



**EUROPEAN COMMISSION**

Internal Market DG

Financial services

**Financial information and company law**

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**CL 58**

Dear Sir Bryan

**Exposure Draft E65: Agriculture**

We welcome this opportunity to comment on the above Exposure Draft. Our comments first deal with general issues of principle, and thereafter with the specific questions to which the Board has sought answers. In drafting this response we have taken account of the remarks made by the representatives of the Member States of the EU in the Technical Sub-Committee of the Contact Committee on the Accounting Directives. However, our comments do not necessarily reflect the unanimous views of all Member States.

**1. GENERAL ISSUES OF PRINCIPLE**

*1.1 Conceptual basis and practicability*

Whilst acknowledging that this exposure draft is well expressed, we do not support it. In our view, the draft fails on three fundamental fronts: conceptual underpinning, logical consistency and practicability. We do not believe that it is demonstrated that fair value is always the most relevant method of measurement for all biological assets. Furthermore, we fear that if this standard were approved, it would present substantial practical difficulties for many preparers.

Whilst we see E65's approach as having some merit for certain agricultural activities, we do not see any merit in applying a blanket approach to all agricultural activities. This approach relies upon a number of unproved assumptions which cast doubt on the validity of the exposure draft's ultimate conclusions and proposals. These unproved assumptions are:

- That efficient markets exist for all biological assets;
- That there exist active and liquid markets for all biological assets, at all stages of growth;
- That biological transformation can be measured with a degree of reliability which is sufficient for recognition in the accounts; and
- That all sectors of agriculture are sufficiently similar as to be accounted for on the same basis.

We question the validity of these assumptions. For instance, it seems unlikely that there exist active liquid markets for all intermediate agricultural products. Whilst there may exist evidence of market transactions in intermediate products, these are likely to represent forward sales of the mature product, not sales of the intermediate product *per se*. In any event, even if active and liquid markets do exist, their associated risks and volatilities do not justify recognising revenue on the basis envisaged by the IASC. This is not to disagree that fair value information concerning biological assets is both relevant and useful, but we question whether fair values will always be sufficiently reliable to be incorporated in accounts. To do so might be imprudent and, in some cases, may even be misleading. It is also likely that the fair value approach proposed by the IASC would place an unnecessary burden on the preparers of accounts to the extent that their costs (including audit costs) would outweigh their benefits.

In any event, under the IASC's present system of revenue recognition (as articulated in IAS 18), this approach would not be appropriate, since the earning process would be too incomplete, too many significant uncertainties would remain, and any resultant profit could not be regarded as having been realised.

E65 asserts that biological assets are the *core income producing assets* of agricultural activities and distinctive from other assets because they are capable of biological transformation. The assertion is that the management of these transformation capabilities distinguishes agriculture from other business. On this basis, E65 proposes valuation at fair value for all biological assets and for all agricultural produce at the point of harvest as the only and best measurement of financial performance.

This is we believe a far too big change from the present situation. There is not sufficient experience in measuring all biological assets at fair value. The IASC should assess further and empirically test the application of this standard on a sufficiently large number of different biological assets and economic environments, including biological assets that are not completely grown.

Furthermore, we would be concerned if this exposure draft is being used to explore the views of the Board and the IASC constituencies on fair value accounting and financial performance generally. We believe the issue of agriculture would be better dealt with once the IASC had developed a standard on reporting financial performance; this would be preferable to creating confusion and controversy in the area of agricultural financial performance reporting.

In any event, government intervention could obscure measures of current period performance and financial position. We would go further and suggest that the existence of government subsidies, quotas, tariffs etc. can, in some cases, be so significant that they may render invalid the efficient market premise on which this exposure draft is based, with the result that inter-company comparisons would then become unreliable.

Moreover, if the standard were to be applied by all companies that undertake agricultural activity as it is envisaged in E65, we believe it could lead to very significant practical application difficulties. Such a scope would mean that a large number of small and mid-size agricultural businesses would have to apply an overly complicated standard.

### *1.2 Processing after harvest outside the scope of E65*

This is an example of the logical inconsistencies that exist in the draft. If valuation at fair value is considered the appropriate method of measurement, then fair values should be used all the way through. It is not coherent to establish that, whereas biological transformation brings about fair value changes, further processing after harvest does not. Furthermore, it is illogical to require fair value accounting during the period of relative uncertainty, volatility and measurement unreliability, and then revert to historical cost accounting once certainty and reliability are restored.

### *1.3 Agricultural land*

We believe there are strong practical difficulties in making a split between biological assets and the agricultural land on which they grow. It is not uncommon that certain agricultural lands are only used for specific types of biological assets that may take long periods to grow and/or which may give rise to particular varieties of agricultural produce. Under these conditions, there are no logical or conceptual arguments for the separation of agricultural land and fair value measurement of related biological assets. Furthermore, the value basis for measuring the land in isolation from the asset could be affected by totally different conditions.

## **2. ANSWERS TO THE SPECIFIC QUESTIONS**

### *Q1 Further processing after harvest outside the scope of the exposure draft*

- (b) As explained in more detail in section 1.2 above, we do not understand the conceptual basis for using an accounting treatment for assets growing in a biological process that is different to that of agricultural stocks held to be traded. It seems to us that there should be consistency of measurement from the beginning to the end in the accounting treatment applied to the agricultural process.

### *Q2 Biological assets: measure at fair value*

As indicated in our general comments above, we have considerable difficulty with the blanket application of fair value accounting to all biological assets and agricultural produce. We believe that the Board has formulated its

approach on a number of unproven assumptions which undermine the validity of its proposals.

Under the accrual system of accounting, the so-called “accretion approach” is a well established basis of revenue recognition. The accretion approach involves the recognition of revenue during the process of ‘production’, rather than at the end of a contract or when production is complete. This approach is generally accepted under existing accounting standards in two broad areas of enterprise activity: (1) the use by others of enterprise resources, for example, in the case of recognising rental, royalty or interest income, and (2) long-term construction contracts where the amount of revenue to be recognised on construction contracts is determined according to the ‘percentage-of-completion method’.

However, in the area of natural growth (or “biological transformation”), existing accounting rules (see IAS 18) and practice suggest that the accretion approach is not appropriate. This is because the earnings process would be too incomplete, too many significant uncertainties would remain, and a profit could not be regarded as having been realised.

This is not to disagree that fair value information concerning biological assets is both relevant and useful, but we question whether fair valuations will be sufficiently reliable to be incorporated in the accounts. We therefore question the merit in applying a blanket approach to all biological assets in all situations.

### *Q3 Reliability of fair value measurement*

- (a) As stated above, we challenge the draft’s underlying assumptions that there exist active and liquid markets for all biological assets, at all stages of growth and, therefore, that biological transformation can be measured with a degree of reliability which is sufficient for recognition in accounts. It is, however, much more likely that reliable measures of fair value can be determined at the point of harvest, and it is therefore contradictory to say that this is the point at which fair valuation ceases.
- (b) No.
- (c) This is a somewhat pejorative question, as it implies that unreliable fair values will always be more “relevant to the user”. We find this somewhat contradictory, since E65 itself (in para. 26(f)) recognises the use of cost under certain circumstances. In any event, it would seem fruitless to engage in a dialogue on this point given the fact that the Board’s mindset seems to be that “relevance” is supreme, even if it means the reporting of unreliable information.

We have difficulty also with paragraph 26(d), which implies that “value in use” could replace fair value if this could not be determined. We do not consider it appropriate to include “value in use” figures for biological assets and agricultural produce in financial statements prepared on the basis of a fair value model.

#### *Q4 Fair value changes in profit and loss*

- (a) We believe that if fair value changes of biological assets are the single measure of financial performance, then they should be presented in the income statement for the period. The questions are what should be understood by performance of agricultural activity and whether all fair value changes of biological assets are part of performance. We find that the exposure draft has not fully articulated its position on these fundamental questions.

#### *Q5 Definition of fair value*

- (a) We agree with paragraph 24, on the basis that fair value should be determined on the basis of prices in an active market where this exists. However, as stated in 1.1 above, we have serious reservations about the extent to which this will be the norm – particularly in the cases of agricultural entities operating in unstable economic environments and biological assets that are at a relatively immature stage of growth.

#### *Q6 Agricultural land: follow IAS 16*

- (d) However, we believe E65 establishes an inconsistent and artificial separation that may not be achievable in many instances. It is not always possible to separate the land component and the biological asset component of fair values (for example, in the situation set out in (c)). Also there might not be active markets for selling each asset separately. This inconsistent separation is a consequence of E65 approach, i.e. applying a fair value model only to some pieces of the total picture.

#### *Q7 Government grants*

- (a) The spectrum of government aid to agricultural activities is broad. E65 does not address fully the different possibilities and does not shed very much additional light on the various issues that arise in the context of the proposed accounting treatment. However, in principle we support an approach that achieves consistency between E65 and E64. IAS 20 does not deal appropriately with government grants in the context of fair value accounting. However, this is an issue of a broader scope than can adequately be discussed in a standard that deals specifically with agriculture.

We are also concerned that E65 has not addressed the issue of inter-period allocation of government grants to agriculture in the context of fair value as the single measure of performance.

#### *Q8 Components of biological assets*

- (a) The key issue here is one of practicability. We note also that the proposed separate disclosures for mature and immature assets would in many cases be possible only on the basis of management intent.

*Q9 Components of change in fair value*

- (b) This is a disclosure that could become exceedingly complex, and we therefore welcome that fact that the Board has not proposed it as a mandatory requirement. We see no harm in encouraging companies to provide the information voluntarily, but this should only be done where the split can be made with a sufficient level of reliability.

*Q10 Guidance on components of change in fair value*

- (a) We consider the general guidance set out in paragraphs 56 to 58 to be useful and do not have any suggestions for improvement. Nevertheless, we believe that situations may arise where it may not be possible to make this split with sufficient reliability to be useful. In such cases, entities should be prohibited from providing the split, to prevent the reporting of misleading information.

*Q11 Analysis of expenses*

- (b) We are in favour of encouraging but not requiring a classification based on the nature of expenses. The aim should be a presentation that allows comparability and at the same time is workable for conglomerates with both agricultural and non-agricultural activities.

*Q12 Disclosures in general*

- (b) We believe that in general E65 requires over-extensive supplementary disclosures in the notes to financial statements both in numerical and in narrative form. We acknowledge such disclosures might be required, given the inherent complexity of the accounting rules set up in E65. However, these somewhat excessive disclosures seem to be needed in order to mitigate the reliability problems inherent in what E65 proposes. A more practically workable standard would need fewer disclosures. In any event, the amount and level of disclosure should be consistent with existing IASs and with the general rules established in IAS 1. In particular, we find excessive the disclosures required in paragraphs 63(c), (d) and (e), bearing in mind the disclosures also required in paragraphs 51 and 61. Furthermore, we believe that the disclosure required in paragraph 64(f) should be encouraged but not required.

*Q13 Present value sensitivity disclosure*

- (b) Again, this question seems to stem from doubts over the reliability of fair value measures. If the Board is convinced that fair values can be determined with sufficient reliability for inclusion in financial statements, then we do not think that it is necessary to provide a sensitivity analysis. At the same time, we do not believe that the provision of a sensitivity analysis is an adequate response to concerns about reliability.

*Q14 Transition: Follow IAS 8*

- (e) We believe that specific transitional provisions, such as those in IAS 39, would be necessary. We do not find it appropriate to consider the allowed alternative treatment under IAS 8 in these circumstances. Retrospective

application of the standard and restating comparative information should not be considered when it is not practicable.

We would be pleased to discuss in more detail any of the matters that we have raised in this response.

Yours sincerely

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Head of Unit