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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **Recognition and measurement of biological assets and agricultural produce in accordance with IAS 41 (Agenda Paper 12)**

INTRODUCTION

1. At its November meeting, the IFRIC agreed to recommend to the Board that it amend IAS 41.21 to remove the prohibition on taking into account additional biological transformation when using discounted cash flows to measure the fair value of a biological asset.

2. The IFRIC also asked the staff to consider the best way to address the divergence which would continue to exist in practice if this specific phrase was removed and no further changes were made.

3. The divergence which the IFRIC believed would continue to exist can be illustrated using the example of a fish farm. The farm sells fully grown mature fish on the open market. Because of some cross contamination between tanks, when a crop of mature fish is sold, it will inevitably contain some immature fish. These are sold as scrap. An active market (albeit a scrap market) for immature fish therefore exists.

4. The fish farm also has tanks of immature fish which it is waiting to grow before taking to market as mature fish. Two views exist as to how these fish should be valued.

- Supporters of View 1 note IAS41.17 which states "If an active market exists for a biological asset or agricultural produce, the quoted price in that market is the appropriate basis for determining the fair value of that asset." Supporters of this view argue that as an active market exists (effectively a scrap market) then the immature fish must be valued based on the quoted price in that market.
- Supporters of View 2 note IAS41.17 which states "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." Supporters of this view note that the fish are expected to be grown to maturity to be sold in a market for mature fish. The valuation of the fish should therefore be based upon the value in that market.

5. This paper considers the best route to address the potential divergence between view 1 and view 2.

INTERACTION WITH THE FAIR VALUE MEASUREMENT DISCUSSION PAPER

6. The staff notes that, on 30 November 2006, the Board issued its Discussion Paper on Fair Value Measurement ('FVM'). This Discussion Paper includes the full text of SFAS157 which the IASB intends to use as the starting point for its deliberations on fair value measurement.

7. The guidance in that standard includes a number of items which are likely to be helpful in reducing divergence in this area. In particular:

- the guidance includes a concise definition of 'fair value' which establishes the principle that should be applied to measuring fair value (paragraph 5 of the DP);
- the Discussion Paper explains that the price is assessed based on an orderly transaction (paragraph 7 of the DP);

- it establishes a principle that, in measuring fair value, an entity should assume that a transaction occurs in the principal market or, in the absence of a principal market, in the most advantageous one (paragraph 8 of the DP); and
- it states that, when applied to assets, "fair value measurement assumes the highest and best use of the asset" (paragraph 12).

8. The staff considers that, if the above principles are applied to biological assets or agricultural produce, then they should resolve the divergence in this area.

9. For example, in the situation described above, SFAS 157 would first require that the entity identify the principal market[1] which would be the market for mature fish. Once this market has been identified, SFAS 157 would require the entity to apply the fair value heirachy described in paragraphs 22 – 31 to that market.

10. By identifying the market which should be used to measure fair value, and stating that fair value should be measured with reference to an orderly transaction (ie not a forced break-up at the balance sheet date), the staff believes that the Board's FVM project will address the divergence described in the example above.

11. The staff notes that comments on the FVM Discussion Paper are due by 2 April 2007. An exposure draft is expected to be published late in 2007 or early in 2008 with a final standard forecast for late 2008. Any guidance issued by the IFRIC is unlikely to be finalised before the end of 2007.

12. In recommending the best route to resolve the divergence in this area, the staff has taken care to avoid proposing that any guidance be issued which conflicts with that being developed by the Board or undertaking work which duplicates efforts currently being undertaken by the Board's FVM team.

[1] IF the principal market could not be identified, then SFAS 157 would require that the entity consider the most advantageous market which is assumed to be the market for fully grown, mature fish for the purpose of this example.

CHANGES TO IAS 41

13. In considering what changes should be proposed to IAS41, the staff has considered the changes that were suggested in the revised draft of IAS 41 discussed by the IFRIC in its May 2004[2] meeting.

14. These changes included a number of items which have subsequently been removed from the IFRIC's agenda. In particular :

- the draft includes changes to replace the phrase point-of-sale costs with costs to sell. This change is now being considered by the Board's annual improvements project;
- the changes implement a fair value hierarchy which duplicates work being undertaken as part of the Board's project on FVM; and
- the changes include an example on accounting for obligations to replant which the IFRIC has decided not to pursue (this item has been raised with the Board's IAS 37 project team).

15. The staff has not considered these changes further.

Changes to paragraph 21

16. In the draft discussed by the IFRIC in May 2004, it was proposed that paragraph 21 be amended as follows :

"An entity may use present value techniques ~~The objective of a calculation of the present value of expected net cash flows is~~ to determine the fair value less costs to sell of a biological asset ~~in its present location and condition~~. If so, an entity includes the net cash flows that market participants would expect the highest and best use of the asset to generate. However, the present value does not include any cash flows from finance costs or income tax expense, or from re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation forest after harvest). ~~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~~

[2] ~~The staff can provide IFRIC members with a copy of this draft on request.~~[footnote omitted from the observer note]

~~of the entity, such as those related to enhancing the future biological transformation, harvesting, and selling."~~

17. The staff notes that amending paragraph 21 in this way removes the phrase "additional biological transformation" which is responsible for divergence in this area. Additionally, these changes introduce the notion of "highest and best use" which, by making clear which is the reference market for valuing the assets should resolve the issue discussed in the fish farm example above.

18. IAS 41.BC31 states "When an entity has access to different markets, the Standard indicates that the entity uses the most relevant one. For example, if an entity has access to two active markets, it uses the price existing in the market expected to be used. Some believe that the most advantageous price in the accessible markets should be used. The Standard reflects the view that the most relevant measurement results from using the market expected to be used."

19. Amending the standard to refer to "highest and best use" will bring it into line with the wording of SFAS 157 (paragraph 12) but change the requirement of IAS 41 that the market expected to be used should be the one utilised in measuring fair value.

20. The staff notes that, if this change is made, it will require further changes to be made to the standard in addition to changing paragraph 21.

21. The staff considers that, amending the standard in this way will resolve the divergence which is described in the fish farm example above. Additionally, it will bring the standard into line with the expected requirements of the future FVM standard. This will mean that, by adopting the IFRIC's proposed changes to IAS 41, constituents will be effectively adopting the FVM standard early. In turn, this will avoid the need for constituents to adopt new guidance once the IFRIC completes its work, followed by further new guidance once the FVM project is completed.

22. On the other hand, making this change may be seen as pre-judging the result of the Board's FVM project. The current status of this project is that a Discussion Paper has been issued. Comments and discussion arising from this may result in the Board concluding that fair value should be measured with reference to a different market (for example the relevant market in IAS 41). If this is the case, then changing IAS41 to require the 'highest and best use' may result in

constituents being forced to make multiple changes to the way that they value biological assets. The staff also notes that the Board Project is likely to replace any guidance on measuring fair value in IAS 41. Amending that guidance shortly before the issuance of a final FVM standard (which will remove the revised guidance) may cause considerable confusion amongst constituents.

23. The staff considers that issuing guidance which states that the “highest and best use” should be used in assessing fair value may pre-judge the result of the Board’s project. Furthermore, making significant changes to the market used to assess fair value shortly before the Board’s project concludes is likely to cause confusion amongst constituents and will duplicate work being undertaken by the Board’s team. The staff does not therefore propose amending paragraph 21 to require reference to ‘highest and best use’ in assessing fair value.

24. On the other hand, the staff considers that it is necessary to amend paragraph 21 to clarify which market should be used to assess fair value of biological assets. Without this change, the divergence discussed in the fish farm example above will continue to exist.

25. The staff therefore recommends that paragraph 21 be amended to remove the prohibition on taking into account ‘additional biological transformation’ and to include a statement that fair value should be measured with reference to the most relevant market.

26. The staff believes that, by making it clear which market fair value should be measured with reference to, the divergence illustrated in the fish farm example above should be removed.

27. ~~The staff therefore propose that paragraph 21 be amended to read :~~[Paragraph omitted from the observer note]

~~“An entity may use present value techniques 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. If so, an entity includes the net cash flows that market participants would expect the asset to generate in its relevant market. However, the present value does not include any cash flows from finance costs or income tax expense, or from re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation forest after harvest). An entity considers the risk associated with bringing the~~

~~asset to the condition and location in which it will be sold in the relevant market 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.”~~

ISSUANCE OF AN INTERPRETATION

28. At its previous meeting, the IFRIC asked the staff to consider whether an Interpretation could be issued which would further help to reduce the divergence in this area without contradicting or replicating work which the Board’s FVM project was undertaking. Since the guidance within the FVM project is intended to replace the guidance in individual standards, any guidance included in such an Interpretation would have to be compatible both with the existing standard and with the Board’s FVM Project.

29. The staff has considered what guidance could be issued in this form if the changes discussed above are made to IAS 41.

30. The staff notes that the changes above should remove the divergence which exists because of the prohibition on taking into account ‘additional biological transformation’ and make it clear that the market that an entity should use to measure fair value is the ‘most relevant market’ ie the one in which the asset is expected to be sold. By making this change, the staff believes divergence will be reduced.

31. The staff notes that during the previous IFRIC discussions on this issue, a number of other areas of difficulty have been identified within the standard. For example, in some cases, it was noted that the value of land was reduced by the presence of biological assets on the ground (because of the cost of removing them). It was also noted that unexpected results could arise with biological assets valued differently in differing locations (because of localised weather conditions) and that further difficulties could exist with some very long lived assets (for example oak trees which may take 250 years to mature). Concerns were also raised because in some situations, discounted cash flows could give rise to very small (or negative) present values despite the fact that the intention was to keep assets for the long term.

32. The staff considered these issues but noted that they are outside of the scope of the IFRIC's current project. Furthermore, it is unlikely that they could be resolved by the issuance of an Interpretation.

33. The staff considered that further application guidance could be issued to demonstrate how IAS 41 should be applied, but noted that the IFRIC had, in the past, declined to take on items to develop Interpretations which were little more than application guidance.

34. As the staff could not identify specific items of divergence that could be reduced by the issuance of an Interpretation without duplicating the work of the Board or issuing application guidance, the staff concluded that no Interpretation should be issued.

CONCLUSION AND STAFF RECOMMENDATION

35. The staff considers that IAS 41.21 could be amended to remove the phrase "additional biological transformation" and make clear that entities should measure fair value with reference to the 'most relevant market'. By doing so, divergence in the application of "additional biological transformation" could be reduced.

36. The staff does not believe that further amendment should be made to change 'relevant market' to 'highest and best use' in advance of the completion of the Board's fair value measurement project.

37. The staff does not believe that significant further divergence could be reduced by issuing an Interpretation and therefore proposes that the IFRIC limit its work to recommending an amendment of IAS41.21.

38. [Paragraph omitted from the observer note]~~The staff propose that IAS 41.21 be amended as follows :~~

~~"An entity may use present value techniques 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. If so, an entity includes the net cash flows that market participants would expect the asset to generate in its relevant market. However, the present value does not include any cash flows from finance costs or income tax expense, or from re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation~~

~~forest after harvest). An entity considers the risk associated with bringing the asset to the condition and location in which it will be sold in the relevant market 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."~~

~~Does the IFRIC agree with the staff's recommendations that:~~

1) ~~The IFRIC should recommend that IAS 41.21 be amended to remove the prohibition on additional biological transformation?~~
2) ~~The standard should not be amended to refer to 'highest and best use' of an asset?~~
3) ~~IAS 41.21 should be amended to specifically refer to 'the relevant market'?~~
4) ~~The IFRIC should not develop an Interpretation but should limit its work to recommending an amendment of IAS 41?~~