



## **Staff Paper—Potential Implications of Draft IFRS 13 *Fair Value Measurement* for IAS 41 *Agriculture***

### **Background and Purpose**

- 1 The recent issue of a confidential near-final draft of IFRS 13 *Fair Value Measurement* (see Agenda Paper 3.2) caused staff to take a fresh look at the fair value guidance in IAS 41 *Agriculture* (particularly given the range of instances in which biological assets do not have observable market prices).
- 2 Staff identified an apparent practical problem with the recommended disclosure in paragraph 51 of IAS 41. Although the apparent problem is neither created nor mitigated by the expected content of IFRS 13, staff think it is worth bringing to your attention now in the context of IFRS 13. This paper discusses the apparent problem, a possibly related misapplication of AASB 141 *Agriculture* in practice, and how the Board might wish to respond to that apparent problem.

### **Paragraph 51 of IAS 41**

- 3 Paragraph 51 of IAS 41 encourages separate disclosure of the components of the change in the fair value less costs to sell of biological assets due to physical changes and due to price changes [paragraph 51 is quoted in the Appendix to this paper]. This encouraged disclosure works for fair values determined by multiplying a current physical quantity by a current price. However, staff think it does not work for fair value estimates based on the present value of future cash flows (which is determined as an expected physical quantity multiplied by an expected price, discounted by a particular rate). In present value based estimates of fair value (referred to in paragraph 20 of IAS 41 [see Appendix to this paper]), current physical quantities are inputs to expectations about future cash flows but are not multiplied by a price to determine present fair value. Therefore, to encourage separation of physical change and price change, as in paragraph 51 of IAS 41, is regarded by staff as inappropriate in circumstances in which such a distinction is infeasible.

## **Practice issue arising possibly as a consequence of paragraph 51 of IAS 41**

- 4 Feedback on industry practice in applying AASB 141 indicates that, for biological assets without observable market prices in their present condition, it has been practice to apply an approach that does not appear to faithfully reflect fair value. For such biological assets (for example, growing timber yet to reach a saleable state), staff understand that some entities estimate fair value (and changes therein) on the basis of an assumed linear relationship with physical growth. For example:

An entity makes a projected estimate of the quantity of timber that will exist when trees reach maturity and become saleable (assume for simplicity they are harvested and sold at that time). By direct observation, the entity measures the quantity of the timber existing at the end of the current reporting period at 30% of the estimated quantity upon maturity and sale. It therefore estimates the current fair value of the trees at 30% of the estimated current sale price for sawn logs.

- 5 This practice possibly occurs as a consequence of the emphasis paragraph 51 of IAS 41 places (without scope delimiters) on distinguishing between physical changes and price changes as the components of changes in fair value less costs to sell. The potential for confusion is increased by the comment in paragraph 52 of IAS 41 [see Appendix to this paper] that physical changes have “a direct relationship to future economic benefits” (‘direct’ could be read as ‘linear’).
- 6 The problem with assuming a linear relationship between physical growth and fair value is that the pattern of physical growth may differ from the time value of money, the pattern of risk over the period to the biological asset becoming marketable, and market participants’ expectations regarding the future prices that will be obtained for the biological asset. The significance of physical growth for a period is not that fair value will vary in a linear fashion. Rather, its implication for the asset’s fair value is that any differences from the expected amount of physical growth for the period should cause a reassessment of the present value of future cash flows.
- 7 Nothing in the expected content of IFRS 13 would support continuing to assume such a linear relationship exists. Furthermore, staff note that the consequential

amendments to IAS 41 included in the January 2011 confidential draft of IFRS 13<sup>1</sup> do not affect paragraphs 51 – 52 of IAS 41.

- 8 The IASB recently removed from IAS 41 a potential source of confusion regarding the treatment of physical growth. In its May 2008 amendment of IAS 41, the IASB removed the prohibition on an entity taking into account the cash flows resulting from ‘additional biological transformation’ when estimating the fair value of a biological asset using discounted cash flows (see paragraph BC8 of the IASB’s Basis for Conclusions on IAS 41, quoted in the Appendix to this paper). That amendment should have dispelled any perception that a linear approach to estimating fair value is preferable to a discounted cash flows approach.

### **Staff Recommendations**

- 9 In summary:
- (a) staff does not think IFRS 13 will create a problem in the application of the fair value-related requirements in IAS 41; and
  - (b) staff thinks the disclosure in paragraph 51 of IAS 41 (discussed in paragraph 3 above) should only be encouraged in relation to biological assets with fair value determined through current volume/price multiples. Staff suggests that the Board writes to the IASB to recommend narrowing the context of that encouraged disclosure (whether through Annual Improvements or otherwise).

### **Questions for Board members**

- Q1** Do you agree that a Board letter should be sent to the IASB recommending that the encouraged disclosure in paragraph 51 of IAS 41 should only apply to biological assets with fair value determined through current volume/price multiples?
- Q2** If your answer to Question 1 is yes, do you agree that the letter should be finalised via the Chairman (i.e., no need for Subcommittee review)?

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<sup>1</sup> The more recent, ‘near-final’, draft of IFRS 13 (released by the IASB on 5 April 2011)—Agenda Paper 3.2—is an abridged version that does not include draft consequential amendments to other IFRSs. Therefore, staff considered the draft consequential amendments included in the January 2011 draft.

## APPENDIX

### Extracts from IAS 41 *Agriculture*

- 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 rate in determining fair value.
- 51 The fair value less costs to sell of a biological asset can change due to both physical changes and price changes in the market. Separate disclosure of physical and price changes is useful in appraising current period performance and future prospects, particularly when there is a production cycle of more than one year. In such cases, an entity is encouraged to disclose, by group or otherwise, the amount of change in fair value less costs to sell included in profit or loss due to physical changes and due to price changes. This information is generally less useful when the production cycle is less than one year (for example, when raising chickens or growing cereal crops).
- 52 Biological transformation results in a number of types of physical change – growth, degeneration, production, and procreation, each of which is observable and measurable. Each of those physical changes has a direct relationship to future economic benefits. A change in fair value of a biological asset due to harvesting is also a physical change.

### Extract from IASB's Basis for Conclusions on IAS 41 *Agriculture*

- BC8 Sometimes the fair value of an asset in its current location and condition is estimated using discounted cash flows. Paragraph 21 could be read to exclude from such calculations increases in cash flows arising from 'additional biological transformation'. Diversity in practice had developed from different interpretations of this requirement. The Board decided that not including these cash flows resulted in a carrying amount that is not representative of the asset's fair value. The Board noted that an entity should consider the risks associated with cash flows from 'additional biological transformation' in determining the expected cash flows, the discount rate, or some combination of the two. Therefore, the Board decided to amend IAS 41 to remove the prohibition on an entity taking into account the cash flows resulting from 'additional biological transformation' when estimating the fair value of a biological asset.