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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **22 February 2007, London**

Project: **Annual Improvements Process**

Subject: **IAS 41 *Agriculture: Measurement of Biological Assets in accordance with IAS 41* (Agenda paper 6)**

INTRODUCTION

1. At its January meeting, the IFRIC asked the staff to recommend to the Board that it amend IAS 41 to remove the prohibition on taking into account 'additional biological transformation' in estimating the fair value of biological assets using discounted cashflows.

2. The reason for proposing this amendment is that the current wording of IAS 41 is creating divergence in practice with some entities being unable to interpret the wording in a meaningful way.

3. The amendment is not intended to pre-judge the Board's Fair Value Measurement ('FVM') Project or to make significant changes to the accounting for biological assets. Instead, it is intended to remove divergence, which is arising due to people being unable to apply the current wording.

4. This paper sets out the IFRIC's proposed amendments to IAS 41 and proposes that these amendments be made as part of the Board's annual improvements process.

BACKGROUND TO THE ISSUE

5. IAS 41 requires biological assets to be measured at fair value. Paragraphs 17 – 19 state that, if an active market for an asset exists, fair value should be measured with reference to that market. If an active market does not exist, a recent transaction, market prices for similar assets, or sector benchmarks may be used to compute fair value. Paragraph 20 states that, if market-determined prices or values are not available for an asset, discounted cashflows should be used to estimate the fair value of the asset. IAS 41 paragraph 21 explains how an entity should use discounted cashflows to estimate the fair value of a biological asset.

6. IAS 41.21 states: '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.'

7. In many situations, cash inflows will only arise from a biological asset after additional biological transformation has taken place. For example, a forest may only generate cashflows after the trees have developed to maturity. Some preparers are reading the current wording of the standard as prohibiting them from taking into account cashflows that are expected to be generated from mature assets when measuring the fair value of immature assets.

8. These preparers may feel that they are forced to use a different model to estimate fair value, for example estimating fair value with reference to a scrap market for the immature forest.

9. The IFRIC considered that this treatment not only gives rise to divergence, but also does not reflect the intention of the Board when it wrote the standard.

10. The IFRIC therefore asked the staff to propose that the Board amend IAS 41.21 to remove the prohibition on taking into account additional biological transformation. The IFRIC also proposed some other minor amendments to make the current wording of IAS 41 clearer. Attachment 1 to this document sets out all of the IFRIC's proposed amendments. The remainder of these are discussed further below.

OTHER AMMENDMENTS TO IAS 41

11. The IFRIC considered the example of a fish farm. The farm grows fish for sale in a market for mature fish. Due to some cross-contamination between tanks, when a tank of mature fish is harvested, it will contain some immature fish. These are sold as scrap, for a negligible value. Since the immature fish are sold, an active market for immature fish is created.

12. Even if the prohibition on taking into account additional biological transformation is removed some preparers may argue that, in the above example, an active market exists for immature fish (albeit a scrap market). They would argue that, in accordance with paragraph 17, immature fish should be valued with reference to that market. This approach will result in a negligible value being assigned to a tank of growing immature fish which could command a much higher value if it were sold as a live growing asset.

13. The IFRIC considered that this may result in continuing divergence, and a treatment which is not consistent with the Board's intentions when writing the standard.

14. The IFRIC therefore proposed that further changes be made to clarify the standard. In particular :

    - in paragraph 17, to make clear that the requirement that assets be measured with reference to an active market price only applies if the active market exists for assets in the same location and condition. This change would mean that the existence of a scrap market for dead assets does not imply that an active market exists for a growing asset;

    - to amend the definition of 'biological transformation' in paragraph 5 to make clear that death or harvesting is a biological transformation. This change will further re-enforce that a dead asset is not in the same condition as a living asset; and

    - to make clear, in paragraph 21, that when using discounted cashflows to value an asset, an entity should consider cashflows in the most relevant market. This change will clarify which market an entity should use to estimate future cashflows.

Does the Board agree with the staff's proposed changes to IAS 41? If so, does the Board agree that the changes should be addressed as part of the Board's annual improvement process?

ATTACHMENT 1: PROPOSED CHANGES TO THE STANDARD

5 The following terms are used in this Standard with the meanings specified:

Agricultural activity **is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets.**

Agricultural produce **is the harvested product of the entity's biological assets.**

A *biological asset* is a living animal or plant.

Biological transformation **comprises the processes of growth, degeneration, production, procreation and harvesting or killing that cause qualitative or quantitative changes in a biological asset.**

A *group of biological assets* is an aggregation of similar living animals or plants.

Harvest **is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.**

17 If an active market exists for a biological asset or agricultural produce in its present condition and location, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an entity has access to different active markets, the entity uses the most relevant one. For example, if an entity has access to two active markets, it would use the price existing in the market expected to be used.

18 If an active market does not exist, an entity uses one or more of the following, when available, in determining fair value:

(a) the most recent market transaction price, provided that there has not been a significant change in economic circumstances between the date of that transaction and the balance sheet date;

(b) market prices for similar assets with adjustment to reflect differences; and

(c) sector benchmarks such as the value of an orchard expressed per export tray, bushel, or hectare, and the value of cattle expressed per kilogram of meat.

19 In some cases, the information sources listed in paragraph 18 may suggest different conclusions as to the fair value of a biological asset or agricultural produce. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a relatively narrow range of reasonable estimates.

20 In some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate in determining fair value.

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. In determining the present value of expected net cash flows, an entity includes the net cash flows that market participants would expect an asset to generate in its most relevant market. ~~The present condition of a biological asset excludes any increases in fair 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).

23 In agreeing an arm's length transaction price, knowledgeable, willing buyers and sellers consider the possibility of variations in cash flows. It follows that fair value reflects the possibility of such variations. Accordingly, an entity incorporates expectations about possible variations in cash flows into either the expected cash flows, or the discount rate, or some combination of the two. In determining a discount rate, an entity uses assumptions consistent with those used in estimating the expected cash flows, to avoid the effect of some assumptions being double-counted or ignored.