12 September 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

Re: ED/2013/6 'Leases'

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.1 billion and total assets of US$601 billion.

We acknowledge the significant progress the International Accounting Standards Board (IASB) has made in relation to the development of a standard that will address the IASB's overriding objective to require lessees to recognise assets and liabilities arising under operating leases. In meeting this objective, we regard the current ED as a significant improvement on the previous ED, in particular the removal of the performance obligation approach.

However, on balance, considering the costs and benefits of the changes proposed, ANZ <u>does not support</u> a change to the current lease accounting requirements. The basis for this view is:

- We believe the introduction of a rules based approach to lease accounting, whereby a lease is classified and measured depending on whether it is property or not, does not reflect the substance of a leasing arrangement. We believe the existing model, which is well understood by preparers and users, more accurately reflects the economics of a leasing transaction as it takes into account the risks and rewards of ownership. Further, users of financial statements understand the existing model and concerns about the current off balance sheet treatment of leases can be mitigated by ensuring lease disclosures allow users of financial statements to identify a company's future cash flow commitments relating to leases and, significant assumptions and judgements made in determining lease commitments are sufficiently disclosed.

- We note that given the number of leases we are involved in, both as lessee and lessor, and the complexity of some of our structured lending leases, the cost of implementing the proposals will be significant and the value derived by the users of financial statements will be minimal.

- While the current leasing requirements do present entities with structuring opportunities, we note that the lack of guidance within the proposals, such as the definition of an identified asset; the distinction between a lease and a service contract; and, the proposals for determining the lease payments to be included in the lease asset, may lead to divergence, either due to inconsistent interpretation or

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deliberate structuring around the complex rules, and thus there will be different applications of the proposals which could undermine the objectives of the ED.

If the IASB continues with its current proposals, we note the following areas of concern:

- The continuous reassessment requirements proposed in the ED will be difficult to achieve in practice for any entity with more than an insignificant number of leases, given the significant time commitment and management overlay required.

- As a regulated entity, we are concerned by the capital implications of the proposals, which could be a significant cost to our business. It is unclear whether the right-of-use asset will be treated as a tangible or intangible asset, which may have consequential implications for regulatory capital purposes, as prudential standards are based off accounting standards.

  We believe that the right-of-use asset should be treated as a tangible asset on the basis that conceptually a tangible asset reflects the economics of a leasing transaction more than an intangible asset. While the IASB is not responsible for regulatory requirements or setting prudential standards, it should be noted that the classification of the right-of-use asset as an intangible asset would affect the calculation of risk-weighted assets, as intangible assets result in a 100% regulatory capital deduction. The impact of this globally would be significant, in particular, in Australia where this regulatory deduction would be on a pre-tax basis. Therefore, we recommend that the IASB clarify the classification of the right-of-use asset.

- The disclosure requirements under the ED are excessive in comparison to the existing leasing disclosures and we would question whether users of financial statements require all of the disclosures proposed.

- The proposals introduce a significant level of complexity that does not exist in the current requirements, due to the calculations required to measure the lease asset and liability. Technology systems will need to be upgraded to accommodate the calculations and disclosure requirements and a significant amount of time will be required to gather all the required information and to review all lease agreements using the new principles and terms referred to in the proposed ED. We would propose the IASB look for opportunities to simplify the measurement of lease assets and liabilities.

Overall, we believe that the proposals are not an improvement to the existing lease accounting requirements. We therefore do not support a change from the existing requirements and we would encourage the IASB to reconsider the costs and benefits of the lease proposals.

Detailed comments on the questions raised in the ED are attached as an Appendix to this letter. Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely

Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

APPENDIX

Question 1
This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We believe that the definition of a lease should refer to whether risks and rewards of ownership have been transferred, as opposed to having the ability to direct the use and receive the benefits from use of the identified asset. The current concept of risks and rewards reflects the economics of a leasing transaction, as it considers the lease arrangement in light of the total economic life of the asset. However, the current proposals only consider whether the ability to direct the use and receive the benefits from use of an identified asset occurs over the term of the lease contract. We believe further consideration should be given to considering the lease arrangement against the economic life of the asset and not just the lease term.

We believe the distinction between a lease and a service contract in the ED proposals is unclear. We acknowledge that examples have been provided to determine if an arrangement contains a lease or a service contract, however, we believe additional guidance is required to prevent diverging treatment for similar transactions.

In addition, we believe that the introduction of the concept of 'the use of an identified asset' may lead to divergent treatment, as entities may structure contracts to refer to a type of asset rather than a specific asset.

Question 2
Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the introduction of a rules based approach where income and expenses are measured based on whether the leased asset is property or not. The current proposals will have a financial impact that does not reflect the economics of certain leases currently classified as operating leases. Under the ED, the expense for Type A leases is front-loaded, as a result of the application of the effective interest rate method. However, under the current requirements, the operating lease expense is recognised evenly over the period of the lease, in many cases reflecting the economics of the arrangement and matching the delivery of benefits under the lease. For a lease that is akin to a financing arrangement, that is, where risks and rewards of the underlying asset have been transferred, the proposed treatment is more logical.

We agree that for Type B leases straight line expense recognition is desirable, however we have concerns around the complexity created by this, specifically the calculation of the amortisation of the right-of-use asset. Given the existing model also has straight line expense

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recognition for the majority of property leases (as generally they would be classified as operating leases), we would question whether the benefit of changing models exceeds the cost. As a preparer, significant cost will be incurred to ensure technology systems are upgraded to accommodate these changes. We would support a change in disclosures to allow users of financial statements to make informed decisions regarding a company's lease commitments by reference to note disclosures within a company's annual report (see question 8).

Finally, it is unclear whether the right-of-use asset will be treated as a tangible or intangible asset, which may have consequential implications for regulatory purposes, as prudential standards are based off accounting standards.

We believe that the right-of-use asset should be treated as a tangible asset on the basis that conceptually a tangible asset reflects the economics of a leasing transaction more than an intangible asset. While the IASB is not responsible for regulatory requirements or setting prudential standards, it should be noted that the classification of the right-of-use asset as an intangible asset would affect the calculation of risk-weighted assets, as intangible assets are result in a 100% regulatory capital deduction. The impact of this globally will be significant. Therefore, we recommend that the IASB clarify the classification of the right-of-use asset.

Question 3
Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the different accounting approach for Type A and Type B leases, where a lease receivable is recognised for a Type A lease compared with Type B leases, where the underlying asset continues to be recognised. This is also inconsistent with the proposed lessee accounting, where a right-of-use asset is recognised for both Type A and Type B leases. We believe that the principles should be applied consistently across lease type and between lessee and lessor.

We believe the accounting for a residual asset is complex and do not believe that interest should be recognised on a non-financial asset. We do not support the recognition of a gain at inception of the lease, where this gain is effectively the profit arising from the lease contract; we believe this profit should be earned as the lease service is provided.

In structuring a lease contract, the lessor will consider the expected value of the lease contract and the expected residual value. The lessor is likely to add a profit margin to the expected lease payments and be conservative in the estimation of the residual value – in other words in pricing the lease contract the lease payments will be close to a fair value whereas the residual value is more likely to be conservative and less than the fair value.

We would prefer an approach that determines the residual asset as the difference between the carrying amount of the underlying asset at inception and the present value of lease payments.

Question 4
Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the principle that lease classification should be based on the nature of the underlying asset. We believe the introduction of a rules based approach to lease

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accounting, whereby a lease is classified and measured based on whether it is property or not, does not reflect the substance of a leasing arrangement. We believe the existing model, which is well understood by preparers and users, more accurately reflects the economics of a leasing transaction as it takes into account the risks and rewards of ownership. Concerns about the current off balance sheet treatment of leases can be mitigated by ensuring lease disclosures allow users of financial statements to identify a company's future cash flow commitment relating to leases and significant assumptions and judgements made in determining the lease commitment are sufficiently disclosed.

We also do not agree that for Type A leases, the total economic life of the underlying asset is used to classifying a lease, compared with the remaining economic life of the underlying asset for Type B leases. We believe a consistent approach should be adopted and that the current principle of the lease term being a major part of the total economic life of the underlying asset should be retained.

The proposals introduce new concepts in classifying a lease, in particular 'insignificant', 'major part' and 'substantially all'. We believe additional guidance should be provided to ensure the concepts are consistently applied.

We support the exemption from applying the ED to short-term leases for both lessees and lessors as this will provide significant relief for entities that are involved in a large number of low-value lease arrangements.

Question 5
Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We do not agree with the proposals relating to the lease term. We believe that there is insufficient guidance as to what a 'significant economic incentive' to exercise an option is and this may therefore lead to inconsistent application of the standard.

We do not believe that measuring the lease liability by reference to having a significant economic incentive to exercise an option meets the definition of a liability, as the entity does not have a present obligation. Further, the requirement for a lessor to reassess the lease term or lease payments based on whether a lessee has a significant economic incentive to exercise an option seems inappropriate, as in practice, it will be difficult to predict the lessee's actions and, therefore, as lessor we would be unable to measure the asset accurately.

We believe the requirement to reassess the lease term will be onerous for ANZ given the judgement required to determine if there is a significant economic incentive to exercise an option, coupled with the number of leasing arrangements that ANZ has, both as lessee and lessor.

Question 6
Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree that usage and performance-based variable lease payments should be excluded from the measurement of the lease liability. However, we believe there will be divergence or inconsistency in measuring the lease asset or liability for a portfolio that includes market rent reviews, which are common in Australia, and CPI variable lease payments. Applying the reassessment requirements outlined in the ED would lead to significantly different assets and

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liabilities given we would be required to measure the lease liability using CPI at lease commencement date, for term of the lease, compared with measuring the lease liability up to the date of the first market rent review.

Variable lease payments that are in-substance fixed payments are included in the measurement of the lease asset and liability. While the Illustrative Examples give an example of variable lease payments that are in substance fixed payments, there is no definition or guidance as to what an in-substance fixed payment is. We believe a definition and guidance is required for in-substance fixed payments.

Question 7
Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

We agree with the proposal of using either a modified retrospective approach or a full retrospective approach on transition. We also agree with the proposal to carry forward amounts recognised as finance leases on transition date.

We recommend sufficient lead time is allowed for application of the standard, as a new system will be required to capture the information required by the proposed ED. In addition, a significant amount of time will be required to gather all the required information and to review all lease agreements using the new principles and terms referred to in the proposed ED.

Question 8
Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We believe that the disclosures proposed are excessive and we would question whether users of financial statements require all the disclosures proposed, particularly reconciliations of amounts recognised in the statement of financial position. We recommend that disclosures are limited to only what users would want to see. We would therefore support disclosures surrounding the significant assumptions and judgements made in determining the lease commitment, such as determination of the lease term and discount rate used and future cash flow commitment. We would expect these disclosures to be aggregated at a portfolio level, for example by asset type, to ensure users can make informed decisions, without being presented with excessive information.

Users of financial statements are concerned with the future cash flow commitments under lease arrangements and any estimates a company makes in deriving the lease asset and liability balances and therefore disclosures should be limited to these areas.

We believe the IASB should reconsider the level of disclosures, particularly as significant time and cost will be required to adopt the recognition and measurement requirements and including all the disclosures proposed would add to this.

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Questions 9, 10 and 11 (FASB only)
Non-public entities and related party leases.

We have no comment on Questions 9, 10 and 11.

Question 12
Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of an investment property? If not, what alternative would you propose and why?

For sub-leases we do not believe that the right-of-use asset should be within the scope of IAS 40. If fair value measurement were applied to the right-of-use asset, then at the end of the lease term the lessee would have an asset recognised on balance sheet that they would not be able to realise (unless ownership was transferred at the end of the lease term). The right-of-use asset for sub-leases should be measured consistently with other leases to ensure that at the end of the lease term the right-of-use asset is nil. In addition, the lessee's lease liability of the property lease would be measured in accordance with the proposals and therefore there would be an accounting mismatch if the right-of-use asset is fair valued.

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