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International
Accounting Standards
Board



**INFORMATION FOR OBSERVERS**

**Board Meeting:** **21 June 2007, London**

**Project:** **Annual Improvements**

**Subject:** **IAS 41 – Replanting obligations (Agenda paper 12L)**

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1. The staff has identified that the following issue would be most appropriately resolved via the annual improvements process.

   *Issue:* Should IAS 41, *Agriculture*, be amended to address an issue identified with the accounting for replanting obligations?

## Staff recommendation

2. The staff recommends that the Board:

   - should add this issue to the annual improvements project; and
   - should amend IAS 41 as proposed in paragraph 23 of this paper.

## Background

3. The staff has been notified of a practical issue that arises when an entity that has biological assets also has an obligation to replant such assets. This paper sets out the issue and considers possible solutions.

**IAS 41 guidance on replanting costs**

4. Paragraph 22 of IAS 41 states: '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)'.

5. The costs of replanting relate to future biological assets rather than the existing biological assets. This is the rationale for excluding such costs from the fair value measurement of existing assets.

**Replanting obligations and liabilities**

6. Circumstances can exist in which an entity has an obligation to replant a biological asset after it has been harvested. Examples of such circumstances include:

- statutory obligations to replant a forest after harvest; and
- contractual obligations to replant biological assets on leased land after harvest.

It should be noted that the obligation to replant is generally a condition attached to the land rather than a condition attached to the crop, even though it is the harvesting of the crop that triggers the obligation.

7. The statutory or contractual obligation to replant considered in this paper arises only at the point of harvest. Accordingly there does not appear to be a basis to recognise a liability, and the corresponding cost of that liability, until harvest has occurred (IAS 37, paragraph 14). A contrast can be drawn with asset decommissioning obligations which arise at the start of the asset's life through the installation or commissioning of the asset. This is considered further in paragraph 18 of this paper.

## Interaction with the IAS 41 fair value measurement basis

8. IAS 41 paragraph 12 requires that biological assets be measured at fair value on initial recognition and subsequently. Accordingly profit earned from biological assets is recognised in the income statement as the biological asset grows. No profit is recognised by the act of harvesting.

9. However, the act of harvesting appears to trigger the obligation to replant. Therefore a liability for replanting costs is recognised at the time of harvest. The cost of replanting relates to the next crop of biological assets but no asset can be recognised for this until it is planted. Accordingly the cost of replanting must be expensed when the liability is recognised.

10. The result of the above interaction of IAS 41 and IAS 37 is that a net expense is recognised at the point of harvest as a result of the triggering of the replanting obligation. The concern that has been brought to the staff’s attention is that this does not reflect the commercial reality of what has occurred.

11. An entity that has access to the benefits of the replanted crop will subsequently record an equivalent fair value gain in the income statement when the replanting takes place. An entity will generally have access to the economic benefits except when the land is leased and the next harvest is expected to occur after the end of the lease period.

12. An entity will not have access to the economic benefits of the replanted crop when the land is leased and the next harvest is expected to occur after the end of the lease period. Such an entity will record the net expense on harvesting of the previous crop but no subsequent fair value gain.

## Alternative views

13. The staff has identified the following possible solutions to address this issue:

    *View 1:* Require the cost of <u>compulsory</u> replanting to be reflected in the calculation of fair value of the preceding crop.

*View 2:* Require the cost of compulsory replanting to be recognised as an asset at the time the liability is recognised.

**Analysis of view 1**

14. The existing biological asset crop is required to be measured at fair value less costs to sell[1] by IAS 41. The economic benefits of the crop will be realised through harvest and sale. The act of harvest triggers the obligation and the cost to replant. It can be argued that the cost of compulsory replanting should be reflected in the determination of fair value less costs to sell of the current crop.

15. The advantages of view 1 are that it solves the troublesome income statement effect and links the cost of replanting to the action that triggers it, which is the harvesting of the current crop.

16. The disadvantage of view 1 is that it links the measurement of the existing crop to a condition that arises from the land on which the crop is growing. It is not reflecting a condition of the crop itself.

**Analysis of view 2**

17. Replanting the crop will give the entity access to additional future economic benefits. The recognition of a liability to replant is the first step in that process. It is appropriate to recognise an asset in respect of those future economic benefits.

18. A similar situation arises where an entity has an obligation to decommission an asset, for example an oil production platform, at the end of the asset's life. The required accounting in such a circumstance is to recognise the liability when the obligation arises (when the asset is installed or commissioned) and to include the cost of the liability as part of the cost of the asset. This approach acknowledges that the cost of decommissioning is part of the cost of accessing the benefits associated with the asset concerned.

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[1] This paper assumes for convenience that the proposed amendment of the term 'fair value less point of sales costs' to 'fair value less costs to sell' will be made.

19. The advantages of view 2 are that it solves the troublesome income statement effect. It also does not affect the fair value measurement of the crop in the way that view 1 does.

20. The disadvantages of view 2 are that it recognises an asset for a crop that has not yet been planted. It would have to be described as a 'crop to be planted' as it does not meet the definition of a biological asset. Additionally, this asset is recognised on a cost basis whereas IAS 41 requires recognition at fair value.

## Staff recommendation

21. The staff believes that view 1 provides the most satisfactory solution to the troublesome income statement effect of the interaction of IAS 41 and IAS 37 and the benefits of this outweigh the disadvantages of this approach. The staff therefore recommends that IAS 41 be amended as proposed in paragraph 23 to require that compulsory replanting costs that are triggered by the harvesting of a crop be reflected in the measurement of the fair value less costs to sell.

22. **Does the Board agree?**

## Drafting

23. The staff recommends that IAS 41 should be amended as follows:

### Recognition and measurement

…

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) <u>except for cash flows for re-establishing biological assets which the entity is legally obligated by contract or statute to incur as a result of harvesting the current biological assets</u>.

# Basis for Conclusions on Proposed Amendments to IAS 41 *Agriculture*

*This Basis for Conclusions accompanies, but is not part of, the draft amendments.*

## Reclassification

BC1 The Board has identified an apparent practical issue that arises when an entity that has biological assets also has a legal obligation to replant such assets after harvest.

BC2 The practical issue relates to the interaction of the requirements of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and IAS 41, *Agriculture*. The measurement of biological assets at fair value means that profit is recognised in respect of such assets as they grow rather than at the point of harvest and sale. IAS 41 requires that the calculation of fair value is not reduced by future replanting costs. A provision for replanting and the associated costs is recognised at the point of harvest where there is a legal obligation to replant in accordance with IAS 37. The cost is recognised as an expense at the point of harvest leading to a net expense when the crop is harvested. An equivalent fair value gain is recognised in the income statement when the replanting takes place.

BC3 The Board has decided to address this practical issue by amending IAS 41 to require the cost of compulsory replanting to be reflected in the calculation of fair value of the preceding crop.