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Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board (AASB)

Dear Sir

Re: ED/2013/6 Leases

We are pleased to have the opportunity to comment on Exposure Draft 2013/6 *Leases* (the ED). Our comments on the specific questions raised by the IASB are addressed in the Appendix.

National Australia Bank Limited (NAB) is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our September 2012 full year results we reported net profit after tax of A$4.1 billion and total assets of A$763 billion.

In our response to the 2010 ED, NAB did not agree with the right-of-use model and we maintain this view. We do not believe that a lessee has a present obligation to make payments to a lessor at commencement of a lease. The right-of-use approach is inconsistent with other types of contracts, such as supply agreements, under which a right (such as to receive purchased goods) and a liability to make payments for the supply of goods, are not recognised on balance sheet at commencement of the contract.

Notwithstanding our negative views on the right-of-use model, we have provided responses to the specific questions raised by the IASB on the basis that the proposals in the ED will be retained.

We have the following general comments on the ED:

The right-of use model reflects that at commencement date, a lessee obtains the right to use the underlying asset during the lease term and a lessor has provided that right. Under this model, all lease contracts create this right of use, irrespective of the extent of consumption of the economic benefits in the underlying asset, and the right-of-use model should result in a single model. The proposed dual measurement for different leases provides a variation to the right-of-use model, and is the result of a pragmatic approach to achieve a straight-line expense outcome for Type B leases. The proposals are therefore rules-based and result in accounting outcomes for Type B leases that are conceptually impossible to justify.

Consequently, we have the following concerns with the proposals in the revised ED which we address in detail in the Appendix:

a) *Accounting for Type B Leases for lessees and lessors*

- The revised proposals for Type B leases create asymmetrical accounting between lessees and lessors. While a lessee is required to recognise a lease payable reflecting a present obligation to pay lease payments to the lessor, this does not result in a corresponding right to receive the lease payments by the lessor. It is difficult to justify how the present obligation criterion is met by the lessee to pay cashflows, but the right to receive the same cashflows is not recognised by the counterparty.

- The measurement of the right-out-use asset recognised by the lessee is effectively a balancing figure which is determined by the impact of a financing cost combined with an amortisation element to achieve a straight-line expense impact in the P&L. Not only is this measurement inconsistent with the cost model approach for an intangible asset, it will create operational complexities.

- The residual asset recognised in the lessor's books is subsequently measured at its initial carrying value plus the unwinding of the discount, and this accretion in value is recognised as interest income in the P&L. It is unclear to us how to explain the carrying value of this non-financial asset.

In finalising a new leasing standard, we believe the Boards should follow a principles based approach, and provide further clarification on these concepts to enable preparers and users of financial statements to understand these accounting outcomes. We have our doubts that a conceptual justification of the proposed approach is possible and are concerned that the proposal would impose significant cost and effort on preparers to achieve an accounting outcome that is not understandable for users.

b) *Disclosure requirements*

We consider the proposed disclosure requirements extensive and not consistent with the objective of providing useful and relevant information and reducing the burden on preparers of financial statements. We believe these should be revised to remove those disclosures that are onerous, or where useful information is already provided under the IFRS 7 requirements or may be duplicated within IFRS projects that are still under development. Our specific concerns are outlined in Question 8.

c) *Transition and ongoing operations*

We have significant concerns with the cost and effort associated with transitioning to the new requirements and the ongoing operational issues which include:

- Significant system changes and data collation for operating leases at transition will require enormous effort and lead time as much of the information is currently not required.
- Additional effort and changes to system capabilities will be required to obtain ongoing data collation for disclosures.
- The straight-line expense approach by a lessee for Type B leases results in an amortisation expense that will need to be computed outside the amortisation process that our systems currently perform. This would need to be addressed by potentially adding a manual element to the process which would weaken the control

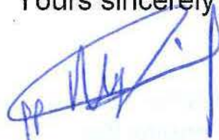
environment, making significant changes to existing systems or developing new system capabilities.
- The interpretation of the lease accounting proposals by regulatory and tax authorities may potentially have significant commercial implications specifically on regulatory capital and tax treatment of leasing transactions.
- Entities in the banking sector will also have to consider and manage the impact of the leasing requirements on their customers, including the potential impact on loans covenants.

In summary, we fail to see how this proposal, which replaces the well understood IAS 17 model with accounting outcomes that cannot be explained from a conceptual perspective to management, users and preparers of financial statements, justifies the significant cost and effort that would be required to implement the ED in its current form.

The Appendix to this letter outlines our responses to the specific questions in the ED which should be read in the context of the general comments raised above.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at Marc.Smit@nab.com.au.

Yours sincerely



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APPENDIX – Response to Specific Questions

Identifying a lease

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.

The ED definition is largely consistent with the definition in IFRIC 4 *Determining whether an Arrangement contains a Lease* and provides additional clarifications and examples.

We agree with the definition and provide the following suggestions for improvement:

- The ED distinguishes leases from service contracts in paragraph 22 of the Basis for Conclusions, which explains that while "...fulfilment of a service contract may require the use of assets, fulfilment typically does not require the delivery of an identified asset." This is demonstrated in the illustrative example IE2. We recommend that the term "service" be specifically defined so that the identification of services is clearly understood without the need to refer to the illustrative example. It could be beneficial to have additional practical illustrative examples such an outsourcing arrangement for IT equipment which includes a service element.

- The term "control" could be tightened by being specifically defined, similar to how control is defined and clarified in other IFRS proposals such *IFRS 10 Consolidated Financial Statements* which discusses substantive and protective rights and *Revenue Recognition* which clarifies the principal and agent relationships in a contract.

Lessee Accounting

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?

Lessor Accounting

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?

Lessee accounting cannot be considered in isolation of lessor accounting and we have therefore combined our response to Q2 and Q3.

In our response to the 2010 ED, NAB did not agree with the right-of-use approach and we continue to maintain this view. We do not believe that at commencement of a lease the lessee has a present obligation to pay the lessor for use of the underlying asset. We consider the right-of-use approach inconsistent with other types of contracts, such as supply agreements, under which a right (such as to receive purchased goods) and a liability to make payments are not recognised on balance sheet at commencement of the contract.

We agree that there should be different approaches for different leases, and this is the current approach within IAS 17 which distinguishes between operating and finance leases. However, we believe that this should use the approach currently used in IAS 17 which is based on whether substantially all the risks and rewards incidental to ownership is transferred to the lessee. We believe that in many cases leases are structured based on the risks and benefits the lessee and lessor are willing to have exposure to, rather than to achieve an accounting outcome. A lessee who does not want to invest capital and purchase an asset outright is looking for a "rental" type arrangement where the lessee will not gain exposure to many of the risks and benefits associated with ownership of the underlying asset.

The revised proposal now introduces a dual measurement approach but creates accounting outcomes that are not well explained at a conceptual level. This is the result of a pragmatic compromise, between the objective of bringing more leases on-balance sheet and practical implementation, aimed at achieving a straight-line expense for a small portion of leases.

Lessee Accounting
We have the following concerns on lessee accounting under a Type B lease:

(i) Accounting outcomes are asymmetrical between a lessee and lessor. While the lessee is required to recognise a lease payable reflecting a present obligation to pay lease payments to the lessor, the lessor does not recognize the corresponding right to receive these lease payments as a lease receivable. It is difficult to justify how the present obligation criterion is met by the lessee to pay cashflows due under the lease contract, when the lessor is unable to recognize the right to receive the same cashflows.

(ii) The lessee initially recognizes the right-of-use asset as the present value of lease payments discounted at the rate charged by the lessor (paragraph 38(a)). Following initial recognition, the proposed measurement requirements for this right-of-use asset is effectively a balancing figure determined by a combination of the impact of a financing cost (the discount unwind on the lease liability) and an amortisation expense element, to achieve a straight-line expense impact in the P&L. This measurement is inconsistent with the cost model approach for an intangible asset.

Lessor accounting
We also find the lessor accounting outcomes for Type B leases under this proposal lack conceptual justification. Our concerns over the lessor accounting for Type B leases include the following:

(i) In our response to Q2, we have already outlined our concerns with the asymmetrical accounting outcomes between a lessee and a lessor.

(ii) Partial duplication in the recognition of the economic benefits in the underlying asset for Type B leases, whereby the lessor continues to recognise the underlying asset (no derecognition) and the lessee recognises a portion of the economic benefits in the same underlying asset via a right-of-use asset. An alternative approach would be to require partial derecognition of the underlying asset by the lessor. However, we do not recommend this as we believe this approach will increase the complexity for lessor accounting and will not enhance the usefulness of financial information reported.

(iii) Measurement of the gross residual asset by the lessor accretes in value over time for the effect of the unwinding of the discount and is recognised as interest income (ED paragraph 77(b)). It is unclear how we would explain the carrying value for the residual asset when its outcome conflicts with the measurement criteria for a non-financial asset.

(iv) In addition, we believe the ED does not sufficiently address back-to-back leases (subleases). Where a lessee (head lessee) of a Type B lease subleases the same underlying asset, the sublease will also be classified a Type B and the right-of-use asset will remain on the head lessee's books. In contrast, if the originating lease and sublease were both classified as Type A leases, the head lessee would be able to derecognize the asset and not have to present the right-of-use asset in its books and instead record a receivable (from sub-lessee) and corresponding payable (to lessor). We believe the latter would be a more faithful representation of a back-to-back lease. We recommend an exception be included for back-to-back leases where the original lease is a Type B. This will result in consistent treatment and more faithful presentation of the accounting for back-to-back leases.

In our view, the proposals in this ED have focussed on addressing the concerns over the complexities in the earlier 2010 ED, resulting in accounting outcomes that are not conceptually justifiable, making it difficult to explain or rationalise to management, preparers and users of financial statements. We believe the proposals should be principles based rather than the proposed rules-based approach.

Classification

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?

While we in principle support a dual approach to lease accounting, we believe the proposals in this ED are not principle-based and therefore are difficult to justify. The Basis for Conclusions (paragraph 42) explains that the Boards concluded a single lease expense provides better information about a lease where the lessee is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset - the 'consumption principle'.

Paragraph 11 of the Basis for Conclusions states that, under the 'right-of-use' model, a lessee obtains the right to use the underlying asset for a period of time, and the lessor provides that right. A true right-of-use model, if driven by the creation of this right, would result in a single accounting approach irrespective of the extent of consumption of the economic benefits embedded in the underlying asset. Therefore we believe that using the consumption principle to develop a dual approach for leases, conflicts with the general principle of the right-of-use model.

In addition, when applying the consumption principle under the proposed ED, the classification of a lease is also dependent on the nature of the underlying asset based on whether it is property or not. We understand the Boards decided to include the nature of the underlying asset as a means to simplify the requirements to reduce complexity and the cost of implementing the proposals (paragraph 50 of the Basis for Conclusions).

The proposed classification requirements that would enable a classification change from a Type A to Type B are based on higher thresholds than that used in the existing IAS 17 for distinguishing operating and finance leases. To change the classification from Type A to Type B, the lease term needs to be for a *more than insignificant* portion of the economic life. In contrast, to change the classification from Type B to Type A, the lease term is only required to be for a *major part* of the economic life. Having disparate thresholds can result in two assets, with the same lease term and same economic life, having different lease accounting outcomes depending on whether it is property or not, as illustrated below.

	Non-property	Property
Underlying Asset	Ship	Building
Lease term	5 years	5 years
Economic life	25 years	25 years
Lease type	Type A	Type B

While the Boards have acknowledged (paragraph 51 of the Basis for Conclusion) that applying the principle in the manner proposed would not always result in conclusions that are consistent with the principle, we do not agree that this sufficiently justifies the accounting outcomes for which we have raised concerns in our earlier responses in Q2 and Q3.

We would support classification requirements that are based on the principle of the expected level of consumption but do not agree with this being based on the nature of the underlying asset, specifically the reference to property.

Lease term

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 support the proposals on lease term and believe this is an improvement to the proposals under the 2010 ED.

In paragraph 140 of the Basis for Conclusions the Boards note that applying the concept of significant economic incentive would provide a threshold similar to well understood existing concepts such as "reasonably certain". Given the term "reasonably certain" is well understood and is already used in existing IFRS, we recommend that it should be captured in the guidance notes in B5–B6 or incorporated in the final standard.

The concept of including lease extension options in measuring the lease liability is contradicted in the requirements for the short term lease exemption. While we support the inclusion of an exemption for short term leases (where the total fixed lease term including any option to extend is less than 12 months), in circumstances where there is an option to extend, even if there is no significant economic incentive in exercising the option, the lease would not qualify for the exemption. We acknowledge that this threshold aims to remove the incentive for abuse; however the concept is counter intuitive and in practice would not provide much relief. We recommend amending the exemption requirement to increase the total term to include the option to extend to three years.

Variable lease payments

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 with the proposals on the measurement of variable lease payments that depend on an index or rate (such as the Consumer Price Index or market interest rate) and the reassessment criteria for subsequent measurement.

We recommend that in-substance fixed payments be defined within the ED to reduce the reliance on illustrative examples which demonstrate the application of this term. We also consider certain minimum payments described in the illustrative example (IE17) to be committed amounts and therefore fixed payments. For example, IE17A refers to variable payments based on a percentage of sales (variable amount) with a minimum amount payable irrespective of sales (the fixed amount). This can be addressed by defining or clarifying in-substance fixed payments within the base IFRS and amending the illustrative examples as appropriate.

Transition

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 option to apply a full retrospective as well as a modified retrospective approach upon transition. The selection of which transition approach to apply depends on the extent of effort and cost to apply a full retrospective approach compared to the impact on retained earnings under the "short-cut" calculations.

We welcome any practical reliefs that will reduce implementation costs. We recommend that the Boards permit relief from applying the transition requirements to previous operating leases that expire within the financial reporting period of adopting the new standard. We believe the cost and effort in applying transition requirements to these leases will far outweigh any benefits in the information provided to users of financial reports.

When determining the final standard implementation date, consideration should be given to the commercial ramifications and potential flow on effects of changing the accounting for leases for financial institutions such as regulatory capital requirements and tax legislation. Financial institutions may be required to hold additional regulatory capital if right-of use-assets are not viewed by regulators in conjunction with the associated lease liabilities. In Australia, current tax legislation distinguishes between operating and finance leases and further clarification and potential legislation amendments will be required to address the concept of Type A and Type B leases. Furthermore, banks will also need to consider the impact of the leasing requirements on customers, such as updating calculations for banking covenants. Preparers will require sufficient lead time to address these additional areas.

Disclosure

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 recognize that the new proposals will lead to additional effort and system requirements and would welcome any practical guidance particularly with an extensive list of requirements.

We support the inclusion of paragraph 59 and 99 which require the lessee or lessor to "...consider the level of detail necessary to satisfy the disclosure objective and how much detail to place on each of the various requirements" but believe these should be given equal prominence as the disclosure objectives (in paragraphs 58 and 98). This could be addressed by including a clear statement that each requirement will not necessarily be disclosed in all situations.

We believe there should be more emphasis within the final standard on those requirements that satisfy the disclosure objectives rather than an extensive list of information that may be of interest for all possible users. Information is already currently required to be disclosed under IFRS 7, and therefore additional disclosures under the proposals should cover key information, such as the maturity profile of lease payments which is currently considered useful information under IAS 17.

We question the usefulness of the reconciliation requirement in paragraph 64 (for the lease liability separately for Type A and Type B leases) and paragraph 103 (for the lease receivable). These requirements are extensive and consideration should be given to the overall increasing disclosure requirements within other draft IFRSs. We also recommend further explanation on why there should be separate reconciliations for Type A and Type B leases as this is not adequately addressed within the Basis for Conclusions.

We also recommend clarification within the draft IFRS together with the inclusion of illustrative examples on how the different types of leases will be presented and disclosed in the financial statements. Our preference is to avoid references to *Type A* and *Type B* when presenting information on lease transactions in our financial statements.

The proposed requirements will result in additional effort in monitoring and preparing information and significant changes to existing systems to enable the collation of the required disclosures. Management currently do no use the information required in the proposed disclosures, and therefore we question the relevance or usefulness of providing all information included in the ED. While the ED allows an entity to consider the extent of detail necessarily to satisfy the disclosure objectives, we believe further emphasis should be given to provide clarity that not all requirements in the draft IFRS will be required in all situations. We encourage the IASB to take into account our responses to this ED and consider the increasing disclosure requirements of other ongoing IFRS projects proposals

Question 12 (IASB-only): Consequential amendments to IAS 40

Question 12
The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property. 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 investment property? If not, what alternative would you propose and why?

We agree to the proposed amendments to IAS 40 *Investment Property* to include a right-of-use asset within its scope if the leased property meets the definition of investment property as this aims to align IAS 40 with the proposed requirements of the ED.