WOLSELEY

International Accounting Standards Board
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Technical Director
Financial Accounting Standards Board
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23 December 2010

Dear Sir/Madam

Exposure draft: Leases

On behalf of Wolseley, I am pleased to respond to the boards' invitation to comment on their exposure draft on leasing.

Who we are
Wolseley plc is listed on the London Stock Exchange, is a member of the FTSE 100, and is the world's largest specialist trade distributor of heating and plumbing products to professional contractors, and a leading supplier of building materials to the professional market. Our revenue of £13.2 billion in the year ended 31 July 2010 was earned through 4,100 branches in 25 European and North American countries.

About 3,300 of our properties are currently leased, at an annual cost in the year ended 31 July 2010 of £244 million. We also have about 9,000 commercial vehicles and company cars, and over 10,000 individual items of office and IT equipment held under lease arrangements. In one of our businesses, where all personal computers, printers, copiers and mobile phones are leased, we have more distinct leased assets than employees. Consequently, we expect the boards' proposals on lease accounting to have a significant effect on our Group. We will need to invest capital and resources over the next few years in the systems and processes we believe are required to enable us to comply fully with the proposed lease accounting approach and disclosures.

We have only responded to the boards' proposals on a few points where we have a clear view. We would emphasise that we have evaluated the proposals at least as much as from the position of a user as of a preparer. Clearly we will be required to prepare financial reports in compliance with the eventual standard, and we can offer some insight into the likely complexities and costs of doing so. However, Wolseley is a decentralised organisation, with a small head office whose main role is to allocate capital among its subsidiaries. As such, we consider ourselves primarily as users of financial information, with a vital interest in regularly receiving from our subsidiaries relevant and reliable information that faithfully represents the results of their operations, and that enables us to make sound investment decisions. It will always be a matter of concern to us when there appears to be a divergence between the information we are required to report publicly, and the information we would seek to use internally to make those decisions.

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Our overall view of the exposure draft
Our group is exposed, as a retailer, wholesaler and distributor, to a cyclical and volatile market that presents us with a relatively short planning horizon and the need to keep our cost structure as flexible as possible. We have been able to manage our business and understand our financial position satisfactorily on the basis of financial reporting that complies with IAS 17, and from our point of view see no evidence that the current accounting model is broken.

We understand however that this may not be the case for other businesses, and acknowledge that it is helpful to investors to have all listed companies reporting on a consistent basis. We are unable to support in full the proposals in the exposure draft for the following three principal reasons:

- We consider that the lease term should be the period for which it is reasonably certain that the lessee will use the asset, not the longest period that it is more likely than not to use the asset.
- We consider that rentals contingent on usage, future market rentals and payments under term option penalties should be accounted for as expenses of the period in which the entity becomes contractually bound to make the payments, not included in the estimated lease liability.
- We consider that the cost and complexity of applying the boards' proposals to short-term and individually insignificant leases will be disproportionate to the benefits.

The accounting model that we prefer appears very similar to that set out by Mr Cooper in the first eight paragraphs of his Alternative View. We consider that we would be able to support the final standard, despite the costs of implementing it, if the boards adopt this alternative approach to optional lease periods and contingent rentals.

Lease term
In the case of a business like ours, which conducts its operations through an extensive branch network, we consider that the most relevant items of information about our lease obligations are

- what cost has been allocated to a reporting period; and
- how much flexibility our contractual arrangements give us to change the scope of our operations, and our cost structure, in response to changing market conditions.

Cost allocation
The current method of accounting for operating leases results in a close correlation between cash outflows in a period and the cost allocated to that period, and we consider it provides strong predictive and confirmatory information about trading performance. We concede that, by agreeing to term payments rather than upfront payment in full, the landlord is providing an element of financing that should be recognised in the income statement. However, we consider that the split of the rental payments between amortisation and interest should be based only on the period for which there is a commitment to making those term payments.

When we have entered into a lease contract that has been structured (whether by break clauses or by options to extend) into a sequence of optional periods, we have done so in order to be able, at each option point, to compare the price available for the current location from the landlord to prices prevailing in the market for alternative locations, and decide whether we want to renew or relocate. The pricing of the original contract reflects both parties' assessment of the probability of such renewals, and accordingly the cost allocated to each optional period should reflect the cash outflows which relate only to that period, not to the full potential term of the arrangement.

Flexibility of cost structure
It is characteristic of property leases that the costs are fixed in the short term and variable in the long term. Understanding how fast occupancy costs can be varied, and hence how fast margins can be restored, if volumes drop or if our strategy changes, is critical to using our income statement to predict future cash flows in different economic scenarios. When there is a market downturn, understanding the committed cash outflows is critical to management's decision whether to exit a market or to hold on and await an upturn. If we make a strategic acquisition, understanding our current contractual liability and how fast it rolls off is an essential precursor to making occupancy decisions for the enlarged business.

Current GAAP does not recognise a liability for such commitments unless the whole contract is onerous. We consider that recognising a liability for lease payments will improve the usefulness of financial reporting, but only if the liability reflects what is relevant to management – the unavoidable exit costs from current contractual commitments.

The boards' proposal
The boards' proposal requires the balance sheet to be grossed up beyond the level required by our preferred approach, as the lease liability and the right-of-use asset reflect the present value of optional lease terms that, at any point, are estimated more likely than not to be exercised. Should circumstances, and hence management estimates, change, the liability and asset can be netted back down again, with the gain or loss to income statement only reflecting the difference between the two arising because the asset is amortised over a different schedule than the liability is settled.

This will have the following consequences:

- A liability that has been recognised in the financial statements can be extinguished as a result of a management decision, without the release of that liability being credited to the income statement.
- An asset that has been recognised in the financial statements, and which is not a receivable and does not have an indefinite useful life, can simply be removed from the statement of financial position without an amortisation or impairment charge being debited to the income statement.
- If a sudden change in circumstances means that management needs to assess the costs of exiting a business sector, then management will be able to place no reliance on the amount recorded in the financial statements as the liability to pay rentals, and will have to conduct a specific exercise to determine the true unavoidable liability.
- Lenders currently make adjustments to the statement of financial position, as they consider that it fails to recognise unavoidable cash outflows and hence does not show the true indebtedness of a business. As the lease liability on the boards' proposal will include avoidable cash outflows, lenders may have to continue adjusting a business's statement of financial position in order to assess its true indebtedness.

We consider that these consequences of the approach proposed by the boards in the exposure draft mean that the resulting financial information will be less relevant, less verifiable, less understandable, and less compliant with the conceptual framework than our preferred approach of recognising only the reasonably certain rental liability.

Rentals contingent on usage
As we do not presently have a significant level of lease contracts which include rentals contingent on usage, we do not expect the boards' proposals to have a significant effect on our business on initial adoption.

However, we consider that the same arguments we have given against including rental payments relating to optional periods in the lease liability will also apply against including rental payments which are contingent on the revenues or profitability of a future trading period. There is a further point to consider specific to this sort of contingent rental. Determining their accounting cost involves estimating – potentially many years forward – the future trading performance of the entity, which is highly subjective and uncertain for any business exposed to cyclical or consumer-driven markets. As these estimates are incorporated in the right-of-use asset, which in turn is amortised over the lease term, it follows that current trading profit would partly reflect management's estimate of the uncertain future trading performance, and indeed that the amortisation charge would change from period to period depending on changes to management's view of likely contingent rentals. We believe that financial reporting that could be distorted in this way is unacceptable as a basis for monitoring the performance of a business.

Cost and complexity

The boards have formed the view that benefits of the proposed IFRS outweigh the costs involved in its initial and continuing application. We are still evaluating the cost implications for Wolseley of adopting the board's proposals, but we expect them to be significant.

Under the boards' proposals, on transition we will have to examine all of the contracts for thousands of leased assets or services that the group has entered into, in order to identify

- whether the contract is potentially a lease, within the scope of the new standard;
- what proportion of the rentals relate to the provision of an asset rather than a service; and
- what is the longest period that we are more likely than not to use the asset (which may be much longer than the minimum non-cancellable term).

We do not believe we can exclude individually immaterial assets from this analysis as the value of the relevant class of assets may be significant or material in aggregate across the group. We will need to perform this analysis groupwide before we can identify individual assets or groups of assets that we may be able to exclude on materiality grounds from the proposed accounting model. All staff involved in maintaining contracts in force at transition, and in negotiating and recording their replacements, will need to be trained in the policies we adopt.

In the case of more significant leases, in particular of property, schedules of future rentals will need to be estimated for the identified lease term of the specific property, and a discount rate appropriate to the lessee and asset determined. We will need to develop and implement new systems, or modify existing ones, to record this data and perform the required calculations for the liability. It is likely that new or modified systems will also be required for the right-of-use asset, as our current fixed asset modules are ill-suited for recording assets for which both the cost and the amortisation period are subject to revision, and current experience indicates that at least 20% of our leased property portfolio would require reassessment annually. All cash flows posted to the leasing system will have to be reconciled to the actual rental payments processed through accounts payable.

We anticipate that these additional processes and systems will have little or no commercial benefit to us. They will be performed purely to comply with GAAP, with some processes requiring input and oversight from relatively senior staff, and all of them will have to be reviewed for compliance with our internal controls. The potential materiality of the assets and liabilities, and the degree of uncertainty and judgment required in the underlying estimates, could mean that the riskiness, and consequent cost, of the external audit may increase, even though there has been no change to our underlying business.

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While we support the boards' willingness to adopt a more pragmatic approach to short-term leases, the proposal will do little to mitigate our compliance costs, as few of our leases have a maximum possible lease term of less than twelve months.

We are concerned that the boards do not appear to appreciate quite how onerous it will be to apply their proposals. We consider that the balance of costs and benefits could be improved if the final IFRS is based on our preferred approach to the measurement of lease terms and contingent rentals, as the resulting financial reporting will be relevant to management decisions, and the estimates required will be easier to verify. However, we do not consider that the benefits of applying the proposed accounting method to thousands of computers, photocopiers, mobile phones and items of office furniture can possibly outweigh the administrative costs of doing so, and are disappointed that the boards' proposals do not recognise the pragmatic case for applying operating lease accounting to assets which are incidental to our business model.

If you have any questions in relation to this letter please do not hesitate to contact me on 0118 929 8700.

Yours faithfully

Robert Smith
Head of Financial Reporting
Wolseley Group Services