



Legal and Technical Commission

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Considerations relating to the reporting of actual and direct exploration expenditures as required by annex 4, section 10, of the Regulations on Prospecting and Exploration for Polymetallic Nodules in the Area

Note by the Secretariat

1. Since 2002, the Legal and Technical Commission has reviewed and provided advice to the Secretary-General on the content of the annual reports submitted by exploration contractors in accordance with the standard clauses of exploration contracts set out in the Regulations on Prospecting and Exploration for Polymetallic Nodules in the Area. It should be recalled that the objective of the reporting requirements under the contracts is not to burden the contractors with unnecessary requirements, but to establish a mechanism whereby the International Seabed Authority, and particularly the Legal and Technical Commission, can be provided with the information necessary to carry out its responsibilities. Over the years, one matter on which the Commission has repeatedly expressed concern is the difficulty experienced in reconciling reported expenditures against the activities carried out during the reporting period. In that regard, the Commission has on a number of occasions recommended that further clarification or information be provided by contractors.

2. At its meeting during the fourteenth session, in view of this persistent concern, the Commission requested the Secretariat to provide it with a more detailed report and analysis of the actual and proposed expenditures reported by contractors to date. The Commission also recommended, in connection with its discussions on proposed new regulations for prospecting and exploration for cobalt-rich ferromanganese crusts, that the provisions relating to financial accounting be revised in the light of experience in order to ensure that contractors maintain and provide information that fully discloses the actual and direct expenditures incurred on exploration and facilitates effective audit.

3. The present report responds to the request by the Commission. It provides a review of the requirements set out in the Regulations and the standard contract



relating to financial reports and an overview of the status of financial reporting by contractors to date. It also contains a brief analysis of some of the main problems and issues and a suggestion that the Commission consider adopting recommendations for the guidance of contractors on this issue, pursuant to regulation 38 of the Regulations.

I. Requirements of the Regulations and the contract

4. The provisions concerning financial reporting are found in the standard clauses for exploration contracts contained in annex 4 to the Regulations. In accordance with section 9 of annex 4, each contractor is required to keep “a complete and proper set of books, accounts and financial records, consistent with internationally accepted accounting principles. Such books, accounts and financial records shall include information which will fully disclose the actual and direct expenditures for exploration and such other information as will facilitate an effective audit of such expenditures”.

5. In accordance with section 10 of annex 4, each contractor is required to submit an annual report. The report is to be submitted within 90 days of the end of each calendar year. In addition to specified information relating to the activities carried out by the contractor, the report must include a statement, in conformity with internationally accepted accounting principles and certified by a duly qualified firm of public accountants, or, where the contractor is a State or a State enterprise, by the sponsoring State, of the actual and direct exploration expenditures of the contractor in carrying out the programme of activities during the contractor’s accounting year.

6. The purpose of requiring the submission of relatively detailed financial reports is twofold. First, it is a due diligence requirement that is commonly found in exploration and mining contracts and is included as a means for objectively quantifying the contractor’s compliance with its plan of work. Thus, even under the pioneer investor regime, registered pioneer investors are required by paragraph 7 (c) of resolution II of the Third United Nations Conference on the Law of the Sea to agree to incur periodic expenditure. The amount of such expenditure was to be “reasonably related to the size of the pioneer area and the expenditures which would be expected of a bona fide operator who intends to bring that area into commercial production within a reasonable time”. Under the current regime, as part of the process of application for a plan of work for exploration, contractors are required to provide a five-year programme of activities and a schedule of anticipated annual expenditures in respect of such programme (regulation 18). Under the standard clauses (annex 4, para. 4.2), contractors are required to spend in each contract year not less than the amount specified in the programme of activities, or any agreed review thereof, in actual and direct exploration expenditures. The annual financial report is thus the only means by which the Authority is able to objectively verify contractors’ compliance with those provisions.

7. The second reason for requiring financial reports is potentially of direct benefit to the contractor. It is general practice in the mining industry to allow some element of the costs of developing a mine site to be set off against the eventual income from production. As far as seabed mining is concerned, detailed provisions relating to the definition of “development costs” and their recovery in certain circumstances were included in article 13 of annex III to the United Nations Convention on the Law of

the Sea. By reason of the 1994 Agreement relating to the Implementation of Part XI of the Convention, those provisions no longer apply. Nevertheless, the possibility that the Authority may in due course make provision for the recovery of some element of development costs is foreseen in annex 4, paragraph 10.2 (c), to the Regulations, which provides that “such expenditures may be claimed by the contractor as a part of the contractor’s development costs incurred prior to the commencement of commercial production”. In those circumstances, it is particularly important that there be some means of verifying objectively the amount of such expenditures, their relationship to the programme of activities and whether they are actual and direct exploration expenditures.

II. Overview of contractors’ financial reporting to date

8. The present section provides a brief overview of issues arising from the contractors’ reports to date, as noted by the Commission in reviewing the annual reports. Precise financial data (which is confidential) from which the conclusions below have been drawn will be made available to the Commission under the usual conditions of confidentiality during its forthcoming meeting.

9. In some cases, it was noted that the financial reporting period was not the same as the activity reporting period.¹ In other cases it was difficult to distinguish the activity reporting period from the stated programme of activities.² These factors frequently made it difficult to make an assessment of the actual exploration costs. There were also cases in which reported expenditure was related to an item that was not in the programme of activities.³ As required by the Regulations, the certified breakdown of expenditures must refer only to the exploration costs that occurred in the course of the accounting year.

10. In some cases, it was noted that the reported exploration activities had been adjusted in comparison with the programme of activities, with significant variations in projected expenditures. The Commission had recommended that any adjustments to the programme of work and to the proposed expenditures be clearly indicated in the annual reports.⁴ This is not only consistent with the standard clauses, but is the only way in which the Commission would be able to assess the reported expenditures against the revised exploration activities.

11. The Commission also observed that, where contractors had claimed a substantial investment of funds for the design of the mining system and other equipment and exploration activities, this should be reflected in the financial reports, which should bear a direct relationship to the techniques that were tested.

12. Some reports contained a financial statement without a breakdown of expenditures; some did not include either a breakdown of expenditures or a

¹ See ISBA/8/LTC/2, paras. 23, 26 and 87 and annex; ISBA/11/LTC/4, paras. 25 and 26; and ISBA/12/LTC/2, paras. 3 and 51.

² See ISBA/9/LTC/2, paras. 19, 38, 39, 42 and 44; ISBA/11/LTC/4, paras. 53 and 58; and ISBA/13/LTC/4, paras. 67 and 68.

³ See ISBA/9/LTC/2, paras. 74, 81, 82, 86 and 95; and ISBA/10/LTC/3, para. 76.

⁴ See ISBA/8/LTC/2, para. 14; ISBA/10/LTC/3, para. 22; ISBA/11/LTC/4, paras. 9, 42, 61, 63, 69, 70 and 72; and ISBA/13/LTC/4, para. 68.

certificate in the form required by the Regulations.⁵ An itemized breakdown of expenditures should have a level of detail sufficient to identify the costs that qualify as actual and direct exploration costs. The standardized content list for annual reports suggested, for example, that a detailed breakdown of expenditures should indicate the number of days allocated to cruises and the number of sampling stations.⁶

13. There were reports in which the financial statement was not appropriately signed and/or certified (either by a duly qualified firm of public accountants, or, where the contractor is a State or a State enterprise, by the sponsoring State).⁷ In several cases in which no formal financial statement was issued, the contractor was requested to indicate when the certificate would be issued and subsequently to provide it without delay.⁸

III. Analysis and recommendations

14. As a starting point of any recommendations for guidance, the Commission may wish to recommend that contractors maintain and present their financial reports in accordance with relevant internationally accepted accounting principles. This is consistent with sections 9 and 10 of annex 4 to the Regulations, which make reference to the need to maintain and present all financial information in a manner consistent with “internationally accepted accounting principles”.

15. Although such principles are not further defined in the Regulations, one widely accepted source of accounting standards is the International Accounting Standards Board, an independent body responsible for developing and promoting the global application of International Financial Reporting Standards (IFRS) (known as the International Accounting Standards (IAS) prior to 2001). The standards are developed in an international consultation process involving interested individuals and organizations from around the world, with the support of an external advisory council, the Standards Advisory Committee. There is also an International Financial Reporting Interpretations Committee, which exists to develop guidance to promote consistent practice. Two standards are of particular relevance to the issue presently before the Commission.

16. IAS 1 prescribes the basis for the presentation of general-purpose financial statements to ensure comparability with both the entity’s financial statements of previous periods and the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. IFRS 6, issued in 2004, deals with the reporting of expenditures associated with the exploration for and evaluation of mineral resources. This standard, effective from 1 January 2006, applies to all expenditures incurred by entities in connection with the exploration for and evaluation of mineral resources (e.g. minerals, oil, natural gas and similar

⁵ See ISBA/8/LTC/2, paras. 43, 46, 63 and 66; ISBA/9/LTC/2, paras. 69, 95 and 98; ISBA/10/LTC/3, paras. 64, 67 and 68; and ISBA/11/LTC/4, paras. 58, 59, 61 and 62.

⁶ See ISBA/8/LTC/2, annex.

⁷ ISBA/8/LTC/2, paras. 23, 26, 33, 36, 43 and 46; ISBA/9/LTC/2, paras. 45 and 72; and ISBA/12/LTC/2, paras. 3, 41 and 43.

⁸ ISBA/9/LTC/2, paras. 32, 33, 76 and 87; ISBA/10/LTC/3, paras. 12, 54 and 57; ISBA/11/LTC/4, paras. 16 and 50; and ISBA/13/LTC/4, paras. 41 and 66.

non-renewable resources). Affected activities comprise the search for mineral resources and the determination of the technical practicability and commercial feasibility of extractive activities. The standard does not include expenditures arising before the entity obtained legal rights to exploration in a specific area (which would be considered prospecting under the Regulations) or expenditures arising after the demonstration of the technical feasibility and commercial viability of extracting mineral resources.

17. The Commission may also wish to clarify the process by which financial statements are certified, at least by requiring contractors to specify which domestic entity has the responsibility for certifying such statements.

18. As established in paragraph 10.2 (c) of annex 4 to the Regulations, reported expenditure must relate only to the actual and direct costs of exploration. This can be broken down into three separate but cumulative requirements.

19. Pursuant to regulation 1, paragraph 3 (b), of the Regulations, exploration means the search for deposits of polymetallic nodules in the Area, their analysis, the testing of collecting systems and equipment, processing facilities and transportation systems, and the carrying out of studies of the environmental, technical, economic, commercial and other appropriate factors that must be taken into account in exploitation. Furthermore, referring to the duration of exploration, annex III, article 17, paragraph 2 (b) (ii), to the Convention specifies that the duration should be sufficient “to permit a thorough survey of the specific area, the design and construction of mining equipment for the area and the design and construction of small and medium-size processing plants for the purpose of testing mining and processing systems”. Consequently, it may be considered that the costs directly associated with exploration must fall under the list of activities defining the term “exploration”.

20. Further assistance may be found in the definition of the contractor’s development costs in annex III, article 13, paragraph 6 (h), which refers to the expenditures “incurred prior to the commencement of commercial production which are directly related to the development of the productive capacity of the area covered by the contract and the activities related thereto for operations under the contract in all cases [...], in conformity with generally recognized accounting principles, including, inter alia, costs of machinery, equipment, ships, processing plant, construction, buildings, land, roads, prospecting and exploration of the area covered by the contract, research and development, interest, required leases, licences and fees”. This is useful as it relates to a phase before commercial production, which takes place “after the termination of the exploration stage and the commencement of the exploitation stage” (annex III, article 17, para. 2 (c)).

21. Secondly, the costs need to be actual, which means that they have actually been incurred and are not notional, estimated or projected. Actual costs are also associated in time with those which occurred during the reporting year. Therefore, they exclude those which relate to past or future exploration work. Actual costs may be different from the projected costs, but grounds for any variation should be provided in the report. Unless unpredictable circumstances arise, any variation, such as that due to the fluctuation of exchange rates, is expected to be insignificant. Moreover, by virtue of the standard clauses (annex 4, para. 4.2), the contractor is required to spend in each contract year not less than the amount specified (or any

agreed review thereof) in the programme of activities as agreed by the parties to the contract.

22. The third requirement is that the actual costs must be incurred directly in connection with the exploration work that has been undertaken in accordance with the programme of work in the contract. This excludes ancillary or associated exploration. This is not unprecedented in land-based mining legislation.⁹ Moreover, useful guidance for the analysis is contained in the performance requirements in annex III, article 17, paragraph 2 (c), to the Convention, which states that periodic expenditures are “reasonably related to the size of the area covered by the plan of work”; those expenditures are those which “would be expected of a bona fide operator who intended to bring the area into commercial production within the time-limits established by the Authority”.

23. In the light of the considerations discussed in the present report, the Commission may wish to establish recommendations for the guidance of contractors relating to financial reporting. Draft recommendations have been prepared for consideration by the Commission at the fifteenth session (see ISBA/15/LTC/WP.1).

⁹ For example, in the State of Victoria in Australia, Rediscover Victoria Drilling funding grant amounts are calculated on the basis of direct drilling costs only and not on ancillary or associated exploration services, such as the costs of administration, drill rig mobilization costs or the geochemical, geophysical, laboratory, legal or ground access costs (see <http://www.dpi.vic.gov.au>).