

Timberlands: generally accepted accounting principles and fair value essay sample...

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INTRODUCTION

This memorandum will address issues raised by the transformation from U. S. Generally Accepted Accounting Principles (US GAAP) to International Financial Reporting Standards (IFRS) in the timber industry. I will cover the following topics: different accounting treatment under U. S. GAAP and IFRS, the influence on investment decisions, Plum Creek's reason for the opposition against transformation, and conclude with my preferred accounting treatment under different roles.

ACCOUNTING TREATMENT

The concern is mainly on recognition of the value of standing timberlands. Under US GAAP, standing timber is accounted for on a historical cost basis. On the other hand, the relevant accounting guidance under IFRS specified that agricultural crops (including standing timber) be valued at their fair market value less estimated harvesting costs at the end of each quarter.

If the fair value of standing timber changed during the accounting period, several differences will incur between the treatment under US GAAP and IFRS. If the fair value increases, no accounts are affected under US GAAP. If the fair value decreases, impairment will show on the income statement. Accordingly, the asset accounts (e. g. inventory account) and equity accounts (mainly retained earnings account) are affected but remain relatively stable on US GAAP's balance sheet if the fair value decreases. In contrast, for IFRS, the income statement and balance sheet are more volatile with changes in the market fair value. There will be gains or impairments on

the income statement as well as raise or drop in the value of asset and equity, with accordance to increase or decrease in the fair value.

INFLUENCE ON INVESTMENT DECISIONS

As a senior manager at a timber company, different accounting treatment of standing timber might affect my decisions about investing in additional forestland to a large extent. In general, under IFRS, the timber market seems riskier to me because of the great volatility reflected from the financial reports. So I might decide to sell some of the company's forestland in order to lower the risks.

Furthermore, the timber industry may seem unattractive to me under IFRS because the operating income from the harvest will be closed to zero (because the timber will be recorded at fair value and should approximate its net selling price). Specifically, my decisions could be largely influenced in a certain period when the fair value of standing timber fluctuates. I might decide to invest more in forestland when the fair value is high and the income is considerably positive, or, on the other hand, decide to pull back some of my investment when the fair value as well as the income are low.

REASONS FOR OPPOSITION

Plum Creek lists numerous reasons against the implementation of fair value accounting in its letter to the SEC. First of all, Plum Creek argues that estimating the fair value of standing timber requires numerous and extensive assumptions. In their opinion, the fair value of partially grown stands is theoretical and cannot be objectively determined. I find this reason

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is compelling because, based on the cash flow model (no market prices available for partially grown stands of timber), there are too many assumptions determining the fair value and each assumption is a myriad of other assumptions. Companies will find it difficult to predict factors such as future log prices and growth rates and the result from the assumptions are thus unreliable.

Another reason concerning reliability is on the time periods. Plum Creek believe that the greater the time periods to be included in the fair value estimate, the less reliable the estimate tends to be. I agree with this argument because standing timber is different from most other agricultural products in terms of its harvest rotation. The managers know about their business and uses statistics to support this argument.

As stated in the letter, Plum Creek's sawlog rotations ranging from 25 years to 50 years compared with annual or even semiannual mature period of other agricultural products. In such a long term, a snowball effect will probably incur on the fair value estimates based on small changes in assumptions, making the estimates inaccurate and meaningless.

Plum Creek further reasons that reporting standing timber at fair values does not improve comparability. To support this argument, they again bring up the extensive and numerous assumptions required in estimating the fair value of standing timber. They argue those estimates are not likely to be consistent among companies and companies will not all revise estimates in the same reporting period. However, in my opinion, this concern can be addressed by FASB's regulation. The legislator will establish a detailed

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document listing standards of timberland value estimation and force the industry to implement it before a certain point of time.

So, Plum Creek's this argument is unreasonable. In addition, the company believes the cost to compute the fair value of standing timber far outweighs any benefit. There will be extensive documentation and auditing requirements for the company in order to shift to fair value accounting method. Plum Creek estimates that an annual appraisal of their standing timber could be twice as high as they are currently paying for the annual audit of financial statements. Indeed, the nature where timber grows varies and the annual appraisal must be extensive and costly. I find this argument compelling and I believe to avoid more cost is the real reason behind their opposition against fair value accounting.

I think Plum Creek opposes the implementation of fair value accounting while Brookfield embraces its adoption mainly because of the different locations of their business. Plum Creek has its whole business operated within the United States while Brookfield Timberlands spread its business over North and South America. Because some countries use IFRS and other use US GAAP, Brookfield may have incurred considerably costs in applying both of the two accounting standards. Thus, no wonder that Brookfield hopes to minor the difference between IFRS and US GAAP. In contrast, Plum Creek has been using GAAP for years and will incur a huge cost in amending its financial statements and introducing new resources if a conversion from GAAP to IFRS happens. So, Plum strenuously opposes fair value accounting.

PREFERENCE FOR TREATMENT

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As a senior management of a timber company, I would prefer using US GAAP. Firstly, I would like to show the public that my company is in a relatively stable financial situation. As discussed above, accounting under IFRS appears to be highly volatile with the earnings and the value of assets fluctuate all the time. Thus, IFRS is not good choice. Secondly, I would like to show the public a more profitable company. However, under IFRS, the operating income is expected to be lower than that reported under US GAAP, because the timber will be recorded at fair value that approximate its net selling price. So I would prefer US GAAP.

As a partner in charge of the external audit of a timber company's financial statements, I would wish to implement US GAAP as well. Under IFRS, besides most of the accounts that need to be audited under GAAP, more items require to be audited such as annual appraisal for timberlands.

What's more, such extensive audit is usually more costly. Just as Plum Creek estimates, the annual appraisal of the standing timber could be as high as \$2.5 million and is obviously higher than the audit cost under US GAAP. In addition, the audit under IFRS has higher potential of litigation because those estimates based on numerous assumptions tend to be highly subjective. Those estimates could easily mislead investors to make unwise decisions, and they would probably sue the auditor for his "inaccurate auditing". In this case, I would prefer US GAAP if I am a partner in charge of the external audit.

As a potential investor of a timber company, however, I would prefer that companies use IFRS in their financial statements. The value of the investment is determined by its cash generation potential not by any

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measure of net income and that cash generation is not affected by changes in accounting methodology. Under IFRS, the book values on the balance sheet should provide a meaningful and consistent measure of the present value of future timber cash flows. Last but not least, IFRS increases the comparability of companies all around the world. If I would like to invest timber industry in a global basis, it would be convenient and less confusing for me to look through companies' financial reports under the same standards. Thus, I would prefer IFRS as an investor.