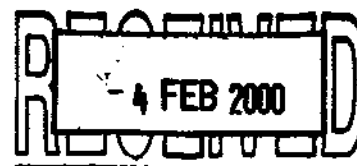


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31 January 2000



The Secretary General  
International Accounting Standards Committee  
166 Fleet Street  
London EC4A 2DY  
UNITED KINGDOM

Dear Sir,

## **E65 AGRICULTURE**

### **Introduction**

This submission represents the views of Southcorp Limited, a publicly listed Company, that is Australia's largest producer of wines, one of the world's top ten wine companies and Australia's largest vineyard operator. It has a significant number of brands including major global brands such as Penfolds and Lindemans.

The Company is pleased to provide comments on exposure draft E65 "Agriculture". There are however, serious concerns about some of the proposals particularly the recognition of value changes in both grapes and vines.

As you are aware the Australian Accounting Standards Board (AASB) issued a new standard AASB 1037 "Self-Generating and Regenerating Assets" which although based on the "Draft Statement of Principles on Agriculture" by the IASC was universally condemned by the wine industry and other agriculturally based industries. It was viewed as an academic approach that would burden the industry with standards somewhat removed from commercial reality.

We believe there are some fundamental issues, which need to be addressed. Our comments also reflect the experience and knowledge of the wine industry in the examination and preparation required to implement AASB 1037 "Self-Generating and Regenerating Assets" standard, which contains similar requirements to those proposed in E65.

The Australian Accounting Standards Board (AASB) deferred the operative date of AASB 1037 because of the difficulties experienced in the implementation process. In view of the fundamental issues below and implementation difficulties, Southcorp strongly recommends that the IASC undertake extensive and focussed field studies as part of the due process before a standard is issued. The IASC indicated in the July 1999 Update that a field test was to be conducted during the exposure period. We understand that the Group of 100 in Australia has made several inquiries as to what this means and to date has had no response.

Southcorp and other major Australian wine companies would be very pleased to participate in those field studies to identify the practicality of the proposals. The outcome of the field studies would be invaluable in your understanding of the concerns and difficulties we have in implementing the requirements of the proposed Standard.

If the present exposure draft becomes the Standard, the results of field-testing would also be invaluable in preparing practical guidance for inclusion in the Standard to assist preparers to implement its requirements and to make reliable measurements of growing assets. This is particularly important in the case of this Standard, since it will be important to ensure that different companies in different countries are reporting on their agricultural activities in a comparable and consistent manner.

We are particularly concerned that the majority of wine companies throughout the world, which are our competitors, will not be affected by these requirements for some time.

Australian companies should not be forced to implement such proposals until it has been generally accepted throughout the world by major grape growing countries.

In proposing measurement at fair value E65 foreshadows a significant change from the present successful and generally accepted historical cost based accounting model, and careful consideration should be given to how such a change is required to be implemented. Generally all other manufacturing companies are not required to use this concept of fair values. The proposal that unrealised gains and losses of biological assets should be recognised in the profit and loss account is of particular concern.

This concern is based on the fact that recognition of unrealised gains, which may remain unrealised for many years, in the income statement will create a presumption on the part of many equity holders that the gains are available for distribution as dividends. Southcorp strongly believes that this may provide misleading information to users of general-purpose financial reports.

Southcorp believes the model proposed in E65 does not appropriately distinguish between increases in value and operating profit. We do not support the proposal to recognise unrealised gains from adjustments to the measurement of balance sheet items in the income statement. However, if the Board proceeds with proposals to use fair value measurements, we strongly believe that the Board should adopt a comprehensive income approach to distinguish between results from operations (realised gains/losses) and changes in equity as a result of movements in values (unrealised gains/losses).

If the fair value model is to be adopted, we believe it is essential that a distinction be made between increments in value (to be recognised as a movement in equity) and realised profit (transferred/recycled from equity to the income statement on realisation).

Southcorp is a global business that seeks to access capital in global markets. A key market is the U.S., where institutional investors are notoriously suspicious of any accounting treatment that makes accounts more opaque or that appears to inflate the results of non-U.S. companies. The standard will require account preparers, Directors and Auditors to have a greater dependence upon valuations, which in times of economic downturn have historically proved unreliable and exposed those involved to a much greater risk – is it really necessary and adding any value.

**Responses to questions:*****QUESTION 1 SCOPE: FURTHER PROCESSING AFTER HARVEST (PARAS 4-7 AND 36)***

Southcorp is concerned that the proposed standard is being used to deal with short-term single crop agricultural sectors, such as market gardening and long-term sectors, such as forestry and annual activities such as orchards and vineyards where the produce is harvested each season. In our opinion, these are inventory or depreciable assets respectively, and should be excluded from the scope of the proposed standard. Otherwise, we agree with the scope of the proposed standard.

Southcorp agrees with the scope of the proposed Standard that a separate stage of the production cycle (manufacturing) commences once agricultural produce (grapes) are harvested and is adequately dealt with in other Standards such as IAS 2 "Inventories" using historical costs.

***QUESTION 2 BIOLOGICAL ASSETS: MEASURE AT FAIR VALUE (PARAS 21 AND 36)***

Southcorp believes that none of the options are appropriate for our industry. In the case of forests you are actually harvesting the biological asset whereas in the wine industry you are not harvesting the vine, it is the fruit of the vines, the grapes.

Developing vineyards (including vines) should be measured at cost, as they do not reach commercial maturity until the end of 4 years. Currently developed vineyards can be measured at cost or market value with the revaluation increment residing in equity under a revaluation reserve.

Refer Question 3 for further comments on vines.

Grapes purchased externally by Southcorp are valued at net market values. However, grapes grown on our own vineyards are measured at cost involving all the inputs which is substantially less than market values.

The fact that Southcorp chooses to grow some of its production inputs should not trigger the use of market valuations.

Why is this so different from a manufacturer choosing to make a part internally rather than procuring it externally? The in-house part is required to be valued at cost and not at the higher market value or external purchase cost.

By valuing this produce at market value and immediately crediting the unrealised gain to profit and loss we would be reporting significant profits on the fruit prematurely. When the product is finally sold, we have already reported the assigned profit on the grape in the year of harvest followed by the remaining profit content in a subsequent year. We make money out of selling wine not out of selling grapes.

The end products can be in maturation from 1 year to over 20 years and longer in the case of fortifieds. In other words and unlike other products we are moving profit on grapes grown on our own vineyards forward to the point at which the fruit is picked.

We believe the nature of the wine industry, particularly with the long production cycle for premium products, makes this aspect clearly inappropriate.

We are firmly of the opinion that grapes grown on our own vineyards should be valued at cost as is the current practice. It is relatively simple to accumulate the costs of operating a vineyard and to apply those costs to the harvest.

Your board believes that cost-based measures are often questionable. As an experienced operator we feel they are far more reliable than adopting fair value.

If the IASC elects to continue this direction then all biological assets should only be measured at fair values if:

- comprehensive field testing is conducted and guidance provided to ensure that a reliable, comparable and consistent measure of fair value can be obtained; and
- a comprehensive income approach including recycling is adopted.

#### **Recommendation**

**We do not consider fair value is appropriate for the wine industry. However, if fair values are adopted we recommend that unrealised gains in value be reflected in the balance sheet carrying amount of the assets and in equity and only transferred to the income statement upon realisation.**

#### ***QUESTION 3 RELIABILITY OF FAIR VALUE MEASUREMENT (PARAS 21-31)***

Southcorp has a major concern with the reliability of fair value measurements and difficulties of implementation of the requirements and strongly recommends that comprehensive field-testing be undertaken to understand the practicality of the proposals and the nature of additional guidance that would be required if implementation took place.

## **Vineyards**

- A vineyard consists of land, vines trellising, irrigation, water licences buildings and other vine related infrastructure. Vines have a life of between 10-100+ years, depending on grape variety, a longer life than a building asset in some cases.
- Merely valuing a vine only will create significant valuation inconsistencies. Under present Australian accounting standards, the unimproved value of the land and buildings can be held at cost or the previous revalued amount until the 3 year revaluation compulsory requirement is completed, after which the increment in value is taken to equity in the revaluation reserve.

Vines, trellising, irrigation, water licences and other vine related infrastructure can be held at cost indefinitely or the entire vineyard can be revalued to market value existing use with the variation taken to equity in the revaluation reserve.

The proposal in this exposure draft will introduce further inconsistencies in what is really one integral asset.

The value of a vineyard depends on a number of critical components being, region, climate, soil characteristics, water resources and physical constraints. A vine is merely a structure that allows a product hang from it and does not in itself have much value. It is the land coupled with water availability that has more value than the vine. This is in contrast to a tree that is physically used and regrown.

It is the critical components mentioned above that gives the vine and its product the uniqueness spoken of earlier which makes them inseparable. Therefore we believe to provide a separate value for vines based on net market value is inappropriate and at best subjective, given that there is no active market for vineyards without the land and the characteristics that comes with the land.

In the vast majority of cases it would never be intended that the plants will be sold at a profit, unlike forests where the trees are increasing in value as they grow and intended to be harvested for profit despite the significant time lag.

The expression of the quality is in the fruit as a result of a combination all the resources such as micro-climate, soil characteristics and vineyard husbandry in the form of trellising and disease control, not in the structure itself. Other factors such as seasonality, droughts and frosts can have a significant effect on a vine and hence value.

In summary, the relationship between vines and the land that they occupy is unique and integrated. The vine itself has little value. However, in conjunction with the land and other vineyard infrastructure the vines do have value.

- Determining the fair value of a vineyard involves estimating tonnes, grape prices and costs for a number of years into future, together with estimating a terminal or perpetuity value and the application of a discount rate to calculate the net present value. A significant proportion of the final discounted net market value results from the weighting of the terminal value that is based on many subjective elements. Practical guidance would be welcomed.

In addition, the discount rate used includes allowances for market risk, acceptable returns, long-term holding characteristics and stability. However, industry participants state that there is no direct comparable experience in the wine industry, thereby making the determination of discount rate very subjective.

The value of vines is then determined as a residual in the valuation process because it is calculated by deducting the current unimproved value of the land, trellis, irrigation, water licences and other vine related infrastructure at each reporting date from the aggregate fair value.

As a residual the valuation of the vines is, because of estimates and subjectivity, open to substantial variability and/or manipulation. As such, the comparability, consistency and reliability of the information in financial reports and between companies and countries are not assured. The various assumptions used in this computation could result in significant variations between companies for similar assets planted in the same area. This concern is exacerbated by the requirement that movements in the fair value of the asset between reporting dates are to be recognised in the periodic income statement. This may encourage manipulation of the variables to reduce the volatility of fair values and reported income.

A significant proportion of the residual value of a vineyard may be attributed to an intangible asset relating to the regional location and 'terroir' of the vineyard and the brand name for which the grapes from that vineyard are used. These factors are integral to the quality of the output and not merely to the vine itself. In this regard part of the residual value attributed to the vines is of the nature of internally generated goodwill the recognition of which is prohibited by IAS 38 "Intangible Assets".

Other impediments to the reliable measurement of these assets include:

- determining the value of vines for interim periods. For example, at interim reporting dates it will be necessary to determine the value of vines including partially formed fruit with all the risks such as heat, drought, frost and disease facing this newly formed fruit until harvest. Further complexity is introduced because both current and non-current components of the vine asset need to be identified; and
- determining the value of a developing vineyard. There are a number of factors that affect its value prior to reaching full maturity – the vine is the least of these. Factors such as the rate of growth relative to climatic conditions, variations between grafted and non-grafted vines, the general unpredictability grape quality during this juvenile period and the final end use all impact on the value.

## Grapes

- Within Australia, where the harvest takes place from January through to May, there is little guidance to support the value of grapes until the end of August of each year when the regional grape price survey data is published.

This data is incomplete in that it does not cover all regions, or all sub-regions and does not take into account the premiums paid for quality or end use, nor the penalties incurred for poor quality fruit. In the period from May to August the application of a net market value to company grown grapes would be somewhat arbitrary at best.

The ultimate value of the grapes will be a factor of many variables, including some of the following:

- time and method of picking
- timing and method of transportation to the winery
- technology and methods of crushing, fermenting and other winery processes
- the skills and expertise of the winemaker and winery staff
- quality of oak maturation, both raw materials used and technology employed
- the end use which may depend on the availability of complementary grapes or wine for blending.

What one winery assigns to the value of a grape could be quite a different to another even from the same region.

The proposal to introduce an arbitrary, unrealised profit at the time of harvesting the grapes from company vineyards will in our view introduce an unnecessary level of inconsistency and inaccuracy into the reported results of vertically integrated wine companies such as Southcorp and the Australian Wine Industry generally.

We strongly believe that the existing methods of inventory valuation deliver the most appropriate results for the reporting of Profit and Loss and inventory valuation in relation to grapes harvested from company owned vineyards.

*In any event, a focussed field-testing program to understand the measurement issues facing the wine industry is essential.*

### **QUESTION 4 FAIR VALUE CHANGE IN NET PROFIT OR LOSS (PARA 22)**

Southcorp is strongly opposed to recognising the unrealised increment or decrement in the fair value of biological assets in the income statement. We believe that in proposing measurement at fair value this draft exposure indicates a significant change from the present historical cost based accounting model.

In particular, the unrealised profit or loss on grapes and vines is grossly distorted as we are being asked to report the increase in value on only the biological section or part of what are integral assets. It is very difficult to understand how this is "the most relevant indicator of the performance of an enterprise engaged in agricultural activities".

In winemaking there are other significant value changes apart from the fact that we choose to grow some of our grapes. The increase in value created during the wine making process is not reported until the wine is sold.

What is so different that makes it necessary to report the value changes on the grape only at the instance it is picked.

In addition there is concern that recognition of unrealised gains, which may not be realised for many years, in the income statement will create a presumption on the part of equity holders that they are available for the distribution of dividends. We strongly believe that this may provide misleading information to users of general-purpose financial reports, particularly as to whether these profits are available for dividends.

Southcorp considers the model proposed in the exposure draft does not appropriately distinguish between increases in the value of assets and operating profit. Despite the fact we disagree with the fundamental issues in E65, until such time as an appropriate model is established in this regard, we cannot support the proposal to recognise unrealised gains from adjustments to the valuation of balance sheet items in the income statement. In this regard we believe that the Board should adopt a comprehensive income approach to distinguish results of operations from changes in equity as a result of movements in values. We urge the Board to give serious consideration in this regard, both in respect of the development of this standard, and in the development of future International Accounting Standards.

#### **Recommendation**

**If fair value measurement is to be required we are strongly of the view that a distinction should be made between unrealised changes in value and operating profit.**

**In these circumstances unrealised gains in value (whether arising from biological change or changes in commodity prices) should be included in the balance sheet carrying amount of the asset and only recognised in the income statement as part of operating profit on realisation or when assets become impaired.**

#### ***QUESTION 5 DEFINITION OF FAIR VALUE (PARA 24)***

Southcorp agrees with the definition of fair value. While the price in an active market is a reliable indication of fair value, the imprecision and judgements involved in estimating fair value in other circumstances raise serious concerns about the recognition of fair value changes in the income statement. We also believe that the contracted prices for similar produce could be regarded as a reliable and acceptable measure for that part of the entity's produce on its owned vineyards. In the Wine Industry, there are many factors in arriving at an appropriate fair value of particular grapes. (Refer comments question 3).



In some cases there may be no equivalent grapes produced in the region or any other region which have the same characteristics or quality.

There is no active market for vines only – therefore there is no reference point. The vineyard needs to be valued and the relevant components deducted, with the balance being the perceived and subjective vine fair value.

***QUESTION 6 AGRICULTURAL LAND: FOLLOW IAS 16 (PARAGRAPH 38)***

Southcorp supports the recognition and measurement of agricultural land in accordance with the requirements of IAS16 "Property, Plant and Equipment". We believe that entities should be able to carry agricultural land at cost or measure it at fair value should they choose to do so.

***QUESTION 7 GOVERNMENT GRANTS (PARAS 41-44)***

We agree that a government grant should be recognised as revenue once it becomes unconditional.

In Australia, some grants are tax related which would make it impracticable under present disclosure requirements to treat it as a reduction to the carrying amount.

***QUESTION 8 COMPONENTS OF BIOLOGICAL ASSETS (PARAS 46-47)***

Southcorp does not support the proposal as it stands.

We do not believe reporting the nature and physical quantity of biological assets should be mandatory. Current accounting standards do not require the reporting of the physical quantities of other assets.

The values of vineyards are subjective and vary considerably, block by block, vineyard by vineyard and region by region.

Disclosure of this information on an aggregate basis would not mean very much to users of financial statements. Information on individual vineyards for the very competitive Australian and global wine industry would be a sensitive issue, as it would give international wine companies not using IAS an unfair advantage. In addition, we believe that there is a risk of information overload for users and consequent difficulties in determining relevant information for decision-making. Accordingly, we see no reason for this requirement to be mandatory for biological assets.

***QUESTION 9 COMPONENTS OF CHANGE IN FAIR VALUE (PARAS 52-58)***

Although the Wine industry would be unaffected by this proposal, Southcorp does not support a requirement to separately disclose the components of a change in fair value principally on the grounds of difficulty and reliability of the measurement. Disclosure should be optional at the discretion of management.

***QUESTION 10 GUIDANCE ON COMPONENTS OF CHANGE IN FAIR VALUE (PARAS 56-58)***

See Question 9.

***QUESTION 11 ANALYSIS OF EXPENSES (PARAS 59-60)***

The manner of presentation and analysis is a matter for each entity to determine. This proposal seems to be adequately covered under IAS 1 and its Australian equivalent where the enterprise must make a selection.

***QUESTION 12 DISCLOSURES IN GENERAL (PARAS 44-67)***

As mentioned above Southcorp believes that the detail of the disclosure of non-financial information is excessive, competitor sensitive and not warranted in this form. Apart from predators, it seems difficult to accept that users of general-purpose financial reports will find this complex and comprehensive disclosure useful and practical. Where relevant to an understanding of an entity's operations, discussion of these matters would form part of a management discussion and analysis and not part of the audited financial statements.

***QUESTION 13 PRESENT VALUE SENSITIVITY DISCLOSURE (PARA 64(C))***

In relation to the Wine Industry, Southcorp indicated under question 3, the difficulties in applying a discount rate to what was already a very arbitrary base involving the heavy weighting the perpetuity year on the resultant valuation. To then require a sensitivity analysis would further undermine the resultant valuation and it is difficult to understand what the users would gain out of this disclosure. This requirement to provide information to enable users of general purpose financial reports to assess the sensitivity of the carrying amounts of biological assets could indicate a lack of confidence in what is proposed in E65.

We also believe that making this type of information mandatory for biological assets and not for other types of assets imposes an unnecessary burden on enterprises and for some would be providing commercially sensitive information to their competitors and customers. In addition, without clearer guidelines this disclosure will highlight the valuation difficulties and interpretations between companies and for these reasons we oppose this information being made mandatory.

**QUESTION 14 TRANSITION: FOLLOW IAS 8 (PARA 69)**

As this exposure draft does not apply to wine, Southcorp is of the opinion that the transitional provision in its present form only applies to the value of vines. Despite the fundamental disagreement with the exposure draft, an adjustment to the value of vines and the resultant adjustment to retained earnings is not of particular concern to Southcorp. We can understand concern in the forestry industry whereby the “unrealised profit” contained in a tree at the date of implementation will never be reported in the operating profit of the entity and, as such, not reported in measures of earnings per share. Southcorp believes that it is imperative that the IASC reconsiders transitional provisions and amend them so that they do not penalise companies to which this significant standard change applies.

The introduction of new conceptual standards such as E65 should never disadvantage companies during the transitional requirements.

We believe that the objective of transitional provisions in new accounting standards is to:

- assist with mitigating, rather than exacerbating, any economic and other impacts associated with implementing a new standard; and
- ensure that the reporting of financial performance in the current period’s income statement is not distorted by an initial adjustment to balance sheet amounts.

This approach changes the accounting paradigm applying to agricultural assets. The switch from the conventional accounting income recognition to the new fair value regime will result in an anomalous treatment of the latent revenues and expenses embodied in the opening balances of those assets in the first period in which the Standard is required to be applied.

Directors of companies which control assets are concerned that the potential market consequences of this distortion of the reporting of performance will include a misunderstanding by financial report users (including shareholders, analysts, rating agencies and lenders) of the performance of businesses and a consequent mis-pricing of securities and debt for entities which control those assets. Southcorp believes that the company performance will not be judged fairly in this circumstance, and disclosure or alternatives would overcome the fundamental deficiency in the reporting of performance which would be caused by transitional provisions of this type and would soon be forgotten.

Southcorp does not believe that the transitional provisions adequately address this major problem.

**Recommendation**

**In keeping with recommendations on the recognition of unrealised profits Southcorp recommends that if the fair value approach is adopted, the initial adjustment on application of the Standard should be recognised in equity (not in retained profits) and released to the operating profit when the biological asset is harvested and sold or is used for further processing.**

**Conclusion**

For the Wine Industry, Southcorp considers the adoption of fair value inappropriate especially in relation to vines only and grapes grown on its own vineyards.

It is clear from our reading of E65, the thrust of the standard is directed at forestry products. It is our view, irrespective of whether it should be applied to the forestry industry, it has no reasonable application to vines and other fruit plants. It may be preferable for the IASC, if it wishes to pursue the implementation of the standard for the forest product industry, to restrict its application to other industries until further discussion and review.

However if it was inevitable Southcorp would much prefer the measurement of biological assets at fair values for balance sheet purposes provided that the unrealised changes in value are recognised in equity and recycled to operating profit when realisation occurs.

As mentioned a number of times we consider it critical to the process that the IASC should undertake extensive field testing of the proposals to ensure that the authors of the Standard understand the issues and build-in sufficient guidance so that requirements can be at least applied consistently.

This was not undertaken by the Australian standard setters.

As a major Wine Company in Australia we would very willing to participate in a structured and focussed field-testing program.

Yours Sincerely



David J Jeffries  
**General Manager Accounting**