CL 134

25 October2002

Sir David Tweedie
IASB Chairman
International Accounting Standards Board
30 Cannon Street
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BY FACSIMILE TO: +44 20 7246 6411

Dear Sir David

RE: EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTA TION AND IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

The Minerals Council of Australia (MCA) appreciates the opportunity to comment on the International Accounting Standards Board's (IASB) Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 32 ED and IAS 39 ED).

Australia is one of the world's principal producers and suppliers of ores, concentrates and refined metals with a modern and efficient process sector. Approximately 85 per cent of Australian minerals production is conducted by members of the Minerals Council of Australia, which is the national body representing the exploration, mining and minerals processing industry of Australia.

The MCA's major focus in considering the IAS 32 ED and the IAS 39 ED is the proposed treatment in respect of hedging. Hedging activity is widely used in the minerals sector to hedge foreign exchange exposures and forward sales (the latter, particularly in the gold sector but also for base metals and elsewhere). The MCA's detailed comments on the IAS 32 ED and the IAS 39 ED and the importance of hedge accounting to the minerals industry can be found at Attachment 1.

For the sake of emphasis, I have highlighted the key issues the MCA has raised for your consideration.

The MCA acknowledges that Australia, through the Financial Reporting Council, has formally supported the adoption by Australia of international accounting standards (including IAS 32 and IAS 39) by 1 January2005. The MCA agrees that a single set of high quality accounting standards which are accepted in major International capital markets may facilitate cross-border comparisons by investors, reduce the cost of capital, and assist Australian companies wishing to raise capital or list overseas. **However, it is important that the development and adoption of these standards take into account the particular circumstances of individual industries;**

In this context, the **MCA endorses the continuation of hedge accounting proposed in the IAS 39 ED**. The IAS 39 ED approach to hedge accounting is more appropriate to companies with well-developed risk governance and financial exposure management practices than alternatives such as the US Financial Accounting Standards Board's Statement 133 (FAS 133), and the Financial Instruments Joint Working Group (JWG) Standards Setters' draft standard "Accounting for Financial Instruments and Similar Items" approach proposed in December 2000. Compared to the JWG proposal, the IAS 39 ED proposals deal more appropriately with non-financial institutions, such as minerals companies, that seek to prudently hedge their future cash flows with derivatives (in that there will be no accounting-related volatility where there are effective economic hedges).

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The economic viability of large minerals projects depends upon financial arrangements that minimise risks associated with movement in currencies, interest rates and commodity prices. Minerals companies use such instruments to manage the primary risks presented by their businesses.

Minerals companies should be distinguished from banks and other financial intermediaries whose primary interest in financial instruments is to deal in them for a profit. The accounting and taxation treatment of these financial intermediaries should be appropriate to their business objectives and methods; and will rarely be appropriate for the business activities conducted by minerals companies.

In addition, it is important to note that Australia leads the world in minerals industry hedging, particularly gold hedging. Australian gold producers have very successfully hedged their prices for future gold production in recent years and protected their gold sales revenue at levels in excess of spot price.

Within this context, the MCA notes the proposed standard appears to ignore that hedging is also undertaken to underwrite the viability of extracting Ore Reserves at some time in the future. As commodity prices vary, there is a compensating valuation transfer between hedging commitments and physical Ore Reserves. The proposed standard is one-sided, dealing only with the hedging impact. While it might be suggested that this could be addressed through the recognition of and valuation of Ore Reserves in the accounts, there is no generally accepted international accounting standard for doing this. In addition, there are many difficulties in valuing Ore Reserves on a reliable and consistent basis rendering such an approach undesirable.

In certain cases, the proposals in the IAS 39 ED could result in a negative net asset position (if, for example, there was a significant rise in gold prices) implying the company in question was insolvent. At the same time, the company's market capitalisation would be likely to exceed its current value, as the share price would be boosted by the impact of gold prices on the non-hedged portion of the book. The share market effectively values the Ore Reserves when valuing the company but the EDs appear to endorse an approach that increases the gap between balance sheet values and market capitalisation.

Moreover, the "Extractive Industries" issues paper issued by the International Accounting Standards Committee (the predecessor organisation to the IASB) in November 2000 does not propose that minerals companies apply a fair value to their Ore Reserves. The MCA recommends that the IASB should first complete the extractive industries standard before the IAS 39 ED proposals in relation to this area are further considered. It is vital that any final positions are in harmony and take account of relevant material differences between industries. The MCA would welcome the opportunity to work with the IASB to ensure that a high quality extractive industries standard, that is acceptable for all users, is developed.

The MCA would welcome the opportunity to meet with the Board or its secretariat to discuss any aspect of this submission should you consider this appropriate.

Yours sincerely

Mitchell H. Hooke

MITCHELL H. HOOKE
CHIEF EXECUTIVE

Enc.

MHH:EMD

ATTACHMENT 1

DETAILED COMMENTS FROM THE MINERALS COUNCIL OF AUSTRALIA ON THE IASB EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 32 *FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION* AND IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

The Importance of Hedging Activity in the Minerals Industry

Large minerals projects require large amounts of long-term capital, which must be raised in public markets, often overseas. The outputs from such projects are commodities that are priced and sold in world markets, generally in foreign currencies. The cash flows inherent in minerals projects are large and irregular and require careful cash management.

For these reasons, the economic viability of such projects depends upon financial arrangements that minimise risks associated with adverse movements in currencies, interest rates and commodity prices. Minerals companies use such instruments to manage the primary risks presented by their businesses.

Minerals companies should be distinguished from banks and other financial intermediaries whose primary interest in financial instruments is to deal in them for a profit. The accounting and taxation treatment of these financial intermediaries should be appropriate to their business objectives and methods; and will rarely be appropriate for the business activities conducted by minerals companies. The EDs attempt to define rules of universal application to all companies and thus ignores the fundamental distinctions between financial intermediaries, *traders* in commodity hedges for profit and the goods producing sector.

As gold producers, for example, do not have long-term sales contracts in place, they use long-term hedge positions as a risk management tool to provide some certainty going into the future, thus rendering the spot price irrelevant (just as in a long-term coal contract). This may in fact be required of them by their financiers. For example, a gold project is being developed with plans to extract gold for, say, a seven-year period. As prices fluctuate considerably and in the absence of long-term contracts, a bank may require some hedging activity for risk management purposes over the expected life of the project.

Some very large minerals companies because of their mixture of global operations, products and financing requirements, do not need to take out derivative financial risk instruments and are therefore impacted less by the proposals in the ED. Smaller companies are not in this position and need protection through derivative financial instruments.

Foreign currency hedging

As noted above, the minerals industry is highly capital intensive and has long lead-times between funding development and realising revenue cashflows. The large quantity of debt funds required to develop any new minerals project mean that the size of borrowings associated with most of these projects is beyond the capacity of Australian capital markets to finance. Much of the debt funding, therefore, has to be borrowed from overseas lenders, with consequent currency and other risks.

It is common in the minerals industry to undertake borrowings in a foreign currency. Often the borrowings will be project specific and there will be a natural hedge with the currency in which the mineral product to be produced is sold. However, minerals companies may also take out foreign currency derivatives to hedge their exposure under foreign currency loans or to foreign currency denominated revenue streams or to hedge their investment in foreign operations.

This hedging may be undertaken to minimise balance sheet volatility and the risk of breaching ratios established under financing agreements. The other reason for establishing foreign currency hedging is, as discussed earlier, to establish greater certainty in Australian dollar revenue for products typically priced in foreign currency.

Borrowings by the Australian minerals industry are estimated to have been A$1 5.9 billion at 30 June 2001 with 70 per cent held in foreign currencies and 30 per cent in Australian currency.[1] These proportions vary over time, partly due to changes in the level of overseas debt measured in Australian dollars (due to currency movements) and partly due to the need for companies to vary their holdings of Australian and foreign denominated debt.

Hedging of anticipated sales

Considerable flexibility is necessary to satisfactorily hedge expected mineral production. This is because of the particular characteristics and circumstances of mineral commodity producers, especially in the gold sector, where the positions tend to be for far longer periods than, for example, for zinc or copper hedging.

Australia leads the world in gold hedging. Australian gold producers have very successfully hedged their future gold production in recent years and protected their gold sales revenue at levels in excess of spot price.

Hedging policies can differ widely between companies. Some may involve ensuring a predictable price for enough production to cover loan repayments and the cost of production. Others may also seek to secure a cash margin necessary to finance exploration and development to maximise the value of the deposit. In this manner, gold producers can develop and reinvest in many projects that otherwise would not be viable because of the volatility of the gold price.

Many Australian minerals companies, therefore, hedge currency risk in respect of anticipated future sales of minerals denominated in $US using derivative financial instruments. Under the current accounting treatment adopted by many of these companies:

- the mark to market valuations of <u>unrealised</u> hedge contracts are provided by way of comprehensive note disclosure to the financial statements; and

- the mark to market valuations of <u>realised</u> hedge contracts are recognised as deferred hedge losses or deferred hedge liabilities in the balance sheet.

Under the treatment proposed by the IAS 39 ED, these currency hedges would be regarded as cash flow hedges (subject to meeting criteria for hedge accounting). Prior to the occurrence of the underlying sale of minerals, the mark to market valuation of both realised and unrealised contracts would be recorded directly in equity. At the time the underlying sale of mineral occurs, the gain/loss on hedge contracts would to be reclassified as profit/loss in the profit and loss account.

This proposal raises a number of issues and concerns for the Australian minerals industry:

- not a comprehensive fair value model – there is a lack of symmetry between the recognition of Ore Reserves and financial instruments. Whilst changes in fair values of derivative financial instruments designated as hedges are reflected directly in equity prior to the underlying sale of minerals, the off setting fair value movement in Ore Reserves is not recognised. The proposed treatment of cashflow hedges under the IAS 39 ED does not result in a true and fair view of the financial position of minerals companies who undertake commodity and currency hedging. **The preferred approach for minerals companies who undertake hedging should be by way of note disclosure.**

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[1] Source: Minerals Council of Australia (2001), *2001 Minerals Industry Survey Report*, prepared by PricewaterhouseCoopers, December (available at <u>https://mcasurvey.com.au/ABAS/miningsupub.nsf/pages/images/$file/2001%20MIS.pdf</u>).

The ED ignores the implication that fair valuing of financial instruments has for non-financial assets/liabilities, which are measured on a cost basis. For minerals companies, mining and mineral processing assets are one of the most significant non-financial assets.

Each time there is a fair value movement in the company's hedge book, the value of the company's Ore Reserves moves in the opposite direction offsetting the fair value movement. The proposals in the ED would recognise only one side of the movement in value, being the hedge book impact, and ignores the complementary impact on the value of the operation calculated at spot. Thus, the ED proposal advocates a change in the accounting treatment for hedges, which is potentially misleading to investors.

It might be argued that fair valuing of reserves in the primary financial statements is preferred as it gives more accurate and useful information upon which to make decisions. However, **the MCA does not support this on practical grounds, because of:**

- the difficulty of measurement;
- lack of an internationally accepted standard; and
- lack of comparability.

The ED proposals would therefore result in a hybrid of valuation bases being used in financial statements, with physical assets being valued at historical cost and financial assets being valued at fair value. Arguably this mix of valuation bases does not provide relevant and reliable information to users of the financial statements.

A major criticism of the retention of the historical cost approach for non-financial assets is that it makes no allowance for future cash flows from assets that can be predicted with some certainty. This piecemeal approach to fair value accounting does not align with the approach of investment analysts who apply a present value to all expected future cash flows.

Moreover, the "Extractive Industries" issues paper issued by the International Accounting Standards Committee (the predecessor organisation to the IASB) in November 2000 does not propose that minerals companies apply a fair value to their Ore Reserves. The MCA recommends that the IASB should first complete the extractive industries standard before the IAS 39 ED proposals in relation to this area are further considered. It is vital that any final positions are in harmony and take account of relevant material differences between industries. The MCA would welcome the opportunity to work with the IASB to ensure that a high quality extractive industries standard, that is acceptable for all users, is developed.

It is crucial that the relevant standards are developed in a manner that results in reliable and comparable financial information having regard to specific and material differences between industries. For example, as previously noted, the banking industry is involved in commercial hedging activities in order to make a profit on these transactions. The minerals industry employs hedging for commercial risk management purposes. The ED does not appear to have adequately recognised this issue.

As a principle of sound accounting standards development, the proposals should not interfere with the existing commercial treatment of transactions in the minerals industry.

- Impact on volatility of earnings - the proposals in the ED would potentially result in increased earnings volatility for many companies in the minerals industry (recognising that the proposals apply in relation to instruments that previously may have qualified as hedges, but do not pass the strict effectiveness testing measures).[2] This is because the market price of commodities

[2] The MCA also acknowledges that under the IAS approach, this volatility will be between income and equity, rather than concentrated in income, as would have been the case under the JWG proposals.

and exchange rates can vary significantly in a short space of time. It would also significantly reduce comparability of financial statements from one period to the next as well as between companies, particularly in the gold mining industry where hedging activities are unique to the underlying operations.

As the volatile component within these earnings will be unrealised, a company could also be making available for dividend payment, earnings with no underlying cash generation. Such unrealised gains or losses may also distort key financial ratios. This may have potential implications for borrowing covenants.

As discussed above, it is important also to note that many of the gold mining companies have gold hedge books that cover anywhere up to ten years of production. Some may go even further. Under the ED's proposals, these companies would be required to report commodity price swings in respect of up to ten years production in each reporting period. This would result in financial results that are potentially misleading for users.

This analysis suggests that if the ED proposals were put in place the effect on earnings volatility could discourage minerals companies from hedging, notwithstanding it being an effective and sound risk management tool. This would clearly impact on current commercial arrangements.

Hedging of acquisition of assets

It is common in the Australian minerals industry to import major capital items from overseas. To mitigate currency exposure risk, it is also common to hedge the purchase of such equipment. Under current accounting treatment in Australia these hedge gains/losses are recorded directly against the carrying value of the acquired asset with resultant impact on depreciation. Under the proposed IAS 39 ED, these hedge gains or losses are initially recognised directly in equity and subsequently released to the profit and loss account in the period in which the hedged asset affects profit and loss (that is, through depreciation).

This approach seems inconsistent with the economic rationale for undertaking the hedge of an asset acquisition, that is, to minimise the currency impact on the recorded asset acquisition cost. Furthermore, this approach results in significant additional administration to separately record and amortise hedge gains/losses through equity. The nature of major capital items in the minerals industry is that they are long-lived assets, with continual restatements in asset life dependent on changes in estimated Ore Reserves. These adjustments between equity and profit and loss would potentially continue in excess of twenty years and require frequent recalculation.

Transitional Provisions

It is proposed that the standards be applied retrospectively, except as specifically prescribed. This is consistent with the expected requirements of the IASB in relation to first time application of IAS. In theory this approach is valid, despite administrative costs to complete, to ensure comparability of financial statements of companies which were previously prepared under different. However this must be balanced against practical considerations – companies that made valid decisions under alternative jurisdictions should not now be unnecessarily penalised on retrospective first time application of IAS, for example in relation to debt covenants and other contractual arrangements. The MCA does not recommend a retrospective approach be adopted in relation to the provisions for hedge accounting, which should be adopted prospectively from the date of transition.

Paragraph 171C of proposed IAS 39 ED provides that the carrying amount of non-financial items shall not be adjusted to exclude gains/losses related to cashflow hedges that were included in the carrying amount before application of the standard. **This is a practical exclusion that the MCA supports.**