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MEMO

Date: 15/04/2004

To: Mr Colin Mr Colin Fleming
International Accounting Standards Board

From: Les Nethercott

RE: ED6

Dear Mr Fleming,

I enclose some comments on ED6 “Exploration for and Evaluation of Mineral Resources”. I hope they prove useful to the Board.

Yours faithfully,

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Attachments

Comments

1. I believe the transitional provisions enabling entities to comply with their current accounting policies is too flexible. Given the idea of convergence of standards this option must lead to lack of comparability of data and hence its relevance to making informed economic decisions. In Australia this gives an outcome where firms are able to expense their exploration and evaluation expenditure or to carry it forward until the result of the exploration is ascertained. In reality this has meant the small mining firms have carried forward such expenditure while larger firms, with a positive cash flow, have tended to write off such expenditure.

   A question also arises therefore with IAS 108 as to whether such entities may subsequently be able to write the expenditure back based on a change of estimate or prior period error. See below.

2. The adoption of a "cash generating unit" or "cash generating unit for cash exploration and evaluation" for treating exploration and evaluation expenditure adopts a substantially different focus for accountability (compared with the area of interest method used in Australia under AASB 1022). As a result the cash flow focus will raise a number of difficulties. In particular ED6 states that exploration and evaluation expenditure shall be carried forward and subject to an impairment test based on the cash generating unit. The impairment test is based on IAS 36 which states that an asset is impaired when the carrying amount of the asset exceeds its recoverable amount, where recoverable amount is the higher of the assets net selling price and value in use (which reflects the future cash inflows attributable to the asset discounted at an appropriate rate).

   Because exploration programs have a long gestation period and are associated with a high level of risk it is most probable, that especially in the early stages of exploration, that the uncertainty and the lack of progress will mean that the expenditure incurred will not satisfy the criteria for it to be carried forward as an asset under the impairment test. In comparison the current Australian Standard allows entities to carry forward such expenditure until the result or outcome is determined (but with appropriate disclosure). Alternatively the Australian Standard provides an option for such expenditure to be written off when it is incurred.

   The problem of whether exploration expenditure should be carried forward under the new IAS ED6 is made more difficult by the narrowing of the cost centre to the cash generating unit for exploration and evaluation. It would seem that the adoption of such a cost centre would mean that expenditure on exploration and evaluation activities would only meet the carry forward test when activities have progressed to the later stage of evaluation where development is likely.

3. Given the predisposition of ED6 to effectively force entities to write off their exploration expenditure the question arises what should occur if expenditure which has been written off actually does result in the discovery of a viable

mineral deposit. Although this is not covered in ED6 it seems that the provisions of IAS 8 would apply. This raises the matter of whether such a reversal would come under a change in accounting estimate or a prior period error. It is also possible that an entity could change its policy from an area of interest method to that outlined in ED6. If this did occur would this be regarded as a change in accounting policy? Depending on which outcome is chosen the application of IAS 8 would present different outcomes. In particular the retrospective or prospective adjustments result in different outcomes for the Profit and Loss and Balance Sheet.

4. ED6 provides no guidance on change of accounting policy. It would seem that an entity can continue to apply its existing accounting policy without the need to change to ED6 so long as the financial statements are more relevant to the user and more reliable. If this is the case it would raise the question whether the adoption of ED6 will provide more useful and reliable data. In my opinion this outcome has not been satisfactorily addressed, in fact if entities make the judgement that there existing accounting policy is preferable there would be no convergence on the accounting standard as proposed in ED 6.