Rolls Royce

UK, Industrials

Accounting		Climate Assumptions		Audit		Date of analysis: April 26 2021
Judgements	Consistency with other reporting	Visibility	Paris alignment	Visibility in KAMs	Consistency check	Year end: December 2020 Report date: March 31 2021 AGM: May 13 2021
Some concerns	Significant concerns	Significant concerns	Significant concerns	Some concerns	Significant concerns	CA 100+ company, so seen by investors as key to driving global net zero emissions

Summary view:

- Rolls Royce displays an impressive commitment to consider climate change, and has significantly advanced its communication on the issue over the year as well as continuing to invest despite financial challenges.
- However, while climate is mentioned in the financial statements (and by the auditor) the incorporation in the financials does not reflect the broader discussion and approach. The audit committee will consider climate assumptions in 2021.

Background

The Business

- One of the three main engine suppliers for the civil aerospace business, Rolls Royce is highly dependent on activity levels in, and the long-term success of, the aviation industry.
- This is particularly true given that its revenues, and particularly its profits, largely arise from long-term servicing agreements associated with engine sales. Typical engine programmes run for 30-55 years and are loss-making in the early years, only turning profitable later through the service contracts. A core determinant of servicing demand is the number of flying hours.
- Large engine flying hours in 2020 were down to 43% of 2019 levels, leading to a reported loss in the civil aerospace segment of some £2.5bn.
- In addition to the civil aerospace business, Rolls Royce has significant defence and power systems businesses. The largest portion of the power systems segment is power generation.

Approach to climate change

- Rolls Royce is targeting net zero GHG emissions in operations and facilities by 2030, though the fact that this excludes product test emissions illustrates the scale of its challenge in relation to Scope 3. It has committed to become fully net zero carbon by 2050, including Scope 3 emissions. It intends to publish a roadmap to deliver this in 2021.
- The company aims to use its engineering expertise to help the globe transition to net zero – and hopes for growth from this activity from 2025 – but recognises the need to restore financial returns and rebuild its balance sheet first. Nonetheless, it details investments and research and development into relevant technology areas which continued through 2020.
- While it is developing electric power systems for flights, Rolls Royce believes that power to weight ratios mean that only gas turbines will be suitable power sources for large aircraft and long-haul flight for decades to come. It is thus experimenting with sustainable aviation fuels.
- The only element of its business model that Rolls Royce does not acknowledge as potentially impacted by climate change risks is ‘capture through-life value of in-service products’. This seems to reflect a perception that climate will only have an impact some time in the future.

Accounting: judgements and consistency with other reporting

Accounting judgements		Some concerns

- The company reports under IFRS standards.
- The Basis of Preparation discussion in the Accounting Policies note to the accounts includes a climate change section. This states that management has considered climate change’s impact in the light of narrative reporting disclosures, including the net zero targets. It states: “These

considerations did not have a material impact on the financial reporting judgements and estimates, consistent with the assessment that climate change is not expected to have a material impact on the Group's going concern assessment to September 2022 nor the viability of the Group over the next five years." As well as highlighting specific investments, it notes that the impact of climate change has been considered with regard to key estimates, including on impairment assessments of intangibles and goodwill, deferred tax and long-term contracts.

- Of these highlighted areas, climate change is only specifically referenced in relation to deferred tax. The planning horizon of 5 years does not reflect the 25-year typical length of Rolls Royce's long-term service contracts.
- A small £9m impairment was taken in a Power Systems JV because of changes to climate change regulations in a particular (unspecified) market.

Consistency with other reporting		Significant concerns

- The company sets out extensive commitments and ambitions in relation to climate change in the narrative reporting elements of its Annual Report. These include: a TCFD report, sustainability disclosures, and also references within risks discussions (which are much better articulated than in the 2019 Annual Report), business model reporting and viability statement.
- Rolls Royce details its technological R&D on zero carbon offerings, which have continued through 2020. These include: the UltraFan engine, which enjoys enhanced efficiency; testing of existing engines with sustainable aviation fuel; fuel cell technologies, hybrids and electric engines; and small modular nuclear power stations.
- Despite the references to climate change in the financials, these are not as well developed as the substantive narrative reporting discussions of the issues and concrete steps being taken.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Significant concerns

- It does not appear that climate-related assumptions are disclosed.
- Nevertheless, some key sensitivities are disclosed: (i) if engine flying hours fall by 15% over the remaining lives of contracts, this would lead to an adjustment of £100m-130m (90% of which as a cut in revenues, the remainder as onerous contracts, and so an increase in cost of sales); (ii) if flying hours fall by 5% then impaired assets would be subject to a further £50m impairment; (iii) a 5% fall in workshop visits (again, largely a function of flying hours – which the accounts note may be influenced by climate change) would reduce expected profits, leading to a reduction in the deferred tax asset by around £100m; and (iv) a 15% fall in widebody flying hours would lead to a further provision of £10m-15m for onerous contracts.
- The audit committee states that the impact of climate change on assumptions will be a key area for its focus in 2021.

Paris alignment		Significant concerns

- With no disclosure, there can be no alignment with the goals of the Paris Agreement.

Audit: visibility in KAMs and consistency check

Audit firm: PricewaterhouseCoopers LLP	Responsible partner: Ian Chambers
Audit standards: ISAs as adopted in the UK	

Visibility in Key Audit Matters		Some concerns

- There is an explicit reference to climate change in the auditor's report. It is referenced in the deferred tax KAM as one of the variables that needs to be considered in developing future forecasts, particularly for forecasts beyond the company's normal 5-year forecasting process.

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- There are 9 KAMs identified (one solely for the parent company): long-term contract accounting; deferred tax; foreign-currency transactions and balances; presentation and accuracy of underlying results and one-offs; recoverability of accounts receivable and contract assets; recoverability of intangible programme assets; going concern; recoverability of parent company's investment in subsidiaries; and impact of the COVID-19 pandemic.
- Though other KAMs encompass areas involving assumptions on future long-term cashflows, climate is mentioned only in the deferred tax KAM.

Consistency check		Significant concerns

- The auditor is obliged to consider the reporting that accompanies the financial statements and highlight any apparent inconsistencies.
- The apparent limitation of the time horizon in the financial statements' consideration of climate change to 5 years seems inconsistent with the broader reporting and acknowledgement of the fundamental risks to the business that potentially arise from climate issues.

The Climate Accounting Project is an independent investor-led project to reinforce the statements of the IASB and IAASB that material climate change issues are incorporated within their standards. This analysis seeks to understand the extent to which companies and auditors are delivering against this aspect of these standards and similar local standards.		**Key**
		Good practice
		Few concerns
		Some concerns
		Significant concerns

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