Studies in Management and Accounting for the
FOREST PRODUCTS INDUSTRIES

ACCOUNTING FOR BUYING BACK TIMBER CUTTING CONTRACTS

by Wendell L. Hamilton
and Armond B. Clemens,
Coopers & Lybrand,
Eugene, Oregon
INTRODUCTION

The recently enacted Federal Timber Contract Payment Modification Act (the relief bill) brings new hope to the forest products industry and new accounting concerns to the affected companies. The views expressed in this monograph are those of the authors, but it is intended to provoke thoughtful consideration of the accounting questions involved and, hopefully, to bring uniformity in application of accounting principles within the industry.

BACKGROUND

Continued inflation in the market price of its product and a perceived shortage of available timber caused the industry to carry on a bidding war during the 1970s. When the market-price bubble broke in the fall of 1979 no great concern was noted in the industry because of the historical "peak and valley" market that had been accepted as normal. As this valley continued through 1981 and 1982, the industry awakened to the fact that the spiral of the '70s might not return and those companies that had contracted to buy stumpage at prices several times the appraisal price faced serious financial problems. The situation was pervasive in the industry - most of the privately-owned companies faced financial ruin and, to varying degrees, the large publicly-owned companies were looking at substantial losses.

In 1982, an effort at legislative relief was introduced, known as the Hatfield-McClure Bill. This bill was on a rocky path from the outset and collapsed in 1983 when the industry support was splintered, the Southern pine group rejecting federal aid to its competition in the Northwest. Finally, in early 1984, the industry reached a nearly unanimous compromise, although it was tenuous. This common front convinced Senator Hatfield to renew his efforts at relief for the industry so vital to his constituency. In August 1984, Senator Hatfield introduced in the Senate and Representative Weaver introduced in the House the relief bill that was finally passed by both Houses and signed by President Reagan in October.

THE LAW

The relief bill permits timber companies to turn back to the federal agencies those expensive pre-1982 timber cutting contracts by payment of a buy-out cost. The volume of timber under contract to be turned back is specified in the relief bill. That cost is simply stated as:

- $10 per thousand board feet (MBF) for those companies whose potential loss on those contracts exceeded their "net book worth".
10% of the overbid if the potential loss is 50% to 100% of their net book worth (but at least $10 per MBF).

15% to 30% of the overbid if the potential loss is less than 50% of their net book worth. This last computation is on a progressive scale depending on the volume of timber turned back.

DEFINITIONS AND DETAILS

Many definitions and procedures cannot be known until regulations are issued, as provided for in the bill. This could be a lengthy procedure -

1. Original drafting with suggestions being offered by the industry and other interested groups.

2. Exposure for debate and criticism.

3. Final approval by the various federal agencies.

Although many of the computations to be made relative to relief cannot be made until those regulations are issued and we have more definitive rules to work with, it is not inappropriate to consider in advance the concepts and alternatives to be faced.

The terms to be defined and questions to be answered in the regulations include:

1. Net Book Worth - based on the language in the relief bill, it is assumed this can be defined as owners' equity adjusted by removing any recorded assets and liabilities on these contracts.

2. Potential Loss - a determination of the potential loss on the timber contracts must be made by each company in order to make the comparison to net book worth. This computation is akin to a net realizable value test, with many assumptions to be made, e.g., market value of product (logs or lumber?), processing costs - logging (and manufacturing?), overhead allocation, etc. We can only assume that the regulations will specify how this determination is to be made.

3. Balance Sheet Date - the net book worth is to be taken from a recent balance sheet. Senator Hatfield discussed the fact that publicly-held companies report financial results quarterly, but some privately-held companies prepare only year-end balance sheets. No guidance is given as to which balance sheet is to be used in the comparison or whether each company has a choice.
Role of the Certified Public Accountant — although the relief bill provides that "Net book worth shall be... determined by an independent public accountant...", it appears that the federal agencies will permit self-certification. Apparently, this will permit each company to determine which buy-out category is applicable to them and submit a statement to the agency as notification.

Deposits — will credit be given against the buy-out cost? The same question applies to timber removed versus payments made on those contracts partially cut.

Roads — will credit be given for construction of roads on BLM tracts? Will equity be arranged on Forest Service road construction versus ineffective purchaser road credits?

Footage Measurement — some timber contracts have been sold using a 32-foot log for measurement while others are based on a 16-foot log, depending on region and federal agency involved. Hopefully, a formula will be established to convert to 32-foot logs to avoid the conflict between the two measurement techniques.

ACCOUNTING PRINCIPLES

Character of the Buy-Out Cost — once the regulations answer the questions left unanswered by the law and the amount of the buy-out cost can be determined, it is necessary to determine the character of this cost. The alternatives include:

A Deferred Charge — similar to start-up costs which are for the benefit of future periods, therefore, are amortized over those periods. It's difficult to identify any benefit to future periods from this buy-out cost; therefore, it is not a deferred charge.

A Prior Period Adjustment — Statement of Financial Accounting Standards (SFAS) No. 16 identifies the criteria for charges which qualify as a prior period adjustment. The only possible consideration for the timber buy-out cost falling within the guidelines of SFAS No. 16 would be as "correction of an error in the financial statements of a prior period". The forest products industry has long treated the potential losses on timber contracts as a contingency as described in SFAS No. 5, contending that the loss should be recognized in the period that the amount is determinable. Using that accounting principle, we have to recognize the loss in the current period because this is when it becomes determinable. It is not a correction of a prior period.
A Current Period Charge - using the definition and treatment contained in SFAS No. 5, the buy-out cost is a current period expense. Depending on materiality, it may be appropriate to have this as a line item in the statement of operations, as discussed in Accounting Principles Board Opinion (APB) No. 30, paragraph 26.

An Extraordinary Item - there may be holders of timber cutting contracts that would qualify to treat the buy-out cost as an extraordinary item. Whether they meet the criteria for extraordinary treatment, as discussed in APB No. 30, should be considered on a company-by-company basis.

Timing of the Charge - the question then follows as to which period the buy-out cost should be recorded on the company's books. There appears to be two alternatives:

- When management determines that they will avail themselves of the relief bill and the selection of contracts has been made.
- When the contracts to be turned back have been agreed upon between the purchaser and the federal agency.

There may be some difference of opinion as to whether SFAS No. 5 is directly applicable to this situation; however, the similarity is close enough that the spirit of the matter would dictate that the procedure of SFAS No. 5 be applied. Using that logic, it appears that the charge to income should be made when management decides which contracts will be turned back. At that time, the amount of the buy-out cost can be reasonably estimated. The actual amount may vary because of change in the selection of contracts turned back; nevertheless, the amount can be reasonably estimated.

Waiting until the contracts to be returned have been agreed upon between the purchaser and the federal agency appears to demand a degree of precision not normally required in accounting.

REMAINING CONTRACTS

Nearly all affected companies will be left with some unprofitable timber cutting contracts after the turn back. It would seem appropriate to apply historic accounting principles of the industry - these are purchase commitments to be evaluated in accordance with SFAS No. 5.
A VISION

Hopefully, the industry will gain a new insight from its plight of the last five years. More information should be disclosed in the financial statements regarding timber purchase commitments. The reader of the financial statements should be made aware of footage under contract, average cost per MBF (perhaps by year of expected cutting or contract termination) and a formula for relating that to present price levels or break-even points.

TAX CONSIDERATIONS

The income tax considerations relate to the deductibility of the buy-out cost, its character and the timing of the deduction. These are briefly discussed in the following paragraphs:

. Deductibility - there is a well established principle that a payment to obtain relief from a burdensome or unprofitable business obligation is a deductible item. It must be clear that such payment does not represent the purchase of property with a useful life extending into the future. The payments in question should easily meet the deduction criteria.

. Character - generally, in order for an item to be treated as a capital loss, there must be either the sale or exchange of a capital asset or a specific statutory provision which treats an event as such a sale or exchange. In the present situation, we have a payment to obtain relief from a performance obligation. The deduction is an ordinary business expense. The elements of a capital loss are not present.

. Timing - the general rule for accrual basis tax accounting is that an item is deductible when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy", IRC Sec. 461(h)(4).

. With respect to fact of liability, it is important to note that the contract relief under the legislation is entirely voluntary. In any particular situation, the economics may indicate that electing such relief is the only logical choice. However, until the taxpayer takes some action to establish a legal liability for the payment, all the necessary events to establish a deduction have not occurred. Thus, a taxpayer who seeks the deduction would be well advised to submit his requested contract cancellation to the government before the end of his fiscal year.
With respect to the amount of deduction, absolute accuracy is not necessary, only "reasonable accuracy". The legislation provides mechanical rules for computing how much relief may be sought and the price to be paid. In many cases, the resulting amount will be readily determinable. However, there will be situations where the answer may not be as simple.

It is apparent that the procedures to designate which contracts are to be turned back will not likely be published before the end of 1984. A formal action of the Board followed by written communication to interested parties (primary creditors, stockholders, loggers, the government, etc.) stating the irrevocable decision to participate in the program should suffice.

An aggressive argument might be to say that the 1984 legislation has perfected a loss which already existed. The taxpayer has been liable on contracts which he knew embodied an unavoidable loss. However, the loss was incapable of measurement due to all the variables of expenses and selling price which ultimately determine profit or loss. The 1984 Act gave an objective measuring stick for the loss by fixing the buy-out cost.

A conservative position would be to defer accrual of the deduction until completing the selection of contracts and submitting the request to the government.

For cash-basis taxpayers, the expenses should be deductible no earlier than when actually paid. The optional nature of the relief and the other contingencies discussed above prevent this from being characterized as a "loss" deductible when incurred. Rather it is an expense, deductible when paid. A cash-basis taxpayer who chooses to finance the buy-out cost by the government's five-year program would be hard pressed to justify a deduction before actual payment.

**SUMMARY**

Current legislation has provided the timber industry with relief and also presents a challenge to report the costs associated with this legislation in a clear and meaningful manner to the ultimate users of financial statements.

Federal legislation has provided various definitions and formulas to compute these costs for each company. These costs are considered a current period charge to the statement of operations in accordance with the provisions of APB No. 30, "Reporting the Results of Operations". These costs should be accrued at a time when the amount of the buy-out cost can be reasonably estimated as discussed in SFAS No. 5, "Accounting for Contingencies".
Following appropriate action by management or a Board of Directors, there should be no difference in reporting the cost associated with the relief bill for financial reporting purposes and for income tax purposes by accrual-basis taxpayers. Cash-basis taxpayers should report the costs as a deduction when actually paid.
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