Critical Accounting Policies

The Group prepares its consolidated financial statements in accordance with Australian Accounting Standards and other authoritative accounting pronouncements. However, notwithstanding the existence of relevant accounting standards, there are a number of critical accounting treatments, which include complex or subjective decisions or assessments. The Group requires all such applications of judgement to be reviewed and agreed by Group Finance, and where the impact is material, the accounting treatment be reviewed during the audit process by the Group's external auditors.
All material changes to accounting policy are approved by the Audit Committee of the Board.

Historical changes

No change has been made to any of the critical accounting policies or their related methodologies over the last 3 years.
A brief discussion of critical accounting policies, and their impact on the Group, follows:

a) Economic Loss Provisioning

Description and Significance

Each month the Group recognises an expense for credit losses based on the expected long term loss ratio for each part of the loan portfolio. The monthly charge is booked to the General Provision which is maintained to cover losses inherent within the Group's existing loan portfolio. The method used by the Group for determining this monthly expense charge is referred to as 'economic loss provisioning' (ELP). The Group uses ELP models to calculate the expected loss by considering:

- the history of credit loss for each type and risk grade of lending; and
- the size, composition and risk profile of the current loan portfolio.

Ongoing reviews

The Group regularly reviews the assumptions used in the ELP models. These reviews are conducted in recognition of the subjective nature of the ELP methodology. Methodologies are updated as improved analysis becomes available. In addition, the robustness of outcomes is reviewed considering the Group's actual loss experience, and losses sustained by other banks operating in similar markets.

To the extent that credit losses are not consistent with previous loss patterns used to develop the assumptions within the ELP methodology, the existing General Provision may be determined to be either in excess of or insufficient to cover credit losses not yet specifically identified.

As a result of the reassessments, ELP charge levels may be periodically increased or decreased with a direct impact on profitability.

As part of its review of the ELP model outputs, the Group also regularly evaluates the overall level of the General Provision. The Group is required, by APRA prudential standards, to have policies which cover the level of General Provisions that are needed to absorb estimated losses inherent in the credit portfolio. In some limited circumstances, the assessment of the inherent losses in the portfolio may require an additional charge to profits to ensure the adequacy of the General Provision. The Group considers it appropriate to maintain its General Provision in excess of the APRA guidelines.

Quantification of Sensitivity

The average charge to profit for ELP was 0.39% of average net lending assets or $614 million (Sep 2002: 0.43% or $610 million excluding the special general provision of $250 million. During 2002 an additional provision for bad debts of $250 million was added to the general provision to restore its balance to an appropriate level). During the same period, specifically identified credit losses net of recoveries during the year were $527 million (Sep 2002: $728 million).

As at September 2003, the balance of the General Provision of $1,534 million (Sep 2002: $1,496 million) represents 1.01% (Sep 2002: 1.06%) of risk weighted assets.

b) Specific Provisioning

Description and Significance

The Group maintains a specific provision for doubtful debts arising from its exposure to organisations and credit counterparties.

The Group's ELP provisioning methodology is used to estimate the extent of losses inherent within the loan book. Once a specific doubtful debt loss is identified as being probable, its value is transferred from the General Provision to the Specific Provision. Specific provisioning methodology applies when the full recovery of one of the Group's exposures is identified as being doubtful resulting in the creation of a specific provision equal to the full amount of the expected loss plus any enforcement/recovery expenses.

Recoveries resulting from excess specific provisions arising when actual losses are determined to be less than the amount provided for within the specific provision are transferred back to the General Provision.

Quantification of Sensitivity

The recognition of losses has an impact on the size of the General Provision rather than directly impacting profit. However, to the extent that the General Provision is drawn down beyond a prudent amount it will be restored through a transfer from the current year's earnings. Recoveries of amounts previously specifically provided against are applied to the restoration of the General Provision balance. The amount of net transfer from the General Provision to the Specific Provision, net of recoveries, during the year was $527 million (Sept 2002: $728 million).

c) Deferred acquisition costs, software assets and deferred income

Description and Significance

The Group recognises assets and liabilities that represent:

› Deferred acquisition costs – direct costs from the acquisition of interest earning assets;

› Software assets – direct costs incurred in developing software systems; and

› Deferred income – liabilities representing income received in advance of services performed.

Deferred acquisition costs – Initially, expenses related to the acquisition of interest earning assets are recognised as part of the cost of acquiring the asset and written-off as an adjustment to its yield over its expected life. For assets subject to prepayment, expected life is determined on the basis of the historical behaviour of the asset portfolio, taking into account prepayments. Commissions paid to third party mortgage brokers are an example of expenditure that is deferred and amortised over the expected average life of a mortgage of 4 years.

Software assets – Costs incurred in acquiring and building software and computer systems are capitalised as fixed assets and expensed as depreciation over periods of between 3 and 5 years except for the branch front end applications where 7 years is used. The carrying value of these assets is subject to a 'recoverable amount test' to determine their value to the Group. If it is determined that the value of the asset is less than its 'book' value, the asset is written down to the recoverable amount. Costs incurred in planning or evaluating software proposals, or in maintaining systems after implementation, are not capitalised.

Deferred income – Income received in advance of the Group's performance of services or in advance of having been earned, is initially recorded as a liability. Once the recognition criteria are met, it is then recognised as income.

Quantification of Sensitivity

Deferred acquisition costs – At 30 September, the Group's assets included $336 million (Sep 2002: $289 million) in relation to costs incurred in acquiring interest earning assets. During the year, amortisation of $169 million (Sep 2002: $132 million) was recognised as an adjustment to the yield earned on interest earning assets.

Software assets – At 30 September, the Group's fixed assets included $465 million (Sep 2002: $419 million) in relation to costs incurred in acquiring and developing software. During the year, depreciation expense of $83 million (Sep 2002: $50 million) was recognised and adjustments were made to recognise the right to use software in Tradecentrix. Following prior periods of above average project activity which replaced significant parts of the Group's core infrastructure, the software depreciation expense will increase before stabilising going forward. Consistent with US accounting rules on software capitalisation only costs incurred during configuration, coding and installation stages are capitalised. Administrative, preliminary project and post implementation costs including determining performance requirements, vendor selection and training costs are expensed as incurred.

Deferred income – At 30 September, the Group's liabilities included $272 million (Sep 2002: $170 million) in relation to income received in advance. This income is largely comprised of 2 components: (1) fees received for services not yet completed; and (2) profit made on an interest rate swap that was hedging future payments (years 2004 and forward) on the Group's preference shares. Under Australian Accounting Standards, this profit is deferred and recognised when the hedged transaction occurs, or immediately if the hedged transaction is no longer expected to occur.

The balances of deferred assets at 30 September were:

	Deferred Acquisition Costs		Software Assets		Deferred Income	
	2003 $m	2002 $m	2003 $m	2002 $m	2003 $m	2002 $m
Personal Banking Australia	–	–	242	176	–	–
Corporate	–	–	14	9	7	11
Institutional	7	27	50	14	7	30
Consumer Finance	–	–	47	45	9	–
Mortgages	102	73	33	27	–	–
Asset Finance	227	189	21	29	–	–
Asia Pacific	–	–	2	1	–	2
Other	–	–	56	118	249	127
Total	336	289	465	419	272	170

d) Derivatives and Hedging

Description and Significance

The Group buys and sells derivatives as part of its trading operations and to hedge its interest rate risk, foreign exchange risk and equity risks (in the ING Australia joint venture). The derivative instruments used to hedge the Group's exposures include:

- swaps;
- forward rate agreements;
- futures;
- options; and
- combinations of the above instruments.

Accounting treatment – In accordance with the requirements of Australian Accounting Standards, derivative instruments entered into for the purpose of hedging are accounted for on the same basis as the underlying exposures or risks.

Derivative instruments entered into to hedge exposures that are not recorded at fair value, do not have their fair values recorded in the Group's Statement of Financial Position (in accordance with Australian Accounting Standards).

Exposures hedged by derivatives not recorded at their fair value include risks related to:

- revenues from foreign operations;
- structured lending transactions;
- lending assets; and
- funding liabilities.

Hedge accounting is only applied when the hedging relationship is identified at the time the Group enters into the hedging derivative transaction. If a hedge ceases to be effective, the hedging derivative transaction will be recognised at fair value. Gains and losses on derivative instruments not carried at their fair value amounts are recognised at the same time as the gain or loss on the hedged exposure is booked.

Movements in the value of foreign exchange contracts that are hedging overseas operations are not recognised as income or expenses. Instead these movements are recognised in the Foreign Currency Translation Reserve together with the net difference arising from the translation of the overseas operation.

Fair value determination –Derivatives entered into as part of the Group's trading operations are carried at their fair values with any change in fair value being immediately recognised as part of trading income. Where liquid markets exist, fair value is based on quoted market prices. For certain complex or illiquid derivative instruments, it may be necessary to use projections, estimates and models to determine fair value. In addition, judgemental factors such as the need for credit adjustments, liquidity and other valuation adjustments affect the reported fair value amounts of derivatives.

e) Special purpose and off balance sheet vehicles

The Group may invest in or establish special purpose companies, or vehicles (SPVs), to enable it to undertake specific types of transactions.

Where the Group controls such vehicles, they are consolidated into the Group financial results.

Certain SPVs may be set up by the Group to facilitate Group strategic aims, or to assist with structured transactions for clients. The accounting treatment of each SPV is assessed using existing Australian guidance, with reference also to International and US accounting standards where specific issues are yet to be addressed in Australia. The table below summarises the main types of SPVs that are not consolidated into the Group, the reason for their establishment, and the key risks associated with them.

Type of Special Purpose Vehicle (SPV)	Reason for establishment	Key Risks	SPV Assets 2003 $m	SPV Assets 2002 $m
Securitisation vehicles	Assets are sold to an SPV which funds the purchase by issuing securities. Enables ANZ or customers to increase diversity of funding sources.	ANZ may manage securitisation vehicles, service assets in a vehicle or provide liquidity support or other support and retains the risks associated with the provision of these services. Credit and market risks associated with the underlying assets are not retained or assumed by ANZ. ANZ may also provide other services (eg. swaps, credit guarantees). ANZ earns fees at a commercial rate for providing these services.	9,954[1]	6,992[1]
Structured finance entities	These entities are set up to assist with the structuring of client financing.	ANZ may retain liquidity risk, if it provides liquidity support to the vehicle. ANZ may also manage these vehicles.	2,124	1,968
Managed funds	These funds invest in specified investments on behalf of clients.	The ANZ/ING Australia joint venture, as manager of the funds, exposes ANZ to operational risk and reputational risk.	28,655	26,642

1 The amounts disclosed are the total assets managed or arranged by ANZ. They include SPV's that purchase assets from sellers other than ANZ

f) Valuation of investment in ING Australia Limited (INGA)

Description and significance

The Group adopts the equity method of accounting for its 49% interest in the INGA joint venture. As of 30 September 2003, the Group's carrying value is $1,648 million (2002: $1,593 million).

The carrying value is subject to a recoverable amount test, to ensure that this does not exceed its recoverable amount at the reporting date. This involves, the Group obtaining an indication of whether the carrying value may be less than the recoverable amount. If so, an independent valuation is sourced to determine current recoverable amount.

Any excess of carrying value above recoverable amount is written off to the Statement of Financial Performance.

Quantification of sensitivity

During the year the Group engaged Ernst and Young ABC Ltd (EY ABC) to provide an independent valuation of INGA as at 31 March 2003. The valuation was a stand alone market based assessment of economic value, and excluded the Group's specific synergies and hedging arrangements. The independent valuation was based on a discounted cashflow approach, with allowance for the cost of capital. EY ABC presented an independent valuation range of $3,304 million to $3,690 million, reflecting a range of sales and cost base assumptions.

The key assumptions used in that valuation were reviewed by EY ABC against recent business experience as at 30 September 2003 to assess any potential valuation impacts. Based on this review, ANZ believes no change is required to the carrying value of the investment at 30 September 2003.

Key valuation assumptions

The 31 March 2003 valuation was based on a 31 December 2002 benchmark date with a roll-forward assesment to 31 March 2003. The valuation was based on a discounted cash flow approach comprising the present value of estimated future distributable profits after corporate tax, together with (in Australia only) the present value of 70% of the attaching imputation credits.

The assumptions underlying the cash flow projections were generally based on a long term view, together with an assessment of the current market environment.

The following gross of tax risk discount rates were used:

- Australian life insurance business 10.75% pa
- Australian funds management businesses 11.75% pa
- New Zealand businesses 13.00% pa

All economic assumptions, including future investment earnings and discount rates, were derived using the Capital Asset Pricing Model.

The value of future new business was based on a projection of 20 years of future new business allowing for:

- anticipated new business growth and volumes; and
- future margin squeeze

Other business assumptions were set relative to the experience of the business and the industry as well as management business plans.