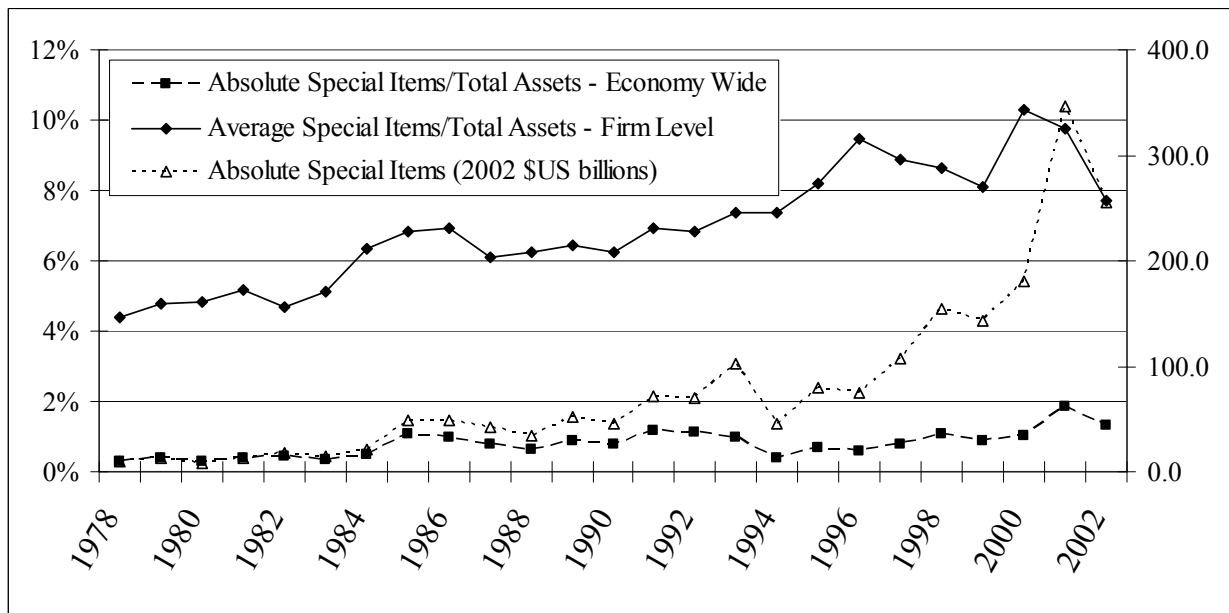
## APPENDIX A

### Frequency and Magnitude of Reported Special Items: 1978 – 2002

**Panel A:** Frequency of Reported Special Items



**Panel B:** Magnitude of Reported Special Items



#### Notes:

These figures present the increase in frequency and magnitude of reported special items over time, using annual Compustat data. Panel A presents the percentage of Compustat firms reporting net

negative or net positive special items annually for the years 1978 – 2002. Panel B presents the magnitude of special items over the same time period using three annual measures. The first (represented by squares) reflects the scaled economy-wide magnitude of special items, and is measured as the absolute reported special items (totaled across all firms) for year  $t$  as a percentage of lagged total assets (also totaled across all firms). The second (represented by diamonds) presents the scaled firm-level average magnitude of special items, and is measured as the absolute annual reported special items divided by lagged total assets for each firm reporting special items, and then averaged within a year across those firms reporting special items. The third (represented by triangles) reflects the economy-wide magnitude of special items, and is measured as the unscaled total absolute special items across all firms within a year, with all figures shown in \$US billions adjusted to 2002 levels.

TABLE 1  
Sample Selection

	Firm Years	Firms
Available observations from Compustat Annual, 1993 – 2002	<u>72,473</u>	<u>11,557</u>
Observations designated as S&P 1500 by Compustat 1993 – 2002	<u>14,400</u> <sup>a</sup>	<u>2,466</u>
All available observations for 1993 – 2002 for any firm designated as within the S&P 1500 during the sample period	<u>20,198</u>	<u>2,466</u>
Final Sample: Random selection of 500 firms, including all available years for 1993 – 2002	<u>4,695</u>	<u>500</u>

**Notes:**

This table shows the sample selection process. We begin with all firm-years available on Compustat for the period 1993 – 2002. We then identify all firms designated as falling within the S&P 1500 at any point during the sample period. From these firms, we randomly choose 500. For the 500 firms selected, we then include all available firm-years for the sample period, leading to 4,695 observations.

<sup>a</sup> Per discussion with Compustat, there are only 900 firms classified within the S&P 1500 for 1993; this results in 600 fewer available firm-years than expected (i.e.,  $15,000 - 14,400 = 600$ ).

TABLE 2  
Descriptive Data

	N	Unique Firms	Total Assets <sub>t</sub>	NI <sub>t</sub>	NI <sub>t</sub> (pre SI)	SI <sub>t</sub>	SI <sub>t</sub>   / Total Assets <sub>t-1</sub>	% SI Income Statement Presentation	% SI Footnote Presentation
All Observations	4,695	500	8,449	207	271	(64)	2.5%	64%	36%
By Existence of SI:									
No SI	2,283	477	5,461	171	171	-	-	-	-
SI	2,412	475	11,277	241	365	(124)	4.8%	64%	36%
By Magnitude of SI:									
SI ≥ 1% Total Assets <sub>t-1</sub>	1,279	400	4,951	94	296	(203)	8.3%	76%	24%
SI < 1% Total Assets <sub>t-1</sub>	1,133	500	18,418	408	443	(36)	0.4%	52%	48%
By Sign of SI:									
Only NSI	1,452	451	10,185	202	329	(127)	5.5%	67%	33%
Only PSI	349	215	8,419	342	295	46	3.3%	51%	49%
Both NSI and PSI	611	267	15,496	277	492	(215)	4.0%	66%	34%
By Category of SI:									
Restructuring	1,108	354	16,764	241	469	(229)	4.8%	74%	26%
Write-off	836	359	7,465	76	315	(239)	6.5%	61%	39%
Other	1,723	450	11,618	269	399	(130)	5.3%	63%	37%
By Presentation of SI:									
Income statement Presentation	1,335	399	12,265	171	317	(146)	6.1%	100%	0%
Footnote presentation	733	309	9,274	340	383	(42)	1.6%	0%	100%
Mixed presentation	344	196	11,687	304	516	(213)	6.5%	64%	36%

## Notes:

This table provides descriptive data for the observations used in our analyses.  $N$  is the number of observations. *Unique firms* is the number of unique firms within each grouping. We then report means of the following measures.  $Total\ Assets_t$  is end-of-year total assets.  $NI_t$  is annual net income before extraordinary items.  $NI_t$  (*pre SI*) is annual net income before extraordinary items and special items.  $SI_t$  is annual net reported special items, measured using hand-collected annual data from firms' 10-Ks. The previous four variables are denoted in \$ millions.  $|SI| / Total\ Assets_{t-1}$  is the absolute annual net reported special items divided by beginning-of-year total assets. *% SI Income Statement Presentation* is the average percent of the absolute total special items (not netted) that are presented on the firm's income statement in a separate line item. *% SI Footnote Presentation* is the average percent of the absolute total special items (not netted) that are aggregated within another line item on the income statement and identified only via footnote disclosure.

We present the above measures for six groups of observations. First, *All Observations* is for the pooled observations.

Second, we group observations according to the existence of special items: *No SI* reflect observations reporting no special items; and *SI* reflect those reporting non-zero special items.

Third, we group observations reporting special items based on the magnitude of total reported special items:  $SI \geq 1\% Total\ Assets_{t-1}$  reflects observations reported where special items are greater than or equal to 1% of beginning-of-year total assets; and  $SI < 1\% Total\ Assets_{t-1}$  reflects those where special items are less than 1% of beginning-of-year total assets.

Fourth, we group observations reporting special items based on the directional impact on net income: *Only NSI* reflect observations reporting only income-decreasing (i.e., negative) special items; *Only PSI* reflect observations reporting only income-increasing (i.e., positive) special items; and *BOTH NSI and PSI* reflect observations reporting both income-decreasing and income-increasing special items in the same fiscal year.

Fifth, we group observations reporting special items based on the category of reported special items: *Restructuring* reflect observations reporting any restructuring charges; *Write-off* reflect observations reporting any write-offs; and *Other* reflect observations reporting other categories of special items (which include gains and losses on sales of assets, merger and acquisition costs, litigation settlements, and in-process R&D charges).

Finally, we group observations based on the presentation of the reported special items: *Income statement presentation* reflect observations wherein all special items are reported in separate line items on the income statement; *Footnote presentation* reflect observations wherein all special items are aggregated in other line items on the income statement and identified only via footnote disclosure; and *Mixed presentation* reflect observations wherein some special items are listed separately on the income statement and others are aggregated into other line items.

TABLE 3  
Descriptive Statistics and Correlations

**Panel A:** Descriptive Statistics ( $N = 2,228$ )

Variable	Mean	Median	Standard Deviation
<i>SI_Sep</i>	0.646	1.000	0.455
<i>YEAR</i>	1998.000	1999.000	2.722
<i>SIZE</i>	7.109	7.091	1.676
<i>INST</i>	0.681	0.693	0.223
<i>SI_MAG</i>	0.041	0.012	0.227
<i>IS_DISAGG</i>	14.659	13.000	5.332
<i>SI_PERSIST</i>	0.102	0.061	1.266
<i>NSI</i>	0.859	1.000	0.348
<i>MISS_BENCH</i>	0.289	0.000	0.453
<i>BEAT_BENCH</i>	0.051	0.000	0.211

**Panel B:** Correlations ( $N = 2,228$ )

	<i>SI_Sep</i>	<i>YEAR</i>	<i>SIZE</i>	<i>INST</i>	<i>SI_MAG</i>	<i>IS_DISAGG</i>	<i>SI_PERSIST</i>	<i>NSI</i>	<i>MISS_BENCH</i>
<i>YEAR</i>	-0.017								
<i>SIZE</i>	-0.079 ***	0.104 ***							
<i>INST</i>	0.073 ***	0.278 ***	0.063 ***						
<i>SI_MAG</i>	0.069 ***	0.002	-0.063 ***	-0.025					
<i>IS_DISAGG</i>	-0.026	-0.017	0.002	-0.189 ***	-0.024				
<i>SI_PERSIST</i>	-0.044 **	-0.044 **	-0.007	-0.039 *	-0.006	0.033			
<i>NSI</i>	0.120 ***	0.092 ***	0.004	0.085 ***	-0.014	-0.086 ***	-0.057 ***		
<i>MISS_BENCH</i>	0.134 ***	0.126 ***	0.064 ***	0.085 ***	0.073 ***	-0.075 ***	-0.037 *	0.258 ***	
<i>BEAT_BENCH</i>	-0.001	-0.025	0.011	-0.066 ***	0.119 ***	0.048 **	0.079 ***	-0.248 ***	-0.129 ***

**Notes:**

This table presents descriptive statistics (Panel A) and Pearson correlations (Panel B) for the variables used in the analysis examining management's decision to present special items as a separate line item on the income statement (i.e., income statement presentation)

versus aggregate them within another line item with identification only via footnote disclosure (i.e., footnote presentation). The sample is comprised of observations reporting special items and having available data for Equation (1) ( $N = 2,228$ ).

The variables are defined as follows. *SI\_Sep* is firm  $i$ 's year  $t$  absolute amount of (non-netted) annual special items presented in a separate line item on the income statement, divided by the absolute amount of total annual (non-netted) reported special items: thus it ranges in value from 0 to 1, inclusive. *YEAR* is firm  $i$ 's fiscal year. *SIZE* is the log of firm  $i$ 's year  $t$  sales. *INST* is the percentage of firm  $i$ 's outstanding common shares owned by institutions at the end of year  $t$ . *SI\_MAG* is firm  $i$ 's year  $t$  absolute value of total annual (non-netted) special items, divided by beginning-of-period market value of equity. *IS\_DISAGG* is the average level of financial reporting disaggregation for firm  $i$  during the sample period, measured as the average number of line items reported on firm  $i$ 's income statements for all sample years in which no special items are reported. *SI\_PERSIST* is the persistence parameter assigned to firm  $i$ 's year  $t$  special items. The parameter is derived from three steps: (1) industry level estimation (by 2-digit SIC) of year  $t+1$  net income before special items regressed on year  $t$  net income before special items and special items using all available Compustat firms, and allowing special items to vary by large versus small and income-increasing versus income-decreasing; (2) assigning the estimated special items parameter to the sample firm based on firm  $i$ 's industry, and the size and sign of firm  $i$ 's special items; (3) scaling the assigned special items parameter by firm  $i$ 's core earnings persistence parameter. *NSI* is an indicator variable equal to 1 if firm  $i$  reports aggregate income-decreasing special items in year  $t$ , and 0 otherwise. *MISS\_BENCH* is an indicator variable equal to 1 if firm  $i$ 's year  $t$  net special items cause the firm to be below any of three benchmarks (prior year's net income, consensus analysts' earnings forecast, or zero net income), and 0 otherwise. *BEAT\_PYE* is an indicator variable equal to 1 if firm  $i$ 's year  $t$  net special items cause the firm to be above any of three benchmarks (prior year's net income, consensus analysts earnings' forecast, or zero net income), and 0 otherwise. \*\*\*, \*\*, \* indicate significance at the less than 1%, 5%, and 10% levels for two-tailed tests, respectively.

TABLE 4  
Univariate Comparison of Income Statement versus Footnote Presentation of Special Items

	Income Statement Presentation		Footnote Presentation		Difference	
<b>Panel A:</b> All Observations ( $N = 2,228$ )						
	$(N = 1,555)$		$(N = 673)$			
	Mean	Median	Mean	Median	Mean	Median
$SI\_MAG_{it}$	0.051	0.017	0.018	0.006	0.033 ***	0.012 ^^^
$SI\_PERSIST_{it}$	0.068	0.048	0.180	0.101	-0.112 **	-0.053 ^
<b>Panel B:</b> Non-Big Bath Observations ( $N = 2,012$ )						
	$(N = 1,356)$		$(N = 656)$			
	Mean	Median	Mean	Median	Mean	Median
$SI\_MAG_{it}$	0.040	0.014	0.016	0.006	0.024 ***	0.008 ^^^
$SI\_PERSIST_{it}$	0.066	0.048	0.182	0.099	-0.116 *	-0.052 ^

**Notes:**

This table presents univariate comparisons of select variables across two groups of observations: those in which the firm presents any recognized special items as a separate line item on the income statement (“Income Statement Presentation”), and those in which the firm aggregates all recognized special items into other line items, with identification only via footnote disclosure (“Footnote Presentation”). Only those observations having sufficient data to estimate Equation (1) are included. Panel A includes all observations reporting special items ( $N = 2,228$ ). Panel B includes only “Non-Big Bath Observations” ( $N = 2,012$ ); i.e., “big bath” observations are excluded. “Big bath” observations satisfy the following three criteria ( $N = 216$ ): net special items are income-decreasing; total negative special items exceed 5% of lagged total assets; and the firm reports negative net income before special items.  $SI\_MAG$  is firm  $i$ ’s year  $t$  absolute value of total annual (non-netted) special items, divided by beginning-of-period market value of equity.  $SI\_PERSIST$  is the persistence parameter assigned to firm  $i$ ’s year  $t$  special items. The parameter is derived from three steps: (1) industry level estimation (by 2-digit SIC) of year  $t+1$  net income before special items regressed on year  $t$  net income before special items and special items using all available Compustat firms, and allowing special items to vary by large versus small and income-increasing versus income-decreasing; (2) assigning the estimated special items parameter to the sample firm based on firm  $i$ ’s industry, and the size and sign of firm  $i$ ’s special items; (3) scaling the assigned special items parameter by firm  $i$ ’s core earnings persistence parameter. \*\*\*, \*\*, \* (^^^, ^^, ^) indicate significance at the less than 1%, 5%, and 10% levels, respectively, for two-tailed tests of means (medians) across observations having “Income Statement Presentation” versus “Footnote Presentation.”



TABLE 5  
Determinants of Financial Statement Presentation of Special Items

Variable	Predicted Sign	All Observations	Non-Big Bath Observations
Control Variables:			
<i>Intercept</i>		0.568 ( 8.89) ***	0.550 ( 8.16) ***
<i>YEAR<sub>t</sub></i>	+ / –	–0.009 (–2.54) **	–0.009 (–2.39) **
<i>SIZE<sub>it</sub></i>	+ / –	–0.022 (–3.86) ***	–0.025 (–4.12) ***
<i>INST<sub>it</sub></i>	+ / –	0.179 ( 3.99) ***	0.217 ( 4.51) ***
<i>SI_MAG<sub>it</sub></i>	+	0.668 ( 5.28) ***	0.916 ( 4.73) ***
<i>IS_DISAGG<sub>i</sub></i>	+	0.001 ( 0.47)	0.002 ( 1.02)
Experimental Variables:			
<i>SI_PERSIST<sub>it</sub></i>	+ / –	–0.009 (–2.19) **	–0.012 (–2.77) ***
<i>NSI<sub>it</sub></i>	+ / –	0.122 ( 4.24) ***	0.107 ( 3.64) ***
<i>MISS_BENCH<sub>it</sub></i>	+	0.100 ( 4.45) ***	0.127 ( 5.03) ***
<i>BEAT_BENCH<sub>it</sub></i>	–	0.077 ( 1.53)	0.074 ( 1.43)
<i>Adj-R<sup>2</sup></i>		0.055	0.058
<i>N</i>		2,228	2,012

**Notes:**

This table presents results from OLS regressions examining the management decision to present special items as a separate line item on the income statement (“income statement presentation”) versus aggregate them in another line item with identification only via footnote disclosure (“footnote presentation”). The dependent variable is *SI\_Sep*, measured as the absolute amount of (non-netted) annual special items presented in a separate line item on the income statement divided by the absolute amount of total annual (non-netted) reported special items: thus it ranges in value from 0 to 1, inclusive. The column “All Observations” includes all observations reporting special items and having available data ( $N = 2,228$ ). The column “Non-Big Bath Observations” ( $N = 2,012$ ) excludes observations classified as “big bath.” “Big bath” observations satisfy the following three criteria ( $N = 216$ ): net special items are income-decreasing; total negative special items exceed 5% of lagged total assets; and the firm reports negative net income before special items. Observations with large studentized residuals (representing less than 0.5% of total observations) have been eliminated to reduce the effect of outliers.

The control variables are as follows. *YEAR* is firm  $i$ ’s fiscal year. *SIZE* is the log of firm  $i$ ’s year  $t$  sales. *INST* is the percentage of firm  $i$ ’s outstanding common shares owned by institutions at the end of year  $t$ . *SI\_MAG* is firm  $i$ ’s year  $t$  absolute value of total annual (non-netted) special items divided by beginning-of-period market value of equity. *IS\_DISAGG* is the average level of financial reporting disaggregation for firm  $i$  during the sample period, measured

as the average number of line items reported on firm  $i$ 's income statements for all sample years in which no special items are reported.

The experimental variables are as follows. *SI\_PERSIST* is the persistence parameter assigned to firm  $i$ 's year  $t$  special items. The parameter is derived from three steps: (1) industry level estimation (by 2-digit SIC) of year  $t+1$  net income before special items regressed on year  $t$  net income before special items and special items using all available Compustat firms, and allowing special items to vary by large versus small and income-increasing versus income-decreasing; (2) assigning the estimated special items parameter to the sample firm based on firm  $i$ 's industry, and the size and sign of firm  $i$ 's special items; (3) scaling the assigned special items parameter by firm  $i$ 's core earnings persistence parameter. *NSI* is an indicator variable equal to 1 if firm  $i$  reports aggregate income-decreasing special items in year  $t$ , and 0 otherwise.

*MISS\_BENCH* is an indicator variable equal to 1 if firm  $i$ 's net special items cause year  $t$  net income to be below any of three benchmarks (year  $t-1$  net income, analysts' consensus earnings forecasts, or zero net income), and 0 otherwise. *BEAT\_BENCH* is an indicator variable equal to 1 if firm  $i$ 's net special items cause year  $t$  net income to be above any of three benchmarks (year  $t-1$  net income, analysts' consensus earnings forecasts, or zero net income), and 0 otherwise.

$t$ -statistics are in parentheses. \*\*\*, \*\*, \* indicate significance at the less than 1%, 5%, and 10% levels for the indicated one- or two-tailed tests, respectively. Standard errors control for heteroskedasticity and are clustered by company.

TABLE 6  
Relative Persistence of Special Items Across Their Presentation in the Financial Statements

	Base Regression	Presentation of Special Items	Presentation and Magnitude of Special Items	Presentation and Sign of Special Items	Presentation and Category of Special Items
	(1)	(2)	(3)	(4)	(5)
<i>Intercept</i>	0.020 ( 5.71) ***	0.020 ( 5.71) ***	0.019 ( 5.69) ***	0.018 ( 5.32) ***	0.019 ( 5.39) ***
<i>E<sub>it</sub><sup>*</sup></i>	0.910 (51.56) ***	0.911 (51.61) ***	0.909 (51.10) ***	0.919 (51.61) ***	0.910 (50.00) ***
<i>SI<sub>it</sub></i>	0.177 ( 9.90) ***				
<i>SI_IS<sub>it</sub></i>		0.163 ( 8.62) ***			
<i>SI_FN<sub>it</sub></i>		0.296 ( 5.32) ***			
<i>LARGE_IS<sub>it</sub></i>			0.166 ( 8.71) ***		
<i>LARGE_FN<sub>it</sub></i>			0.282 ( 4.85) ***		
<i>SMALL_IS<sub>it</sub></i>			-0.021 (-0.14)		
<i>SMALL_FN<sub>it</sub></i>			0.401 ( 2.18) **		
<i>NSI_IS<sub>it</sub></i>				0.145 ( 7.32) ***	
<i>NSI_FN<sub>it</sub></i>				0.311 ( 5.20) ***	
<i>PSI_IS<sub>it</sub></i>				0.311 ( 6.28) ***	
<i>PSI_FN<sub>it</sub></i>				0.410 ( 2.67) ***	
<i>RESTR_IS<sub>it</sub></i>					0.142 ( 2.35) **
<i>RESTR_FN<sub>it</sub></i>					0.436 ( 2.53) **
<i>WO_IS<sub>it</sub></i>					0.123 ( 4.28) ***
<i>WO_FN<sub>it</sub></i>					0.111 ( 1.08)
<i>ONEG_IS<sub>it</sub></i>					0.209 ( 5.22) ***
<i>ONEG_FN<sub>it</sub></i>					0.643 ( 3.55) ***
<i>OPOS_IS<sub>it</sub></i>					0.333 ( 6.53) ***
<i>OPOS_FN<sub>it</sub></i>					0.447 ( 2.82) ***
<i>Year Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes
<i>Adj-R<sup>2</sup></i>	0.441	0.441	0.441	0.443	0.429

*F-Test of:*

<i>SI_IS</i> – <i>SI_FN</i>	–0.133 [5.06] <sup>∇∇</sup>		
<i>LARGE_IS</i> – <i>LARGE_FN</i>		–0.116 [3.58] <sup>∇∇</sup>	
<i>SMALL_IS</i> – <i>SMALL_FN</i>		–0.422 [3.38] <sup>∇∇</sup>	
<i>NSI_IS</i> – <i>NSI_FN</i>			–0.166 [6.85] <sup>∇∇∇</sup>
<i>PSI_IS</i> – <i>PSI_FN</i>		–0.099 [0.38]	
<i>RESTR_IS</i> – <i>RESTR_FN</i>			–0.294 [2.62] <sup>∇</sup>
<i>WO_IS</i> – <i>WO_FN</i>			0.012 [0.01]
<i>ONEG_IS</i> – <i>ONEG_FN</i>			–0.434 [5.62] <sup>∇∇∇</sup>
<i>OPOS_IS</i> – <i>OPOS_FN</i>			–0.114 [0.48]

#### Notes:

This table presents regressions examining the persistence of reported special items in predicting one-year ahead net income. The dependent variable is  $E_{t+1}$ , or firm  $i$ 's year  $t+1$  net income. Across all regressions,  $N = 3,745$ . We eliminate observations with large studentized residuals (representing approximately 1% of total observations) to reduce the effect of outliers.

The variables are defined as follows. Note all variables, including the dependent variable, are scaled by market value of equity at the beginning of year  $t$ .  $E^*_t$  is firm  $i$ 's year  $t$  net income before special items.  $SI_t$  is firm  $i$ 's year  $t$  special items.  $SI\_IS$  ( $SI\_FN$ ) are firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation.  $LARGE\_IS$  ( $LARGE\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation when firm  $i$ 's non-netted special items divided by beginning market value of equity are above the sample median.  $SMALL\_IS$  ( $SMALL\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation when firm  $i$ 's non-netted special items divided by beginning market value of equity are below the sample median.  $NSI\_IS$  ( $NSI\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that are income-decreasing (i.e., negative).  $PSI\_IS$  ( $PSI\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that are income-increasing (i.e., positive).  $RESTR\_IS$  ( $RESTR\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to restructuring charges.  $WO\_IS$  ( $WO\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to asset write-offs.  $ONEG\_IS$  ( $ONEG\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to other special items charges (that is, neither restructuring nor write-offs) that are income-decreasing.  $OPOS\_IS$  ( $OPOS\_FN$ ) equals firm  $i$ 's year  $t$  special items receiving income statement (footnote) presentation that relate to other special items charges (that is, neither restructuring nor write-offs) that are income-increasing.

\*\*\*, \*\*, \* represent significance at the less than 1%, 5%, and 10% levels for two-tailed tests examining whether the coefficients differ from zero.  $t$ -statistics are shown in parentheses.

<sup>∇∇∇</sup>, <sup>∇∇</sup>, <sup>∇</sup> represent significance at the less than 1%, 5%, and 10% levels for one-tailed tests comparing differences across coefficients for special items receiving income statement versus footnote presentation.  $F$ -statistics are shown in brackets.

Standard errors control for heteroskedasticity and are clustered by company.

TABLE 7  
Determinants of Financial Statement Presentation of Special Items – Sensitivity Analyses

**Panel A: Logistic Regressions**

Variable	Predicted Sign	Non-Big Bath Observations	Excluding Mixed Presentation
Control Variables:		(1)	(2)
<i>Intercept<sub>it</sub></i>		−0.164 [−0.25]	0.301 [ 0.81]
<i>YEAR<sub>t</sub></i>	+ / −	−0.026 [−1.72]	−0.043 [ −4.48] **
<i>SIZE<sub>it</sub></i>	+ / −	−0.089 [ 8.59] ***	−0.150 [−21.71] ***
<i>INST<sub>it</sub></i>	+ / −	1.151 [22.43] ***	1.152 [ 21.38] ***
<i>SI_MAG<sub>it</sub></i>	+	9.874 [24.42] ***	8.394 [ 18.25] ***
<i>IS_DISAGG<sub>i</sub></i>	+	0.006 [ 0.39]	0.010 [ 1.26]
Experimental Variables:			
<i>SI_PERSIST<sub>it</sub></i>	+ / −	−0.048 [−4.55] **	−0.058 [ −6.28] **
<i>NSI<sub>it</sub></i>	+ / −	0.620 [20.61] ***	0.358 [ 6.62] ***
<i>MISS_BENCH<sub>it</sub></i>	+	0.799 [30.27] ***	0.796 [ 27.42] **
<i>BEAT_BENCH<sub>it</sub></i>	−	0.251 [ 0.92]	0.252 [ 0.87]
<i>Wald Statistic</i>		138.42 ***	114.32 ***
<i>N</i>		2,012	1,701

**Panel B: OLS Regressions of Non-Big Bath Observations By the Magnitude of Special Items**

Variable	Predicted Sign	Special Items Above Median	Special Items Below Median
Control Variables:		(3)	(4)
<i>Intercept</i>		1.316 (19.28) ***	0.129 ( 1.32)
<i>YEAR<sub>it</sub></i>	+ / −	−0.024 (−6.61) ***	0.010 ( 1.73) *
<i>SIZE<sub>it</sub></i>	+ / −	−0.043 (−7.79) ***	−0.008 (−0.85)
<i>INST<sub>it</sub></i>	+ / −	0.156 ( 3.66) ***	0.244 ( 3.30) ***
<i>SI_MAG<sub>it</sub></i>	+	0.343 ( 2.74) ***	4.272 ( 2.87) ***
<i>IS_DISAGG<sub>it</sub></i>	+	−0.011 (−4.52)	0.007 ( 3.02) ***
Experimental Variables:			
<i>SI_PERSIST<sub>it</sub></i>	+ / −	−0.011 (−1.78) *	−0.013 (−2.57) **
<i>NSI<sub>it</sub></i>	+ / −	0.031 ( 0.89)	0.074 ( 1.96) *
<i>MISS_BENCH<sub>it</sub></i>	+	0.008 ( 0.38)	0.065 ( 1.27)
<i>BEAT_BENCH<sub>it</sub></i>	−	0.049 ( 1.17)	−0.082 (−0.82)
<i>Mean (Special Items<sub>it</sub> / MVE<sub>it-1</sub>)</i>		0.04	0.01
<i>Adj-R<sup>2</sup></i>		0.141	0.041
<i>N</i>		1,006	1,006

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**Notes:**

This table presents results from sensitivity analyses examining the management decision to present special items as a separate line item on the income statement (“income statement presentation”) versus aggregate them in another line item with identification only via footnote disclosure (“footnote presentation”). Across both panels, the samples include only “non-big bath” observations; that is, the sample excludes observations classified as “big bath.” “Big bath” observations satisfy the following three criteria: net special items are income-decreasing; total negative special items exceed 5% of lagged total assets; and the firm reports negative net income before special items. Panel A presents results from logistic regressions. For column (1), the dependent variable equals 1 if *any* special items receive income statement presentation, and 0 otherwise (i.e., all reported special items receive footnote presentation). For column (2), the dependent variable equals 1 if all special items receive income statement presentation, and 0 if all reported special items receive footnote presentation. Thus, column (2) excludes observations having mixed presentation ( $N = 311$ ). Panel B presents results from OLS regressions, wherein the dependent variable is *SI\_Sep*, measured as the absolute amount of (non-netted) annual special items presented in a separate line item on the income statement divided by the absolute amount of total annual (non-netted) reported special items: thus it ranges in value from 0 to 1, inclusive. For column (3), the sample includes only observations wherein absolute non-netted special items divided by beginning market value of equity exceed the sample median. For column (4), the sample includes only observations wherein absolute non-netted special items divided by market value of equity are below the sample median.

All variables are defined in Table 5. Wald Chi-Square statistics (*t*-statistics) are presented in brackets (parentheses) under columns 1 and 2 (3 and 4). \*\*\*, \*\*, \* indicate significance at the less than 1%, 5%, and 10% levels for the indicated one- or two-tailed tests, respectively. Standard errors control for heteroskedasticity and are clustered by company.