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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **March 2008, London**

Project: **ED Annual Improvements Project—Comment Analysis**

Subject: **IAS 41 Biological Transformation (Agenda paper 8J,
question 40)**

BACKGROUND

1. IAS 41 *Agriculture* requires entities to measure biological assets at fair value which is determined using a hierarchy. The hierarchy requires entities to refer first to quoted prices in an active market. If no quoted prices exist, prices from recent transactions are used. In the absence of recent transactions, quoted prices for similar assets or sector benchmarks are used. If market-determined prices are not available, IAS 41 requires entities to use a discounted cash flow model to estimate the fair value of the biological assets in their present location and condition. IAS 41.21 states “*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.*”
2. Diversity has developed in practice because some entities believe that the prohibition in IAS 41 on taking future biological transformation into account means that cash flow forecasts should be based on selling the asset at a future date in its current condition.

Example

3. Suppose that a farmer owns an acre of land on which there is a 5 year old forest. The 5 year old trees can be sold for pulp (effectively scrap) or can be grown. When they have matured (when they reach 15 years of age), they will be sold for timber.
4. Some believe that, because there is an active market (for pulp), the trees must be valued based on their current pulp value. Some base their cash flow forecasts on the estimated selling price of mature timber in 15 years time adjusted to take into account the costs of growing the crop for a further ten years discounted to current values. Others believe that the prohibition on taking additional biological transformation into account requires the valuation to be based on selling 5 year old trees for pulp in 15 years time.
5. In response to this diversity, the Board proposed that IAS 41 be amended to:
 - a) make clear that an active market must exist for the asset *in its current location and condition* for IAS 41 to require that market to be used to value the asset;
 - b) clarify that harvest alters the condition of an asset. An active market for harvested trees is not therefore an active market for a growing forest (although, in some situations, it may be appropriate to use the price of the harvested trees as a starting point and adjust to obtain the fair value of the growing crop);
 - c) remove the prohibition on taking additional biological transformation into account; and
 - d) require prospective application.
6. This paper sets out a summary of the comments received in response to the proposals along with the staff's recommendations for addressing those comments.

Comment letter analysis

7. The Board received 75 comment letters on the annual improvements ED. Of these, 26 commented on this issue. 23 were supportive of the proposed change. 3 respondents objected on the basis that it would change existing practice and

conflict with the objective of measuring the value of the asset in its current location and condition.

‘We do not agree with the proposal to remove the exclusion of “additional biological transformation” from IAS 41.21, because it conflicts with the objective of the calculation of the present value of expected net cash flows, which is to determine the fair value of a biological asset in its present location and condition (IAS 41.21). If increases in value from additional biological transformation are included, this would infringe upon the fundamental principle of portraying the financial position as at the balance sheet date. Furthermore, because of the hierarchy of guidance for management reference in selecting accounting policies pursuant to IAS 8 consequences for other items might evolve, for example for intangible assets. Finally, it might be too early to integrate the “market participant view” into the IFRSs given that the project on “Fair Value Measurements” has not yet been finalised.’ [CL10]

8. Other commentators agreed with the proposal but suggested that further guidance could be included to make clear what the Board intended by making these changes:

‘The amendment suggested should be sufficient to avoid divergence in practice, but ... one must refer to the preliminary works [sic] of the amendments, that is the agenda papers of the IFRIC, in particular Agenda Paper No 6 to the IFRIC meeting in February 22, 2007 to understand the grounds for the amendments. In our opinion therefore, the basis for conclusions section should be amended to include an explanation of the wordings of par. 17 to make sure that it is clear than an active scrap market is not relevant.’ [CL20]

9. Six respondents (including 5 of those who were supportive of the changes) expressed concerns about changing the definition of biological transformation to include harvest:

“We do not agree with the proposal to insert the words ‘and harvest’ into the definition of ‘biological transformation’. Harvesting is a process carried out by man, so it is not a biological transformation. The reason for the proposal is obscure, and its effect can only be confusing.” [CL58]

10. One commentator asked for guidance on the accounting for a replanting obligation¹.

Staff Analysis

11. Commentators that disagreed with the proposals did so because they believed that they allow entities to take into account future growth in measuring the fair value of biological assets. The commentators therefore considered that the proposals were inconsistent with the objective of measuring fair value.
12. The staff believes that the objective of using a discounted cash flow model is to estimate a 'market' price for the asset in its current location and condition. Any 'market' price will take into account the potential to access the future benefits associated with an asset. In particular, a buyer of an immature biological asset would take into account the potential for that asset to reach maturity in determining how much they would pay to acquire it. The staff does not therefore believe that taking into account the potential of a biological asset to grow is inconsistent with the objective of measuring the value of the asset in its current location and condition.
13. The staff does not, therefore, propose changing the proposals to remove the phrase 'additional biological transformation' or to make clear that an active market must exist for the asset 'in its current location and condition'. However, the staff recommends that the basis for conclusions be enhanced to make absolutely clear that the objective of using discounted cash flows remains to estimate the value in the current location and condition.
14. The staff next considered the change proposed to the definition of biological transformation to include 'harvest'. The staff notes that this change was proposed to make clear that a growing crop in situ is not in the same condition as a harvested crop. An active market for a harvested crop is not therefore an active market for a growing crop (although the market for a harvested crop may be used as a starting point in the calculation of the fair value of a growing crop).
15. In the light of the comments received, the staff proposes that the definition of biological transformation not be amended but instead the phrase 'biological

¹ The staff notes that the Board considered replanting obligations in 2007 and was unable to reach a consensus. The staff has not therefore considered this comment further in this paper. If the Board would like to re-consider this issue, the staff suggests that it is raised as part of a future annual improvements project.

transformation or harvest' be used in the standard when appropriate. This will mean that the respondents' comments that harvest is a human activity rather than a biological transformation are reflected but that the desire to clarify that a harvested asset is not in the same state as a growing crop is also respected. As with the removal of the term 'additional biological transformation', the staff proposes that an enhanced basis for conclusions is published explaining the reason for this change.

Transitional provisions

16. In the Annual Improvements ED, the Board proposed that all improvements be applied retrospectively. The staff has become aware that this may not be appropriate for the amendment relating to biological transformation.
17. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that changes in accounting policy should be applied retrospectively except to the extent that it is impracticable to determine either the period-specific or the cumulative effects of the change. IAS 8.52 states that it is impracticable to estimate a fair value not based on an observable price or observable inputs retrospectively.
18. The staff believes that the change proposed in the annual improvement relates to the measurement of fair value using measures that are not observable prices or observable inputs. The staff therefore believes that applying this change retrospectively would not be practicable in accordance with IAS 8.
19. The staff therefore recommends that this change be applied prospectively.

CONCLUSION, RECOMMENDATION AND QUESTION FOR THE BOARD

20. The staff recommends that the Board finalises this amendment as an annual improvement. In doing so, the staff proposes that the Board make the following changes to its ED:
 - a) The basis for conclusions should be expanded to make clear that the reason for using a discounted cash flow model is to estimate a market based value of the asset in its current location and condition.
 - b) The word 'harvest' should be removed from the definition of 'biological transformation' and the phrase 'biological transformation' be replaced with 'biological transformation or harvest' when applicable in the standard.

- c) An expanded basis for conclusions should be provided to explain why the word harvest has been inserted.
 - d) The transitional arrangements should be changed to require the amendment to be applied prospectively.
21. If the Board agrees with these proposals, the staff will include drafting to implement these recommendations in a ballot draft.