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# One-Time Charges: Never Having to Say You're Sorry?

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*Although financial analysts sometimes dismiss one-time charges to company earnings as unimportant, stock returns appear to suffer significantly during periods of frequent one-time charges. Distinguishing among types of one-time charges is important. Some charges represent sound economic decisions that the market appears to recognize. One-time charges relating to accounting changes usually reflect catching up with past events (e.g., recognizing the true cost of postretirement benefits). These charges can result in companies changing policy going forward. The charges that appear most problematic are restructuring charges and those taken for discontinued operations. When such charges occur frequently, they may yield insights into future expected cash flows and the quality of companies' management.*

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**E**ach quarter, investors and analysts anxiously await Earnings announcements. Sometimes, the stock movements that follow such announcements appear perverse: Earnings that look "bad" are greeted with euphoria, and what appear to be "good" earnings send stock prices lower. Often, the reason lies in the Extraordinary Items and Charges category that is included within earnings. Analysts usually consider earnings from continuing operations the most important item and dismiss one-time charges as "noncash" items that have no real economic impact. Understanding the nature and frequency of one-time charges is important, however, because they give important insights into future expected cash flows and the quality of companies' management.

## **NONCASH CHARGES: FORMER OR FUTURE CASH**

The value of a company's stock derives from its future expected cash flows. Valuation tools such as the dividend discount model, for example, can generate either expected returns or target prices by comparing estimated future cash flows with current stock prices. Clearly, the main determinant of future earnings will be companies' current businesses plus any expansion plans from either existing businesses, new businesses or markets, or acquisitions. From an economic standpoint, discontinued busi-

nesses or failed ideas are merely sunk costs, assuming they do not continue to cost money.

One should recognize, however, that every noncash charge at some point was or will be a cash item. A discontinued business or a closed plant, for instance, required cash outlays in the past. Changes in accounting principles that reduce earnings may imply that earlier reported earnings were overstated because the company had underestimated the true economic cost of, for instance, postretirement health benefits or pensions. Occasionally, one-time charges represent future cash when they are accruing for future expenses. These charges often occur when a company has chosen to take a "big bath"—throwing as many charges as possible into a period of large losses, hoping that this tactic will then "clean up" earnings going forward.

Most companies at some time need to take one-time charges. Sometimes they are the result of economic events, and sometimes they are attributable to accounting rules and regulations requiring items to be reported "below the line." Accounting principles and practice require charges relating to continuing operations to be included "above the line" in Income from Continuing Operation or Income before Extraordinary Items. Items that are unusual and nonrecurring in nature are displayed separately below the line, before Net Income. Companies need to take risk in running and growing their businesses. Not every decision can work out as planned, and companies should not necessarily be penalized for making decisions that did not

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work out, assuming that the decisions were reasonable at the time they were made. Management may have a preference, however, for putting charges below the line rather than above the line because analysts focus on Primary Earnings per Share (EPS) from Continuing Operations.

### THE COST IN INVESTMENT RETURN

Two screens were run to test whether the stock market penalizes companies that report one-time charges frequently. The first screen looked for companies in the Compustat data base that had reported one-time charges or extraordinary items that reduced Primary EPS in three or more years between 1989 and 1994. The most recent full year reported by most companies was 1993, although some companies with fiscal year-ends in early to mid-1994 showed fiscal 1994 results. The cumulative total stock return for the 124 companies that passed the screen was computed for the five years ending December 31, 1994. The average cumulative stock return of those companies was 36.5 percent. Table 1 compares the returns of these companies with those of the S&P 500 and the Russell 3000, 2000, and 1000 indexes. The average for the selected companies was substantially below that of the indexes.

As Table 2 shows, of the 124 stocks, 79 underperformed the S&P 500 (including 53 with a negative return for the five years). Forty-five stocks outperformed the S&P 500, including Mattel (209.2

percent), which was up almost four times as much as the Index; Federal National Mortgage Association (+141.5 percent); and Dial Corporation (+104.9 percent).

The second screen went back into the data base for the prior five years (1983 to 1988) and found companies reporting one-time charges three or more times in that period. Cumulative stock returns were computed for the five years ending December 31, 1989, and for the same group of companies, for the subsequent five years ending December 31, 1994. Eighty companies passed this screen. The cumulative average stock return on this group of companies was 37.2 percent in the 1985-89 period, compared with 91.3 percent for the S&P 500. Nineteen of the stocks outperformed the S&P 500, and 61 underperformed (with 37 producing negative returns). These results were similar to those of the first screen in that during the period that unusual items were being reported frequently, relative stock returns suffered. Going forward, however, the 80 stocks in this sample produced an average cumulative return of 68.3 percent from 1989 to 1994 compared with the S&P 500 Index return of 51.5 percent. Thirty-three of the stocks in the sample outperformed the index and 48 underperformed. Only 15 companies appeared in both lists of stocks (i.e., reporting one-time charges and extraordinary items that lowered Primary EPS in at least three years of the first five-year period and three of the second five-year period). Thus, companies that may

**Table 1. Cumulative Stock Returns of Selected Companies and Stock Market Indexes**  
(percentages)

Time Period	Companies Reporting Charges in 3 or More Years	S&P 500	Russell	Russell	Russell
			3000	1000	2000
1985-89	37.2	91.3	139.6	145.4	83.4
1989-94	36.5	51.5	54.6	53.8	62.5

**Table 2. Relative Investment Performance of Selected Companies**

Time Period	Number of Companies in Sample	Number of Companies Outperforming S&P 500	Number of Companies Underperforming S&P 500	Number of Companies with Negative Investment Return
1985-89	80	19	61	37
1989-94	124	45	79	53

have been troubled in the past appear to reduce the incidence of anomalous charges and are given a fresh start in the eyes of the market.<sup>1</sup>

### **WHAT TYPES OF CHARGES ARE CAUSE FOR CONCERN?**

Anomalous accounting charges may be placed into four broad categories: restructuring or specific charges, charges related to discontinued operations, extraordinary items, and charges arising from accounting changes.

Restructuring or specific charges are above-the-line charges that relate to ongoing businesses. They reflect the effect of past decisions in a company's core businesses that did not work out as planned. Similarly, charges related to discontinued operations reflect lines of business with disappointing results. Extraordinary items do not necessarily reflect poor luck or judgment; they include debt extinguishment, operating loss carryforwards, and litigation settlements, among others. During the past few years, the early extinguishment of high-coupon debt has been the most common reason for an extraordinary charge, and this move can help companies' future earnings and financing flexibility.<sup>2</sup>

The fourth type of charge results from accounting changes and reflects catching up with past events rather than issues affecting current or future earnings. Yet, changes in accounting practices can also affect future management decisions because they highlight the cash flow consequences of certain policies. For example, SFAS 106 and 112 forced many companies to recognize the magnitude of postretirement benefits head on. In recent years, a number of companies have trimmed back the levels or structure of postretirement benefits, quite possibly as a result of recognizing their true cost. Defined-contribution retirement plans (for which companies' cash flow obligations may be more easily forecast), for instance, have become more popular than defined-benefit plans (for which eventual cash flow requirements are less certain).

### **A SAMPLE OF STOCKS**

A small sample of the stocks that appeared in the first screen (1989 to 1994) were selected for further examination. National Medical Enterprises (NME), which is now Tenet Corporation (THC), reported below-the-line items in four of the five years between 1989 and 1994. The cumulative total return on its stock was -13.1 percent. In fiscal 1994, discontinued operations accounted for a \$4.19 charge to Primary EPS; in 1993, they accounted for \$0.63;

and in 1992, \$0.50. In addition, 1994 saw a \$0.36 charge relating to an accounting change. NME, an owner and operator of hospitals, was a very troubled company during this period. In August 1993, for instance, federal investigators searched its premises. Improper practices had been discovered in the company's psychiatric hospital division relating to marketing and billing procedures and practices. In 1993, the company settled litigation in two separate settlements with 19 insurers, totaling \$215 million. That year, the company also settled two-thirds of its psychiatric patient claims involving fraudulent practices and allegations of conspiracy. In June 1994, the company paid \$363 million to conclude the federal investigation. The company, during this five-year period, brought in new senior management and exited the psychiatric hospital business. The one-time charges reflected poor management practice in prior periods. The decline in the stock price reflected the company's ills and its cloudy outlook.

Mattel (MAT), whose stock returned 209.2 percent in the 1989-94 period, had extraordinary charges in three of five years. The bulk of the charges came from the cost of the early retirement of long-term debt. For instance, in fiscal 1993, Primary EPS was reduced by \$0.09 from the retirement of 10.69 percent debt subsequent to the company's merger with fellow toymaker Fisher Price. Although a cost was associated with the early retirement of high-coupon debt, the economic advantage in doing so was clear, given the declining interest rate environment. The company's future cost of funds would be lower, and the company would have increased future financing flexibility.

The three years of consecutive one-time charges taken by another company in the sample, the Federal National Mortgage Association (FNM), were also related to the early retirement of high-coupon debt. FNM's stock in the period returned 141.5 percent. In the case of these two companies, the below-the-line charges represented sound economic decisions.

Bell Atlantic (BEL) was one of the two regional telephone companies to pass the screen. Its five-year total stock return was 14.9 percent (well below the S&P 500's 51.5 percent). Although Bell Atlantic also retired high-coupon debt early in both 1992 and 1993, the company's below-the-line charges reflected other elements. In 1991, BEL took a \$3.63 charge against EPS from the adoption of SFAS 106 (relating to postretirement health care benefits). The company chose to recognize the cumulative effect of the accounting change, which amounted to \$1.55

billion, at one time, although the accounting standard gives companies the option to phase in the transition effects of the change over 20 years. In 1993, Bell Atlantic had a \$0.04 charge from the adoption of SFAS 112. The company, in common with many older companies with mature work forces, was severely affected by the change in accounting standards relating to postretirement and postemployment benefits. These charges allowed the company to play catch-up on recognizing those expenses. Of course, this practice also means that earlier years' earnings had been commensurately overstated. Nevertheless, the decision to take the big charge at one time means that future years' earnings numbers will capture a truer picture of ongoing postretirement benefit costs.

The adoption of SFAS 106 and SFAS 112 also played a part in the one-time charges taken by Armstrong World (ACK), whose stock returned 23.4 percent for the five years. The company's 1992 Primary EPS prior to those charges were a loss of \$1.98. After the adoption of the accounting changes, Primary EPS were -\$6.49. The company also reported losses and provisions for losses from discontinued businesses below the line in 1991. Restructuring charges that were taken above the line were \$89.9 million in 1993, \$165.5 million in 1992, and \$12.8 million in 1991. This example highlights the flexibility management has in showing items above or below the line.

## CONCLUSION

Many factors influence stock returns. Understanding a company's business, its industry and position within its industry, and its competitive edge (or lack thereof) is critical. Looking forward, a company's future cash flows are the main determinants of investment returns. Although this fact may lead analysts to disregard charges unrelated to continuing operations, the frequency and nature of one-time charges can be used to fine-tune earnings estimates and to evaluate management.

Although some types of extraordinary charges make economic sense (such as the retirement of high-coupon long-term debt), companies that repeatedly produce unusual expense items may have substantive issues to face either in their businesses and markets or in the decision-making ability of their leadership. The results of these screens suggest that the market recognizes this weakness by penalizing companies reporting extraordinary items three or more years within a five-year period. Not all such stocks underperform, however, so understanding the nature of these extraordinary items is critical in order to make informed estimates of the likelihood of their recurrence. Furthermore, the market appears to forgive and forget once the period of frequent charges is over, giving some of those stocks the opportunity to subsequently outperform the broad index.<sup>3</sup>

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## NOTES

1. See M. Clayman's "Excellence Revisited," *Financial Analysts Journal*, vol. 50, no. 3 (May/June 1994):61-65, and "In Search of Excellence: The Investor's Viewpoint," *Financial Analysts Journal*, vol. 43, no. 3 (May/June 1987):54-63, for a discussion of reversion to the mean and the outperformance of "bad" versus "good" companies.
2. *Accounting Trends and Techniques*, eds. Jack Shohet and Richard Rikert (Jersey City, NJ: American Institute of Certified Public Accountants, 1992): Table 317, p. 338.
3. The author would like to thank Gerald I. White, Robin A. Schwartz, and Robin Schoen for their helpful comments on this paper.