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International Accounting Standards Board
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2 September 2014

Dear Sirs/Mesdames

Response to recent tentative decisions made by the IASB in respect of the *Leases Project*

Woolworths Limited ("Woolworths") has been following the recent discussions held by the International Accounting Standards Board ("the IASB") and the Financial Accounting Standards Board ("the FASB") (collectively "the Boards"). We would like to take this opportunity to bring certain matters to the attention of the IASB which we believe are important for the IASB to consider prior to the finalisation of a Standard.

Woolworths Limited ("Woolworths") is one of the largest retailers in Australia and New Zealand, with 3,231 retail locations and a further 754 wholesale supplied stores in Australia and New Zealand as at 29 June 2014. The Woolworths business includes:

- Australian Food, Liquor and Petrol – Woolworths' Australian supermarkets, retail liquor outlets, wholesale and online operations and petroleum products retail outlets (including outlets which are co-branded Woolworths/Caltex)
- New Zealand Supermarkets – New Zealand Supermarkets (trading as Countdown), supermarkets wholesale and online businesses
- General Merchandise – discount department stores and online business
- Hotels – pub operations including bars, restaurants, gaming functions and accommodation
- Home Improvement – Home Improvement retail stores, wholesale and online operations
- Property – comprising property leasing, management and development.

Woolworths has more than 5,000 leases, of which approximately 3,000 are store leases. Each of our businesses has different lease arrangements in addition to the lease arrangements that are applicable to our corporate and warehouse operations. Accordingly we consider that we are well placed to provide comment on the impact of the changes across the Australian and New Zealand retail economies. In addition our Home Improvement business is a joint venture with the US based Lowe's Companies, Inc.

Globally leasing is an important activity for many entities and therefore any changes to lease accounting has far-reaching consequences. In addition, with increasing globalisation, many companies operate across multiple jurisdictions and are required to comply with both International Financial Reporting Standards as well as US GAAP.

Overall, we continue to support the retention of the existing guidance in IAS 17 (refer to our previous submissions dated 10 July 2009, 14 December 2010, 1 May 2012 and 11 September 2013) until such time as the IASB has adequately differentiated the boundary between an executory and a financing contract.

We see no benefit from moving away from the existing IAS 17 model. The market is already fully informed of leasehold obligations. The new standard leads to significant additional complexity, huge costs and administrative burden on companies and for no benefit. There has been no significant user issues that we are aware of on the current accounting for leases which has been well established for a significant period of time. We are also concerned that the cost of implementing these proposals exceeds the benefit to users of the financial statements.

To the extent that the Board continues to believe that all leases should be recognised on balance sheet and consistent with the IASB's position set out in IASB Exposure Draft ED/2103/6 Leases ("revised ED"), we believe that a dual approach is necessary to reflect the differing economic substance of real estate leases and, in particular, to provide a solution to the profit or loss distortion that a single approach creates. Under these circumstances, we therefore believe that the IASB should converge with the FASB in applying a dual approach to lessee accounting. In the event this approach is taken, it is crucial that entities be given sufficient time to transition to a new standard given the significant differences from the current approach.

Further commentary is set out below.

Distinction between executory and financing contract

In our opinion, real estate leases are more executory in nature because both the lessor and lessee have ongoing obligations under the lease contract:

- If either party fails to meet their obligations at any point during the contract, this would lead to restitution in the form of reduced rental payments or rights to end the lease agreement. The lessor of real estate assets provides the mix of tenants, ambiance of the centre to attract customers, overall quality of the property and amenity protection, including quiet enjoyment, centre cleaning, maintenance, building insurance and parking facilities. The lessee agrees to remain open for certain hours to assist with the centre ambiance, adds brands and merchandising. Without the operating business generating customer traffic the lease has no value
- The lessee receives the benefits of using the property at the same time as it pays for this benefit and as a result there is no financing element within the lease.

The differing economic substance of real estate leases

In our opinion, a dual model is necessary to reflect the differing economic substance of real estate leases. Real estate leases are significantly different to motor vehicle, office equipment or plant & equipment leases because:

- Real estate is generally an appreciating asset, that may include both land and buildings
- Real estate is required to be maintained, as set out in the lease agreement, and may also be upgraded during the life of the lease
- Real estate typically has a relatively long life and a large proportion of the lease payments may relate to the land element inherent in the lease
- In many cases the lessee is unable to purchase the real estate (e.g. part of shopping centre)
- In many cases the lessee is unwilling to take on the risk associated with real estate ownership (e.g. fluctuations in the value of the real estate, maintenance or full management of the property)
- Substantial management is required by the lessor during the lease term (e.g. providing mix of tenants, ambiance of centre to attract customers, overall quality of the property, amenity protection including quiet enjoyment, centre cleaning, maintenance, building insurance, parking facilities).

This view of real estate is also consistent with the way in which we manage our business internally. Property owned by Woolworths is primarily recorded in a separate division and leased out to the retail divisions under an operating lease to ensure that the results of the retail divisions are not distorted by the impact and risks of owning property.

The straight-line profile of the dual approach reflects the economic substance of real estate leases

In our opinion, the straight-line expense for real estate leases most closely reflects the economics of a real estate lease where there is limited transfer of risk and the lessee is generally expected to consume only an insignificant portion of the economic benefits of the real estate. In addition, the straight-line expense:

- Is consistent with how leases are priced. Real estate rentals are driven by the market and are based on market yields. They do not include a return for that part of the property that is consumed and ‘lending’ return arising from lessor not being able to use the residual asset during the lease term
- Is consistent with how equity analysts and institutional investors analyse our business. In the retail industry the vast majority of equity analysts and institutional investors commonly use an earnings based measure such as earnings before interest, tax, depreciation and amortisation (“EBITDA”), earnings before interest and tax (“EBIT”) or net profit after tax (“NPAT”) to assess performance and drive the valuation of the business because actual cash flow can be distorted by the timing differences in working capital. The analysts typically do not make any adjustment to earnings to recognise the real estate leases as “financing transactions”
- Is easily understood by users of the financial statements
- Is consistent with the lessor that recognises rental income on a straight-line basis over the life of the lease.

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We commend the IASB for the extensive outreach conducted to date and we appreciate the time and cost that has been spent to develop the proposals. To the extent that the IASB decisions differ significantly from that set out in the revised ED, such as requiring a single model for all leases, further consideration be given to these proposals and they be re-exposed for further comment under the IASB's Due Process guidance.

If you have any questions regarding this submission, please do not hesitate to contact either Anna Cameron (Group Financial Controller) at acameron@woolworths.com.au or myself at dmarr@woolworths.com.au.

Yours faithfully

David Marr
Chief Financial Officer