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Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
13 September 2013

Dear Sir

Exposure Draft – Leases ED/2013/6

I am writing in response to the above exposure draft.

Rolls-Royce Holdings plc is a constituent of the FTSE100 and a world-leading provider of power systems and services for use on land, at sea and in the air, and has established a strong position in global markets - civil aerospace, defence aerospace, marine and energy.

We have significant operating leases both as a lessor and a lessee and also interests in joint ventures which lease equipment.

Summary

I have set out our responses, where relevant, to the Board's specific questions in the appendix to this letter.

Overview

While we acknowledge that the Board has addressed a number of the concerns that were raised in respect of the 2010 exposure draft, we remain unconvinced that the revised proposals represent a sufficient improvement on the existing requirements for users to offset the significant additional complexity and costs for preparers.

We consider that the distinction between Type A and B leases, and their respective accounting is inappropriate. If there is to be a distinction, which we broadly support, then we consider that it should be based solely on principles. A presumption that property is Type B, with everything else Type A is inconsistent with a principles-based approach. However we do see it as an acknowledgement by the IASB that not all leases are the same. On this presumption, we do not consider that the limited differences in accounting for the two types are sufficient to recognise the distinction. While we understand the IASB's view that leases are different from service contracts, we believe that many shorter-term leases have more in common with service contracts than with a lease which is in substance the financing of an asset purchase. Accordingly, we do not consider that the proposed right-of-use model is necessarily appropriate for all leases and the proposals may lead to differential accounting for broadly similar arrangements. In developing the proposals, there appears to have been an underlying intent to 'get all all leases on balance sheet at any cost'.

We also note that the IASB has recently published a Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*, which proposes revised definitions of assets and liabilities. We believe that it is inappropriate to introduce a new type of asset – the right-

of-use – before these concepts are developed further. We would suggest an interim solution of enhanced disclosure until the revised conceptual basis has been properly considered.

We also note that the proposals for a lessee's accounting for a Type B lease result in the right-of-use asset being a balancing figure. We are unconvinced that this is meaningful or consistent with the IASB's objective of a high quality reporting standard.

Costs and benefits of the proposals

We do not consider that sufficient consideration has been given to the high costs to preparers of implementing and maintaining accounting in accordance with the proposals. This will include new or modified systems (which will require significant development), additional staff (for example to undertake reassessments where a relevant index changes), and training. If the proposals are finalised in their current form, we urge the IASB to consider these factors in setting the effective date.

In order to mitigate some of these costs, we would urge the IASB to provide more guidance on practical expedients to application. At present this is only referred to in passing in paragraph BC405, which considers using a materiality threshold for immediate expensing, as is commonly done for purchased assets. However, this could be interpreted as expensing the whole asset immediately, creating a liability for the future payments – a sort of lease liability without the corresponding asset. Alternatively, it could be interpreted as expensing the lease payments as they become due – effectively a continuation of an operating lease. Another example that we believe will be common is a portfolio of individually immaterial leases with similar terms, which aggregate into a material liability. We believe that it should be possible to meet the objectives of the proposals by adopting a portfolio approach to estimate the accounting entries and that it would be helpful if the IASB provided some guidance in this area.

We would also urge the IASB to consider further the impact on the relationship between the accounting for, and taxation of, leases. In the UK, taxation is based on operating and finance leases as set out in IAS 17. This will not automatically change if the proposals are adopted, so there could be a requirement for dual accounting for tax and financial reporting purposes, adding further complexity and cost. If the tax legislation is amended to reflect the proposals, then there may be adverse cash tax implications for lessors, who would recognise taxable income in advance of lease rentals.

Finally we would also urge the IASB to consider the impact of its proposals on debt covenants, which may be adversely affected, potentially causing breaches and increased borrowing costs.

Presentation and disclosure

We consider that the proposed presentational requirements are excessive and inconsistent. For example:

- under the Type B model, a financial liability will be included in the statement of financial position, but there will be no corresponding financing item in the statement of profit and loss; and
- paragraph 56 requires presentation in the statement of profit and loss of amounts relating to leases, when equivalent amounts for other assets would be included in the notes.

Similarly, we consider that the proposed disclosure requirements will, in many cases, be disproportionate. For example, we do not understand the rationale for potentially requiring three reconciliation tables for property plant and equipment (owned, Type A and Type B) in an environment that is seeking to 'cut the clutter'.

Conclusion

We do not believe that the current proposals appropriately address different types of leases and that the costs of implementing the proposals in their current form will outweigh the benefits to the users of financial statements. We believe the proposals will be complex for users to understand and may just lead to them making different adjustments to those that it is acknowledged they already make.

Please feel free to contact me if you wish to discuss our comments on the proposals.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Will Mansfield', with a stylized flourish at the end.

Will Mansfield
Group Chief Accountant

APPENDIX

Question 1: identifying a lease

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.

No. We consider that there will be many cases where assets will be inextricably linked with a service contract and that it will, in many cases, be difficult to separate the lease component. We remained unconvinced that the right-of-use model is appropriate for many lease contracts that have more in common with service contracts. We are concerned that an inability to separate a lease component could result in service contracts being treated as leases in their entirety, even where the 'lease component' is a minor component of the contract as a whole. We would suggest that, where services are a predominant factor of a contract, the whole arrangement should be treated as a service contract.

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?

While we agree that the recognition, measurement and presentation of different leases should differ, as noted above, we do not consider that the proposed Type A and B lease accounting appropriately differentiates between the substance of these leases or that the case for a universal right-of-use model has been adequately made. However, if right-of-use lease assets are presented in accordance with the underlying assets, then we would suggest that the expenses and cash flows should be presented on a similar basis. In particular, we consider the proposals for Type B leases to be illogical. If a lease liability is recognised in the statement of financial position, then the recognition of all the related expenses and cash flows as operating items seems to make little sense and will lead to confusing financial ratios, necessitating further adjustments by users.

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 agree that different accounting will be appropriate for different leases and also consider that the proposals are an improvement to the previous exposure draft insofar that it avoids the double counting of assets. However, if the lessee has a right to use an asset under a Type B lease, we find it odd that the lessor continues to report an unencumbered underlying asset, rather than derecognising a portion to reflect the right-of-use given up. This anomaly becomes particularly apparent if there is a back-to-back lease of a Type B asset, where the intermediate entity would recognise a right-of-use asset for an item that it has leased to another party.

We also note that, if an asset is subject to a number of leases (a spare aero engine would typically be leased up to 10 times during its life), the lessor will, assuming a Type A lease,

report the asset either as property, plant and equipment or a lease receivable and residual asset depending on whether the asset is on lease at the reporting date. As well as adding considerable complexity, we question whether this continual changing of classification is helpful to users. We believe that a better reflection of the business model would be to show all assets held for use in such leases as a single category, with appropriate disclosure of the amount on lease at the reporting date.

Overall, we think that the distinction proposed, and the different accounting treatment resulting, will lead to significant additional complexity for lessors without representing a significant improvement to the existing requirements for users.

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?

No. To a limited degree, the proposal to classify leases as Type A or Type B recognises that not all leases are the same. However, as we note in the body of the letter, we believe that any distinction should be based solely on principles and that a presumption that property is Type B, with everything else Type A is inconsistent with a principles-based approach. We believe that for some leases of high value capital equipment, the conclusions for a Type B lease are equally applicable. For example, spare aero engines lose little of their value early in their life due to the strict maintenance requirements, but the value will decline rapidly as the related aircraft fleet starts to exit service.

We also do not consider that the subsequent accounting appropriately reflects the difference nature of the leases. We believe that many leases have more similarities with service contracts than with in-substance financings, and that the right-of-use model is not necessarily appropriate for all leases. Further, as the reduction in the right-of-use asset in a Type B lease is a balancing figure, it is difficult to see how this can have any meaningful use as a measure of the consumption of the of the economic benefits of the asset and appears inconsistent with the objective of a high quality reporting standard.

Finally, if the proposed distinction is retained, then the key terms 'insignificant' and 'substantial' need additional guidance to allow consistent application.

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?

Yes. These appear broadly consistent with the requirements of IAS 17, although we would suggest that the 'reasonably certain' criteria from IAS 17 are easier to understand and apply than the revised 'significant economic incentive'.

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?

While we agree with the principles behind the proposals and welcome the exclusion of performance-based variable lease payments, we are concerned with the degree of work that

may be involved to reassess a large volume of leases which include a relevant index and would urge the IASB to consider further the practical implications of these proposals for preparers.

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?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

We agree that mandatory full retrospective application would be too onerous and therefore agree that simplified transitional arrangements are necessary. Without performing significant analysis it is difficult to assess potential issues that may arise from the proposed modified retrospective approach and we would urge the IASB to ensure that these have been fully field tested before finalisation of a standard.

As previously noted, we would urge the IASB to take full account of the practical implementation issues when deciding on an effective date.

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?

No. While we note that the ED states that an entity should consider the level of detail required to meet the objectives, we believe the mandated presentational requirements do not fully reflect this. In an environment that is seeking to 'cut the clutter', we believe that the detailed disclosure requirements will lead to excessive disclosure for items that are of relatively minor importance.

For example, paragraph 88 requires lease receivables to be presented separately on the statement of financial position. We believe that the presentation should depend on the circumstances and core activities of an entity – lease receivables may well be expected to be presented on the face of a leasing entity's statement of financial position, but it seems unnecessary for an entity for which leasing is not a core activity, further cluttering the statement of financial position.

Similarly, the movement tables in paragraph 61 may generate a large volume of disclosure about relatively small amounts. Assuming that right-to-use assets are included in the relevant balance sheet category (most likely PP&E), there may be scenarios with three, full movement tables included within PP&E notes – owned, Type A and Type B. Perhaps a more appropriate disclosure would be to only disaggregate the net book values of the three categories.

We believe that the any final standard should be clearer in setting out whether all of the disclosures listed are regarded as mandatory or non-mandatory, depending on the circumstances and materiality, and that conclusions arising from the *Disclosure Initiative* should be explicitly considered.

Questions 9-11 (FASB-only)

Not applicable.

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

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?

No comments.