# IAS 41: Cannabis Accounting – Costs Incurred Related to Biological Transformation

## Extract, IFRS® Discussion Group Report on the Meeting – June 21, 2018

Paragraph 12 of IAS 41 *Agriculture* 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 [FVLCS], except for the case described in paragraph 30 where the fair value cannot be measured reliably."

Once the cannabis plant has been harvested, the costs incurred thereafter are within the scope of IAS 2 *Inventories*. However, questions arise with regards to how to account for the costs incurred related to the biological transformation of the biological asset between the point of initial recognition and the point of harvest (also referred to as "subsequent expenditures").

Paragraph B62 of the Basis for Conclusions on IAS 41 states, in part, that "[t]he Board decided not to explicitly prescribe the accounting for subsequent expenditures related to biological assets in the Standard, because it believes to do so is unnecessary with a fair value measurement approach."

The Group discussed the following fact pattern to highlight some of the considerations on the accounting for subsequent expenditures related to the development of biological assets.

### *Fact Pattern*

- An entity has cannabis plants that are measured at FVLCS of $200 at December 31, 2017, which is near the beginning of their growth cycle.
- During the first quarter of 2018, $300 of expenditures are incurred to grow the cannabis plants, and the FVLCS of the cannabis plants at March 31, 2018 is $600.

### ***Issue 1: Should the subsequent expenditures relating to the development of biological assets that are measured at FVLCS be expensed or capitalized?***

The accounting treatment of subsequent expenditures affects disclosures and expenditure classification in the Statement of Comprehensive Income.

The figure below illustrates the fact pattern above and the effect under the two views (i.e., Views 1A and 1B) discussed below.

| | **View 1A<br>Expense Subsequent Expenditures** | | **View 1B<br>Capitalize Subsequent Expenditures** | |
|---|---|---|---|---|
| | Biological Asset Continuity Debit / (Credit) | Profit or Loss Impact Debit / (Credit) | Biological Asset Continuity Debit / (Credit) | Profit or Loss Impact Debit / (Credit) |
| **FVLCS, December 31, 2017** | **$200** | | **$200** | |
| Capitalized to biological assets | | | $300 | |
| Expensed | | $300 | | |
| Change in FVLCS on growing cannabis | $400 | ($400) | $100 | ($100) |
| **FVLCS, March 31, 2018** | **$600** | | **$600** | |
| **Net Profit or Loss impact** | | **($100)** | | **($100)** |



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*View 1A – Expense subsequent expenditures.*

Proponents of this view think that the requirements of IAS 41 could mean that the remeasurement of FVLCS of cannabis plants up to the point of harvest is meant to capture the changes in value throughout the biological transformation of the cannabis plants in profit or loss.

The true change in fair value should not be shown net of expenditures made during the period. By expensing subsequent expenditures, a financial statement user is able to see the change in FVLCS separate from the subsequent expenditures incurred to grow the biological asset (i.e., gross presentation).

*View 1B – Capitalize subsequent expenditures.*

Proponents of this view think that it would make sense that the amount shown as a change in FVLCS should be net of subsequent expenditures incurred as those costs contributed to the growth of the plants, and therefore, the increase in FVLCS. This approach would result in the change in fair value gain or loss on the growing cannabis being attributed purely to the natural growth of the plants.

*View 1C – There is an accounting policy choice.*

Proponents of this view refer to paragraph BC62 of the Basis for Conclusions on IAS 41 and think that an entity could develop an accounting policy choice since IAS 41 intentionally does not prescribe the accounting for subsequent expenditures. Such a policy could be developed based on principles in other standards by analogy and should be clearly disclosed.

*The Group's Discussion*

Group members supported View 1C because IAS 41 intentionally does not prescribe the accounting for subsequent expenditures to grow biological assets. A representative of the Canadian Securities Administrators noted that since IAS 41 does not prescribe how an entity should account for subsequent expenditure in relation to biological assets, an entity is required to develop an accounting policy with reference to guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 requires, among other things, that management use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

One Group member observed that the Basis for Conclusions on IAS 23 *Borrowing Costs* refers to paragraphs B61 and B62 of the Basis for Conclusions on IAS 41 in explaining why the IASB decided not to require the capitalization of borrowing costs relating to assets that are measured at fair value, but did not prohibit presenting items in profit and loss as if borrowing costs had been capitalized. This Group member supports an accounting policy choice to capitalize or expense borrowing costs on investment properties measured at fair value in accordance with IAS 40 *Investment Property* and, as a result, thinks that an accounting policy choice is also supportable for subsequent expenditures related to producing biological assets.

Another Group member noted that there is diversity in accounting for subsequent expenditures in jurisdictions outside Canada, and that this is anecdotal evidence of an accounting policy choice.

Although most Group members supported View 1C, some were also of the view that capitalizing subsequent expenditures would result in a gross profit that was more understandable to users of financial statements. These Group members thought that increases in the fair value of biological assets should be presented net of the expenditures to produce them.

### *Issue 2: If subsequent expenditures should be capitalized, how would an entity determine what costs to capitalize?*

*View 2A – Analogize to IAS 2.*

Proponents of this view note that the cannabis plants will yield only a single harvest and will be replaced by agricultural produce in scope of IAS 2 on the day they are harvested, and measured in accordance with IAS 2 from that point onward. As a result, IAS 2 provides the most relevant cost guidance to determine which expenditures should or should not be capitalized during the development of the biological assets.

Also, analogizing to IAS 2 may be more appropriate than analogizing to IAS 16 *Property, Plant and Equipment* in this fact pattern as the plants are not bearer plants. Paragraphs 10 to 18 of IAS 2 may help an entity develop an accounting policy for determining what costs to capitalize during the development of biological assets.

*View 2B – Analogize to IAS 16.*

Proponents of this view think that, prior to harvest, the cannabis plants do not represent inventory. Instead a biological asset is being developed in order to produce inventory. As such, even though the biological asset will produce only one harvest, proponents of this view believe it is appropriate to analogize to IAS 16.

Immature bearer plants are accounted for under IAS 16 similar to construction in progress based on paragraph 22A of IAS 16. Paragraph 22 of IAS 16 further states, in part, that "[t]he cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see IAS 2)."

While judgment is required as to what costs would be capitalized, proponents of this view think paragraph 22 of IAS 16 suggests that an IAS 16 approach is likely to yield a capitalized cost amount that is generally the same as an IAS 2 approach.

Proponents of this view note that for certain biological assets, distinguishing the cost of maintaining a mature biological asset from costs that contribute to the asset's biological transformation or improve its anticipated yields is a significant judgment. However, this is less likely to be a significant judgment for cannabis plants as such plants are harvested once they are mature.

Paragraphs 16 to 22A of IAS 16 may help an entity develop an accounting policy for determining what costs to capitalize during the development of biological assets.

*View 2C – There should be an accounting policy choice on the standard to which to analogize.*

IAS 41 does not prescribe how an entity should account for subsequent expenditures. As a result, an entity could select an accounting policy for capitalizing subsequent expenditures that is broadly consistent with the principles in other standards (i.e., either IAS 16 or IAS 2) as long as the policy is disclosed and is applied consistently.

*The Group's Discussion*

Group members discussed whether there would be a different accounting outcome based on the standard to which an entity analogizes the determination of cost and concluded that the results could be different, particularly where judgment is required. One Group member noted that IAS 16 is more stringent with regards to the capitalization of non-production overhead costs.

Some Group members supported View 2A, noting that there is a natural relationship between IAS 41 and IAS 2 because agricultural produce beyond the point of harvest is within the scope of IAS 2.

One Group member thought that the development of the biological asset is not inventory, and therefore, analogizing to IAS 16 may be more appropriate. Another Group member observed that entities should consider the effect of how they account for subsequent expenditures on other financial statements, such as the Statement of Cash Flows, and whether analogizing to IAS 16 would be appropriate if these expenditures were reflected as investing activities.

Other Group members supported the view that there should be an accounting policy choice because IAS 41 is silent on the accounting treatment for subsequent expenditures. These Group members observed that entities need to think about what approach would produce the most relevant results for financial statement users.

After considering the diversity in views expressed, the potential effect on financial statements, and the rapid growth of the industry, the Group recommended that Issues 1 and 2 be discussed with the AcSB to determine whether they should be raised to the IASB or IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip).