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International Accounting Standards Board
1st Floor, 30 Cannon Street
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11 September 2013

Dear Sirs/Mesdames

Request for Comment on IASB Exposure Draft ED/2013/6 *Leases*

Thank you for the opportunity to comment on the IASB Exposure Draft ED/2013/6 Leases ("revised ED").

Woolworths Limited ("Woolworths") is one of the largest retailers in Australia and New Zealand, with 3,113 retail locations and a further 765 wholesale supplied stores in Australia and New Zealand as at 30 June 2013. The Woolworths business includes:

- Australian Food and Liquor – Woolworths' Australian supermarkets, retail liquor outlets and Australian food and liquor wholesale and online business
- New Zealand Supermarkets – New Zealand Supermarkets (trading as Countdown), supermarkets wholesale and online business
- Petrol – Australian petroleum products retail outlets (including outlets which are co-branded Woolworths/Caltex)
- BIG W – 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 business
- Property – comprising property leasing, management and development.

Woolworths has approximately 6,000 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.

We commend the International Accounting Standards Board ("the Board") for the extensive outreach that it has conducted in response to concerns expressed by respondents in respect of the previous Exposure Draft and specifically its willingness to find a solution to the profit or loss distortion that the previous proposals created as well as reconsider the treatment of turnover rents and extension options.

In summary, 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 and 1 May 2012) until such time as the IASB has adequately differentiated the boundary between an executory and a financing contract. We are concerned that the cost of implementing these proposals exceeds the benefit to users of the financial statements. We estimate the cost of implementing the proposals will be in excess of A$1.5 million.

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 strongly recommended that proper cost benefit analysis be undertaken to justify the significant burden that will be placed on companies globally.

To the extent that the Board continues to believe that all leases should be recognised on balance sheet:

- We agree that a single model is not appropriate for all leases. In particular, real estate leases are significantly different to leases of other assets
- We agree that the straight-line income statement profile under the dual model more appropriately reflects the substance of our real estate leases.

Further commentary is set out below.

The existing IAS 17 model should be retained. To the extent the Board continue to pursue Balance Sheet lease recognition, until there is adequate differentiation between an executory and a financing contract as part of the Conceptual Framework Project, IAS 17 should be retained.

We recommend that the Board do not make any recognition or measurement changes to IAS 17 until such time as it has adequately differentiated the boundary between an executory and a financing contract as part of the Conceptual Framework Project. This is because:

- We believe that the adoption of the dual model in the revised ED calls into question whether all leases are in fact financing and whether it is appropriate to recognise a right-of-use asset and lease liability for all leases
- We do not believe that real estate leases have been satisfactorily distinguished from executory contracts. 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
- Recognition of real estate leases on balance sheet is inconsistent with the accounting treatment proposed for the lessor
- Users are expected to continue to make adjustments to suit their needs, therefore no significant benefit is provided as a result of recognising the leases on balance sheet
- The cost to implement the revised changes is expected to be in excess of A$1.5 million as a result of the volume of leases, the inception dates and IT system changes. In addition to this, we will have higher recurring costs as a result of the ongoing reassessment of CPI linked rents and renewal options, increased stakeholder education and audit fees.

We acknowledge that until such time as the Conceptual Framework Project is completed, it may be necessary to consider whether additional disclosures (including those in the revised ED) are necessary to satisfy the needs of users. We recommend that the Board hold specific public roundtables with:

- Users – to understand their requirements and the benefits of such disclosures
- Preparers – to understand the complexity and cost of the disclosures proposed by the users.

The results of these roundtables should be exposed for comment prior to finalisation of any amendments to IAS 17.

A single model is not appropriate for all leases

To the extent that IAS 17 is not retained, we agree with the Board that a dual model is necessary because not all leases have the same economic substance. In our opinion, 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 model reflects the economic substance of real estate leases

We agree that the straight-line expense for real estate leases most closely reflects the economics of a Type B real estate lease because 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, 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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Our response to matters on which specific comment is requested is included in the attached Appendix.

If you have any questions regarding this submission, please do not hesitate to contact either Martyn Roberts (General Manager – Corporate Strategy and Business Development and Acting Group Financial Controller and Investor Relations Manager) at MRoberts@woolworths.com.au or myself at TPockett@woolworths.com.au.

Yours faithfully

Tom Pockett
Finance Director

APPENDIX: RESPONSES TO QUESTIONS

The responses to the questions below are provided on the assumption that the final Standard adopts the right-of-use approach as set out in the revised ED.

Question 1: Identifying a lease

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 the revised definition is an improvement on the guidance that is currently included in IFRIC 4 *Determining whether an Arrangement contains a Lease*. We anticipate that there may be some practical difficulties from the perspective of the purchaser in understanding whether there are economic or other barriers that would prevent the supplier from substituting alternative assets, especially where the arrangement does not prohibit substitution. We recommend the final Standard clarify that the purchaser would only need to consider information that it would reasonably be aware of, for example through supplier negotiations or publicly available information.

Question 2: Lessee accounting

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?

Subject to our concerns expressed in the covering letter, and specifically that we continue to believe that IAS 17 should be retained until such time as the Conceptual Framework Project distinguish between executory and financing arrangements, we agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ based on the underlying economics of the leases. The consumption principle is a reasonable methodology for distinguishing between different leases.

Question 3: Lessor accounting

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 support retention of the current IAS 17 principles. IAS 17 is well understood by users and preparers and we are not aware of any concerns being raised in respect of the current accounting applied by lessors.

Question 4: Classification of leases

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?

Yes, for the reasons set out in our covering letter, we agree that real estate leases are significantly different from leases of other assets and that the classification should differ based on whether the underlying asset is property or another asset.

We also agree that, for the purposes of classification, land and buildings should be assessed together. However, we do not believe that it is appropriate to make the assumption that the economic life of the building is always the economic life of the property being leased. Where the building element is clearly immaterial in relation to the land, recognition as a Type A lease would be misleading.

In addition, for the purposes of classification, the lease term should be compared to the *total* economic life, rather than the *remaining* economic life of the building. We are concerned that this creates inconsistent treatment between, for example, the first ten years of a real estate lease and the last ten years of the same real estate lease. We recommend that the Board amend paragraph 30 to refer to the *total* economic life.

Question 5: Lease term

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 continue to believe that the existing definition of 'reasonably certain of exercise' should be retained as we believe it is well understood. In addition, the Board views the concept of 'significant economic incentive' as being a similar threshold; therefore we are unclear as to the benefit of the change.

To the extent the final Standard includes the concept of 'significant economic incentive' we agree with the basis for conclusions that an expectation of exercise alone without any economic incentive to do so would not meet the threshold. We also agree with considering contract, asset and market-based factors as these are not subject to significant judgment. However the interpretation of 'significant' and 'economic incentive' in the context of entity-based factors is unclear. For example, in retail it is not uncommon to renew a lease, however this decision is made based on the facts and circumstances *in existence at the time of renewal* and may include factors such as profitability of the store, location, rental cost and strategic advantage. In our opinion, these factors do not indicate significant economic incentive at either the beginning of the lease or until such time as the economic decision to renew has been made. In addition, the rental and any incentives are negotiated at the time of renewal, therefore we believe that it would be inconsistent with the economic reality of how leases are negotiated to straight-line the lease incentive across a period beyond the non-cancellable period of the lease.

To the extent that the Board is concerned about structuring of shorter term leases, Woolworths would not restructure leases to shorten the lease term with more renewal options as this may result in an increased cost to our business to compensate the lessor.

We are also concerned about the requirement to continually reassess the inclusion of renewal options. In our view, this is too onerous, as it will require extensive manpower to consider each of the factors over our large portfolio. Practically this is no different to requiring a reassessment at each reporting date, including half-year reporting periods, which the Board has acknowledged is too onerous.

Question 6: Variable lease payments

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 commend the Board for listening to our concerns that the inclusion of contingent rentals, such as turnover rents, would result in significant measurement uncertainty and complexity. We agree with the proposals.

Question 7: Transition

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?

We agree with the transition proposals. Given the complexity and significant time impost of these proposals, we recommend the Board propose an extended implementation period. This will allow IT software providers sufficient time to develop robust systems and ourselves time to:

- Implement the proposals, gather data and develop appropriate internal controls systems to manage judgments
- Educate and gain acceptance of the changes by users of the financial information
- Renegotiate debt covenants
- Review key financial ratios impacting management compensation.

We recommend that the effective date of the proposals is consistent with the final Revenue Standard and that this is not before years beginning on or after 1 January 2018.

Question 8: Disclosure

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 request the Board develop a disclosure framework that will simplify and ensure the relevance of financial statement lease disclosures.

We agree that Woolworths, as preparer of the financial statements, should be able to exercise judgment to determine the level of disclosures necessary to provide useful information to users. The revised ED proposes extensive qualitative disclosures. Woolworths has approximately 6,000 leases, of which approximately 3,000 are store leases and it will be important that we are able to provide information at a level that is useful, but not in such detail that it obscures the material information. In line with this principle, we recommend that entities should be able to determine the appropriate number of time bands for the purpose of the maturity analysis of lease payments.

Consistent with our concerns about real estate leases, and their nature, we question the usefulness, which in our view is negligible, of providing reconciliations for the right-of-use asset and lease liability for Type B leases.

Other comments

Short-term leases

To the extent that the Board decide that all leases should be recognised on balance sheet, in our view the short-term exemption should be extended to leases with a maximum possible term of 3 years. Related extension options should only be included in that threshold if it is reasonably certain that those options will be exercised.

Impairment

We request that the Board provide guidance in respect of the application of IAS 36 *Impairment of Assets* for Type B leases. Under the principles in the revised ED a right-of-use asset is included within the carrying amount of the cash generating unit. However, the cash flows remain unchanged and therefore it would be misleading to recognise an impairment, merely because of the change in accounting model.