Independent Auditor's Report

to the members of Rolls-Royce Holdings plc

1 Our opinion is unmodified

We have audited the financial statements of Rolls-Royce Holdings plc ("the parent Company") for the year ended 31 December 2017 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated Balance Sheet, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity, and the related notes, including the accounting policies in Note 1, and the Company Balance Sheet, Company Statement of Changes in Equity, and the related notes, including the accounting policies in Note 1.

In our opinion:

- **the financial statements give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 December 2017 and of the Group's profit for the year then ended;**
- **the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union;**
- **the parent Company financial statements have been properly prepared in accordance with UK accounting standards, including FRS 101 Reduced Disclosure Framework; and**
- **the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.**

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the Audit Committee.

We were appointed as auditor by the directors for the year ending 31 December 1990. The period of total uninterrupted engagement is for the 28 financial years ended 31 December 2017. This is my fifth year as Senior Statutory Auditor. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

2 Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the audit team. We summarise below the key audit matters in arriving at our audit opinion above, together with our key audit procedures to address those matters and our findings from those procedures in order that the Company's members as a body may better understand the process by which we arrived at our audit opinion. These matters were addressed, and our findings are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

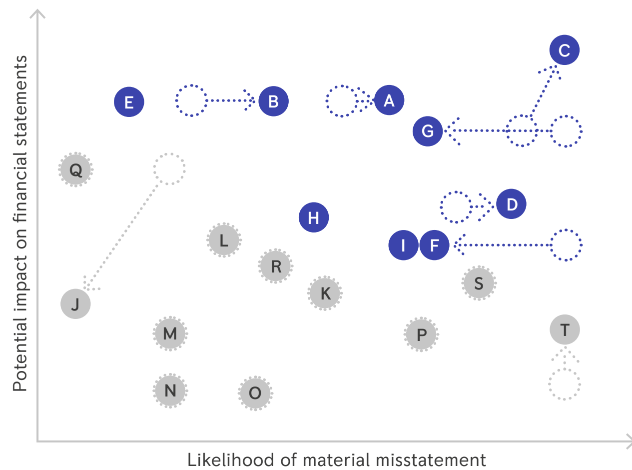
When planning our audit, we made an assessment of the relative significance of the key risks of material misstatement to the Group financial statements, initially without taking account of the effectiveness of controls implemented by the Group. This initial assessment is shown below in the output from our Dynamic Audit planning tool. Of the 20 key risks identified, we consider nine (those in dark blue on the risk map) to be key audit matters. There have been a number of changes since last year:

- During the year, the Group acquired the 53.1% of Industria De Turbo Propulsores SA (ITP Aero) that it did not already own and the risks relating to the remeasurement of the interest already owned to fair value, the risks relating to the identification and measurement at fair value of the acquired intangible assets and the consequent recognition of a "bargain purchase gain" are key risks (and a key audit matter) this year.
- The Group will adopt IFRS 15 *Revenue from contracts with customers* with effect from 2018 and is disclosing the impact in these financial statements for the first time. The risks that the Group has not developed policies in line with the new standard, that not all material areas of potential change have been identified and that the policies have not been applied appropriately are key risks (and a key audit matter) this year.
- The Group entered into deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas territories in January 2017. If the Group were found to have failed to fulfil its responsibilities under the deferred prosecution agreements it would risk prosecution and this would require disclosure in the financial statements. The key risk identified last year relating to bribery and corruption has been subsumed into a broader key risk (which is also a key audit matter) relating to the omission of such disclosure. In addition, the key risk identified last year relating to the disclosure of the consequences of the investigations is no longer considered to be a key risk.
- Over recent years, the Group has reduced the level of asset value support provided to customers (though it continues to provide standby credit lines to customers) and we assessed the risk of material misstatement to have reduced to such an extent that this key risk is no longer a key audit matter.

Apart from this, the key risks are the same as in the previous year.

Finally, following changes to auditing standards, we have included a key audit matter relating to the recoverability of the parent Company's investment in its subsidiaries.

Dynamic Audit planning tool
(Relative significance of audit risks before taking account of controls)



- (A) The pressure on and incentives for management to meet revenue, profit and cash targets
- (B) The basis of accounting for revenue and profit in the Civil Aerospace business
- (C) The measurement of revenue and profit in the Civil Aerospace business
- (D) Recoverability of intangible assets in the Civil Aerospace business
- (E) Consequences of deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas markets
- (F) The presentation of 'underlying profit'
- (G) Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount
- (H) Gains resulting from the acquisition of a controlling interest in Industria De Turbo Propulsores SA
- (I) Disclosure of the impact of adopting IFRS 15
- (J) Liabilities arising from sales financing arrangements (see page 130)
- (K) Measurement of revenue and profit on long-term contracts outside the Civil Aerospace business (see pages 124 and 125)
- (L) Determination of development costs to be capitalised (see page 124)
- (M) The basis of accounting for contractual aftermarket rights (see page 122)
- (N) Determination of the amortisation period of development costs and contractual aftermarket rights (see pages 128 and 129)
- (O) The basis of accounting for Risk and Revenue Sharing Arrangements (see pages 123 and 124)
- (P) Estimating provisions for warranties and guarantees (see page 125)
- (Q) Valuation of derivatives and hedge accounting (see pages 127 and 128)
- (R) Measurements of post-retirement benefits (see page 125)
- (S) Accounting for uncertain tax positions and deferred tax assets (see page 125)
- (T) Valuation of goodwill (see page 124)

(A) The pressure on and incentives for management to meet revenue, profit and cash targets

Refer to pages 21 to 41 (Business review) and pages 99 and 100 (Audit Committee report – Financial reporting)

The risk *(Subjective estimates)* – The continuing pressure on and incentives for management to meet targets increases the inherent risk of manipulation of the Group financial statements. The financial results are sensitive to significant estimates and judgements, particularly in respect of revenues and costs associated with long-term contracts, and there is a broad range of acceptable outcomes of these that could lead to different levels of profit and revenue being reported in the financial statements. Relatively small changes in the basis of those judgements and estimates could result in the Group meeting, exceeding or falling short of forecasts, guidance or targets. The Group's incentive schemes include targets related to profit and to cash generation.

The significance of this risk increased somewhat during the year as (1) the Group has been impacted by the increasing cost and challenge of managing significant in-service engine issues on the Trent 1000 and Trent 900 programmes and so there could be motivation to overstate financial performance to downplay the impact of these on the Group and (2) there have been significant changes in the Executive Leadership Team in the last year and so there could be motivation to establish credibility.

Our response – Our procedures included:

- ***Personnel interviews:*** We have made specific enquiries designed to assess whether judgements and estimates exhibited unconscious bias or whether management had taken systematic actions to manipulate the reported results and whether sector management received instruction from Group to make changes in estimates that failed to consider appropriately all relevant information in determining the estimate;
- ***Test of details:*** Compared the results to forecasts, guidance and targets, and challenged variances at a much lower level than we would otherwise have done based on our understanding of factors affecting business performance with corroboration using external data where possible;
- ***Our sector experience:*** Applied an increased level of scepticism throughout the audit by increasing the involvement of the senior audit team personnel, with particular focus on audit procedures designed to assess whether revenues and costs have been recognised in the correct accounting period, whether central adjustments were appropriate and whether the segmental analysis has been properly prepared. In particular:
  - when considering the risk relating to *The measurement of revenue and profit in the Civil Aerospace business* ((C) refer to pages 185 and 186), we challenged the basis for changes in the estimated revenues and costs in long-term contracts, with a heightened awareness of the possibility of unconscious or systematic bias with particular emphasis on the treatment of the additional costs estimated to have to be incurred as a consequence of the in-service engine issues on the Trent 1000 and Trent 900 programmes;
  - when considering the risk relating to *Recoverability of intangible assets in the Civil Aerospace business* ((D) refer to pages 186 and 187), we challenged, with a heightened awareness of the possibility of unconscious or systematic bias, the basis of cost estimates in particular those relating to the development of the Trent 900 modifications required to give improvements to time on wing and fuel burn; and
- ***Assessing transparency:*** When considering the risk relating to *The presentation of underlying profit* ((F) refer to pages 188 and 189) and the risk relating to *Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount*

(G refer to pages 189 and 190), we sought to identify items that affected profit (and/or the trend in profit) unevenly in frequency or amount (especially those where management had a greater degree of discretion over the timing or scale of transactions entered into) at a much lower level than we would otherwise have done and to assess the balance and transparency of disclosure of these items.

Our findings – Our testing did not identify any indication of manipulation of results *(2016 audit finding: none)*. We found the degree of caution/optimism adopted in estimates to be balanced overall *(2016 audit finding: balanced)*. We found that there was ample unbiased disclosure of items affecting the trend in profit.

B The basis of accounting for revenue and profit in the Civil Aerospace business

Refer to pages 122 and 123 (Key areas of judgement – Introduction, Contractual aftermarket rights, Linkage of OE and long-term aftermarket contracts), page 126 (Significant accounting policies – Revenue recognition) and pages 99 and 100 (Audit Committee report – Financial reporting)

The risk *(Accounting treatment)* – The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of the related engines as this drives the accounting basis to be applied. As the commercial arrangements can be complex, significant judgement is applied in selecting the accounting basis in each case. The most significant risk is that the Group might inappropriately account for sales of engines and long-term service agreements as a single arrangement as this would usually lead to revenue and profit being recognised too early because the margin in the long-term service agreement is usually higher than the margin in the engine sale agreement.

The significance of the risk increased during the year as more engines were delivered this year.

Our response – Our procedures included:

- ***Accounting analysis:*** We evaluated the appropriateness of the accounting bases the Group applies in the Civil Aerospace business by reference to accounting standards focusing on the substance of the transactions.
- ***Assessing transparency:*** We considered whether the disclosure included in the financial statements enables shareholders to understand how the accounting policies represent the commercial substance of the Group's contracts with its customers.
- ***Testing application:*** We made our own independent assessment, with reference to the relevant accounting standards, of the accounting basis that should be applied to each long-term aftermarket contract entered into during the year and compared this to the accounting basis applied by the Group.

Our findings – We found that the Group has developed a framework for selecting the accounting bases which is consistent with a balanced interpretation of accounting standards and has applied this consistently *(2016 audit finding: balanced)*. We found that the disclosure was ample *(2016 audit finding: ample)*. For the agreements entered into during this year, it was clear which accounting basis should apply.

C The measurement of revenue and profit in the Civil Aerospace business

Refer to pages 122 and 123 (Key areas of judgement – Measurement of performance on long-term aftermarket contracts), page 126 (Significant accounting policies – Revenue recognition and TotalCare arrangements) and pages 99 and 100 (Audit Committee report – Financial reporting)

The risk *(Subjective estimates)* – The amount of revenue and profit recognised in a year on the sale of engines and on aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can typically span 15-25 years and the profitability of these arrangements typically assumes substantial life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in estimating future engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. In addition unanticipated technical issues can emerge without prior indication and add many hundreds of millions of pounds to future cost estimates.

The nature of these estimates means that their continual refinement can have an impact on the profits of the Civil Aerospace business that can be significant in an individual financial year and the range of acceptable of judgements are such that the cumulative profit to date on the programs could vary by some hundreds of millions of pounds.

The Group has experienced significant in-service engine issues on both the Trent 1000 and Trent 900 programmes. Assessing the estimated cost of managing these issues, assessing which costs relate to long-term aftermarket contracts and which are development costs and assessing the extent to which the proposed engineering solutions will improve engine performance are all significant judgements which have a significant effect on profit recognition.

As a consequence of these in-service engine issues, the significance of the risk has increased significantly during the year.

Our response – Our procedures included:

- ***Controls:*** We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on these contracts is accurately reflected in the financial statements; these controls operated over both the inputs and the outputs of the calculations.
- ***Historical comparisons and our sector knowledge:*** We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates indicated any evidence of systematic or unconscious management bias in the context of the heightened pressure on and incentives for management to meet forecasts, guidance and targets discussed above. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods in relation to both cost and revenue forecasts, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions within programmes as well as with our sector experience.

Our analysis of forecast revenues considered each significant airframe that is powered by the Group's engines. We developed expectations of changes which were based on discussions with commercial and operational management and our own experience, supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuation specialist was objective and suitably qualified.

Our analysis of forecast costs considered costs on both a programme-by-programme basis and on a cross-programme basis. We undertook detailed assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of the impact of known technical issues on cost forecasts. We compared future cost assumptions to those adopted in the prior year and sought explanations for these movements from financial and operational management, corroborating to appropriate engineering cost data. We focused on the estimates of costs expected to be incurred to respond to the in-service engine issues on the Trent 1000 and Trent 900 programmes.

We considered the nature of the causes of the in-service engine issues on the Trent 1000 and Trent 900 programmes and challenged management on its assessment of the extent to which the proposed engineering solutions will improve engine performance and the extent to which this assessment has been reflected in the estimated cumulative profit on aftermarket contracts on the affected fleets. As this assessment is dependent on deep engineering expertise of management personnel, we requested and received specific representations from the Board of Directors that it was likely that the proposed engineering solutions should improve engine performance to at least the levels included in these accounting estimates.

- ***Test of details:*** We considered a combination of external and internal information to determine expectations for contract revenue and cost assumptions for each programme and identified contracts that were outliers. We sought explanations for these outliers and corroborated these explanations by reference to appropriate commercial information and, where necessary, the underlying contracts.

  For all new contracts in the period we assessed whether key contractual terms, such as the contract length, the number of engines expected to be delivered and the flying hour rates, were correctly reflected in the contract accounting models. We also reviewed the contracts for unusual terms that might indicate a cost profile different to the baseline cost assumptions for the fleet.

  We also checked the mathematical accuracy of analysis of the in-year margin impact of changes in cost and revenue estimates on a contract by contract basis. For a sample of contracts we obtained explanations for the changes in assumptions, corroborating those explanations by reference to appropriate commercial and operational data, and assessed whether any changes identified had been reflected across other fleets where relevant.

  We considered the completeness of cost estimates for emerging technical issues by reviewing a combination of external information, such as air worthiness directives, and internal information such as registers of in-flight events and disruption indices.

  We challenged the assessment of the recoverability of contract assets by considering external customer credit ratings and searching for any other indicators of stress amongst the customer base. We also considered whether there were any indicators of heightened risk over forecast revenue assumptions by considering the recent hours flown by customers, with a particular focus on older fleets.

- ***Personnel interviews:*** We interviewed a wide range of financial and operational personnel to identify any factors that should be taken into account in our analysis. In all cases we corroborated management's explanations, including changes in assumptions, and evaluated these relative to our own analysis. We assessed whether there were any indicators of bias in the explanations provided to us by management.

Our findings – We focused our controls testing on controls that we assessed as likely to provide effective audit evidence, largely those relating to revenue estimates. We also considered the operation of other controls in order to provide relevant comment to management and the Audit Committee. We found that the remediation of control weaknesses identified in earlier periods had been consolidated. The scope and depth of our detailed testing and analysis was expanded to take account of the remaining control weaknesses.

We found that the in-service issues on the Trent 1000 and Trent 900 programmes largely related to a shorter than expected life of turbine blades. We therefore consider that the short-term costs of monitoring the condition of these blades and replacing them earlier than anticipated where necessary and the costs of fitting replacement parts with longer lives (and the cost of related disruption claims) were properly assessed as being contract costs and that the cost of designing replacement parts with longer lives (and associated improvements) were properly assessed as being development costs that should be charged to the income statement as incurred.

We found that the estimates included in the accounting for long-term aftermarket contracts on the Trent 1000 and Trent 900 fleets affected by the in-service engine issues were balanced and that the current level of understanding and the nature of some of these issues are such that the estimated level of improvement in engine performance and the estimated costs could change significantly in the future as this understanding matures.

Our testing did not identify any indicators of management bias in the estimation of future contract costs or revenues and verified that refinements to estimates made during the period were justifiable and within a range of reasonably expected outcomes. Overall, our assessment is that the assumptions and resulting estimates resulted in balanced (2016 audit finding: balanced) profit recognition.

D Recoverability of intangible assets (certification costs and participation fees, development expenditure and contractual aftermarket rights) in the Civil Aerospace business

Refer to page 124 (Key sources of estimation uncertainty – Forecasts and discount rates), pages 128 and 129 (Significant accounting policies – Certification costs and participation fees, Research and development, Contractual aftermarket rights and Impairment of non-current assets), pages 142 to 143 (Note 9 to the financial statements – Intangible assets) and pages 99 and 100 (Audit Committee report – Financial reporting)

The risk *(Forecast-based valuation)* – The recovery of these assets depends on a combination of achieving sufficiently profitable business in the future as well as the ability of customers to pay amounts due under contracts often over a long period of time. Assets relating to a particular engine programme are more prone to the risk of impairment in the early years of a programme as the engine's market position is established. In addition, the pricing of business with launch customers makes assets relating to these engines more prone to the risk of impairment.

The significance of the risk has increased during the year due to the substantial increase in the estimated cost of managing in-service engine issues and developing longer-lived turbine blades (and associated improvements) for the Trent 900 programme, which is the programme where the intangible assets are most susceptible to impairment.

Our response – Our procedures focused on the Trent 900 programme intangible assets and included:

- ***Controls:*** We tested the controls designed and applied by the Group to provide assurance that the assumptions used in preparing the impairment calculations are regularly updated, that changes are monitored, scrutinised and approved by appropriate personnel and that the final assumptions used in impairment testing have been appropriately approved.
- ***Historical comparisons and our sector knowledge:*** We challenged the appropriateness of the key assumptions in the impairment tests (including market size, market share, pricing, engine and aftermarket unit costs, individual programme assumptions, price and cost escalation, discount rate and exchange rates). Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, our understanding of the commercial prospects of key engine programmes, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes and customers and comparison of assumptions with public data where this was available. This assessment was also informed by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuation specialist was objective and suitably qualified.

  We also assessed whether the significant increase in the estimated cost of managing the in-service engine issues on the Trent 900 programme indicated that management's estimates made for the 2016 impairment test for that programme were optimistic and whether that should impact on our assessment of estimates made this year.

  We considered the nature and causes of the in-service engine issues on the Trent 900 programme and challenged management on its assessment of the cost of addressing these issues and on the extent to which the proposed engineering solutions will improve engine performance and the extent to which this assessment has been reflected in the estimated future cash flows of the affected fleets. As these assessments are dependent on deep engineering expertise of management personnel, we requested and received specific representations from the Board of Directors that it was likely that the proposed engineering solutions should improve engine performance to at least the levels included in these accounting estimates.
- ***Test of details:*** For in-service engines we compared the assumptions in the impairment model to those that we had verified to be appropriate in the contract accounting models through the procedures discussed above. We compared assumptions in the business plans to those adopted in prior periods and for all changes we obtained explanations, corroborating those explanations by reference to appropriate commercial and operational data.
- ***Sensitivity analysis:*** We performed sensitivity analysis to assess the impact of possible different assumptions related to revenue and cost estimates including (1) increases or decreases to the forecast period of aftermarket revenue on current in-service engines, (2) decreases to the forecast future engine sales and (3) increases or decreases to the forecast costs or delays in delivering the solutions to the in-service technical issues referred to above including any increased pay-outs under associated guarantees to a cornerstone customer.
- ***Personnel interviews:*** We interviewed a wide range of financial and operational personnel to identify any factors that should be taken into account in our analysis. In all cases we corroborated management's explanations, including changes in assumptions, and evaluated these relative to our own analysis. We assessed whether there were any indicators of bias in the explanations provided to us by management.
- ***Assessing transparency:*** We considered whether the disclosures in Note 9 to the financial statements describe the inherent degree of subjectivity in the estimates and the potential impact on future periods of revisions to these estimates.

Our findings – Our testing did not identify weaknesses in the design and operation of controls that would have required us to expand the nature or scope of our planned detailed test work. We found no errors in calculations *(2016 audit finding: none)*.

With regard to the Trent 900 programme assets, we found (1) that the cost estimates made for the 2016 impairment test were appropriate in hindsight, based on the emergence of the issues late in 2016 and the data available at that time; (2) that there is no evidence that estimates made for the 2017 impairment test were biased; and (3) that overall the assumptions and resulting estimates on the Trent 900 programme were mildly optimistic and that other acceptable estimates could have led to the recognition of an impairment *(2016 audit finding: balanced)*. We found that the disclosures relating to the carrying value of programme intangible assets were proportionate in the context of a significant portion of these assets being derecognised on adoption of IFRS 15 *Revenue from Contracts with Customers (2016 audit finding: proportionate)*.

E Consequences of deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas markets

Refer to pages 109 (Safety & Ethics Committee report – Ethics and compliance)

The risk *(Omitted disclosure)* – In January 2017, the Group entered into deferred prosecution agreements with the UK Serious Fraud Office (SFO) and the US Department of Justice (DoJ) and a leniency agreement with the Brazilian Federal Prosecution Service (MPF) (the "Agreements") related to allegations against the Group for making fraudulent payments to commercial intermediaries in overseas territories. Under the Agreements, prosecution was suspended provided that the Group fulfils certain requirements, including the payment of a financial penalty. If the Group were found to have failed to fulfil its responsibilities under the Agreements it would risk prosecution and this would require disclosure in the financial statements.

We have read the Agreements and consider that the most relevant circumstance that could result in the risk of prosecution would be identification of further instances of bribery and corruption (whether or not reported to the authorities). The Group operates in an industry where some procurement processes are highly susceptible to the risk of corruption. A large part of the Group's business is characterised by competition for individually significant contracts with customers which are often directly or indirectly associated with governments. In addition the Group operates in a number of territories where the use of commercial intermediaries is either required by the government or is common practice.

We therefore designed an approach to provide reasonable assurance that we would identify bribery and corruption involving commercial intermediaries that would require disclosure in the financial statements. However, as described below reasonable assurance is a high level of assurance. It does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when one exists. As with any audit, there remains a higher risk of non-detection of irregularities (such as bribery and corruption), as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

Whilst this inherent limitation is the same as that in other audits, it should be of greater significance to the addressee of this audit report.

This is a risk arising for the first time this year.

Our response – Our procedures included:

- ***Heightened scepticism and use of our anti-bribery and corruption expertise:*** Throughout the audit we maintained a high level of vigilance to possible indications of significant non-compliance with laws and regulations relating to bribery and corruption whilst carrying out our other audit procedures. In particular, we communicated the risks over bribery and corruption to our team, which included individuals with experience relevant to considering bribery and corruption risks in the context of an audit, and we requested our component teams to report on any possible indications of irregularities in this area.
- ***Control design:*** We evaluated the tone set by the Board of Directors and the Executive Leadership Team and the Group's approach to managing the risk of bribery and corruption. We evaluated and tested the Group's policies, procedures and controls over selection, appointment and renewal of intermediaries, contracting with intermediaries, ongoing management of contracts with intermediaries and payments made to intermediaries. We observed Sector Audit Committee meetings at which lists of payments were reviewed for completeness. We evaluated internal audits covering payments to intermediaries and we compared the results of the internal audits to the results of our testing of payments described below. We also made enquiries of the Group's central compliance function and reviewed their reporting to the Safety & Ethics Committee and to the Sector Audit Committees in connection with the identification of and response to suspected breaches of policy.
- ***Test of details:*** We sought to identify payments made to commercial intermediaries during the year using data analysis techniques. This included (1) searching for transaction details which included specific terms or names of organisations that in our experience could be associated with potential payments to commercial intermediaries, or the names of commercial intermediaries that had been rejected through the Group's selection process or had been identified during the investigations by the DoJ, SFO and MPF and (2) extracting details of transactions that had been recorded in accounts that were intended to record payments to commercial intermediaries. For a sample of these transactions, we then tested whether the identified transactions had been subject to the Group's controls over approval of payments made to commercial intermediaries including whether the organisations to which payments were made had been subject to the Group's controls over the appointment and renewal of commercial intermediaries.
- ***Enquiry of lawyers:*** Having enquired of management, including the Head of Ethics and Compliance and the Group General Counsel, the Audit Committee and the Board of Directors as to whether the Group is in compliance with laws and regulations relating to bribery and corruption, we made written enquiries of and met with the Group's legal advisers to cross check the results of those enquiries and also to enquire whether they were aware of any matters relating to the Group's compliance with the Agreements.
- ***Compliance report scrutiny:*** We reviewed the compliance reports required to be made to the DoJ and the SFO under the Agreements and to other authorities and vouched the status of matters documented in these reports to further support where objectively verifiable.

Our findings – We did not identify any breaches of the requirements of the Agreements, payments of bribes or other corrupt behaviour that would result in omitted disclosure in the financial statements.

Presentation and explanation of results

Refer to pages 21 to 41 (Business review), pages 16 to 19 and 50 to 54 (Financial review), pages 132 to 136 (Note 2 to the financial statements – Segmental analysis) and pages 99 and 100 (Audit Committee report – Financial reporting)

F The presentation of 'underlying profit'

The risk *(Presentation appropriateness)* – In addition to its Adopted IFRS financial statements, the Group presents an alternative income statement on an 'underlying' basis. The directors believe the 'underlying' income statement reflects better the Group's trading performance during the year. The basis of adjusting between the Adopted IFRS and 'underlying' income statements and a full reconciliation between them is set out in Note 2 to the financial statements on pages 134 and 135.

A significant recurring adjustment between the Adopted IFRS financial information and the 'underlying' financial information relates to the foreign exchange rates used to translate foreign currency transactions. The Group uses forward foreign exchange contracts to manage the cash flow exposures of a proportion of forecast transactions denominated in foreign currencies (with the aim of having transactions denominated in foreign currencies in the current period fully hedged) but does not apply hedge accounting in its Adopted IFRS financial information for these transactions. The 'underlying' financial information translates transactions denominated in foreign currencies at the achieved foreign exchange rate on forward foreign exchange contracts settled in the period, retranslates assets and liabilities at exchange rates forecast to be achieved from future settlement of such contracts and excludes unrealised gains and losses on such contracts which are included in the Adopted IFRS income statement. The Group has discretion over which forward foreign exchange contracts are settled in each financial year, which could impact the achieved rate both for the period and in the future. Management bias in the selection of the settled forward foreign exchange contracts could distort the performance of the Group.

In addition, adjustments are made to exclude one-off past-service costs on post-retirement schemes, the cost of restructuring programmes that involve the substantial closure or exit from a site, facility or line of business or other major transformation activities, the effect of acquisition accounting (including any subsequent impairments of goodwill or other intangible assets), gains or losses on the sale of businesses and a number of other items.

Alternative performance measures (such as the 'underlying' financial information) can provide shareholders with appropriate additional information if properly used and presented. In such cases, measures such as these can assist shareholders in gaining a more detailed and hence better understanding of a company's financial performance and strategy. However, when improperly used and/or presented, these kinds of measures might prevent the Annual Report being fair, balanced and understandable by hiding the real financial position and results or by distorting the apparent profitability of the Group.

The significance of this risk has decreased this year following the inclusion of somewhat improved disclosure of the nature and amounts of the adjustments between Adopted IFRS and underlying measures in the 2016 and 2017 Annual Reports.

Our response – Our procedures included:

- ***Assessing principles:*** We assessed the appropriateness of the basis for the adjustments between the Adopted IFRS income statement and the 'underlying' income statement.
- ***Assessing application:*** We assessed the consistency of application of this basis and we recalculated the adjustments with a particular focus on the impact of the foreign exchange rates used to translate foreign currency amounts in the 'underlying' income statement. We assessed whether or not the selection of forward foreign exchange contracts settled in the year showed any evidence of management bias.
- ***Assessing transparency:*** We also assessed: (i) the extent to which the prominence given to the 'underlying' financial information and related commentary in the Annual Report compared to the Adopted IFRS financial information and related commentary could be misleading; (ii) whether the Adopted IFRS and 'underlying' financial information are reconciled with sufficient prominence given to that reconciliation; (iii) whether the basis of the 'underlying' financial information is clearly and accurately described and consistently applied; and (iv) whether the 'underlying' financial information is not otherwise misleading in the form and context in which it appears in the Annual Report.

Our findings – We found no concerns regarding the basis of the 'underlying' financial information or its calculation and no indication of management bias in the settlement of forward foreign exchange contracts. We consider that there is proportionate disclosure of the nature and amounts of the adjustments to allow shareholders to understand the implications of the two bases on the financial measures being presented *(2016 audit finding: proportionate (and somewhat improved))*. We found the overall presentation of the 'underlying' financial information to be balanced *(2016 audit finding: balanced)*.

G Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount

The risk *(Presentation appropriateness)* – The Group's profits are significantly impacted by items, such as cumulative adjustments to profit recognised on long-term contracts, impairments (and reversals of impairments) of goodwill, CARs and other intangible assets, sale and leasebacks of spare engines to joint ventures, research and development charges, reorganisation costs and foreign exchange translation, which can be uneven in frequency and/or amount. If significant either to the profit for the year or to the trend in profit, appropriate disclosure of the effect of these items is necessary in the Annual Report and financial statements to provide the information necessary to enable shareholders to assess the Group's performance.

The significance of this risk has decreased this year as the Group now has a well-established practice of providing ample disclosure of these items.

Our response – Our procedures included:

- ***Assessing balance and assessing transparency:*** We undertook detailed analysis of business performance at Group and segment level that sought to identify items that affect profit (and the trend in profit) which are uneven in frequency or amount at a much lower level than we would otherwise have done and to assess the transparency of disclosure of these items. We challenged the prominence and adequacy of the disclosures throughout the Annual Report and in the results announcement relating to the significant in-service engine issues on the Trent 1000 and Trent 900 programmes, in particular the adequacy of the disclosure indicating the estimated future cost of these issues in the context of only a proportion of the cash impact being incurred to date and of contract accounting resulting in only a proportion of the estimated ultimate cost having been recorded in the income statement to date.

Our findings – We identified a number of significant items that had affected profit for the year or the prior year that required appropriate disclosure in the Annual Report to enable shareholders to assess the Group's performance. The key items are:

(1) the £2,648m unrealised fair value gains *(2016: £4,420m losses)* on derivative contracts;

(2) the £227m loss *(2016: £98m loss)* relating to in-service engine issues on the Trent 1000 and Trent 900 programmes;

(3) the £113m gain *(2016: £217m gain)* arising from the impact of improvements in lifecycle costs on long-term contracts;

(4) the £148m loss *(2016: £98m loss)* on long-term contracts arising from technical issues on Civil Aerospace engines including £114m *(2016: £55m)* relating to the in-service engine issues on the Trent 1000 and Trent 900 programmes which is also included in (2) above;

(5) the £77m gain *(2016: nil)* resulting from an improvement in a customer credit rating;

(6) the £60m loss *(2016: £29m loss)* arising from other estimate changes on long-term contracts;

(7) the £795m *(2016: £918m)* of research and development charges, which excludes £83m of costs capitalised in 2017 as certain programmes reached capitalisation point under revised application of the Group's accounting policy;

(8) the £104m, net of a release of prior year provisions of £3m, *(2016: £129m, net of a £5m release)* of exceptional restructuring charges;

(9) the £75m *(2016: £119m)* profit arising from sales of spare engines to joint ventures;

(10) the £798m of gains resulting from the acquisition of a controlling interest in ITP Aero;

(11) the £163m *(2016: nil)* of advance corporation tax recognised on change of tax legislation;

(12) the £219m impairment of goodwill recognised in 2016;

(13) the £30m loss arising on Civil Aerospace new engine programmes in 2016;

(14) the £671m financial penalties recognised in 2016 from agreements with investigating authorities in connection with alleged historic bribery and corruption involving intermediaries in overseas territories;

(15) the £53m release of accruals in 2016 relating to the termination in prior years of intermediaries services;

(16) the £306m loss recognised in 2016 from the restructuring of the UK pension schemes.

We found that ample disclosure of these items had been provided in the Annual Report and financial statements taken as a whole *(2016 audit finding: ample)*.

H Gains resulting from the acquisition of a controlling interest in Industria De Turbo Propulsores SA (ITP Aero)

Refer to pages 99 and 100 (Audit Committee report – Financial reporting), page 128 (Note 1 to the financial statements – Accounting policies) and page 167 (Note 25 to the financial statements – Acquisitions and disposals)

The risk *(Subjective valuation)* – On 19 December 2017, the Group purchased the outstanding 53.1% of Industria de Turbo Propulsores SA (ITP Aero) that it did not already own. As explained on page 167, given the proximity of the acquisition to the end of the year, the fair values of the assets and liabilities acquired have been assessed on a provisional basis.

Estimating the fair value of the intangible assets of ITP Aero at the date of acquisition involved the use of complex valuation techniques and the estimation of future cash flows over a considerable period of time.

The Group's existing 46.9% shareholding has been remeasured to estimated fair value at the acquisition date and a £553m gain has been recognised in the income statement. As the consideration payable for the remaining interest was established through a contractual mechanism included in the option agreement under which the remaining interest was "put" to the Group, it is not considered to be indicative of a fair value of the existing shareholding. The Group has calculated the fair value of the existing shareholding using a discounted cash flow methodology that involves the use of significant judgement in estimating future cash flows over a considerable period of time, assessing the appropriate discount rate to use and establishing a suitable non-controlling interest discount to deduct from the enterprise value.

Our response – Our procedures, which were carried out in the context of the fair values of the acquired intangible assets only being able to be estimated on a provisional basis, included:

- ***Assessing the valuer's credentials:*** Management engaged a third party expert to assist in identifying ITP Aero's intangible assets and in determining their fair values at the acquisition date. We evaluated the expert's competence and independence and whether it had been appropriately instructed and had been provided with complete, accurate data on which to base its valuations.
- ***Assessing the due diligence provider's credentials:*** Management engaged a third party expert to assist in estimating the future cash flows of ITP Aero to be used in valuing the intangible assets acquired and the existing shareholding in ITP Aero. The third party expert was provided with base data by the management of ITP Aero and subjected this to challenge and derived adjustments to the base cash flows provided by management for use in the valuations. We evaluated the expert's competence and independence and whether it had been appropriately instructed.
- ***Our corporate finance expertise and our sector knowledge:*** We evaluated the basis upon which management identified the intangible assets acquired. We assessed whether the measurement bases used to estimate the fair values of the identified assets were reasonable, taking account of our experience of similar assets in other comparable situations and our assessment of the work performed by the third party expert.
- ***Our corporate finance expertise and our sector knowledge:*** We assessed the basis used by management to value the existing shareholding in ITP Aero. We challenged the appropriateness of the key assumptions underlying the forecast cash flows (including program assumptions and the terminal value growth rate) and compared these to the Group's own forecasts where ITP Aero's and the Group's businesses overlapped. We challenged the discount rate applied and the non-controlling interest discount deducted from the enterprise value in management's valuation. We also assessed whether or not the estimates showed any evidence of management bias.
- ***Assessing transparency:*** We assessed whether the appropriate disclosures have been provided on the judgements and estimates applied in arriving at the fair values.

Our findings – We found that the intangible assets identified were typical of acquisitions of similar businesses and the valuation bases were in accordance with accounting standards. We have no concerns with the basis on which the valuer had been instructed by the Group and found that the valuer was objective and competent and the estimates used in the valuations were balanced. We found that the disclosure regarding the provisional nature of the fair values attributed to the intangible assets was balanced given the timing of the acquisition and limitations on the information ITP Aero could provide to the Group prior to completion of the acquisition.

We found that the basis used to value the existing shareholding in ITP Aero was in accordance with accounting standards and that the key assumptions applied in the valuation were balanced.

I Disclosure of the impact of adopting IFRS 15

Refer to pages 99 and 100 (Audit Committee report – Financial reporting), pages 131 to 132 (Note 1 to the financial statements – Accounting policies – IFRS 15 Revenue from Contracts with Customers) and pages 170 to 171 (Note 27 to the financial statements – Impact of IFRS 15)

The risk *(Accounting treatment and accounting application)* – IFRS 15 *Revenue from Contracts with Customers* will be effective for the year beginning 1 January 2018 and will have a pronounced impact on the recognition of revenue and profit in the Civil Aerospace business. The Group has disclosed the estimated impact of applying the new standard to its 2017 results. The Group's contracts can be complex and there is significant judgement applied in selecting the accounting policies under IFRS 15. There is a risk that the Group has not captured the correct policies in line with the new standard and that not all material areas of potential change have been identified. In addition there is a risk that the policies are not applied appropriately.

Our response – Our procedures included:

- ***Accounting analysis and our sector experience:*** Starting in 2015, we reviewed the process and outputs of the adoption of IFRS 15 impact analysis, evaluated the appropriateness of the key judgements and estimates, and assessed whether the policies adopted are in compliance with IFRS 15. Based on our knowledge of the business and of the impact of adoption of IFRS 15 on other companies with similar businesses, we assessed whether all material areas of potential change under IFRS 15 have been identified. We considered each significant distinct revenue stream and our knowledge of the terms of the contracts to determine the likelihood of there being a material difference between the current treatment and the requirements of IFRS 15. Our analysis covered the whole business but we were particularly focused on the Civil Aerospace business and on the treatment of long-term contracts in other parts of the Group.
- ***Test of details:*** We selected samples of contracts based on a risk assessment of contracts most likely to be affected by IFRS 15 and recalculated the impact of applying the accounting policies developed by the Group.
- ***Assessing transparency:*** We assessed whether the disclosure adequately disclosed the key revenue recognition policies under IFRS 15 and the estimated impact on the 2017 income statement and net assets at 31 December 2017.

Our findings – We found that the Group had carried out an analysis of potential differences between revenue recognition under IFRS 15 and under its current accounting policies commensurate with describing the effect of applying the new standard. We found that the Group had made judgements in developing its IFRS 15 accounting policies that were consistent with a balanced interpretation of the new standard with an objective of faithfully representing the substance of the Group's transactions with its customers. We found that in compiling the estimated impact of applying IFRS 15, the Group had applied those policies consistently to similar transactions. We found the resulting disclosure to be ample.

Recoverability of the parent Company's investment in subsidiaries
(£12 bn; 2016: £12bn)

Refer to page 173 (parent Company financial statements).

The risk *(Low risk, high value)* – The carrying amount of the parent Company's investments in subsidiaries represents 100% (2016: 100%) of its total assets. Their recoverability is not at a high risk of significant misstatement or subject to significant judgement. However, due to their materiality in the context of the parent Company financial statements, this is considered to be the area that had the greatest effect on our audit of the parent Company's financial statements.

Our response – Our procedures included:

- ***Our sector experience:*** Having established that the parent Company owns the whole of the issued share capital of a company that directly or indirectly owns all other group companies, we used our understanding of the sectors in which the Group operates and of the Group's business to identify any potential indicators of impairment of the investment in that company and then carried out analysis to evaluate whether any of these potential indicators of impairment represented an indicator of impairment.

Our findings – We identified some potential indicators of impairment, including the current trading conditions affecting the Commercial Marine business and the parent Company's net assets exceeding the Group's consolidated net assets. We assessed that individually and in aggregate these did not amount to an indicator of impairment.

In reaching our audit opinion on the financial statements we took into account the findings that we describe above and those for other, lower risk areas included in the output from our Dynamic Audit planning tool set out above. Overall the findings from across the whole audit are that the financial statements have been prepared on the basis of appropriate accounting policies, reflect balanced estimates and provide proportionate disclosure. However, having assessed these findings and evaluated uncorrected misstatements in the context of materiality and considered the qualitative aspects of the financial statements as a whole, we have not modified our opinion on the financial statements.

3 Our application of materiality and an overview of the scope of our audit

Materiality

Materiality for the Group financial statements as a whole was set at £40m *(2016: £30m)*, determined with reference to a benchmark of group profit before tax averaged over the last three years, in order to take into account the volatility in profits over this period, and normalised to exclude the impact of gains and losses on revaluation of foreign currency and other derivative financial instruments, which could otherwise result in an inappropriate materiality level being determined. This benchmark was £950m *(2016: £1,039m)* and this materiality measure represents 4.2% *(2016: 2.9%)* of this benchmark and 0.8% *(2016: 0.6%)* of total reported profit/loss before tax. We carry out audit procedures to assess the accuracy of the gains and losses on these derivative financial instruments (which this year amounted to a £2.6bn gain *(2016: £4.4bn loss)*) as part of our audit of the Group's treasury operations.

Materiality for the parent Company financial statements as a whole was set at £36m *(2016: £27m)*, determined with reference to a benchmark of net assets, of which it represents 0.3% *(2016: 0.2%)*, as the parent Company is treated as a component for the purposes of the audit of the Group financial statements.

We agreed to report to the Audit Committee (i) all material corrected identified misstatements; (ii) uncorrected identified misstatements exceeding £2m *(2016: £1.5m)* for income statement items; and (iii) other identified misstatements that warranted reporting on qualitative grounds.

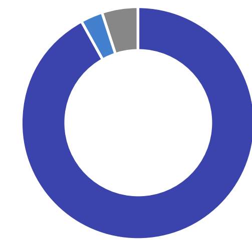
The scope of our audit

Of the Group's 367 reporting components, we subjected 25 *(2016: 34)* to full scope audits for group purposes and 7 *(2016: 13)* to specified risk-focused audit procedures. The latter were not individually financially significant enough to require a full scope audit for group purposes, but did present specific individual risks that needed to be addressed. This work also provided further audit coverage.

The components within the scope of our work accounted for the percentages illustrated opposite.

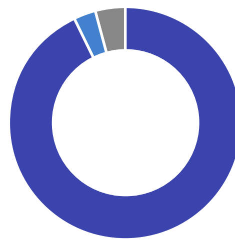
The remaining 5% of total group revenue, 4% of group profit before tax and 5% of total group assets is represented by 335 reporting components, none of which individually represented more than 0.8% of any of total group revenue, group profit before tax or total group assets. For these residual components, we performed analysis at an aggregated group level to re-examine our assessment that there were no significant risks of material misstatement within these.

Revenue



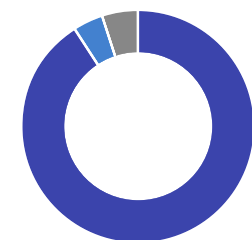
- **92%** (2016: 94%)
- **3%** (2016: 5%)
- **5%** (2016: 1%)

Underlying profit before tax



- **93%** (2016: 89%)
- **3%** (2016: 8%)
- **4%** (2016: 3%)

Total assets



- **91%** (2016: 89%)
- **4%** (2016: 8%)
- **5%** (2016: 3%)

- Audit for group reporting purposes
- Specified risk-focused audit procedures
- Group-level procedures only

The Group operates shared service centres for the bulk processing of financial transactions in Derby (UK), Indianapolis (US) and Singapore, the outputs of which are included in the financial information of the reporting components they service and therefore they are not separate reporting components. Each of the service centres is subject to specified risk-focused audit procedures, predominantly the testing of transaction processing and review controls. Additional audit procedures are performed at certain reporting components to address the audit risks not covered by the work performed over the shared service centres.

The work on 21 of the 32 components *(2016: 19 of the 47 components)* was performed by component audit teams and the rest, including the audit of the parent Company, was performed by the Group audit team. The Group audit team instructed component auditors and the audit teams of the shared service centres as to the significant areas to be covered (including the relevant risks detailed above), the audit approach to be taken on significant risks and the information to be reported to the Group audit team. The Group audit team set the materiality to be used for each component audit, which ranged from £1.4m to £30m *(2016: £0.2m to £30m)*, having regard to the mix of size and risk profile of the components.

The Group audit team maintained close contact with the audit teams on the more significant components through weekly telephone conference meetings and other ad hoc communications and the Group team visited 20 *(2016: 33)* locations in UK, the US, Germany and Scandinavia meeting with the component audit teams and component management. The purpose of these communications was to update the Group team's understanding of the components' business and related risks of material misstatement and to monitor progress of the audit.

For the more significant components (18 components contributing 88% of revenue and 70% profit before tax), the Group audit team received reporting on audit findings and participated in Sector Audit Committee meetings and closing meetings with component management. Towards the conclusion of each component audit, the Group audit team met the component audit teams (either face to face or on a telephone conference) and discussed the findings reported to the Group audit team in more detail and reviewed and evaluated the audit work of each component audit team on significant audit risks and other relevant areas. Any further work required by the Group audit team was then performed by the component audit team.

The Group audit team communicated the independence and other ethical requirements that apply to the audit to component audit teams. Throughout the year, the Group audit team assessed each non-audit service that the Group requested KPMG undertake worldwide and only approved the service once it was established that the service was permissible under auditor independence regulations and had been pre-approved by the Audit Committee.

4 We have nothing to report on going concern

We are required to report to you if:

- we have anything material to add or draw attention to in relation to the directors' statement in Note 1 to the financial statements on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Group and Company's use of that basis for a period of at least twelve months from the date of approval of the financial statements; or
- the related statement under the Listing Rules set out on page 63 is materially inconsistent with our audit knowledge.

We have nothing to report in these respects.

5 We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover this other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

Strategic report and directors' report

Based solely on our work on the other information:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

Directors' remuneration report

In our opinion the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

Disclosures of principal risks and longer-term viability

Based on the knowledge we acquired during our financial statements audit, we have nothing material to add or draw attention to in relation to:

- the directors' confirmation within the Compliance with the UK Corporate Governance Code 2016 Statement (page 77) that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency and liquidity;
- the Principal Risks disclosures (pages 59 to 62) describing these risks and explaining how they are being managed and mitigated; and
- the directors' explanation in the Going Concern and Viability Statements (page 63) of how they have assessed the prospects of the Group, over what period they have done so and why they considered that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Under the Listing Rules we are required to review the Going Concern and Viability Statements (page 63). We have nothing to report in this respect.

Corporate governance disclosures

We are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our financial statements audit and the directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy (page 114); or
- the section of the Annual Report describing the work of the Audit Committee (pages 97 to 103) does not appropriately address matters communicated by us to the Audit Committee.

We are required to report to you if the Compliance with the UK Corporate Governance Code 2016 Statement (pages 77 and 78) does not properly disclose a departure from the eleven provisions of the UK Corporate Governance Code specified by the Listing Rules for our review.

We have nothing to report in these respects.

6 We have nothing to report on the other matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent Company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

7 Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 114, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Group and parent Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Group or the parent Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or other irregularities (see below), or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

Ability to detect irregularities

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our sector experience, through discussion with the directors and other management personnel (as required by ISAs (UK)), and from inspection of the Group's regulatory and legal correspondence.

We had regard to laws and regulations in areas that directly affect the financial statements including those relating to financial reporting (and related company legislation) and taxation. We considered the extent of compliance with those laws and regulations as part of our procedures on the related financial statements items.

In addition, we considered the impact of laws and regulations in the specific areas of civil aviation safety, export control, defence contracting and anti-bribery and corruption legislation recognising the financial and regulated nature of the Group's activities. With the exception of any known or possible non-compliance identified in the course of our audit, as required by ISAs (UK), our work in respect of these areas was limited to enquiry of the directors and other management personnel and inspection of regulatory and legal correspondence. We considered the effect of any known or possible non-compliance in these areas as part of our procedures on the related financial statements items.

Additional considerations in respect of bribery and corruption are set out in the key audit matter disclosures in section 2 of this report.

We communicated these identified areas of laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit. This included communication from the Group audit team to component audit teams of relevant laws and regulations identified at group level, with a request to report on any indications of the potential existence of non-compliance with relevant laws and regulations ("irregularities") in these areas, or other areas directly identified by the component team.

As with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

8 The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the parent Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and the terms of our engagement by the parent Company. Our audit work has been undertaken so that we might state to the parent Company's members those matters we are required to state to them in an auditor's report and the further matters we are required to state to them in accordance with the terms agreed with the parent Company and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the parent Company and the parent Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Jimmy Daboo (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants
15 Canada Square
London E14 5GL
6 March 2018

Sustainability Assurance Statement

To: the stakeholders of Rolls-Royce Holdings plc

Independent limited assurance statement

Introduction and objectives of work

Bureau Veritas UK Limited (Bureau Veritas) has been engaged by Rolls-Royce Holdings plc (Rolls-Royce) to provide limited assurance over selected sustainability performance indicators for inclusion in its 2017 Annual Report and website. This assurance statement applies to the related information included within the scope of work described below.

Scope of work

The scope of our work was limited to assurance over the following information included within the Rolls-Royce Holdings plc 2017 Annual Report (the Report) for the period 1 January to 31 December 2017 (the selected information):

- energy consumption;
- scope 1 and scope 2 greenhouse gas (GHG) emissions;
- total reportable injury (TRI) rate; and
- the number of people reached through the science, technology, engineering and mathematics (STEM) education outreach programmes.

Reporting criteria

The selected information are reported according to the Rolls-Royce basis of reporting document, as set out at www.rolls-royce.com/sustainability.

Limitations and exclusions

Excluded from the scope of our work is any verification of information relating to:

- activities outside the defined verification period; and
- other information included in the Report.

This limited assurance engagement relies on a risk-based selected sample of sustainability data and the associated limitations that this entails. This independent statement should not be relied upon to detect all errors, omissions or misstatements that may exist.

Responsibilities

This preparation and presentation of the selected information in the Report are the sole responsibility of the management of Rolls-Royce.

Bureau Veritas was not involved in the drafting of the Report or of the reporting criteria. Our responsibilities were to:

- obtain limited assurance about whether the selected information has been prepared in accordance with the reporting criteria;
- form an independent conclusion based on the assurance procedures performed and evidence obtained; and
- report our conclusions to the management of Rolls-Royce.

Assessment standard

We performed our work in accordance with International Standard on Assurance Engagements (ISAE) 3000 Revised, Assurance Engagements Other than Audits or Reviews of Historical Financial Information (effective for assurance reports dated on or after 15 December 2015), and in accordance with International Standard on Assurance Engagements (ISAE) 3410, Assurance Engagements on Greenhouse Gas Statements, issued by the International Auditing and Assurance Standards Board.

Summary of work performed

As part of its independent verification, Bureau Veritas undertook the following activities:

- assessed the appropriateness of the reporting criteria for the selected information;
- conducted interviews with relevant personnel of Rolls-Royce;
- carried out nine site visits, selected employing a risk-based approach, in the UK, US, Germany, Italy, Norway and Singapore;
- reviewed the data collection and consolidation processes used to compile the selected information, including assessing assumptions made, the data scope and reporting boundaries;
- reviewed documentary evidence produced by Rolls-Royce;
- agreed a selection of the selected information to the corresponding source documentation; and
- re-performed aggregation calculations of the selected information.

Conclusion

On the basis of our methodology and the activities described above, nothing has come to our attention to indicate that the selected information has not been properly prepared, in all material respects, in accordance with the reporting criteria.

Statement of independence, integrity and competence

Bureau Veritas is an independent professional services company that specialises in quality, environmental, health, safety and social accountability with over 185 years' history. Its assurance team has extensive experience in conducting verification over environmental, social, ethical and health and safety information, systems and processes.

Bureau Veritas operates a certified[1] Quality Management System which complies with the requirements of ISO 9001:2008, and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Bureau Veritas has implemented and applies a Code of Ethics, which meets the requirements of the International Federation of Inspections Agencies (IFIA)[2] across the business to ensure that its employees maintain integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and high ethical standards in their day-to-day business activities.

The assurance team for this work does not have any involvement in any other Bureau Veritas projects with Rolls-Royce.

Bureau Veritas UK Limited
London
6 February 2018

[1] Certificate of Registration FS 34143 issued by BSI Assurance UK Limited.
[2] International Federation of Inspection Agencies – Compliance Code – Third Edition

Other Financial Information

Foreign exchange

Foreign exchange rate movements influence the reported income statement, the cash flow and closing net funds balance. The average and spot rates for the principal trading currencies of the Group are shown in the table below:

		2017	2016	Change
USD per GBP	Year end spot rate	**1.35**	1.23	+10%
	Average spot rate	**1.29**	1.36	-5%
EUR per GBP	Year end spot rate	**1.13**	1.17	-3%
	Average spot rate	**1.14**	1.22	-7%

The Group's global corporate income tax contribution

Around 95% of the Group's underlying profit before tax (excluding joint ventures and associates) is generated in the UK, the US, Germany, Norway, Finland and Singapore. The remaining profits are generated across more than 40 other countries. This reflects the fact that the majority of the Group's business is undertaken, and employees are based, in the above countries.

In common with most multinational groups, the total of all profits in respect of which corporate income tax is paid is not the same as the consolidated profit before tax reported on page 116. The main reasons for this are:

(i) the Consolidated Income Statement is prepared under Adopted IFRS whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;

(ii) accounting rules require certain income and costs relating to our commercial activities to be eliminated from, or added to, the aggregate of all the profits of the Group companies when preparing the Consolidated Income Statement ('consolidation adjustments'); and

(iii) specific tax rules including exemptions or incentives as determined by the tax laws in each country.

The Group's total corporation tax payments in 2017 were £180m. The level of tax paid in each country is impacted by the above. In most cases, (i) and (ii) are only a matter of timing and therefore tax will be paid in an earlier or later year. As a result, they only have a negligible impact on the Group's underlying tax rate, which excluding joint ventures and associates would be 34.9% (2016: 37.5%). The underlying tax rate including joint ventures and associates can be found on pages 19 and 50. This is due to deferred tax accounting, details of which can be found in note 5 to the Consolidated Financial Statements. The impact of (iii) will often be permanent depending on the relevant tax law.

Further information on the tax position of the Group can be found as follows:

- Audit Committee report (page 99) – The group tax director gave a presentation to the Audit Committee during the year which covered various matters including tax risks and how they are managed;
- Note 1 to the Consolidated Financial Statements (pages 125 and 127) – Details of key areas of uncertainty and accounting policies for tax; and
- Note 5 to the Consolidated Financial Statements (pages 138 to 140) – Details of the tax balances in the Consolidated Financial Statements together with a tax reconciliation. This explains the main drivers of the tax rate.

At this stage we expect these items to continue to influence the underlying tax rate. The reported tax rate is more difficult to forecast due to the impact of significant adjustments to reported profits, in particular the net unrealised fair value changes to derivative contracts and the recognition of advance corporation tax.

Information on the Group's approach to managing its tax affairs can be found at www.rolls-royce.com/sustainability.

Investments and capital expenditure

The Group subjects all major investments and capital expenditure to a rigorous examination of risks and future cash flows to ensure that they create shareholder value. All major investments, including the launch of major programmes, require Board approval.

The Group has a portfolio of projects at different stages of their lifecycles. Discounted cash flow analysis of the remaining life of projects is performed on a regular basis.

Sales of engines in production are assessed against criteria in the original development programme to ensure that overall value is enhanced.

Financial risk management

The Board has established a structured approach to financial risk management. The Financial risk committee (Frc) is accountable for managing, reporting and mitigating the Group's financial risks and exposures. These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 17. The Frc is chaired by the Chief Financial Officer. The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets. The Group's policy is not to engage in speculative financial transactions. The Frc sits quarterly to review and assess the key risks and agree any mitigating actions required.

Capital structure

£m	2017	2016
Total equity	5,849	1,864
Cash flow hedges	112	107
Group capital	5,961	1,971
Net funds	(305)	(225)

Operations are funded through various shareholders' funds, bank borrowings, bonds and notes. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required. Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

The Group holds cash and short-term investments which, together with the undrawn committed facilities, enable it to manage its liquidity risk.

During the year, the Group extended the maturity of the £1,500m committed bank borrowing facility from 2021 to 2022 and extended the maturity of the £500m committed bank borrowing facility from 2019 to 2020. Both of these facilities were undrawn at the period end. Also during 2017, the Group drew a committed loan of £280m, maturing in 2024. At the year end, the Group retained aggregate liquidity of £5.1bn, including cash and cash equivalents of £3.0bn and undrawn borrowing facilities of £2.1bn. Circa £80m of borrowings mature in 2018 and £745m in 2019.

The maturity profile of the borrowing facilities is regularly reviewed to ensure that refinancing levels are manageable in the context of the business and market conditions. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating. The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 11.

Credit rating

	Rating	Outlook	Grade
Moody's Investors Service	A3	Negative	Investment
Standard & Poor's	BBB+	Stable	Investment

The Group subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings. At the date of this report, the Group maintained investment grade ratings from both agencies.

As a capital-intensive business making long-term commitments to its customers, the Group attaches significant importance to maintaining or improving the current investment grade credit ratings.

Accounting

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU.

No new accounting standards had a material impact in 2017. The impacts of changes to IFRS, in particular IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments* which are effective from 1 January 2018 are included within the accounting policies in note 1.

Share price

During the year, the share price increased by 27% from 668p to 847p, compared to a 5% increase in the FTSE aerospace and defence sector and a 8% increase in the FTSE 100. The Company's share price ranged from 640p in January 2017 to 981p in November 2016.

Other Statutory Information

Share capital

On 31 December 2017 the Company's issued share capital comprised of:

1,840,597,108	Ordinary shares	20p each
28,429,035,421	C Shares	1p each
1	Special Share	£1

The ordinary shares are listed on the London Stock Exchange.

Payment to shareholders

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend.

Shareholders can choose to:

- redeem all C Shares for cash;
- redeem all C Shares for cash and reinvest the proceeds in the C Share Reinvestment Plan (CRIP); or
- keep the C Shares.

The CRIP is operated by Computershare Investor Services PLC (the Registrar). The Registrar will purchase ordinary shares in the market for shareholders electing to reinvest their C Share proceeds. Shareholders wishing to participate in the CRIP or redeem their C Shares in July 2018 must ensure that their instructions are lodged with the Registrar no later than 5.00pm (BST) on 1 June 2018 (CREST holders must submit their election in CREST before 3.00pm (BST) on 1 June 2018). Redemption will take place on 5 July 2017.

At the 2018 AGM, the Directors will recommend an issue of 71 C Shares with a total nominal value of 7.1p for each ordinary share. The C Shares will be issued on 2 July 2018 to shareholders on the register on 27 April 2018 and the final day of trading with entitlement to C Shares is 25 April 2018. Together with the interim issue on 3 January 2018 of 46 C Shares for each ordinary share with a total nominal value of 4.6p, this is the equivalent of a total annual payment to ordinary shareholders of 11.7p for each ordinary share.

Further information for shareholders is on pages 202 and 203.

Share class rights

The full share class rights are set out in the Company's Articles of Association (Articles), which are available at www.rolls-royce.com. The rights are summarised below.

Ordinary shares

Each member has one vote for each ordinary share held. Holders of ordinary shares are entitled to: receive the Company's Annual Report; attend and speak at general meetings of the Company; appoint one or more proxies or, if they are corporations, corporate representatives; and exercise voting rights. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

C Shares

C Shares have limited voting rights and attract a preferential dividend of 75% of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis. The Company has the option to redeem the C Shares compulsorily, at any time if: the aggregate number of C Shares in issue is less than 10% of the aggregate number of all C Shares issued on or prior to that time or the event of a capital restructuring of the Company; the introduction of a new holding company; the acquisition of the Company by another company; or a demerger from the Group.

On a return of capital on a winding-up, the holders of C Shares shall be entitled, in priority to any payment to the holders of ordinary shares, to the repayment of the nominal capital paid-up or credited as paid-up on the C Shares held by them, together with a sum equal to the outstanding preferential dividend which will have been accrued but not been paid until the date of return of capital.

The holders of C Shares are only entitled to attend, speak and vote at a general meeting if a resolution to wind up the Company is to be considered, in which case they may vote only on that resolution.

Special Share

Certain rights attach to the special rights non-voting share (Special Share) issued to the UK Secretary of State for Business, Energy & Industrial Strategy (Special Shareholder). These rights are set out in the Articles. Subject to the provisions of the Companies Act 2006 (the Act), the Treasury Solicitor may redeem the Special Share at par value at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

Certain Articles (in particular those relating to the foreign shareholding limit, disposals and the nationality of the Company's Directors) that relate to the rights attached to the Special Share may only be altered with the consent of the Special Shareholder. The Special Shareholder is not entitled to vote at any general meeting or any other meeting of any class of shareholders.

Restrictions on transfer of shares and limitations on holdings

There are no restrictions on transfer or limitations on the holding of the ordinary shares or C Shares other than under the Articles (as described here), under restrictions imposed by law or regulation (for example, insider trading laws) or pursuant to the Company's share dealing code. The Articles provide that the Company should be and remain under UK control. As such, an individual foreign shareholding limit is set at 15% of the aggregate votes attaching to the share capital of all classes (taken as a whole) and capable of being cast on a poll and to all other shares that the Directors determine are to be included in the calculation of that holding. The Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee.

Shareholder agreements and consent requirements

The Company and Bradley Singer are party to a relationship agreement with ValueAct (a summary of which can be found at www.rolls-royce.com). The agreement will expire on 3 May 2018 but will be replaced with a new agreement covering treatment of confidential information and conflicts of interest only.

No disposal may be made to a non-Group member which, alone or when aggregated with the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear propulsion business or the assets of the Group as a whole, without the consent of the Special Shareholder.

Authority to issue shares

At the AGM in 2017, authority was given to the Directors to allot new C Shares up to a nominal value of £500m as an alternative to a cash dividend.

In addition, a special resolution was passed authorising the Directors to allot new ordinary shares up to a nominal value of £122,588,225 equivalent to one-third of the issued share capital of the Company. This resolution also authorised the Directors to allot up to two thirds of the total issued share capital of the Company, but only in the case of a rights issue.

A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of 5% of the issued share capital of the Company.

These authorities are valid until the AGM in 2018, and the Directors propose to renew each of them at that AGM. The Board believes that these authorities will allow the Company to retain flexibility to respond to circumstances and opportunities as they arise.

Authority to purchase own shares

At the AGM in 2017, the Company was authorised by shareholders to purchase up to 183,882,337 of its own ordinary shares representing 10% of its issued ordinary share capital.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2018 or 15 months from 4 May 2017, whichever is the earlier. A resolution to renew it will be proposed at the 2018 meeting.

Deadlines for exercising voting rights

Electronic and paper proxy appointments, and voting instructions, must be received by the Registrar not less than 48 hours before a general meeting.

Voting rights for employee share plan shares

Shares are held in an employee benefit trust for the purpose of satisfying awards made under the various employee share plans. For shares held in a nominee capacity or if plan/trust rules provide the participant with the right to vote in respect of specifically allocated shares, the trustee votes in line with the participants' instructions. For shares that are not held absolutely on behalf of specific individuals, the general policy of the trustees, in accordance with investor protection guidelines, is to abstain from voting in respect of those shares.

Change of control

Contracts and joint venture agreements

There are a number of contracts and joint venture agreements which would allow the counterparties to terminate or alter those arrangements in the event of a change of control of the Company. These arrangements are commercially confidential and their disclosure could be seriously prejudicial to the Company.

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2017, these facilities were less than 22% drawn (2016: 15%).

The Group has entered into a series of financial instruments to hedge its currency, interest rate and commodity exposures. These contracts provide for termination or alteration in the event that a change of control of the Company materially weakens the creditworthiness of the Group.

Employee share plans

In the event of a change of control of the Company, the effect on the employee share plans would be as follows:

- PSP – awards would vest pro rata to service in the performance period, subject to Remuneration Committee judgement of Group performance.
- APRA deferred shares – the shares would be released from trust immediately.
- Sharesave – options would become exercisable immediately. The new controlling company might offer an equivalent option in exchange for cancellation of the existing option.
- Share Incentive Plan (SIP) – consideration received as shares would be held within the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.
- LTIP – awards would vest on the change of control, subject to the Remuneration Committee's judgement of performance and may be reduced pro rata to service in the vesting period. Any applicable holding period will cease in the event of a change in control.

Major shareholdings

At 6 March 2018 the following shareholders had notified an interest in the issued ordinary share capital of the Company in accordance with the DTR.

Shareholder	Date notified	% of issued ordinary share capital
ValueAct Capital Master Fund, L.P.	1 February 2018	10.94
The Capital Group Companies, Inc.	13 October 2017	5.07
Credit Suisse Group AG	3 May 2017	3.91

Directors

The names of the Directors who held office during the year are set out on page 70.

Disclosures in the Strategic Report

The Board has taken advantage of Section 414C(11) of the Act to include disclosures in the Strategic Report including:

- employee involvement;
- the future development, performance and position of the Group;
- the financial position of the Group;
- R&D activities; and
- the principal risks and uncertainties.

Political donations

The Group's policy is not to make political donations and therefore did not donate any money to any political party during the year. However, it is possible that certain activities undertaken by the Group may unintentionally fall within the broad scope of the provisions contained in the Act. The resolution to be proposed at the AGM, authorising political donations and expenditure, is to ensure that the Group does not commit any technical breach of the Act.

During the year, expenses incurred by Rolls-Royce North America, Inc. in providing administrative support for the Rolls-Royce North America political action committee (PAC) was US$118,104 (2016: US$42,742). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The PAC is independent of the Group and independent of any political party. The PAC funds are contributed voluntarily by employees and the Group cannot affect how they are applied, although under US law, the business expenses are paid by the employee's company. Such contributions do not count towards the limits for political donations and expenditure for which shareholder approval will be sought at this year's AGM to renew the authority given at the 2017 AGM.

Greenhouse gas emissions

In 2017, our total greenhouse gas (GHG) emissions were 715 kilotonnes carbon dioxide equivalent ($ktCO_2e$). This represents a increase of 1% compared with 705 $ktCO_2e$ in 2016. This is a result of increased production and product testing as new engine variants enter service.

We have revised our total GHG emissions for 2016 to reflect the actual figures for the full year, rather than estimated figures prepared in line with our basis of reporting. This revision is not material (< ±5%) but does impact the year-on-year trend.

We have included the reporting of fugitive emissions of hydroflurocarbons (HFCs), associated with air conditioning equipment, into our GHG emissions figures for 2016 and 2017. These include emissions from our facilities in the UK, US, Canada and France only. We do not anticipate that emissions from other facilities will have a material impact. Figures from prior years (2013 to 2015) exclude emissions associated with HFCs.

Total GHG emissions ($ktCO_2e$)	2013 */**	2014	2015☑	2016☑	2017☑
Direct emissions (Scope 1)	394	456	374	368	**379**
Indirect emissions (Scope 2)	325	396	375	336	**336**
Total emissions (Scope 1 + Scope 2)	719	852	749	704	**715**
Intensity ratio (total emissions normalised by revenue) ($ktCO_2e$/£m)	0.063	0.062	0.055	0.047	**0.043**

* Figures for 2013 do not include GHG emissions associated with Power Systems and therefore are not directly comparable.

** The intensity ratio for 2013 has been restated to reflect the exclusion of revenues associated with Power Systems.

☑ We engaged Bureau Veritas to undertake a limited assurance engagement, reporting to Rolls-Royce Holdings plc, using the assurance standards ISAE 3000 and ISAE 3410 over the energy, GHG, TRI rate and STEM data that has been highlighted with ☑ and as set out on pages 44 to 48 and in the table above. The sustainability assurance statement is included on page 195.

With the exceptions noted above, we have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. These sources fall within our Consolidated Financial Statements. We do not have responsibility for any emission sources that are not included in our Consolidated Financial Statements.

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014, data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC) Energy Efficiency scheme, and emission factors from the UK Government's GHG Conversion Factors for Company Reporting 2016.

Further details on our methodology for reporting and the criteria used can be found within our basis of reporting, available to download at www.rolls-royce.com/sustainability.

Branches

Rolls-Royce is a global company and our activities and interests are operated through subsidiaries, branches of subsidiaries, joint ventures and associates which are subject to the laws and regulations of many different jurisdictions. Our subsidiaries, joint ventures and associates are listed on pages 175 to 182.

ITP Aero post balance sheet events

Following approval from the relevant authorities in Spain in December 2017, the Company has now concluded the acquisition of a 53.1% shareholding in ITP Aero from SENER resulting in ITP Aero becoming a wholly-owned subsidiary of the Company. The consideration of €718m will be settled over a two-year payment period, payable in eight equal instalments, and the agreement with SENER allows the Company flexibility to settle up to 100% of the consideration in the form of ordinary shares. The first instalment was settled by issuing 9,612,581 ordinary shares on 15 January 2018 and the Company has notified SENER of its intention to settle the second instalment in the form of ordinary shares. Final consideration as to whether the remaining six instalments will be settled in the form of cash or ordinary shares will be determined by the Company during the remaining payment period.

Financial instruments

Details of the Group's financial instruments are set out in note 17 to the Consolidated Financial Statements.

Related party transactions

Related party transactions are set out in note 24 to the Consolidated Financial Statements.

Information required by UK Listing Rule (LR) 9.8.4

There are no disclosures to be made under LR 9.8.4.

Management report

The Strategic Report and the Directors' Report together are the management report for the purposes of Rule 4.1.8R of the DTR.

Disclosure of information to auditors

Each of the persons who is a Director at the date of approval of this report confirms that:

- So far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware. The Director has taken all steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given, and should be interpreted, in accordance with the provisions of section 418 of the Act.

Shareholder Information

Financial calendar 2018-2019

Managing your shareholding

Your shareholding is managed by Computershare Investor Services PLC (the Registrar). When making contact with the Registrar please quote your Shareholder Reference Number (SRN), a 10-digit number prefixed with the letter 'C' that can be found on the right-hand side of your share certificate or in any other shareholder correspondence. It is very important that you keep your shareholding account details up to date by notifying the Registrar of any changes in your circumstances.

You can manage your shareholding at www.investorcentre.co.uk, speak to the Registrar on +44 (0)370 703 0162 (8.30am to 5.30pm Monday to Friday) or you can write to the Registrar at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

Payments to shareholders

The Company makes payments to shareholders by issuing redeemable C Shares of 0.1p each. You can redeem C Shares for cash and either take the cash or reinvest the cash to purchase additional ordinary shares providing you complete a payment instruction form, which is available from the Registrar. Once you have submitted your payment instruction form, you will receive cash or additional ordinary shares each time the Company issues C Shares. If you choose to receive cash we strongly recommend that you include your bank details on the payment instruction form and have payments credited directly to your bank account. This removes the risk of a cheque going astray and means that cleared payments will be credited to your bank account on the payment date.

Share dealing

The Registrar offers shareholders an internet dealing service available from its website www.computershare.co.uk and a telephone dealing service (+44 (0)370 703 0084). Real-time dealing is available during market hours, 8.00am to 4.30pm, Monday to Friday excluding bank holidays. Orders can still be placed outside of market hours. The fee for internet dealing is 1% of the transaction value subject to a minimum fee of £30. The fee for telephone dealing is 1% of the transaction value plus £35. Stamp duty of 0.5% is payable on all purchases. This service is only available to shareholders resident in certain jurisdictions. Before you can trade you must register to use the service. Other share dealing facilities are available but you should always use a firm regulated by the FCA (see www.fca.org.uk/register).

Your share certificate

Your share certificate is an important document. If you sell or transfer your shares you must make sure that you have a valid share certificate in the name of Rolls-Royce Holdings plc. If you place an instruction to sell your shares and cannot provide a valid share certificate, the transaction cannot be completed and you may be liable for any costs incurred by the broker. If you are unable to find your share certificate please inform the Registrar immediately.

American Depositary Receipts (ADR)

ADR holders should contact the depositary, JP Morgan, by calling +1 (800) 990 1135 (toll free within the US) or emailing adr@jpmorgan.com.

Warning to shareholders – investment scams

We are aware that some of our shareholders have received unsolicited telephone calls or correspondence, offering to buy or sell their shares at very favourable terms. The callers can be very persuasive and extremely persistent and often have professional websites and telephone numbers to support their activities. These callers will sometimes imply a connection to Rolls-Royce and provide incorrect or misleading information. This type of call should be treated as an investment scam – the safest thing to do is hang up.

You should always check that any firm contacting you about potential investment opportunities is properly authorised by the FCA. If you deal with an unauthorised firm you will not be eligible for compensation under the Financial Services Compensation Scheme. You can find out more about protecting yourself from investment scams by visiting the FCA's website www.fca.org.uk/consumers, or by calling the FCA's consumer helpline on 0800 111 6768 (overseas callers dial +44 20 7066 1000). If you have already paid money to share fraudsters contact Action Fraud immediately on 0300 123 2040, whose website is at www.actionfraud.police.uk.

Remember: if it sounds too good to be true it probably is.

Visit Rolls-Royce online

Visit www.rolls-royce.com to find out more about the latest financial results, the share price, payments to shareholders, the financial calendar and shareholder services.

Keeping up to date

You can sign up to receive the latest news updates to your phone or email address by visiting www.rolls-royce.com and registering for our alert service.

Dividends paid on C Shares held

C Share calculation period	C Share dividend rate (%)	Record date for C Share dividend	Payment date
1 July 2017 – 31 December 2017	0.17	17 November 2017	3 January 2018
1 January 2017 – 30 June 2017	0.20	2 June 2017	3 July 2017

Previous C Share issues

	Apportionment values					CGT apportionment				
Issue date	No. of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of payment instruction forms by Registrar	Price of ordinary shares on first day of trading (p)	Value of C Share issues per ordinary shares (p)	Ordinary shares (%)	C Shares (%)	Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
3 January 2018	46	26 October 2017	1 December 2017	851.20	4.6	99.46	0.54	5 January 2018	9 January 2018	867.7115
3 July 2017	71	28 April 2017	1 June 2017	896.50	7.1	99.21	0.79	5 July 2017	7 July 2017	925.5883

For information on earlier C Share issues, please refer to www.rolls-royce.com.

Analysis of ordinary shareholders at 31 December 2017

Type of holder	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	175,005	97.46	90,662,315	4.93
Institutional and other investors	4,552	2.54	1,749,934,793	95.07
Total	179,557	100.00	1,840,597,108	100.00
Size of holding (number of ordinary shares)				
1 – 150	56,788	31.63	5,258,063	0.28
151 – 500	87,879	48.94	23,755,565	1.29
501 – 10,000	33,203	18.49	51,515,559	2.80
10,001 – 100,000	1,177	0.66	32,369,515	1.76
100,001 – 1,000,000	342	0.19	114,444,596	6.22
1,000,001 and over	168	0.09	1,613,253,810	87.65
Total	179,557	100.00	1,840,597,108	100.00

Glossary

ABC	anti-bribery and corruption
ACARE	Advisory Council for Aviation Research and Innovation in Europe
AGM	Annual General Meeting
AMC	Approved Maintenance Centre
AMRCs	Advanced Manufacturing Research Centres
APRA	annual performance related award plan
Articles	Articles of Association of Rolls-Royce Holdings plc
ASC	Authorised Service Centres
bps	basis points
Brexit	UK exit from the European Union
C Shares	non-cumulative redeemable preference shares
C&A	commercial and administrative
CARs	contractual aftermarket rights
CEO	chief executive officer
CFO	chief financial officer
COO	chief operating officer
Company	Rolls-Royce Holdings plc
CPS	cash flow per share
CRIP	C Share reinvestment plan
DARPA	Defense Advanced Research Projects Agency
DJSI	Dow Jones Sustainability Index
DoJ	US Department of Justice
DPA	deferred prosecution agreements
DTR	the FCA's Disclosure Guidance and Transparency Rules
EASA	European Aviation Safety Agency
ELT	Executive Leadership Team
EPS	earnings per share
ERG	employee resource group
EU	European Union
EUR	euro
FCA	Financial Conduct Authority
FCAS	UK-France Unmanned Combat Air System
FCF	free cash flow
FRC	Financial Reporting Council
FX	foreign exchange
GBP	Great British pound or pound sterling
GHG	greenhouse gas
Global Code	Global Code of Conduct
Group	Rolls-Royce Holdings plc and its subsidiaries
HFCs	hydroflurocarbons
HSE	health, safety and environment
IAB	International Advisory Board
IAE	International Aero Engines AG
IASB	International Accounting Standards Board
IFRS	International financial reporting standards
ITP Aero	Industria de Turbo Propulsores S.A.
KPIs	key performance indicators
ktCO$_2$e	kilotonnes carbon dioxide equivalent
LGBT	lesbian, gay, bisexual and transgender
LIBOR	London inter-bank offered rate
LTIP	long-term incentive plan
LTPR	long-term planning exchange rate
LTSA	long-term service agreement
MPF	Ministério Público Federal, Brazil
MRO	maintenance repair and overhaul
MTC	Manufacturing Technology Centre
NCI	non-controlling interest
OCI	other comprehensive income
OE	original equipment
OECD	Organisation for Economic Co-operation and Development
P&L	profit and loss
PBT	profit before tax
PGB	power gearbox
PPE	property, plant and equipment
PSP	performance share plan
R&D	research and development
R&T	research and technology
Registrar	Computershare Investor Services PLC
RMS	risk management system
RRSAs	risk and revenue sharing arrangements
SDC	service delivery centres
SENER	SENER Grupo de Ingeniería, S.A.
SFO	UK Serious Fraud Office
SMR	small modular reactors
SMS	safety management system
SSA	Special Security Agreement
STEM	science, technology, engineering and mathematics
TCFD	Taskforce on Climate-related Financial Disclosures
the Code	UK Corporate Governance Code
Trent 1000 TEN	Thrust, Efficiency and New technology
TRI	total reportable injuries
TSR	total shareholder return
USD/US$	United States dollar
UTCs	University Technology Centres

Trade marks

The following trade marks which appear throughout this Annual Report are trade marks registered and owned by companies within the Rolls-Royce Group:

BR710®
CorporateCare®
Flex®
Gnome®
LiftSystem™
MTU®
MTU PowerPacks®
RB211®
Reman®
TotalCare®
Trent®
UltraFan®

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