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The Chairman
Australian Accounting Standards Board
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Our ref AGC comment letter re IFRS1

12 March 2004

Dear Sir

ED 130 *Request for comment on IASB ED 6 Exploration for and Evaluation of Mineral Resources*

We are writing to outline our concerns in relation to ED 130 *Request for Comment on IASB ED* 6 *Exploration for and Evaluation of Mineral Resources*. However, before we do so, we make some brief overall comments about the minerals industry in Australia, so that you can understand our comments in the context of what this ED might mean for the industry.

Mining is a very important industry to the Australian economy providing substantial export revenues, significant employment opportunities, particularly in rural communities, and attracting large amounts of overseas investment. You should also be aware that Australia is an important country in the industry, being in the top five producers for almost every major commodity, and in the top 2 or 3 for many.

The companies involved in the industry are varied in size and complexity:

- There are numerous global overseas organisations with significant funds invested here, as well as a large number of Australian companies listed on the Australian Stock Exchange ("ASX")

- there are in excess of five hundred companies listed on ASX which are colloquially known as "juniors", Juniors are companies that are purely involved in exploration for mineral resources. Where resources are found, the juniors may develop them in their own right, or through joint ventures or otherwise seek to add value through sale of discovered resources to other companies with the capacity to develop them. As such, these companies do not have a steady source of income, rather they are reliant on equity markets as a source of ‘venture capital” to enable them to continue their activities, with investors typically recognising that these companies operate at the speculative end of the market and, in investing in these companies, are seeking a capital return.

- there are a number who started out as juniors, but have found a project and developed it and hence now do have a steady source of income, producing income as well as capital returns for shareholders.

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- there are a number of major mining houses which have multiple operating sites and long term reliable cash flows from operations in one or more commodities.

  Typically accounting for exploration expenditure for the majority of these companies under existing Australian GAAP is as follows:

- The juniors capitalise exploration and evaluation costs provided they meet the tests required in the existing standards for carrying forward such costs namely either that they are expected to be recoverable, or they are not yet capable of assessment and active exploration is continuing.

- The majors typically treat exploration costs like any other class of non-current asset and therefore expense such costs to the extent that they are not capable of demonstrating that they meet a "recoverable amount" test.

- The emerging or small producing companies are a mix of the two approaches outlined above.

Our comments in relation to ED 130/ED 6, outlined below in the remainder of this letter are made in the context of their impact on Australian companies operating in the industry as characterised above. Our comments are also premised in our present understanding that IASB intends to return to a more comprehensive project on issues impacting on companies operating in the extractive industries, and that ED 130/ED 6 is therefore a stop gap measure, rather than an ultimate solution for the accounting needs of the industry.

In this context, we strongly support the objective as set out in paragraph 1 of ED 6, being to make "limited improvements to accounting practices for exploration and evaluation expenditures without requiring major changes that may need to be reversed when the Board undertakes a comprehensive review of accounting practices used by entities engaged in the exploration for and evaluation of mineral resources."

We also note that to give effect to this objective, paragraph 4 of ED 6 indicates that "when an entity first applies this [draft] IFRS, it may elect to continue to recognise and measure exploration and evaluation assets in accordance with the accounting policies applied in its most recent annual financial statements

Our comments set out below in the remainder of this letter outline our serious concern that ED 6 as drafted will fail to meet its objectives as outlined above in the context of the Australian minerals and exploration business community.

Paragraph 13(f) as presently drafted applies a far tougher test than any of the other indicators in paragraph(a) to (e). Indeed, in our view, it will bring the rules for testing Exploration and Evaluation costs for impairment into line with the more general rules outlined in AASB 136 *Impairment of Assets* for general Cash Generating Units ("CGU's"). If this proceeds to a standard unchanged, it will negate the whole reason for applying a different set of rules and indeed will call into question the very need for a separate ED on the subject. We recommend that rather than having to meet the positive test set out in paragraph 13(f); that paragraph (f) should be rewritten to refer to a negative test. For example rather than reading:

> "the entity does not expect the recognised exploration and evaluation assets to be reasonably capable of being recoverable ………" it should be changed to read
>
> "based on the information available at balance date, the entity does not have any reason to expect that the recognised exploration expenditure is not capable of being recoverable…….."

This will then allow the practical circumstances to arise, which is consistent with current practice, that if the period for which the entity has the right to explore continues, there are planned exploration and/or evaluation activities in the foreseeable future etc and no decision has been made to abandon or dispose of the project it can be carried forward as no impairment trigger has arisen.

In relation to paragraph 12, we believe clarification is required to ensure it is clear that on an annual basis testing will be carried out to address whether there are impairment triggers and that only if one of the triggers listed in paragraph 13 is met, should actual impairment testing be required.

We also believe that specific exemption should be given or clarified in relation to AASB 1 *First-time adoption of AIFRPS* to make it clear that, on adoption, the requirement in relation to exploration and evaluation costs under a CGU EEA are to assess the existence of triggers, and then to test for impairment only if triggers are in existence.

In relation to paragraph 14, we believe that the whole concept of a Cash Generating Unit for exploration and evaluation assets ("CGU EEA") is fundamentally flawed. If one looks at the practical implications on the companies we have outlined above, it will be noted that under this definition, none of the "juniors" is capable of adopting the CGU EEA concept and therefore of applying the tests outlined in ED 130/ED 6. None of them has a source of cash inflows, which can be attached to exploration costs for the purpose of addressing impairment. Their only source of cash inflow is equity. Ultimately, the only available CGU for those types of companies is the company as a whole, and the only way to measure impairment of their assets is by reference to "net selling price". Instead of applying the rules designed to meet industry needs in ED 130/ED 6, they will therefore either have to write off these costs, or subject themselves to expensive independent valuations on a regular basis in order to determine the extent to which these costs can be carried forward.

One outstanding issue is the means by which exploration expenditure that cannot be attached to a CGU EEA gets assessed for impairment. Exploration assets by their very nature are not, of themselves cash generating units (unless being offered for resale) because cash inflows will not arise until they have been redesignated as development and or production areas. Does paragraph 13 therefore envisage that exploration and evaluation assets which do not form part of a CGU EEA will be grouped in some other way (based on a reasonable allocation to separate assets) and tested against the impairment indicators sets out in paragraph 13; or is it envisaged that these assets have to be grouped into higher and higher groups of assets until they do attach to cash inflows, and hence for juniors, this will mean assessing the value of the company as a whole?

The other fundamental flaw in relation to the concept of CGU EEA is that we do not believe that there is any reason why this concept can only apply to any exploration expenditure that has been subject to impairment testing before the adoption of ED 130/ED 6. There appears to be some debate as to whether Australian companies who have complied with existing Australian GAAP have applied impairment testing under that GAAP because of the unusual nature of the impairment test allowed under AASB 1022 *Accounting for the Extractive Industries*. While we are clearly of the view that an impairment test (albeit an unusual one) did exist under Australian GAAP, we do not see the need to establish that this was the case to enable application of CGU EEA going forwards. The ED as presently drafted does not provide a clear case for this requirement.

The effect is to make the rules so much stricter that they are unusable by the junior sector. The result will be wholesale changes for those companies, which will require proper explanation to the markets and fail in meeting the needs of users of the financial statements. There are some further very practical ramifications for these companies in being able to meet ASX listing rules on application of this guidance, as wholesale write offs of exploration expenditure will leave many with more than half of their assets in cash. This will have a number of very real practical difficulties for those companies, leaving them subject to potential suspension, more onerous reporting requirements or such other sanctions as ASX may seek to impose.

If one then turns to how these rules impact on the major mining houses, you will note that as outlined above, such costs are generally expensed as incurred by the majority of these companies. Therefore while on the face of it, the concept of CGU EEA will allow costs to be capitalised which might otherwise have been written off in the absence of ED 130/ED 6, we believe it unlikely that any change to accounting will occur in practice and these rules will be not be relevant to the major companies.

Turning to the specific questions that IASB have outlined in their request for comment, we respond as follows to each:

Question 1 - Definition and additional Guidance:

We are broadly comfortable with the definitions provided in paragraphs 7 and 8 of the draft standard except that we believe there will be some practical difficulties in dealing with the prohibition on including administrative and other general overhead costs in exploration and evaluation costs. This is a result of the remote locations in which much of these types of costs are incurred and the practical realities that offices are often set up purely to deal with these activities. In the circumstances we would recommend that you add the words “other than those which are directly attributable to the activities” to paragraph 8(b) as we believe this will clarify what will become industry practice;

Question 2 - Method of accounting for exploration for and evaluation of mineral resources

We agree with the objectives as outlined in the question and with the mechanism you have outlined in the question for achieving this. However, for the reasons outlined above we believe that the ED as presently drafted fails in achieving these stated aims.

Question 3 - Cash generating units for exploration and evaluation assets

For the reasons we have outlined above, we believe this is fundamentally flawed, both in achieving the overall objective of the ED, and in meeting the needs of the industry

Question 4 - Identifying exploration and evaluation assets that may be impaired

We believe that indictors in paragraph 13(a) to (e) are appropriate and consistent with current industry practice. Our concerns in relation to indicator 13(0 are outlined above.

Question 5 - Disclosure

We believe that the disclosure requirements are reasonable.

In response to the issues raised by the AASB, we respond as follows:

(a) the impacts that a more rigorous impairment regime may have on the ability of Australian reporting entities to carry forward exploration and evaluation costs

As discussed above, we believe that the ED will remove the ability of many smaller entities to carry forward exploration and evaluation costs.

(b) any regulatory or other issues

As discussed above, we are concerned about the impact of the Listing Rules on junior explorers.

(c) whether the proposals are in the best interests of the Australian economy

We support the use of global accounting standards, but we do not consider that the changes to existing practices imposed by the ED achieve global consistency. We recommend that the ED be redrafted to effectively grandfather existing practices until global consistency can be achieved through the longer-term extractives industry project.

In summary, we concur with the objectives of ED 6 but believe that as presently drafted it will fail to meet the needs of the industry in Australia. As one of the main jurisdictions impacted by this standard, we do not believe this is appropriate and urge the IASB to give due consideration to the practical implications of their proposals before proceeding unchanged.

Yours faithfully

for **ALKANE EXPLORATION LTD**

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Director/Secretary

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