

Date: 15 August 1990
To: John Doe
Chief Financial Officer
From: Brandon Miller
Controller
RE: Recommended Reporting on the Income Statement for the Year Ended August 4, 1990, of Damages Suffered from the Earthquake

On October 17, 1989, the Emporium division of CHHS suffered extensive damage due to the San Francisco area earthquake that registered 7.1 on the Richter scale. Uninsured damages reached \$27.5 million (\$16.5 million after tax benefits.)

There are two best options for reporting the damages of exceedingly large and destructive earthquakes on the income statement. Option one is to report the loss separate from operations as an extraordinary loss. Option two is to include the loss in continuing operations but report it as a separate income statement component. Both options would require footnotes for proper disclosure of the event.

Unusual or infrequent events may be reported as extraordinary items. The advantage of reporting extraordinary items (especially losses) is simple: they are not included under normal operating income and thus are usually not interpreted by investors and creditors as items that will occur in the foreseeable future. Therefore, the event's effects on net income are not judged as being extremely detrimental, since they should not be occurring again. According to the Accounting Principles Board Opinion No. 30 under paragraph 20, extraordinary items must both be unusual and infrequent in nature and must take into account the environment in which the business operates. The key decision for CHHS is determining whether the earthquake satisfies both criteria. According to paragraph 22 of APB 30, "An event of a type that occurs frequently in the environment in which the entity operates cannot be considered as extraordinary, regardless of its financial effects." Paragraph 21 of the opinion states that unusual nature may also not simply be established by events that are out of the control of management. Since there have been 103 earthquakes since 1900 in Northern California with magnitudes of 5 or greater, including only 3 with magnitudes of 6.7 or greater according to the NCEDC, it may be very hard to substantiate that

earthquakes are infrequent and of a type that would not be expected to recur in the foreseeable future. If we were to report the damage as an extraordinary item, it would appear below continuing operations as the net-of-tax number of \$16.5 million.

Items that are either infrequent in occurrence or unusual in nature may be reported under continuing operations as a separate component, according to APB 30 paragraph 26. The advantage of such reporting is to disclose the event as infrequent or unusual while still including it under operations, because it does not qualify as extraordinary. Under this reporting method, investors and creditors are likely to interpret the unusual event as something with actual risk that could happen again, but the probability is minimal. Thus the earthquake and the resulting effect on the net income due to damages would, in all likelihood, be interpreted as an event with a low possibility of occurring again in the short-term. Under this option, we would include the full \$27.5 million loss as a separate component in continuing operations.

The purpose of the income statement is to serve as a guide in predicting the future of the business. Thus I believe that it is in the best interest of CHHS to report the earthquake damages under continuing operations but as a separate income statement component (option two.) Earthquakes are frequent in California, the geographical location of our business, and thus should not be included as extraordinary items according to APB 30. By reporting the earthquake damages as a separate item under continuing operations, CHHS will be consistent with the APB Opinion, because such a large earthquake (only 3 of comparable size in the last 90 years) is indeed unusual in nature and has a high degree of abnormality. Investors and creditors will also have a clear idea of and take into account the abnormally high amount of damages and the unusually destructive nature of the earthquake when interpreting the lower than expected net income on the income statement.

If you have any questions concerning the proposed reporting of earthquake damages on the income statement, please contact me at 353-5148. Thank you.

CC: Other Person A

Other Person B