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To: AASB Mailbox
Subject: AASB 141/Native Forestry

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21 May 2014

Mr. Kevin Stevenson,
Chairman and CEO,
AASB
7/600 Bourke Street
Melbourne, Victoria, 3000

Dear Mr. Stevenson,

AASB 141/Native Forestry

I wish to bring to your attention the serious concerns I have regarding the application of AASB 141 to native forestry in Western Australia and a recommendation as to how I believe the valuation of these biological assets should be treated in financial accounts.

As my points are largely illustrated by example, my comments are made against the philosophy that annual accounts of an organisation are produced for one reason and one reason only: so that shareholders and investors can understand how that organisation has performed. Should such accounts require an expert to interpret them they have essentially failed in meeting this objective.
The basic questions I will address are:

1. If an entity is granted at no cost the right to log native forests ("forests"), should the value of the forests be recorded as $0 (zero value) or as determined by cash flow analyses?
2. Assuming the value has been recorded as $0, should subsequent values as determined by cash flow analyses be considered as profit?
3. Should changes in accounting practices which result in higher values being ascribed to the forests be considered as profit?
4. Should cash flow analyses which show a negative value of the forests be recorded as a liability?
5. As other natural resource and other industries have adopted an accounting standard whereby impairment of asset values is assessed by cash flow analyses and as the only impact on profit occurs when values have been reduced, would not this be a more appropriate procedure for the native forestry industry to adopt?

1. Initial recording of forest value

The Western Australian Forest Products Commission (FPC) was established late in 2000 (2001 financial year). On formation FPC was "given" state-owned native forests and recorded their value as $0 *(FPC 2002 Annual Report p.34).* No rationale was provided in support of this value. Under AASB 141, attributing zero value to the forests meant that any value subsequently ascribed to the forests could be recorded as profit for the FPC.

2. Subsequent valuation and impact on profit

In 2002 FPC increased the value of native forests from $0 to $67 million *(FPC 2002 Annual Report, p. 34).* This valuation was established by the discounted cash flow method. The increase was wholly or in part claimed to be "due to a reduction in attributable management and protection costs." *(FPC 2002 Annual Report, p. 30).* Discussions with Mr. Derek Oelofse (FPC CFO) in 2002 confirmed that these costs had been removed from the 50-year cash flows by which the forests were valued and recorded in another sector of the FPC's operations.

It is my understanding that this was either the first valuation of the forests to be arrived at by the discounted cash flow method or the first in which correctly attributable costs had been considered. In either case it does not appear justifiable to consider this large apparent increase in value as real profit.

3. **Further accounting changes considered as profit**

In 2005 FPC increased the value of native forests by a further $33 million *(FPC 2005 Annual Report p.86)*. This was said to be due to exclusion of an "allocation of corporate overheads" from the cash flows *(FPC 2005 Annual Report p. 88).* If one considers the change in discount rates used, the impact of removing these overheads from the cash flows was in fact in the order of a $75 million increase in FPC's value of native forests *(FPC 2005 Annual Report, p. 87 "Sensitivity analysis").*
Again, it seems extraordinary that a change in accounting practices should be considered as profit.

The above accounting procedures (points 2 and 3) resulted in a combined increase in FPC's value of our native forests and of FPC's reported profit of between $100 million and in excess of $150 million.

FPC now values the forests at $97 million *(FPC 2013 Annual Report, p.97)*. FPC's reported cumulative pre-tax profit since formation has amounted to just $3 million. Had the value of the forests not been initially recorded as $0 and had they not been revalued based on changes in accounting procedures, FPC would have reported a cumulative loss over this period of $94 million. Clearly, forest revaluations play the critical role in this corporation's reported profit.

FPC calculated these increases in value despite:

- Declining forest growth rates, especially in the marginal rainfall forests where rainfall decline has been greatest. (eg. in FPC 2011 Annual Report the Chairman stated "*…the reported result is a $13 million loss. This is predominantly due to the impact of drought on the estimated value of the plantation forest", y*et the value of native forests, which experienced the same rainfall was claimed to have increased by $10.4 million).
- Damage to forests from severe fires, especially in 2011 (FPC does not insure the forests).
- Declining actual and projected rainfall (widely acknowledged for south-west Western Australia, refer various CSIRO reports). This will result in a further decline in growth rates, disease infestations and very likely more fires and fires of greater intensity.
- Catastrophic decreases in the production of quality logs (the volume of FPC's highest value products, premium and 1st and 2nd grade jarrah logs, has fallen dramatically, from 245,000 cubic metres in 2002 to 34,000 cubic metres in 2013, an 85 percent decline);
- Demonstrable unsustainability of karri sawlog production;
- A near doubling in value of our currency (this has had a significant detrimental financial impact on all agricultural products); and
- The Global Financial Crisis (worldwide, prices of all native and agro-forestry products suffered severe declines).

Despite the above, the recorded increases in value of the forests and reported profits were enabled through the application of AASB 141.
It could well be argued that the original value ascribed to the forests should have been $67 million and that subsequent values fell, resulting in an even greater accumulated reported FPC loss.

4. **Zero or negative value of forests**

By cash flow analysis Forestry Corporation of NSW (FCNSW) attributes zero value to NSW native forests *(FCNSW Annual Report 2013, p.74*). It can confidently be assumed that the present value of the discounted cash flow was negative, and the more so as non-forestry activities had been included in estimating the value of this asset *(FCNSW Annual Report p. 59 which states "Ancillary income earned from activities such as the leasing of land for grazing and other occupancy rights is added to the net harvest revenues.").*

It would only seem logical that if an item having a positive net present value is considered an asset, then an item with a negative net present value should be considered a liability. This would give shareholders (NSW residents) a better understanding of the financial position of FCNSW.

5. The impairment option

If (for example) a mining company made a discovery or had reason to increase its mineral reserves and therefore the value of these reserves, clearly this would not be considered as profit. However if the value of an asset, say a mine, as determined by cash flow analysis fell below the book value (as determined by expenditure less depreciation), that asset would be considered to be have been “impaired” and the reduction in value would be recorded as a loss. The value of the asset, as assessed for its impact on profit, would never rise above the cost of its acquisition. This would appear to be a far more reasonable way of demonstrating the financial position of a corporation involved in native forestry and would to some large extent enable the pitfalls described above to be avoided.

Should for some reason this option be considered unacceptable, the very minimum that needs to be done is to insert a proviso into AASB 141 to ensure that changes in forest values which have been due to changes in accounting practices not be recognised as profit.

I can understand that this letter could be construed as simply an objection to the way WA’s native forestry corporation has presented its accounts. It goes well beyond that. It is not only the general public who believe FPC is a profitable and financially viable corporation, but this is the widely held view of politicians and has resulted in a continuing waste of both natural and financial resources. There is good reason to believe that this also applies to the native forestry corporations of other states.

I trust you will accept this letter in the spirit in which it has been written; one of constructive criticism.

Yours sincerely,

Peter Lane

(original by post)