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Direct dial 0207 227 9488

Date 26th April 2013
Our ref MM Sharman
Your ref

Dear Mr Grabowski,

Implementing the recommendations of the Sharman Panel

I am writing in response to the FRC's consultation document on the above.

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.

While we support the FRC's desire to improve the transparency of reporting on corporate governance, we have significant concerns with the potential implications of the consultation document. Our key concerns are set out below and our detailed responses to the questions are set out in the attached appendix.

Two purposes of going concern

We believe that the two purposes of going concern assessment set out are actually two different objectives and should be addressed separately. The requirements for the assessment of going concern for financial reporting purposes are set out in International Financial Reporting Standards and we believe that this definition of going concern is generally understood and should be retained, with liquidity continuing to be the primary focus of the assessment.

The proposals in respect of the stewardship purpose go significantly beyond this and we believe that using the same terminology for a different objective would create confusion to users of annual reports. The proposals for the stewardship purposes would appear to us to be better described as an 'assessment of the sustainability of the business model'.

If it is the FRC's intention to improve narrative reporting in this area, it should be done so explicitly, with appropriate guidance as to how the assessment would complement the existing requirements of the UK Corporate Governance Code and the Companies Act 2006 to report on the business model and the principal risks and uncertainties respectively.

We also consider that the requirements for the disclosure of material uncertainties are likely to be different depending on the purpose. The use of the same terminology for both purposes is confusing and the explanation in the Guidance is not clear as to which purpose the material uncertainties are intended to address. We also consider that, if it is intended that material uncertainties are intended to apply to the stewardship purpose, then these should be clearly distinguished and that those for financial reporting purposes should, take account of the amendments to IAS 1 currently being considered by the IASB.

Level of confidence

As described in our response to questions 2 and 4, we do not consider that the Guidance is clear as to what level of confidence is required to assess a company as a going concern for stewardship purposes. Our interpretation of the Guidance as drafted is that a high level of confidence would be needed for the whole of the foreseeable future, which for many companies, like ourselves, may be a very extended period. We believe that this is unrealistic and that many companies would be unable to conclude that they were a going concern on this basis, with the consequence that they would report, as material uncertainties, matters that may be considered to be normal business risks.

Timetable

The proposed timetable envisages that the guidance will be finalised in June 2013 and that it will be applicable to companies with a financial year commencing on or after 1 October 2012. This would mean that companies with a calendar year-end would need to adopt the Guidance in their 2013 half-year results, which could give them less than one month from the finalisation of the Guidance. We consider this to be too short a timeframe to absorb the requirements and formulate a sufficiently considered position.

If you wish to discuss any of the comments in this letter we would be happy to do so. Please do not hesitate to contact me or Will Mansfield (01332 245463).

Yours faithfully



Mark Morris
Chief Financial Officer

Appendix

Question 1: Do you agree that the Guidance appropriately provides the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting and is appropriate? If not, why not, and what changes should be made to the Guidance?

No. We believe that the term 'going concern' is widely understood so far as it relates to the basis of accounting, is set out in IFRS, which will remain unchanged (subject to any limited scope amendments currently being considered by the IASB), and should be retained. These proposals significantly broaden that definition when the term is used for its stewardship purpose. We believe that the difference is such that a different term should be used and separate guidance provided. Much of the discussion in the proposed guidance is in the context of the business model and we believe a better term would be 'Sustainability of business model', a term already used in section 4.5 of the Guidance.

Question 2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern? Do you agree in particular that this should take full account of all actions (whether within or outside the normal course of business) that the board would consider taking and that would be available to it; and that, if the underlying risks were to crystallise, there should be a high level of confidence that these actions would be effective in addressing them? Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?

While we agree with the description and the consideration of mitigating actions, we do not agree with the level of confidence that the board is expected to apply. Although the guidance emphasises that a high level is not an absolute level of confidence, taking account of the potentially long foreseeable future that might be required by section 2 of the Guidance, we believe that a high level of confidence is unrealistic and that many businesses with a long business cycle would never be able to conclude that they were going concerns to this degree of confidence – see also question 4.

Question 3: Do you agree with the approach the Guidance takes to the implications and nature of actions within or outside the normal course of business? Do you consider that the Guidance explains their nature sufficiently clearly? If not, why not and what changes should be made to the Guidance?

Generally yes, although the implication of the distinction on the going concern assessment is less clear. The Guidance appears to focus on whether there are adequate systems to respond on a timely basis to evolving risks, irrespective of whether the identified actions are within or outside the normal course of business.

Question 4: Do you agree with the approach taken to interpreting the foreseeable future and is this sufficiently clear in the Guidance? If not, why not and how should the Guidance be changed?

No, particularly when considered in conjunction with the level of confidence required.

Section 1 of the Guidance says:

"12. In this Guidance, a company is judged to be a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due and will be able to sustain its business model, strategy and operations

and remain solvent, including in the face of reasonably predictable internally or externally-generated shocks.”

This suggests that the high level of confidence is required throughout the foreseeable future, whereas section 2 of the Guidance says:

“19 The board’s evaluation of the significant solvency and liquidity risks should consider the foreseeable future, ie what the board knows or should reasonably be expected to know about the future. The foreseeable future is not a specific period. Knowledge about the future is a matter of judgement not fact and reflects the expertise and experience of those making the evaluations about the likely development of events and conditions in future periods as part of the assessment process.

“20. The generally accepted minimum period for the assessment of detailed budgets and/or forecasts is 12 months from the date of approval of the financial statements. The board is expected to develop a high level of confidence that solvency and liquidity risks can be managed effectively during at least that period.

“21. When considering solvency, boards address longer periods through the general economic and specific business cycles. The length of the period considered is a matter of judgment and will depend on the nature of the company’s business, its business cycles, the life cycles of its assets, the stage of the general economic cycle at the time of the assessment and the quality of the data available to make the assessment.

“22. Determining the appropriate periods to be covered in carrying out individual aspects of the assessment process (such as the qualitative and quantitative evaluation of risks and potential mitigants, the development of budgets, forecasts and medium term strategy and plans, and the conduct of stress tests) is therefore a key aspect of establishing a sound assessment process. The appropriate periods for this purpose should in principle be consistent with those appropriate for effective business planning and management (see also Appendix 1 – paragraphs 1 to 13).”

Paragraph 20 clearly associates the high level of confidence with a period of 12 months. However, when addressing solvency over a longer period, paragraphs 21 and 22 do not give any further guidance on the level of confidence required, therefore it must be assumed, when read in conjunction with Section 1.12¹, that the high level of confidence is required over the whole period of the foreseeable future, taking account of the nature of the company’s business, its business cycles, the life cycles of its assets and the stage of the general economic cycle. As noted above, we consider that this is an unrealistic requirement for what could be a very extended period.

Question 5: Do you agree that the use of the term ‘going concern’ in the phrase ‘going concern basis of accounting’ is sufficiently clearly distinguished in the Guidance from its use in the Code requirement for a statement that the company ‘is a going concern’ and from its use in the accounting and auditing standards in the context of material uncertainties about the company’s ‘ability to continue as a going concern’? Is it clear from the Guidance that the statement the directors are required to make under the Code (that the Company is a going concern) should

¹ Section 1.14(b), Section 2.2 and Appendix 14 all stress the economic cycle, further indicating that it is over this period that a high level of confidence is required.

reflect the board's judgement and is not intended to be absolute? If not, why not and what changes should be made to the Guidance or the Code requirement?

No. See response to question 1.

Question 6: Do you agree that the judgemental approach in the Guidance to determining when there are material uncertainties to be disclosed is the appropriate interpretation of the relevant accounting standards? Do you agree that the factors and circumstances highlighted respectively in paragraphs 2.30 and 2.31 are appropriate? If not, why not and what changes should be made to the Guidance?

No. We do not consider that the Guidance is clear as to whether the material uncertainties are in relation to the stewardship purpose of the going concern assessment or to the financial reporting purpose. Although the reference to accounting standards in the question might suggest the second, no such reference is included in paragraphs 28-31 of section 2 of the Guidance. We believe that material uncertainties might be quite different, depending on the purpose. This again highlights that the usage of the same terminology for different purposes creates confusion, rather than clarity. Further, section 417 of the Companies Act 2006 requires the disclosure of the principal risks and uncertainties facing the company. However, the Guidance makes no reference to this requirement, nor how the disclosures of material uncertainties should interact with or complement this existing requirement. In addition, we consider that, for financial reporting purposes, the Guidance should, as far as possible, be consistent with IFRS, we consider that the proposed Guidance goes well beyond the requirements of IAS 1 – see question 7 below.

Question 7: Do you agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with FRS 18 and ISA (UK and Ireland) 570? If not, why not and what changes should be made to the Guidance or those standards?

No. Recommendation 2(b) states: “(b) The FRC should seek to clarify the accounting and stewardship purposes of the going concern assessment and disclosure process and the related thresholds for such disclosures and the descriptions of a going concern in the Code (and related guidance for directors and auditors) and in FRS 18 and ISA (UK & Ireland) 570, **if possible in line with such international consensus**; ... ”(emphasis added). We cannot see any evidence in the Guidance that the FRC has attempted to address the international implications. We acknowledge that some inconsistencies in the definition of foreseeable future exist between the current Guidance and IAS 1, however we consider that these are limited and manageable. However, we consider that the proposed Guidance goes considerably beyond these requirements, particularly as we consider it lacks clarity between the requirements of the two purposes of going concern described. The IASB is currently considering amendments to IAS 1 for the disclosure requirements of ‘material uncertainties’. In this context, we consider that a different definition and disclosure requirement in the Guidance would be confusing to users.

Question 8: Do you agree that Section 2 of the Guidance appropriately implements Recommendation 3? Do you agree with the approach to stress tests and the application of prudence in conducting them? Do you agree with the approach to identifying significant solvency and liquidity risks? Do you agree with the description of solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?

Generally yes for stewardship purposes, although as noted above, we believe that this should be addressed separately from the requirement to assess going concern for financial reporting purposes and that the level of confidence required needs to be reconsidered and clarified.

Question 9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate? Is the term 'robustness of the going concern assessment process and its outcome' sufficiently clear? Do you agree that the approach the board should adopt in obtaining assurance about these matters is appropriately reflected in Section 3 of the Guidance? Do you agree that the board should set out how it has interpreted the foreseeable future for the purposes of its assessment? If not, why not and what changes should be made to the Guidance?

Generally yes, although we repeat our observation that the clarity is not enhanced by the combination of the two separate and different going concern purposes. We are not convinced that it is necessary to include the undefined term 'robustness'. The Guidance includes descriptive requirements that should enable the user to form an opinion about the adequacy, or otherwise, of the procedures undertaken.

Questions 10 and 11

No comment

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

No, we consider the implementation date to be completely unrealistic. The significantly broadened requirements for the assessment of going concern for stewardship purposes will require significant planning. The proposed timetable envisages that the guidance will be finalised in June 2013 and that it will be applicable to companies with a financial year commencing on or after 1 October 2012. This would mean that companies with a calendar year-end would need to adopt the Guidance in their 2013 half-year results, which could give them less than one month from the finalisation of the Guidance. We believe that the timetable should be such that companies would have a minimum of one year from finalisation to reporting.

Question 13: Do you believe that the Guidance will deliver the intended benefits? If not, why not? Do you believe that the Guidance will give rise to additional costs or any inappropriate consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged to be a going concern and/or more companies disclosing material uncertainties? If so, what are the key drivers and can you give an estimate or indication of the likely cost or impact? Do you believe that such additional costs or impact would be justified by the benefits?

We believe that the proposed Guidance will lead to many companies being unable to conclude that they are going concerns for stewardship purposes and as a consequence will report material uncertainties, although these uncertainties may well be normal business risks. We do not believe that this will be beneficial.

Questions 14-15

No comment.