

16 December 1999

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

Dear Sir

E65 AGRICULTURE

The Group of 100 (G100) is pleased to provide comments on exposure draft E65 "Agriculture". However, we have serious concerns about some of the proposals particularly the recognition of value changes.

Our comments reflect the experience of our members in preparing to implement the Australian Standard AASB 1037 "Self-Generating and Regenerating Assets", which contains similar requirements to those proposed in E65. As you will be aware, 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 these difficulties, the G100 strongly recommends that the IASC undertakes extensive and focussed field studies as part of the due process before a standard is issued. As previously advised, the G100 would be pleased to arrange for members to participate in field studies to identify the practicality of the proposals. The outcome of the field studies would be invaluable in your understanding of the difficulties and concerns we have in implementing the requirements of the proposed 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.

In proposing measurement at fair value E65 foreshadows a significant change from the present historical cost based accounting model and careful consideration should be given to how such a change is required to be implemented. The proposals 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 equityholders that the gains are available for distribution as dividends. We strongly believe that this may provide misleading information to users of general purpose financial reports.

The G100 considers the model proposed in E65 does not appropriately distinguish between increases in value and operating profit. Until such time as an appropriate model is established in this regard, the G100 does 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 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).

Responses to questions:

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

Except as indicated below the G100 supports the scope of the proposed Standard and agrees that a separate stage of the production cycle commences once agricultural produce is harvested. We consider that further processing is dealt with adequately in other Standards such as IAS 2 "Inventories".

However, we are 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 activities such as orchards and vineyards where produce is harvested each season. There is also no differentiation in treatment of bloodstock and breeding animals or for the products they produce. 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.

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

The G100 believes that biological assets should only be measured at fair values if:

- sufficient 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

If fair values are adopted we recommend that unrealised gains in value should 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)

The G100 has a major concern with the reliability of fair value measurements and difficulties of implementation of the requirements and strongly recommends that field testing be undertaken to identify the practicality of the proposals and the nature of additional guidance required to facilitate implementation. The following comments are provided by members as a result of their experience in preparing to implement the Australian Standard:

Vineyards

- 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.

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 is 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. 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.

A focussed field-testing program leading to the provision of additional guidance on these matters is essential to the orderly implementation of the requirements in the wine growing industry.

Plantations and Forests

Because there is rarely an active market for growing plantations and forests their fair value will frequently need to be determined by using net present value methodology. This is likely to result in diverse practice because of different interpretations with respect to implementing the proposed standard including the following factors:

- uncertainty in predicting the future state of the paper/pulp (and consequently woodchip) market over 10 years (and for pine over more than 30 years) which leads to differences in assumptions about future prices and the use of different estimation techniques. In addition, plantation owners who do not operate an integrated growing, processing and woodchip sale facility may have difficulty in determining stumpage rates due to the difficulty in determining future costs such as harvesting, processing and delivering woodchips. These costs will vary depending on where the processing will ultimately take place (for example, whether a new mill will be built near plantations or whether there will be a mobile plant in the future);
- depending upon the size of the plantation it may not be possible to determine annually on a reliable basis the anticipated yield from every plantation held within an estate. Inventories of the status of the forests are, for example, typically completed at years 3 and 8 for blue gum plantations that are expected to be harvested in years 10 to 12. As such, discovery of losses of physical quantities, for example, numbers of trees and growth rates may be delayed and result in significant adjustments being made when these inventories are completed. The conduct of more frequent assessments of inventories such as an annual inventory of all plantations, would be not be cost efficient;
- the selection of the discount rate is critical in determining fair value. A practical problem exists in determining the most appropriate discount rate and whether this is adjusted on an annual basis to take account of changes in the expectations of investors or changes in bond rates. A further problem is that applying present value methodology may result in a negative net present value of newly planted areas (ie for early years plantations may not meet the return criteria). This gives rise to a further implementation problem of whether different hurdle rates should be used for young plantations (1-3 years) and for mature plantations;
- whether the discount rate used by the entity should be different for forests or plantations on leasehold land as distinct from freehold land and whether, in these cases, comparability is enhanced if estimated cash flows include an allowance for holding costs of freehold forest land; and

- the absence of guidance on whether the fair value should be determined for each coop or whether it should be determined on an aggregate basis. The level of aggregation adopted will have a significant impact on the value of the assets recognised in the financial reports. For example, the discount rate used if coops are valued separately will be significantly higher than the discount rate used if plantations are valued on a portfolio basis.

A focussed field-testing program leading to the provision of additional guidance on these matters is essential to the orderly implementation of the requirements in the forestry industry.

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

The G100 is strongly opposed to recognising the unrealised increment/decrement in the fair value of biological assets in the income statement. We believe that in proposing measurement at fair value E65 foreshadows a significant change from the present historical cost based accounting model.

This concern is based on the fact 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.

The G100 considers the model proposed in E65 does not appropriately distinguish between increases in the value of assets and operating profit. Until such time as an appropriate model is established in this regard, the G100 does not 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)

The G100 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 price should be regarded as a reliable and acceptable measure for that part of the entity's produce which is sold under contractual arrangements which specify the basis upon which the price is to be determined.

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

The G100 supports the recognition and measurement of agricultural land in accordance with the requirements of IAS16 "Property, Plant and Equipment". The G100 believes that entities should be able to measure agricultural land 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.

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

The G100 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 and for some entities this information would be commercially sensitive. 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)

The G100 does not support a requirement to separately disclose the components of a change in fair value principally on the grounds of reliability of the measurement. However, disclosure should be left to 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.

QUESTION 12 DISCLOSURES IN GENERAL (PARAS 44-67)

We believe that the detail of the disclosure of non-financial information is not warranted in this form. 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. Some matters such as those dealt with by paragraphs 65 and 66 should be covered by general requirements and need not be required solely in respect of agricultural activities.

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

A requirement to provide information to enable users of general purpose financial reports to assess the sensitivity of the carrying amounts of biological assets indicates to us a lack of confidence in the proposals 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. For these reasons we oppose this information being made mandatory.

QUESTION 14 TRANSITION: FOLLOW IAS 8 (PARA 69)

Our members are particularly concerned about the transitional provisions of an accounting standard on agriculture. The Australian Standard AASB 1037 requires the transitional adjustment to recognise agricultural assets at net market values to be recognised in the opening balance of retained earnings. This adjustment has the effect of "locking-up" revenues in retained earnings that will never be recognised in the operating profit of the entity and, as such, not reported in measures of earnings per share. The G100 opposes this approach to transitional arrangements. This is a major concern of our members engaged in these activities, particularly those having forestry operations, and we believe that it is incumbent on the IASC to

consider transitional provisions that do not penalise companies to which the standard applies.

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.

Presently, most entities within the forestry industry (and other activities with long gestation periods) recognise profit on a historical cost/realisation basis, whereby revenues and related historical cost-based expenses are recognised mainly at the point of sale of the forest product. That is, most forestry operations currently recognise a profit on the sale of timber or timber-related products at the point of sale, the profit being the difference between the sale price and the historical cost of the forest product.

However, the IASC proposals will change the basis upon which revenues and income are recognised in the forestry industry, from a historical cost/realisation basis to a "mark-to-market" approach. Under this approach, an entity involved in forestry operations will measure and recognise the fair value of its forest asset in the balance sheet and will recognise revenue on the basis of changes in the value of that asset (which will arise from changes in the volume of the forestry asset controlled and price changes).

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

The anomaly results from 'locking-up' the difference between the acquisition (historical) cost and the current fair value (net of tax), in retained earnings. As such, these future revenues will never be recognised in the income statement or in earnings per share. Put another way:

- if the mark-to-market approach had always been applied, the revenues and costs would have been progressively recognised as the forest asset grew and its fair value increased. Under this approach by the time the forest product is sold, the difference between its historical cost and its fair value at the point of sale would have been recognised as profit in the income statement;

- where the historical cost approach is applied, the difference between the historical cost of the forest product and its fair value at the point of sale would be recognised as profit in the income statement; but
- in moving from the historical cost approach to the fair value approach, while the revenues and costs relating to forestry assets grown and/or acquired after the operative date of the Standard will be progressively recognised as those assets grow and their fair value increases, the latent profit embedded in forestry assets controlled when the standard is first applied will be transferred to retained earnings. As such, it will never be recognised in the income statement. This is an odd outcome given that the forestry assets are acquired and/or grown with the objective of making a profit.

This 'lock-up' of profit is inequitable because it disadvantages the industry on adoption of the Standard. Transitional provisions which require adjustments to opening retained earnings will, in these circumstances, have a considerable negative impact on the reporting of operating results and the reported financial performance of forestry entities over an extended period.

Directors of companies which control forestry 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 forestry businesses and a consequent mis-pricing of securities and debt for entities which control forestry assets. The G100 does not believe that, in this circumstance, disclosure or display alternatives would overcome the fundamental deficiency in the reporting of performance which would be caused by transitional provisions of this type.

Whilst the 'lock up' problem will particularly affect the forestry industry, it will also have an impact on other agricultural activities such as livestock.

The G100 does not believe that the transitional provisions adequately address this major problem.

Recommendation


The G100 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

As outlined above the G100 would accept 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 a signal event such as realisation occurs.

We also strongly believe that the IASC should undertake extensive field-testing of the proposals to ensure that the Standard contains sufficient guidance so that requirements can be applied consistently, and will result in reliable and comparable information. As previously advised, and stated above, the G100 would be pleased to identify members who are willing to participate in a structured and focussed field-testing program.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Bryce JH Denison', with a stylized flourish at the end.

Bryce JH Denison
National President