

STAFF PAPER

May 2012

IFRS Interpretations Committee Meeting

Project	IAS 41 <i>Agriculture</i> and IFRS 13 <i>Fair Value Measurement</i>		
Paper topic	Valuation of biological assets using a residual method		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. In April 2012, the IFRS Interpretations Committee (the Committee) received a request seeking clarification on paragraph 25 of IAS 41 *Agriculture*. In this paper, we are proposing an amendment to IAS 41. We sent out a request for information to the International Forum of Accounting Standard Setters (IFASS) to help assess the Committee's agenda criteria, which was still outstanding (due 14 May 2012) when this agenda paper was completed. We will present any update to our recommendations at the May Committee meeting.
2. This agenda paper is organised as follows:
 - (a) summary of the issue (paragraphs 3-7)
 - (b) staff analysis (paragraphs 8-21)
 - (c) outreach activities to date (paragraph 22)
 - (d) agenda / annual improvements criteria and staff recommendation (paragraphs 23-28)
 - (e) Appendix A— Proposed amendments
 - (f) Appendix B— Submission received

Summary of the issue

3. This section outlines a summary of the issue discussed by the submitter. Please refer to Appendix B for further details.
4. Paragraph 25 of IAS 41 addresses the fair value measurement of biological assets physically attached to land (emphasis added).

Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

5. Paragraph 27 of IFRS 13 *Fair Value Measurement* requires that a fair value measurement of a non-financial asset take into account its highest and best use:

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its *highest and best use* or by selling it to another market participant that would use the asset in its highest and best use.
6. The submitter points out when the fair value of raw land based on its highest and best use is different from the value of raw land in its current use, the use of the highest and best use value for the land in calculating the fair value of the biological assets might lead to a fair value of nil for the biological assets.
7. According to the submitter, there are mixed views in their jurisdiction on the application of paragraph 25 of IAS 41. Some think that the value of raw land to be deducted from the fair value of combined assets should be the value of the land based on its current use. Others think that the value of raw land should be its fair value, which would reflect the land's highest and best use in accordance with IFRS 13.

Staff analysis

8. We think that the concern raised by the submitter arises because the example in the last sentence of paragraph 25 of IAS 41 refers to the *fair value* of the land and other assets. Although it is debatable whether the previous definition of fair value (ie before the IASB issued IFRS 13) reflected an asset's highest and best use, IFRS 13 is clear that it does when that asset is required to be measured at fair value by another IFRS.
9. Therefore, we think the question is whether the example in the last sentence of IAS 41.25 *requires* the use of fair value (which assumes the highest and best use of a non-financial asset) for the raw land and land improvements when using the residual method. Although this paper refers mainly to the raw land, the conclusions relate equally to land improvements associated with the combined assets.

Fair value of biological assets in IAS 41

10. Paragraph 12 of IAS 41 states that a biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except when the fair value cannot be measured reliably.
11. Paragraph 25 of IAS 41 provides practical guidance for measuring fair value when there is not a separate market for biological assets (eg when there is not a quoted price in an active market for an identical biological asset or for similar biological assets). When developing IFRS 13, the Board did not wish to remove such guidance from IAS 41, and noted that entities can measure fair value in such circumstances (ie fair value can be measured using Level 3, or unobservable, inputs). However, the Board did not at that time reconsider what an entity should do when the current use of raw land differs from its highest and best use when measuring the fair value of biological assets using the residual method.

Meeting the objective of a fair value measurement

12. When measuring the fair value of biological assets, an entity must meet the objective in IFRS 13, which is to arrive at the price at which an orderly transaction between market participants would take place under current market conditions. To meet that objective, an entity often needs to use a variety of valuation methods (particularly when prices cannot be observed directly and more judgement is required), one of which may be an indirect method such as the residual method described in paragraph 25 of IAS 41. As it will often be appropriate to use a variety of valuation methods, the entity should ensure that, to the extent information is available, it also considers a direct method of valuation for the biological assets. This is similar to the valuation of unquoted equity instruments, which can be valued using a residual, or indirect, method (such as subtracting debt from total enterprise value to arrive at an equity value) or a direct method (such as capitalising dividends or cash flows to equity holders).
13. IFRS 13 provides guidance on selecting valuation techniques and inputs to valuation techniques, stating that valuation techniques should be appropriate in the circumstances and should maximise the use of relevant observable inputs and minimise the use of unobservable inputs (paragraph 61 of IFRS 13). It does not preclude the use of a residual method as long as that method complies with the objective of a fair value measurement.
14. Furthermore, paragraph 22 of IFRS 13 states that an entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

Applying the highest and best use and valuation premise concepts

15. Biological assets are non-financial assets and, therefore, their highest and best use would be considered in measuring their fair value. IFRS 13 presumes that an entity's current use of a non-financial asset is its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. In addition, IFRS 13 requires an entity to determine whether a non-financial asset's fair value would be maximised by using

it on a standalone basis or in combination with other assets (ie its valuation premise). When measuring fair value, assumptions about the highest and best use and valuation premise of a non-financial asset must be consistent for all the assets (for which highest and best use is relevant) within an asset group.

16. In most cases, the highest and best use of a biological asset will be its current use, and the valuation premise will be to use the asset in combination with other assets (eg land and other plantation assets) as a group. In practice, many non-financial assets derive the most value when they are used in combination with other assets—and their standalone value may be a scrap value. For example, grapevines are most valuable (ie they generate higher cash flows) when they are planted in land and their value is likely to be significantly lower if they get separated from the land or soil to which they are attached. However, some biological assets will derive a higher value when being used on a stand-alone basis. For example, timber planted in land for the purpose of production of lumber is likely to generate higher cash flows when it is separated from the land than when it is planted in the land (although cutting down the tree changes the characteristics of the tree and the costs of converting it to the alternative use as lumber would be taken into account).
17. It is important to note that the objective in IAS 41 is to measure the fair value of the biological assets, not all the assets in the group. When using the residual method in paragraph 25 of IAS 41, the land is an input into the fair value measurement of the biological assets. Therefore, if the highest and best use of the biological assets is its current use, for internal consistency the other assets in the combined assets would generally also reflect their values in their current use.
18. Having said that, we think that the conclusion depends on how an entity measures its land in the statement of financial position. That is, it depends on whether it uses the cost model or the revaluation model in accordance with IAS 16 *Property, Plant and Equipment*, as discussed in the next section.

Cost model vs. revaluation model under IAS 16

19. Paragraph 29 of IAS 16 states that an entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment. IAS 41 does not apply to land related to agricultural activity that should be covered by IAS 16. Therefore, the IAS 16 valuation model an entity has chosen for land in general would be applied to the measurement of land that is a part of the combined assets.
20. We think a distinction needs to be made between entities that are using the cost model in IAS 16 to value the land associated with the biological assets and those that use the revaluation model, as follows:
- (a) If an entity uses the cost model to measure the land, the value of the land in the statement of financial position is not being revalued to reflect its highest and best use (although arguably it did at acquisition). The use of the residual method to value the biological assets on a current use basis, as described in paragraph 17 above, is not in conflict with the use of historical cost in the statement of financial position.
 - (b) If an entity uses the revaluation model to measure the land, the value of the land in the statement of financial position reflects its highest and best use (ie the land is at fair value). In such a case, if the land reflected its fair value assuming its highest and best use, and the biological assets reflected their fair value assuming the land's current use, the statement of financial position would overstate the entity's assets (ie overvalue the biological assets) because these uses are mutually exclusive.
21. Our understanding is that in practice most entities use the cost model, not the revaluation model, to measure land in the statement of financial position. However, some entities do use the revaluation model. Consequently, we are proposing an amendment to IAS 41 to clarify that when using the residual method in paragraph 25:
- (a) if the entity uses the *cost* model to measure the land, the value of the land (and other assets in the combined assets) used as an input into the fair value measurement of the biological assets would reflect its *current use*; and

- (b) If the entity uses the *revaluation* model to measure the land, the value of the land (and the other assets in the combined assets) used as an input into the fair value measurement of the biological assets would reflect its *highest and best use* (ie its fair value).

Outreach activities to date

22. We sent out a request for information to the IFASS to help assess the Committee's agenda criteria, which was still outstanding (due 14 May 2012) when this agenda paper was completed. Specifically, we asked:

Q1. In your jurisdiction, is it common for entities reporting under IFRSs to have any biological assets physically attached to land that should be accounted for under IAS 41?

If yes to Q1:

Q2. If you have not yet applied IFRS 13, what is the prevalent approach used to determine fair value for such biological assets?

Q3. If you have already applied IFRS 13, what is the prevalent approach used to determine fair value for such biological assets?

Q4. Based on your response to Q2 or Q3, would your view be that there is diversity in practice for such biological assets?

Q5. Do any of the entities affected in your jurisdiction apply the IAS 16 revaluation model to the land, and if so, does this affect how the biological assets are valued?

We will present any update at the May Committee meeting.

Agenda criteria

23. In this section, we assess the submission against the agenda criteria of the Committee as follows:

(a) The issue is widespread and has practical relevance.

- (b) *The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).*
- (c) *Financial reporting would be improved through the elimination of the diverse reporting methods.*
- (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process.*
- (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*
- (f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

- 24. We will assess the criteria (a) to (c) once the outreach activity is completed.
- 25. We think this issue meets criteria (d) and (e), because we think that the issue can be resolved through an annual improvement and that the Committee will be able to reach a consensus on a timely basis.
- 26. For criterion (f), there are no current projects to address this issue. IAS 41 might be included in the future agenda depending on the result of Agenda Consultation. However, even if so it is not clear whether this issue is addressed, while there is a pressing need to clarify the issue. Consequently, we think this issue meets criterion (f).

Annual improvements criteria assessment

- 27. In planning whether an issue should be addressed by amending IFRSs within the Annual Improvements project, the Board assesses the issue against certain criteria. All the criteria (a)–(d) must be met to qualify for inclusion in annual improvements. We have assessed the potential amendment against the annual improvements criteria, which are reproduced in full below:

Annual improvements criteria	Staff assessment of the proposed amendment
(a) The proposed amendment has one or both of the following characteristics:	(a) Yes.

<p>(i) clarifying—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. <p>A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.</p> <p>(ii) correcting—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs. <p>A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.</p>	<p>The proposed amendment clarifies whether the example in the last sentence of IAS 41.25 <i>requires</i> the use of fair value (which assumes the highest and best use of an asset) for the raw land and land improvements when using the residual method.</p> <p>It maintains consistency with the existing principles within the applicable IFRSs.</p>
<p>(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.</p>	<p>(b) Yes. The issue is sufficiently narrow in scope to ensure that the proposed amendment has been considered sufficient and the extent of the impact of the change has been identified.</p>
<p>(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.</p>	<p>(c) Yes. We think that the Board will reach a conclusion on this issue on a timely basis, because it is a clarification of existing requirements.</p>
<p>(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.</p>	<p>(d) Yes. There are no current projects to address this issue. IAS 41 might be included in the future agenda depending on the result of Agenda Consultation. However, even if so it is not clear whether this issue is addressed, while there is a pressing need to clarify the issue.</p>

Staff recommendation

28. Accordingly, if the Committee agrees with our analysis in this paper, our recommendation for the next steps depends on the results of the outreach:
- (a) If it turns out that the issue satisfies the agenda criteria of (a) to (c), we think that the Committee should recommend to the Board an annual improvement to IAS 41 as in Appendix A.
 - (b) If it turns out, however, that the issue does not satisfy those criteria, we will recommend that the Committee should not add the issue to its agenda.

In either case, we will present any update to our recommendations due to the outreach at the May Committee meeting.

Question to the Committee

Does the Committee agree with our analysis and recommendation?

Appendix A—Proposed amendments (IAS 41)

A1. The proposed amendment to IAS 41 is presented below.

Amendment to IAS 41 *Agriculture*

Paragraph 25A is added. Paragraph 25 is amended to be consistent in wording with IFRS 13.

Recognition and measurement

- 25 Biological assets are often physically attached to land (for example, trees in a plantation forest). There may not be an observable ~~no separate~~ market for biological assets that are attached to the land but an observable ~~active~~ market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.
- 25A However, if the current use of the combined assets that are not biological assets is different from their highest and best use, an entity applies the method described above using the guidance below:
- (a) if the non-biological assets in the combined assets are measured at fair value (eg they are measured at fair value in accordance with the revaluation model in IAS 16), the entity shall use the fair value of raw land, land improvements and combined assets to arrive at the fair value of biological assets. In this situation, the fair value of raw land, land improvements and the combined assets assumes their highest and best use in accordance with IFRS 13.
 - (b) If the non-biological assets in the combined assets are not measured at fair value (eg they are measured at cost in accordance with the cost model in IAS 16), the entity shall use a current value measurement of raw land, land improvements and combined assets reflecting their current use (not their highest and best use) to arrive at the fair value of biological assets. Such a current value measurement would be identical to a fair value measurement, except for the assumption about highest and best use.

A2. We propose adding the paragraph below to the Basis for Conclusions of IAS 41:

**Basis for Conclusions on proposed amendments to IAS 41
*Agriculture***

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

Recognition and measurement

Residual method (paragraph 25)

BC11 The Board considered whether the example in the last sentence of paragraph 25 requires the use of fair value, which assumes the highest and best use of a non-financial asset, for the raw land and land improvements when using the residual method described in that paragraph. The Board observed that IFRS 13 requires that the fair value of non-financial assets reflect their highest and best use. Accordingly, if the highest and best use of raw land and land improvements differs from their current use (eg when the raw land and land improvements can be used for an alternative use, such as for residential or commercial development), then the residual valuation method may return a nil or minimal value for the biological assets. However, the Board noted that a distinction should be made between entities that are using the cost model in IAS 16 to measure the land associated with the biological assets and those that use the revaluation model. That is because it would be internally inconsistent to write down the fair value of the biological assets without simultaneously writing up the value of raw land and land improvements. In such a case, the statement of financial position would understate the entity's assets (ie undervalue the biological assets). Conversely, the statement of financial position would overstate the entity's assets if the raw land reflected its fair value assuming its highest and best use, and the biological assets reflected their fair value assuming the land's current use. Consequently, the Board proposes to add paragraph 25A to clarify the application of the residual method when the current use of raw land and land improvements differs from their highest and best use.

Appendix B—Submission received

We received the following request from the Malaysian Accounting Standards Board (MASB). All information has been copied without modification.

20 April 2012

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Wayne,

IAS 41 AGRICULTURE – VALUATION OF BIOLOGICAL ASSETS ATTACHED TO LAND

The Malaysian Accounting Standards Board (MASB), as you are aware, submitted to the International Accounting Standards Board (IASB) an Issues Paper on IAS 41 *Agriculture* outlining how IAS 41 can be improved - a copy of the letter is attached for your information. The IASB, in response, included IAS 41 (particularly bearer biological assets) as a project suggestion in its Request for Views *Agenda Consultation 2011* which was published in July 2011. We note that the IASB in January 2012 had discussed the feedback received and that it expects to discuss a development plan in due course which we are hopeful will include IAS 41.

In the meantime we would like to seek clarification on paragraph 25 of IAS 41. For biological assets attached to land (for example, trees in a plantation forest), paragraph 25 clarifies that an entity may use information regarding the combined assets (biological assets, raw land and land improvements) to determine the fair value for the biological assets. Paragraph 25 further clarifies that the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of the biological assets.

IFRS 13 *Fair Value Measurement* defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For a non-financial asset,

the IFRS requires an entity to determine its fair value based on its highest and best use from the perspective of market participants, even if the entity intends a different use.

The issue

Based on IFRS 13 requirements, in deriving the fair value of biological assets using the “residual method” of valuation (i.e. Plantation Value - Value of Land = Value of Biological Assets), the fair value of the land portion would be based on its highest and best use. In situations where the highest and best use of the land is different from its existing use, an anomaly arises.

Consider the following example of two identical oil palm plantations — Plantation A is situated near the city and has the potential to be a residential or commercial hub while Plantation B is situated far from the city and hence has little or no development potential.

		Plantation A	Plantation B
		CU	CU
Plantation value /Combined Asset Value	x	10,000	10,000
Land – highest and best use	y	11,000	4,000
Biological assets	x-y	0 ² <i>(limited to zero value)</i>	6,000

Note 1: The above example ignores land improvement.

Note 2: Even if the combined assets value for Plantation A is fair valued on the same basis as the land, i.e. highest and best use to be consistent, the biological assets would still be zero (CU11,000 less CU11,000).

In the above example, the value of the biological assets is significantly different even though both plantations are identical except for its location.

The anomaly arises because the plantation values, i.e. the value of “x”, of Plantation A and Plantation B are both derived based on the net present value of the cash flows generated by the plantations while the land value, i.e. the value of “y”, is based on its highest and best use.

Therefore to dispense of the anomaly, some are of the view that, in computing the value of the biological assets, the value of the raw land to be deducted from

the combined assets should be reverted to the value of its existing use given that the whole plantation value was derived based on its existing use. However, we understand this interpretation would be inconsistent with IFRS 13 requirements which clearly specified that for a non-financial asset, the fair value is the highest and best use of the asset from the perspective of market participants, even if the entity intends a different use.

However, there are some who believe that the value of the land to be deducted from the combined assets should be its highest and best use by virtue of the words “fair value of the raw land” in paragraph 25 of IAS 41 and the anomaly is a consequence of applying IFRS 13.

We urge the IFRS Interpretations Committee to provide clarification on this issue for greater consistency in application across jurisdictions. We believe the issue is relevant to plantations not only in Malaysia but also in other jurisdictions and can be resolved quickly using existing IFRSs.

Most importantly, a clarification from the IFRS Interpretations Committee will certainly ease the transition process of entities converging with IFRS in the future.

If you need further clarification or information, please contact Ms Tan Bee Leng at +603 2240 9200 or by email at beeleng@masb.org.my.

Thank you.

Yours sincerely

MOHAMMAD FAIZ AZMI

Chairman