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Accounting for involuntary conversions; Issues paper (1978 December 20)

American Institute of Certified Public Accountants. Task Force on Involuntary Conversions

12/20/78

ACCOUNTING FOR INVOLUNTARY CONVERSIONS

Introduction

1. If an asset is involuntarily destroyed, stolen, expropriated, or taken by right of eminent domain, the event is referred to as an involuntary conversion. Involuntary conversions can occur in the following ways:

- Nonmonetary to nonmonetary (trade of assets); for example, the federal government exchanges timberland with a company to develop a park.
- Nonmonetary to monetary, with no intent by the owner to reinvest in similar productive assets;[1] for example, the insurance proceeds from the loss of a building due to a fire are not reinvested in a building because the company has excess capacity.
- Nonmonetary to monetary, with intent by the owner to reinvest in similar productive assets; for example, the owner intends to invest the insurance proceeds from the loss of a building due to a fire in a replacement building.

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1 As defined in APB Opinion 29, Accounting for Nonmonetary Transactions, paragraph 3, "Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business."

2. Indemnification is often made for a destroyed, expropriated, or stolen asset by an insurer. Frequently the proceeds received from insurance or from a sale to a governmental unit as a result of an involuntary conversion differ from the carrying amount of the asset lost. If the enterprise intends to replace the asset with a similar productive asset, the question arises of whether to defer recognition of the difference between the proceeds and the carrying amount or to recognize the amount in income immediately.

3. References to involuntary conversions in authoritative literature are limited. Paragraph 4 of APB Opinion 29 states, "for purposes of applying this Opinion, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets." FASB Statement No. 5, "Accounting for Contingencies," mentions expropriations in paragraphs 4 and 32 as examples of loss contingencies but does not refer to them specifically as involuntary conversions. In addition, APB Opinion 30, "Reporting the Results of Operations," states in paragraph 23 that gains or losses resulting from expropriations should be

treated as extraordinary items, provided they meet the criteria for extraordinary item treatment.

4. According to paragraph 4 of APB Opinion 29, that Opinion does not apply to involuntary conversions that result in the conversion of a nonmonetary asset to a monetary asset since there is no obligation to reinvest, on the basis that it is a monetary transaction. The Opinion neither defines "obligation to reinvest" nor explains the appropriate accounting for monetary transactions in those circumstances.

Diversity of Literature and Practice

5. Some believe that APB Opinion 29 requires the immediate recognition of a gain on an involuntary conversion into a monetary asset and eliminates the previous practice of deferring gains (normally accomplished by reducing the carrying amount of the replacement asset by the amount of the gain). Others have expressed the view that APB Opinion 29 does not include involuntary conversions and a gain may or may not be recognized immediately; they express a preference for deferral of the recognition of gain, consistent with IRS provisions.

6. The diversity of opinion in accounting literature also appears to extend to practice. Some companies that produce forestry products have not immediately recognized gains on timberland sold under threat of condemnation if the proceeds

are to be used to purchase replacement property. Some companies in the transportation industry immediately recognize gains on involuntary conversions of equipment when the insurance proceeds are invested in the same type of equipment. Others immediately recognize gains only if proceeds are neither reinvested nor held for reinvestment in similar productive assets. There appears to be no consistent principle applied in practice in accounting for involuntary conversions of nonmonetary assets into monetary assets.

7. Staff Accounting Bulletin No. 21 of the Securities and Exchange Commission (issued June 29, 1978) concludes, "...that the exchange of a nonmonetary asset for a monetary asset results in the realization of gain (or loss) and provides an objective basis for measuring the gain on the transaction." It also indicates that management's decision to reinvest the proceeds should not affect the amount of gain recognized. The SEC used as an example the use of the proceeds realized upon the governmental condemnation of timberlands to purchase replacement timberlands. Some have interpreted SAB 21 as applying only to timberland condemnations. However, on December 17, 1978 the SEC released Staff Accounting Bulletin No. 27 that indicates that even though SABs may be written narrowly, the purpose of SABs is "to disseminate staff views on particular matters for guidance in other situations where events and transactions have similar accounting implications. For example, the staff would

expect that gains on involuntary conversions, whether or not resulting from a transaction involving timberland, would be recognized currently in financial statements."

Justification for Accounting Used

8. There are several viewpoints on the appropriate accounting treatment for (a) the excess (deficiency) of the monetary proceeds over the carrying amount of a nonmonetary asset involuntarily converted and (b) the amount reinvested in similar productive assets.

9. Some support the immediate recognition of gains and losses. Their reasons are:

- The involuntary conversion is a completed transaction that should be reflected in the financial statements.
- The conversion has created a new management decision with a free choice on the use of the monetary proceeds, and the gain should be viewed separately from the reinvestment (APB Opinion 29: "the recipient is not obligated to reinvest").
- If the asset converted was depreciable, the gain may be, at least in part, an adjustment of prior depreciation which was overstated and should be reflected currently.
- To reduce the cost of a replacement asset by

the gain would understate the cost of the asset and future depreciation charges to operations.

- The immediate recognition of gains (losses) is a practical solution in cases in which an insurance settlement includes reimbursement for business interruption as well as property damage. Such settlements are often negotiated and the property damage element is not readily identifiable.

10. Others support the immediate recognition of losses but support deferral of the recognition of gains because:

- An involuntary conversion that results in the reacquisition of a similar productive asset is not the culmination of the earnings process.
- An obligation to reinvest also indicates that the earnings process has not been concluded. An "economic" obligation exists if the company's failure to reinvest the proceeds in other assets would result in a partial liquidation of the productive capacity of the company. A company is under a "formal" obligation if it would not have received the funds unless it agreed to re-

invest them. Under either an economic or formal obligation, management does not have a free choice on using the funds received, and a gain should not be immediately recognized.

- If management is obligated to reinvest in similar productive assets, any economic benefits received, such as obtaining a more modern and efficient plant, will be realized over future periods and not in the current period.
- Deferral of the recognition of losses would result in assets being carried at an amount in excess of fair value at the replacement date.

11. Others hold the view that the recognition of all gains or losses should be deferred if the proceeds of an involuntary conversion are reinvested in similar productive assets. They support this position using arguments similar to the preceding reasons (paragraph 10), with the exception of the last point.

Issues

12. Guidance is needed as to which alternative should be followed. Specifically:

a) Should recognition in income of a gain on an involuntary conversion of a nonmonetary asset into a monetary asset ever be deferred? If so, what should be the criteria?

b) Should recognition in income of a loss on an involuntary conversion of a non-monetary asset into a monetary asset ever be deferred? If so, what should be the criteria?

c) Should paragraph 4 of APB Opinion 29 be interpreted to mean that there is never an obligation to reinvest or that such conversions are not covered by the Opinion?

d) If an obligation to reinvest the proceeds is a criterion for deferral, what constitutes such an obligation?

13. Guidance is also needed in related areas:

a) If a gain or loss is to be recognized,

- What are the criteria for recognition?
  - -- Recognize all gains and losses immediately?
  - -- Recognize all losses and defer the recognition of all gains until related contingencies are resolved?
- What should the balance sheet presentation be for the proceeds received if certain circumstances for recognition in income

have not yet been met?

-- Net against carrying amount of asset involuntarily converted? If net of proceeds against the converted asset is a debit, carry as a deferred charge or, if net is credit, as a deferred credit?

-- Carry proceeds as a deferred credit?

- Should the gain (loss) ever be construed to meet the criteria for classification as an extraordinary item under APB Opinion 30?

b) If recognition in income of a gain or loss is to be deferred,

- Should the definition of "similar productive assets" given in APB Opinion 29 apply if investment in a similar productive asset is a criterion for deferral?

- What should the balance sheet presentation be for the deferral?

  -- Net against the carrying amount of assets involuntarily converted?

  -- Carry a gain as a deferred credit and a loss as a deferred charge?

- Over what period should the deferral be amortized?

- What amortization method should be used?

- What is the appropriate accounting for a partial reinvestment?
- How should the deferral be reported in the statement of changes in financial position?

c) What disclosures should be made in the financial statements?

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Advisory Conclusions

14. In order to provide the FASB with some insights as to tentative conclusions of the members of the Accounting Standards Executive Committee, the committee took an advisory vote of the 14 members attending the AcSEC meeting on November 2, 1978, with the following results:

a) Regarding the question, "Should recognition in income of a gain on an involuntary conversion of a nonmonetary asset into a monetary asset ever be deferred?" The members responded as follows:

4 Yes

9 No

1 Abstention

b) Regarding the question, "Should recognition in income of a loss on an involuntary conversion of a nonmonetary asset into a monetary asset ever be deferred?" The members responded:

-- Yes

13 No

1 Abstention

AICPA

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December 20, 1978

J. T. Ball, CPA
Director for Emerging Problems
Financial Accounting Standards Board
High Ridge Park
Stamford, CT 06905

Dear J. T.:

Enclosed are fifteen copies of an issues paper, "Accounting for Involuntary Conversions," for consideration by the Screening Committee on Emerging Problems.

The paper was prepared by the Task Force on Involuntary Conversions and approved by the Accounting Standards Executive Committee.

Representatives of the division are available to discuss this paper with you or your representatives at your convenience. The division would appreciate being advised on the committee's proposed actions on the issues set forth in this paper.

Sincerely,

Arthur R. Wyatt sc

Arthur R. Wyatt
Chairman
Accounting Standards
Executive Committee

ARW:hjs
Enclosure
cc: Accounting Standards Executive Committee (File 3173)
Task Force on Involuntary Conversions