IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 41—Taxation in fair value measurements		
Paper topic	Initial consideration		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® *Update*. The approval of a final Interpretation by the Board is reported in IASB® *Update*.

Introduction

1. The IFRS Interpretations Committee (Committee) received a request to consider amending IAS 41 *Agriculture* to remove the reference to cash flows from taxation from paragraph 22 of IAS 41.

2. This paper includes:

   (a) background information;

   (b) a summary of our research and analysis; and

   (c) a question for the Committee asking whether it agrees with our recommendation to amend IAS 41 as part of the next annual improvements cycle.

3. A copy of the submission is included in Appendix A to the paper.

Background information

What does the submission say?

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 submitter says in 2008, the Board amended IAS 41 to remove the requirement for entities to use a pre-tax discount rate when applying a discounted cash flow technique to determine the fair value of biological assets. Paragraph BC6 of IAS 41 states:

> The Board noted that a willing buyer would factor into the amount that it would be willing to pay the seller to acquire an asset (or would receive to assume a liability) all incremental cash flows that would benefit that buyer. Those incremental cash flows would be reduced by expected income tax payments using appropriate tax rates (ie the tax rate of a market participant buyer). Accordingly, fair value takes into account future income taxes that a market participant purchasing the asset (or assuming the liability) would be expected to pay (or to receive), without regard to an entity's specific tax situation.

6. Nonetheless, the Board did not amend paragraph 22 of IAS 41, which requires an entity to exclude cash flows from taxation when measuring fair value. The submitter says this is inconsistent and suggests the Board amend paragraph 22 of IAS 41 to remove the reference to cash flows from taxation.

History of the relevant requirements

7. Paragraph 12 of IAS 41 generally requires entities to measure biological assets at their fair value less costs to sell.

8. In May 2008 the Board issued *Improvements to IFRSs,* which amended paragraph 20 of IAS 41 (2008 amendment). Before this amendment, paragraph 20 of IAS 41 required entities to use a current market-determined pre-tax rate to discount cash flows when measuring the fair value of biological assets. Paragraph 22 of IAS 41 required the entity not to include cash flows from taxation. Accordingly, entities using a discounted cash flow technique to measure the fair value of biological assets used pre-tax cash flows and a pre-tax discount rate.

9. The 2008 amendment removed the requirement in paragraph 20 of IAS 41 for entities to use a pre-tax rate to discount cash flows. The purpose of the amendment is explained in paragraph BC6 of IAS 41—reproduced in paragraph 5 of this paper.

10. Nonetheless, the Board did not amend paragraph 22 of IAS 41 to delete the reference to cash flows from taxation. Therefore, after the amendment IAS 41 required an entity to use pre-tax cash flows but it did not require the entity to use a pre-tax discount rate. IAS 41 did not include any requirements on the discount rate.

11. In May 2011 the Board issued IFRS 13 *Fair Value Measurement*, which defines fair value and contains the requirements for measuring fair value. As a consequence, the Board deleted paragraphs 17–21 and paragraph 23 of IAS 41. The Board did not delete paragraph 22 because it contains specific requirements for entities measuring the fair value of biological assets.

What do the existing requirements say?

12. Paragraph 11 of IFRS 13 requires an entity to take into account the characteristics of an asset if market participants would take those characteristics into account when pricing the asset at the measurement date.

13. IFRS 13 does not specify whether an entity uses pre-tax cash flows or post-tax cash flows. Paragraph B14(d) of IFRS 13 requires an entity to use internally consistent assumptions about cash flows and discount rates, and specifically states:

> …after-tax cash flows should be discounted using an after-tax discount rate. Pre-tax cash flows should be discounted at a rate consistent with those cash flows…

14. Paragraph 22 of IAS 41 requires an entity that measures the fair value of a biological asset using a discounted cash flow technique to exclude the effect of tax when estimating the cash flows. Applying IFRS 13, the entity would use a discount rate consistent with those cash flows.

Summary of our research and analysis

15. In order to gather information about the matter described in the submission, we sent requests to members of the International Forum of Accounting Standard-Setters, securities regulators, the large accounting firms and an international valuation body.

16. The request asked those participating to provide information, based on their experience, about:

    (a) how prevalent discounted cash flow techniques are for valuing biological assets;

    (b) the methodologies and inputs used to perform discounted cash flow valuations, in particular how entities reflect tax in their valuations; and

    (c) whether the requirements in paragraph 22 of IAS 41 influence which valuation method an entity applies.

17. We received 10 responses—five from global accounting firms, two from national standard-setters, two from organisations representing groups of regulators and one from a member of an international valuation body. The views received represent informal opinions, rather than formal views of those responding.

Findings from outreach

Prevalence of discounted cash flow techniques

18. Respondents said entities apply different valuation techniques to different types of biological assets.

    (a) entities generally use a discounted cash flow technique for measuring the fair value of agricultural produce that (i) has a maturity of longer than 12 months, such as forestry assets; or (ii) is a perennial crop, such as palm oil fruits.

    (b) entities generally use a market approach to measure fair value if an active market exists. This is generally the case for traded commodities or for live animals such as cattle, pigs and sheep.

Methodologies and inputs used

19. Most respondents said when using discounted cash flow techniques, entities use internal projections of future productivity of the biological assets in estimating future cash flows. Three respondents said in their experience, most entities include cash flows from taxation in this estimate—this is because it is difficult for entities to determine a pre-tax discount rate. However, they are aware of a few entities that exclude cash flows from taxation. One respondent said in its experience, entities did not include cash flows from taxation when measuring the fair value of biological assets.

20. One respondent said paragraph 22 of IAS 41 does not influence which valuation technique an entity uses. However, it said some entities measure the fair value of their biological assets using post-tax discount rates as a base and then make adjustments to ensure compliance with IAS 41. In contrast, one respondent said paragraph 22 of IAS 41 could theoretically affect which valuation technique an entity uses, however it did not identify any diversity in practice. Other respondents did not comment on this matter.

An amendment to IAS 41

21. Half of respondents said they would support an amendment to IAS 41 to remove from paragraph 22 the reference to cash flows. Some of these respondents agreed with the submitter's view that the requirements to exclude cash flows from taxation in paragraph 22 of IAS 41 is inconsistent with paragraph BC6 of IAS 41 and paragraph 11 of IFRS 13. One respondent said they would disagree with a proposal to delete the word 'taxation' from paragraph 22 of IAS 41—however, they did not provide a reason for this view. No other respondents expressed an opinion on this matter.

Other comments

22. Two respondents said one other aspect of paragraph 22 of IAS 41 creates difficulties for entities. They said entities do not apply the requirement to exclude cash flows related to re-establishing biological assets after harvest—entities often include the cost of replanting trees in a plantation forest when calculating fair value, particularly in jurisdictions in which entities have a legal obligation to replant the forest after

harvest. Therefore, these respondents suggest amending IAS 41 to remove this requirement from paragraph 22.

Staff analysis

How does tax affect fair value?

23. The Board's research project on discount rates considered the effect that cash flows from taxation have on discounted cash flow methods. Paragraphs 203–222 of Agenda Paper 17B of the Board's January 2016 meeting provide a summary of the research and findings.

24. Table 12 of that paper shows combinations of different tax perspectives of inputs and resulting measurements. It illustrates that in theory, applying a higher pre-tax rate to discount higher pre-tax cash flows gives the same result as using a lower post-tax rate to discount lower post-tax cash flows. In both cases, the result is a measurement on a post-tax basis. This means that such measurement already includes the effect of tax and no further adjustments for tax are needed.

25. However, the research identified that entities generally have difficulties in identifying a pre-tax discount rate when determining present value measurements, for example applying IAS 36 *Impairment of Assets*. Many entities use a post-tax rate and 'gross-up' the rate to reflect tax—however, paragraph BCZ85 of IAS 36 explains that a simple grossing-up of a post-tax rate by the rate of tax in order to arrive at a pre-tax rate is not always correct. Methods of 'grossing-up' vary and can be overly simplistic. In such cases this can lead to a difference in measurement.

26. The responses to our outreach suggest entities have similar problems in identifying a pre-tax discount rate when measuring fair value of biological assets.

Would amending paragraph 22 of IAS 41 resolve the matter?

27. We think the requirements in paragraph 22 of IAS 41 are not entirely aligned with those in IFRS 13—IFRS 13 requires entities to take into account the characteristics of an asset that market participants would take into account, whereas paragraph 22 of IAS 41 prevents entities from including tax cash flows, regardless of whether market participants would take those cash flows into account. Paragraph 24 of this paper

notes that, theoretically, an entity would determine the same measurement regardless of whether it uses pre or post-tax cash flows as long as the discount rate used is consistent with the cash flows used. However, entities have difficulties in identifying a pre-tax discount rate when measuring the fair value of biological assets.

28. We think amending paragraph 22 of IAS 41 would resolve these challenges because it would remove the requirement for entities to use pre-tax cash flows in measuring fair value—accordingly, entities would no longer be required to estimate a discount rate that is consistent with pre-tax cash flows.

Should the Committee add this matter to its standard setting agenda?

Is the matter widespread and expected to have a material effect on those affected?[1]

29. The outreach responses indicate the use of discounted cash flow techniques for measuring the fair value of biological assets is widespread—particularly for assets that have a maturity of longer than 12 months and perennial crops.

30. Although theoretically an entity would determine the same measurement regardless of whether it uses pre or post-tax cash flows as long as the discount rate used is consistent, entities have difficulty in determining an appropriate discount rate that is consistent with the pre-tax cash flows in paragraph 22 of IAS 41.

Is it necessary to add to or change IFRS Standards to improve financial reporting?[2]

31. We think amending paragraph 22 of IAS 41 to remove the requirement to exclude cash flows from taxation would improve financial reporting. This is because,

    (a) in our view, it would remove the apparent inconsistency in the requirements; and

    (b) help entities that have difficulties in determining an appropriate discount rate that is consistent with pre-tax cash flows.

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[1] Paragraph 5.16(a) of the *Due Process Handbook*.

[2] Paragraph 5.16(b) of the *Due Process Handbook*.

Would any solution developed be effective for a reasonable period of time?[3]

32. The Board does not have any active projects on its work plan or in the research pipeline to amend IAS 41. In addition the Board has recently completed its deliberations on the Discount Rate project and no standard-setting is expected to result from that project.

33. The Board is undertaking a Post-implementation Review (PIR) of IFRS 13. A Request for Information was published in May 2017, which has a comment letter deadline of 22 September 2017. There are no questions specifically on discount rates, however it is possible respondents could raise matters related to these.

34. Based on the information available to use at this time, we think any amendment to IAS 41 in this regard would be effective for a reasonable period of time.

Can the matter be resolved efficiently (is it sufficiently narrow in scope)?[4]

35. We think this is a narrow scope matter that could be resolved efficiently. For further details, see our analysis of the matter in relation to the annual improvement criteria in paragraphs 38–40 of this paper.

36. As noted in paragraph 22 of this paper, two respondents identified another application matter regarding paragraph 22 of IAS 41. We will perform further research on this matter and, if required, provide further information to the Committee at a future meeting.

Staff conclusion, having considered the Committee's agenda criteria

37. Having considered the Committee's agenda criteria, we think the Committee should add a project to amend paragraph 22 of IAS 41 to its standard-setting agenda.

[3] Paragraph 5.21 of the *Due Process Handbook*.

[4] Paragraphs 5.16(c) and 5.17 of the *Due Process Handbook*.

Does this matter meet the annual improvement criteria?

38. Paragraphs 6.11–6.14 of the *Due Process Handbook* include the criteria for annual improvements. To meet these criteria, the proposed solution would need to be limited to:

    (a) clarifying the wording in a Standard; or

    (b) correcting relatively minor unintended consequences, oversights or conflicts between existing requirements.

39. We think the proposed solution regarding paragraph 22 of IAS 41 meets the second of these criteria.

40. As explained earlier, we think the Board's intention regarding the 2008 amendments was to permit entities to include tax cash flows in measuring fair value using a discounted cash flow technique. Therefore, removing 'taxation' from paragraph 22 of IAS 41 would be consistent with that intent. Further, such an amendment would also be consistent with existing principles in IFRS 13, which allow an entity to use different methods to measure fair value—IFRS 13 does not specify whether an entity includes or excludes tax cash flows when using discounted cash flow techniques to measure fair value.

Staff recommendation

41. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the *Due Process Handbook* (discussed in paragraphs 29–40 above), we recommend that the Board:

    (a) propose to amend paragraph 22 of IAS 41 to remove the requirement to exclude cash flows from taxation when measuring fair value; and

    (b) include this proposed amendment in its next annual improvements cycle.

Question for the Committee
Does the Committee agree with the staff recommendation in paragraph 41 of this paper?

Appendix A – Submission

A1. We have reproduced the submission below. We have deleted details that would identify the submitter of this request.

Submission

IFRS IC Potential Agenda Item
IAS 41 Agriculture para 22:

Biological assets in the scope of IAS 41 are measured at fair value less costs to sell. IAS 41 references IFRS 13 to for the measurement of fair value however para 15–25 give some additional guidance.

IAS 41.22 states:

'The 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".

Comments/Questions:

IAS 41 was amended in 2008 to remove para 20 which required the use of pre-tax rates when measuring fair value of agricultural produce and biological assets.

The Board deliberated whether it was appropriate to require a pre-tax rate when measuring the fair value. Fair value should incorporate the characteristics that a market participant would consider. The Board decided that a market participant would take into account future taxes when determining the amount to pay to a seller, and thus it was decided to remove the pre-tax rate requirement from IAS41.20. [IAS41.BC6, 7].

Paragraph 22 in IAS 41, however, was not amended and under the current standard, still excludes taxation cash flows from the calculation of fair value.

Subsequently paragraphs 17-21 were deleted when IFRS 13 was issued. Fair value under IFRS 13, incorporates characteristics that a market participant would take into consideration, and therefore we would expect this to be post tax.

We would propose the word taxation is deleted from para 22.