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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **Recognition and Measurement of Biological Assets and Agricultural Produce in accordance with IAS 41 *Agriculture* (Agenda Paper 5)**

INTRODUCTION AND BACKGROUND

Purpose of the paper

1. Between September 2003 and May 2004, the IFRIC discussed two issues relating to the accounting for biological assets and agricultural produce. Whilst these discussions reached an advanced stage and a number of conclusions were reached, the IFRIC never formally concluded its discussions on these issues, and never finalised the changes to IAS 41 that it was proposing.

2. The purpose of this paper is to update the IFRIC on the status of these issues and to decide what the IFRIC's next steps should be.

Background to the issue

3. The issues which the IFRIC discussed arose as a result of a number of submissions which were received during 2003. The issues principally related to paragraphs 21 and 22 of IAS 41. These paragraphs are set out in full below :

21 The objective of a calculation of the present value of expected net cash flows is to determine the fair value of a biological asset in its present location and condition. An entity considers this in determining an appropriate discount rate to be used and in estimating expected net cash flows. The present condition of a biological asset excludes any increases in value from additional biological transformation and future activities of the entity, such as those related to enhancing the future biological transformation, harvesting, and selling.

22 An entity does not include any cash flows for financing the assets, taxation, or re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation forest after harvest).

4. The questions discussed by the IFRIC were:

    - How should an entity account for an obligation to replant a biological asset after harvest?
    - What does the exclusion from taking into account increases in value from "additional biological transformation" mean in the context of IAS41.21? In particular, what is the implication of this exclusion where a valuation is based on forecast future cashflows (which can only be achieved after future biological growth)?

5. During the course of its deliberations, the IFRIC concluded:

    - that there was divergence in this area and that the IFRIC should take a project onto its agenda to address this divergence;
    - that it would not issue guidance in respect of the first issue, i.e. how an obligation in respect of re-planting should be measured; and
    - that it should propose amendments to IAS 41 rather than pursuing a project to develop a standalone Interpretation.

6. At its May 2004 meeting, the IFRIC discussed a draft revised IAS41 which incorporated the IFRIC's proposed amendments. [Sentence omitted from observer note].

7. In its introduction to the revised standard, the IFRIC noted the main changes that it was proposing to the standard. These changes comprised:

- Replacing "fair value less estimated point-of-sale costs" with "fair value less costs to sell." (IN6)
- Removing the exclusion on taking into account any increases in value from the additional biological transformation and future activities of an entity and replacing it with alternative guidance (see below). (IN7)

- Clarifying that the fair value of an agricultural asset should be based upon the asset's "highest and best use" and that, if an entity has access to different active markets, the fair value should be based on the quoted price in the "most advantageous market." (IN6)
- Incorporating additional guidance on how to apply present value techniques in determining a fair value for a biological asset if an active market neither exists for that asset nor for a similar asset. (IN7)
- Updating the fair value hierarchy to make it more consistent with the contents of other standards. (IN8)

8. In May 2004, the IFRIC agreed that the issue should be taken on by the Board and asked that the staff prepare a discussion paper including the revised standard for presentation to the Board.

9. This discussion paper has never been produced and the issue has not been presented to the Board. However, in June 2004, the IASB agreed to take on a project to consider fair value measurement. The June 2004 issue of IASB Update states :

   "The Board tentatively decided that the fair value hierarchy should be exposed as a separate Exposure Draft and would draw constituents' attention to the implications of introducing it into IFRSs. This hierarchy would apply in IFRSs generally, but only to the extent that an existing IFRS requires an asset or liability to be measured at fair value. The Hierarchy Exposure Draft would not propose to extend the use of fair value measurement."

10. This project was formally taken onto the IASB agenda in September 2005.

11. This paper considers how the IFRIC should progress with this issue.

STAFF ANALYSIS

12. The staff notes that the Board expects to issue a discussion paper in the fourth quarter of 2006 on Fair Value Measurement ('FVM'). The purpose of the discussion paper will be to indicate the Board's preliminary view on the provisions of the FASB's Statement on Financial Accounting Standards No. 157 *Fair Value Measurement* (SFAS 157) and its differences from existing fair value measurement guidance in IFRSs. The Board will invite comments on the contents of the discussion paper which will be used in the development of an

IASB exposure draft on fair value measurement. A final standard is currently expected to be issued on fair value measurement in late 2008 or early 2009.

13. It is likely that the exposure draft, when produced, will include guidance on the measurement of fair value, and will propose resolutions for most of the points previously considered by the IFRIC. The staff note that this exposure draft will not, however, include guidance on or reference to point-of-sale costs (or costs of sale) or on replanting obligations.

14. The staff also notes that, since 2004, a large number of entities and countries have adopted IFRS. There is therefore significantly more practical experience of the difficulties in applying IAS41 than there was at the time of the IFRIC's previous discussions. The staff believes that this practical experience has highlighted the following:

    - that a number of entities have felt able to interpret IAS41.21 as allowing them to use discounted cashflows taking into account biological transformation, as long as they use a suitable risk-adjusted discount factor to estimate a present value of the immature biological assets; and

    - that other entities have felt unable to interpret the standard in this way and so have valued immature agricultural assets based on the current market value of immature assets (for example at a scrap or pulp value).

15. The staff has considered the changes proposed by the IFRIC in May 2004 in the light of these changed circumstances.

Replacing "fair value less estimated point-of-sale costs" with "fair value less costs to sell" (IN6)

16. The staff notes that the FVM project will not address point-of-sale costs as that project is limited to a consideration of fair value measurement (and not costs of sale).

17. The staff also notes that changing the standard so that it refers to fair value less costs to sell rather than fair value less point-of-sale costs would bring the treatment more into line with other standards, for example IAS 39 and IAS 2.

18. Given that the IFRIC has previously drafted the changes needed to make this amendment and that it is a beneficial change which would increase

comparability with other standards, the staff considers that the IFRIC should continue to pursue this amendment.

19. The staff proposes that, if the IFRIC continues with its project to amend IAS 41, this change should remain within the scope of that project. If the IFRIC prefers to issue an Interpretation on the measurement of biological assets and agricultural produce or does not wish to pursue further amendments to IAS 41 then the staff proposes that this change be passed to the Board's minor (annual) amendments project.

Removing the exclusion on taking into account any increases in value from the additional biological transformation and future activities of an entity (IN7)

20. The staff believes that the exclusion on taking into account biological transformation in IAS 41 is one of the paragraphs of IAS41 most responsible for divergence in practice. The staff also considers that, from a practical perspective this paragraph may be virtually inoperable.

21. As an example, the staff considered a 15 year old crop of timber which grows over 20 years. No market exists for 15 year old timber, and so some preparers argue that, if the timber is valued without taking into account any future growth, the 15 year old timber has nil fair value. Others argue that the value of the 15 year old timber can be estimated by taking a projected sales value in 5 years time and discounting (using a discount rate adjusted for the risk associated with storm, flood, disease, and other risks).

22. The staff believes that there is divergence in this area and does not believe that the standard is clear in this respect. Whilst the Board's FVM project will address this point directly, it is possible that the IFRIC may be able to reduce some of the divergence before that project is completed.

23. Whether the IFRIC will be able to complete its work in this area before the Board completes its own FVM project is discussed further under 'practical issues' below.

24. The staff considers that, if the IFRIC is able to complete its work before the Board, it may be advantageous for it to continue to pursue this point, either by pursuing a change to the standard or by developing its own Interpretation.

Clarifying that the fair value of an agricultural asset should be based on the asset's "highest and best use" in the "most advantageous market." (IN6)

25. The staff notes that the question of whether fair value should be measured with reference to the 'most advantageous market', 'the principal market', 'the market in which subsequent sale is expected to be realised' or some other market is a question which is being considered by the Board's FVM project.

26. The staff considers that, if the IFRIC does not make this change, its project may not address the full extent of divergence which exists in practice. In particular, without guidance that states that the fair value should be measured with reference to the 'highest and best use', the staff considers that IAS41 may still be interpreted in different ways. For example, some entities may still interpret the standard as requiring them to measure agricultural assets based on their sales value if the assets are harvested immediately (which may be nil if no market exists for the assets in their current state other than a pulp or scrap market) whilst others may interpret it as allowing them to value the assets based on a higher use (i.e. future growth followed by harvest and sale).

27. Whilst this issue will be addressed by the Board's FVM project, the staff considers that the IFRIC may be able to develop a suitable wording to replace the current wording before a final FVM standard is issued.

28. The staff considers that if the IFRIC decides to pursue its amendments in respect of future growth, then it should continue with its project to address this issue since making this change is central to addressing the divergence in practice. However, the staff considers that the IFRIC will need to take care to ensure that guidance is not developed which will require a change in treatment by preparers only to be superseded by another change in treatment as a result of the completion of the FVM project.

Incorporating additional guidance on how to apply present value techniques in determining a fair value for a biological asset if an active market neither exists for that asset nor for a similar asset. (IN7) and updating the fair value hierarchy to make it more consistent with the contents of other standards (IN8)

29. The staff considers that paragraphs 21 and 22 of IAS 41 are the main causes of divergence in the application of IAS41. Whilst the staff accepts that further guidance on present value techniques and a revised fair value hierarchy would

be extremely useful to preparers, the staff does not consider that issuing this guidance has the same priority in terms of reducing diversity as amending those paragraphs.

30. The staff notes that the purpose of the FVM project is to develop guidance for preparers on how to determine fair values for assets. By developing separate guidance or a separate hierarchy in IAS41, the IFRIC would be duplicating work which is being undertaken by the Board.

31. Given that this is not the main cause of divergence in the standard and that developing guidance would be duplicating the work of the Board, the staff does not recommend that the IFRIC pursue these parts of its project.

How to measure an obligation to replant

32. The staff has noted that the IASB is currently undertaking a project which will result either in a revised version of IAS 37 or a new standard on liabilities being issued.

33. Whilst the IFRIC have previously decided not to issue guidance on how to account for an obligation to replant, the staff has discussed with the IAS 37 project team whether it is possible to include an example within that standard detailing how an obligation to replant should be accounted for.

34. Whilst this is not likely to be decided until 2007, the IAS 37 team have confirmed that they will consider whether such an example can be included in that standard.

PRACTICAL CONSIDERATIONS

35. As discussed above, the Board FVM project is addressing most of the issues previously discussed by the IFRIC. In particular, the Board's project will:

    - replace fair value guidance in IAS41 (and other IFRSs) including the guidance prohibiting taking into account future biological transformation with a single source of guidance to be applied to all fair value measurements;
    - clarify which market should be used in measuring fair value (for example, the most advantageous market, the entity's principal market, the market in which the produce is expected to be sold, etc);

- discuss whether fair value should be measured with reference to an asset's 'highest and best use';
- develop guidance on how to measure fair value where no active market exists; and
- introduce a single fair value hierarchy for all fair value measurements (including those required by IAS 41).

36. Appendix 1 to this document sets out a possible timescale over which the IFRIC could develop an Interpretation or propose amendments to IAS41. This shows that it would not be possible for the IFRIC to publish a final Interpretation or finalise amendments to IAS41 before October 2007. The earliest effective date that could be set for this guidance would be January 2008.

37. The staff notes that, achieving this timetable assumes that:

- both the IFRIC and the Board conclude their discussions (both on the exposure draft and any redeliberations) within one meeting; and
- the text does not need to be exposed for any more than 60 days[1].

38. Whilst the timeline demonstrates that the IFRIC would be able to develop guidance in advance of the Board, the staff considers that there are a number of practical difficulties inherent in this timetable. In particular, the staff notes :

- The Board's FVM discussion paper will be issued in late 2006 with comments due in or around April 2007. The IFRIC's work would be published for comment around March 2007 with comments due in May 2007. The overlapping comment periods for guidance which will be, to a large extent, identical may lead to confusion amongst constituents.
- Issuing a revised standard which incorporates guidance identical to that proposed in a discussion paper while the discussion paper is still available for comment may give the impression that the Board intends to issue that guidance regardless of the comments from constituents. This may undermine the credibility of the comment letter process on the discussion paper.

[1] 60 days is the usual timeframe for an IFRIC Interpretation. If a change to the standard is proposed, a longer timescale in line with the Boards exposure period, may be required

- The Board project will remove fair value guidance from individual standards including IAS41 and replace it with guidance in an IFRS on Fair Value Measurements. The timetable shows the IFRIC issuing final amendments to IAS41 in October 2007 with the Board issuing its exposure draft (which will propose deleting those amendments and all of the guidance surrounding them) later in 2007. Publishing new guidance, and three months later publishing an ED proposing to supersede that guidance may cause confusion amongst constituents.
- The IFRIC's work will become mandatory in January 2008 at the earliest. The Board's FVM standard will become mandatory in late 2009 or early 2010. For a company with a calendar year end, the IFRICs work would be mandatory for its 2008 year end and potentially its 2009 year end but would then be superseded by the Board's work. The cost (in terms of implementation costs and lack of comparability) caused by changing the guidance and then changing it again 18 months to 2 years later may outweigh the benefits of the change.

39. In contrast, the staff considers that the IFRIC's work will serve to reduce divergence, and may result in some of the positive changes expected to result from the Board's FVM project being adopted early.

40. The staff considers that, in deciding how to proceed, the IFRIC must decide whether the benefits of issuing further guidance outweigh the potential disadvantages set out above.

41. The staff also considers that, if the IFRIC decides to proceed with this work, it should ask the Board whether the Board supports its work before considering further changes to IAS 41. This will ensure that the IFRIC does not pursue a project which the Board will not approve because it clashes with its FVM project.

CONCLUSION

42. The staff recommends that the IFRIC continue with its project to amend IAS 41 so that it refers to 'costs of sale' rather than 'point-of-sale costs'. If the IFRIC decides to pursue this amendment in isolation, then the staff recommends that the IFRIC pass the change to the Board's minor (annual) improvements project.

43. The staff notes that the Board is actively pursuing a project to develop further guidance on measuring fair value when no active market exists and to develop a revised fair value hierarchy. The staff considers that these areas are not the primary reasons for divergence in the way that IAS 41 is applied. The staff therefore recommends that the IFRIC cease to pursue its proposed amendments in these areas.

44. The staff also recommends that the IFRIC considers whether it believes that divergence in the accounting for biological assets and agricultural produce is so significant that it needs to be addressed before the Board concludes its work on the FVM project. If not, the staff recommends that the IFRIC cease to consider any further amendments to IAS41 awaiting the results of that work. If the IFRIC considers that divergence is so significant that it needs to be addressed in advance of the Board's project, then the staff recommends that the IFRIC continue to pursue its project to :

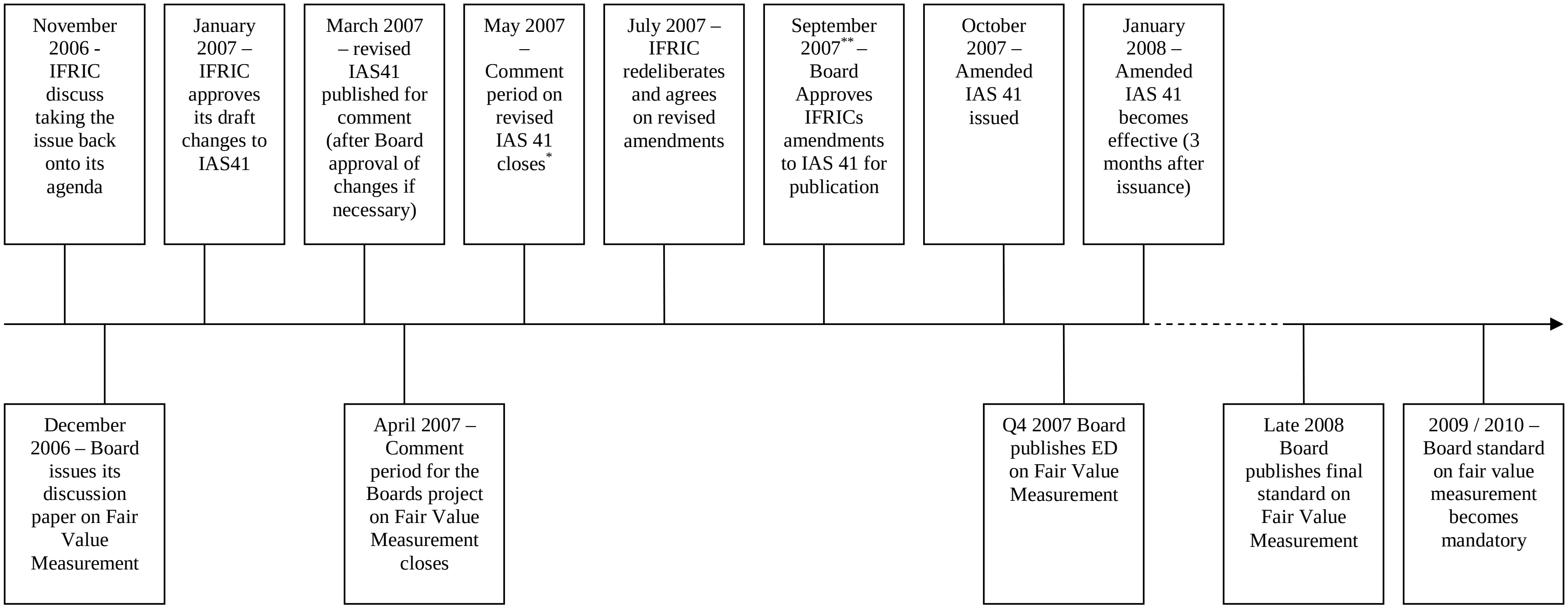
- remove the prohibition on taking into account future biological growth when measuring the fair value of assets; and
- make clear that the fair value should be measured by reference to the agricultural asset's 'highest and best use' in its 'most advantageous market'.

45. If the IFRIC does wish to develop this guidance, then the staff recommends that the IFRIC ask the Board for its approval before proceeding further. The staff also considers that the IFRIC should proceed with caution to ensure that references to the 'highest and best use' or "the most advantageous market" do not introduce changes to requirements which will be subsequently revised by the Board's FVM project.

46. The staff notes that the IFRIC will need to consider whether the best course of action is to pursue an Interpretation or to propose amendments to IAS 41.

Does the IFRIC agree with the staff's recommendations?

Appendix 1 – timeline for amendments to IAS 41



Note : (*) The May IFRIC meeting is the first week in May. Allowing for publication and a 60 day comment period after the February Board meeting (the last week in February), does not allow sufficient time for the IFRIC to be able to discuss the comment letters in its May meeting.
(**) The July 2007 Board meeting is the week following the July 2007 IFRIC meeting. The Board does not meet in August.