

INDEPENDENT AUDITORS' REPORT

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF ROLLS-ROYCE HOLDINGS PLC

Report on the audit of the financial statements

Opinion

In our opinion:

- Rolls-Royce Holdings plc's Consolidated Financial Statements and Company Financial Statements (the "financial statements") give a true and fair view of the state of the group's and of the company's affairs as at 31 December 2020 and of the group's and company's loss and the group's cash flows for the year then ended;
- the Consolidated Financial Statements have been properly prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006;
- the Company Financial Statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law); and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements, included within the Annual Report, which comprise: the Consolidated and Company balance sheets as at 31 December 2020; the Consolidated income statement and Consolidated statement of comprehensive income; the Consolidated cash flow statement for the year then ended; the Consolidated and Company statements of changes in equity for the year then ended; and the Notes to the Consolidated and Company Financial Statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee

Separate opinion in relation to international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union

As explained in note 1 to the Consolidated Financial Statements, the group, in addition to applying international accounting standards in conformity with the requirements of the Companies Act 2006, has also applied international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union.

In our opinion, the Consolidated Financial Statements have been properly prepared in accordance with international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the group.

Other than those disclosed in note 7 to the financial statements, we have provided no non-audit services to the group in the period under audit.

Our audit approach

Overview

Audit scope

- Overall group materiality: £70m, based on 0.5% of the three year average of underlying revenue (2019: £75m, based on 0.5% of underlying revenue).
- Overall company materiality: £147m (2019: £126m), based on 1.0% of total assets. This exceeds group materiality as it is determined on a different basis given the nature of the company's operations. For the purposes of the audit of the Consolidated Financial Statements, our procedures on the company's balances and transactions that do not eliminate on consolidation were undertaken with reference to group materiality.

- Following our assessment of the risks of material misstatement of the Consolidated Financial Statements we subjected 32 individual components (including three joint ventures) to full scope audits for group purposes, which following an element of consolidation, equates to 16 group reporting opinions. In addition eight components performed targeted specified procedures.
- In addition, the group engagement team audited the company and other centralised functions including those covering the group treasury operations, corporate costs, corporate taxation, post-retirement benefits, certain goodwill and intangible asset impairment assessments. The group engagement team performed audit procedures over the group consolidation and financial statements disclosures and performed group level analytical procedures over out of scope components.
- The components on which full scope audits, targeted specified procedures and centralised work was performed accounted for 93% of revenue, 89% of loss before tax and 90% of total assets.
- Central audit testing was performed where appropriate for reporting components in group audit scope who are supported by the group's Finance Service Centres (FSCs).
- As part of the supervision process, the group engagement team has performed 13 virtual file reviews, which included meetings on approach and conclusions with the component teams and review of their audit files and final deliverables.

Key audit matters

- Long-term contract accounting and associated provisions (group)
- Deferred tax asset recognition and recoverability (group)
- Translation of foreign-currency denominated transactions and balances (group)
- Presentation and accuracy of underlying results and disclosure of other one-off items (including exceptional items) (group)
- Recoverability of accounts receivable and contract assets (group)
- Recoverability of intangible programme assets (group)
- Ability of the group and company to continue as a going concern (group and company)
- Recoverability of the company's investment in subsidiary undertakings (company)
- Impact of the COVID-19 pandemic (group and company).

Materiality

- Overall group materiality: £70m (2019: £75m) based on 0.5% of three year average underlying revenues.
- Overall company materiality: £147m (2019: £126m) based on 1% of total assets.
- Performance materiality: £53m (group) and £110m (company).

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements.

Capability of the audit in detecting irregularities, including fraud

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined in the Auditors' responsibilities for the audit of the financial statements section, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud, is detailed below.

Based on our understanding of the group and industry, we identified that the principal risks of non-compliance with laws and regulations related to the UK Corporate Governance Code, the Listing Rules of the UK Financial Conduct Authority, applicable Generally Accepted Accounting Practices, tax compliance legislation, the regulations of country aviation authorities such as the Civil Aviation Authority, import and export restrictions (including International Traffic in Arms Regulations), and the UK Bribery Act, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the preparation of the financial statements such as the Companies Act 2006. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to: (1) posting inappropriate journal entries to manipulate financial results; (2) management bias in accounting estimates such as long-term contract accounting and associated provisions, the recoverability of intangible programme assets, and deferred tax asset recognition; (3) the sale of engines to joint ventures for no clear commercial purpose or above market prices; and (4) inappropriately including or excluding transactions from the group's underlying or free cash flow alternative performance metrics. The group engagement team shared this risk assessment with the component auditors so that they could include appropriate audit procedures in response to such risks in their work. Audit procedures performed by the group engagement team and/or component auditors included:

- Discussions throughout the year with management, internal audit, the group's internal and external legal counsel, and the head of ethics and compliance, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Reading the minutes of the group's Safety, Ethics & Sustainability committee and assessment of 'speak-up' matters reported through the group's Ethics Line and the results of management's investigation of such matters;

INDEPENDENT AUDITORS' REPORT

- Challenging assumptions and judgements made by management in determining significant accounting estimates (because of the risk of management bias), in particular in relation to long-term contract accounting and associated provisions, the recoverability of programme assets, and the recognition and recoverability of deferred tax assets (see related key audit matters below);
- Understanding and evaluating changes in processes and controls as a result of the COVID-19 pandemic;
- Identifying and testing unusual journal entries, in particular journal entries posted with unusual account combinations, and testing all material consolidation journals; and .
- Challenging why certain items are excluded or included from underlying profit or free cash flow and review of disclosures included in the Annual Report explaining and reconciling alternative performance measures to statutory metrics.

There are inherent limitations in the audit procedures described above. We are less likely to become aware of instances of non-compliance with laws and regulations that are not closely related to events and transactions reflected in the financial statements. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

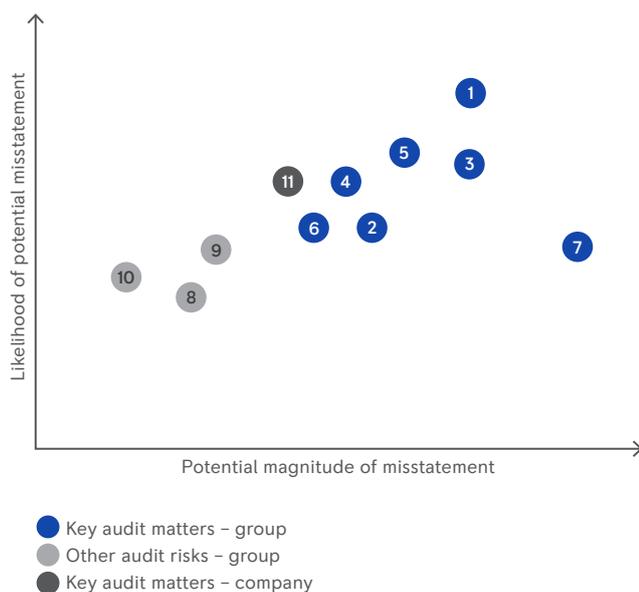
Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, 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 engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

This is not a complete list of all risks identified by our audit.

We have presented the key audit matters and the other risks subject to audit focus in the chart and table below excluding items from last year that are no longer key audit matters or other audit risks for the 2020 audit. This is based on our risk assessment at the start of the audit cycle used to plan our audit approach. Recoverability of intangible programme assets, recoverability of accounts receivable and contract assets and the ability of the group and company to continue as a going concern are new key audit matters this year. The implementation of IFRS 16: Leases and response to deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas markets, which were key audit matters last year, are no longer included because of the fact that the risk associated with IFRS 16 was in relation to 2019 being the first year of adoption of this accounting standard. We now consider the risks associated with IFRS 16 to be normal. The potential exposures to known uncertain tax positions have reduced and accordingly we now consider this as a normal risk. During 2020, the deferred prosecution agreement reached with the Department of Justice expired and was dismissed and the formal reporting obligations for the UK deferred prosecution agreement came to an end. Given this and the positive evolution in the group's compliance environment, we did not assess there to be a heightened risk. Otherwise, the key audit matters below are consistent with last year.

Our risk assessment at the start of the audit cycle used to plan our audit approach



Risks	Change from prior year
Key audit matters – group	
1 Long-term contract accounting and associated provisions	↔
2 Deferred tax asset recognition and recoverability	↔
3 Presentation of accuracy of underlying results and disclosure of other one-off items (including exceptional items)	↔
4 Translation of foreign currency denominated transactions and balances	↔
5 Recoverability of intangible programme assets	↑
6 Recoverability of accounts receivable and contract assets	new
7 Ability of group and company to continue as a going concern	new
Other audit risks – group	
8 Accounting for complex treasury instruments	↔
9 Measurement of post-retirement benefits	↔
10 Consolidation process and joint venture accounting	↔
Key audit matters – company	
11 Recoverability of the company's investments in subsidiary undertakings	↔

The impact of COVID-19 is also reported as a key audit matter as it impacted a number of the risks noted above and other areas of our audit.

Key audit matter

Long-term contract accounting and associated provisions
(relevant to the Consolidated Financial Statements)

Page 78 (Audit Committee report) and page 116 (note 1 to the Consolidated Financial Statements – Accounting policies – Revenue recognition)

The Civil Aerospace and Defence businesses operate primarily with long-term customer contracts that span multiple periods.

These long-term contracts require a number of assumptions to be made in order to determine the expected lifetime revenue and costs of the contract and the amounts of revenue and profit that is recognised in each reporting period.

Small adjustments can have a significant impact on the results of an individual financial year. In addition, changes to the operating condition of engines such as changes in route structure can result in different performance assumptions and hence cost profiles which impact the expected profitability of a contract.

For Defence, long term contracts tend to be for a fixed price or based on a cost plus or target cost reimbursement for qualifying costs and there are also some flying hours arrangements. For Civil Aerospace aftermarket contracts, cash is earned based on engine flying hours, which requires management to estimate future engine flying hours in order to arrive at the total income expected over the life of a contract. As a result of COVID-19, engine flying hours have reduced significantly in 2020. Slow and gradual recovery in engine flying hours is expected which will impact forecast income on aftermarket contracts in the short and medium term. There is much estimation uncertainty over the speed and shape of the recovery in flying hours. An adjustment of £1,061m was recognised in the year, reversing revenue recognised in previous periods largely because of lower engine flying hour forecasts.

In addition, the profitability of aftermarket contracts typically assumes that there will be significant cost improvements over the lifetime (15–25 years) of the contracts. Significant judgement needs to be applied in determining time-on-wing, whether incremental costs should be treated as wastage or are part of the ongoing cost of servicing a contract, future exchange rates used to translate foreign currency income and costs and other operating parameters used to calculate the projected life cycle. These future costs are also risk adjusted to take into account forecasting accuracy which represents an additional judgement.

The expected costs from in-service issues on the Trent 1000 programme have decreased in the year resulting in the release of £560m of the associated provision. This is largely driven by lower than expected customer disruption costs from the in-service issues because of the impact of the COVID-19 pandemic in reducing the number of aircraft on ground as a result of in-service issues. The assessment of the total cost of delivering this programme, the cost of the proposed engineering solutions, changes in the shop visit profile, speed of implementation of design, manufacture and installation of improved parts and the level of customer disruption which was not expected at the inception of the contract are all significant judgements which impact the value and timing of revenue and profit recognition. In addition, certain contracts may become onerous as a result and require immediate recognition of the loss.

How our audit addressed the key audit matter

We focused our work on a number of contracts where we consider there to be the highest degree of management judgement or estimation and designed specific procedures over the long-term contract accounting targeted at the associated risks. We also sample tested the remaining population of contracts. This approach was applied in the Civil Aerospace and Defence businesses and was substantive in nature. The audit procedures performed included:

- We attended meetings with Civil Aerospace and Defence engine programme and customer contract managers in order to understand the operational matters impacting the performance of specific contracts and any amendments to contractual arrangements required by changes to underlying expectations of performance;
- We obtained and read the relevant sections of a sample of contracts to understand the key terms including performance obligations and pricing structures;
- We assessed how management had forecast the speed and shape of the recovery of engine flying hours including by considering the downside scenarios modelled and comparing the assumptions to industry data;
- We challenged management's judgments and associated risk adjustments relating to the risk of customer default and insolvency, the risk of airlines parking more mature aircraft as a result of COVID-19 and the ability for contractual protection clauses to be enforced across the customer portfolio;
- We re-performed the calculations used to determine the degree of completion for a sample of contracts and this was also used in assessing the magnitude of any catch-up adjustments;
- We compared the previously forecast results of a sample of contracts with the actual results to assess the performance of the contract and the historical accuracy of forecasting;
- We verified a sample of costs incurred to third party documentation in order to assess the validity of the forecast costs to complete;
- We challenged management's judgement around whether incremental contract costs arising from in-service issues should be accounted for over the expected duration of the underlying contract or recognised immediately;
- Where the disruption has resulted in payments to customers we have validated the settlement to contractual agreements, considered the terms of previous settlements, correspondence with customers, the forecast period of further aircraft being on the ground and the completeness of the liability;
- We assessed the assumptions relating to life cycle cost reductions to determine the likelihood of realisation and where relevant the speed at which they would be achieved, including the impact on the number of shop visits, validating these assumptions directly with the senior programme engineers;
- We obtained support for the risk adjustments made in respect of future costs and challenged management's assumptions through assessment against historical performance, known technical issues and the stage of completion of the programme;
- We challenged the assessment of provisions for loss making or onerous contracts to determine the completeness of the unavoidable costs to fulfil the contractual obligations;

Key audit matter	How our audit addressed the key audit matter
<p>Long-term contract accounting and associated provisions <i>continued</i></p> <p>At the development stage of a programme, agreements are entered into with certain Civil suppliers to share in the risk and rewards of the contracts (Risk and Revenue Sharing Partners – ‘RRSP’). This can involve upfront participation fees from the RRSP that are amortised over the engine production phase. In addition, specified revenue and costs are recorded in the Consolidated Income Statement net of the RRSP’s share.</p> <p>The nature of the Civil Aerospace business gives rise to a number of contractual guarantees, warranties and potential claims. The accounting for these can be complex and judgemental and may impact the Consolidated Income Statement immediately or over the life of the contract. The valuation of provisions for the associated amounts may be judgemental and needs to be considered on a contract by contract basis.</p>	<ul style="list-style-type: none"> – We assessed the sensitivity of the Trent 1000 provision to reasonable changes in estimates, particularly in respect of the repair and overhaul facility capacity, technical cost creep on the known issues and cost outturns against previous provisions, in determining whether the provision was sufficient; – We read and understood the key terms of a sample of RRSP contracts to assess whether revenue and costs had been appropriately reflected, net of the share attributable to the RRSP in the Consolidated Income Statement; – We considered whether there were any indicators of management override of controls or bias in arriving at their reported position; and – We also assessed the adequacy of disclosures in note 1 of the key judgements and estimates involved in long-term contract accounting. <p>Misstatements identified from our work were largely corrected by management leaving an immaterial uncorrected position. Overall we concluded that the key estimates and judgements used by management for long-term contract accounting were supportable and no material exceptions arose from our work.</p>
<p>Deferred tax asset recognition and recoverability <i>(relevant to the Consolidated Financial Statements)</i></p> <p><i>Page 78 (Audit Committee report), page 118 (note 1 to the Consolidated Financial Statements – Accounting policies – Taxation), and pages 134 to 137 (note 5 to the Consolidated Financial Statements – Taxation)</i></p> <p>The recognition and recoverability of deferred tax assets in Rolls-Royce plc is a significant judgement. Rolls-Royce plc has recognised significant deferred tax assets on the basis of expected future levels of profitability. The magnitude of the assets recognised necessitates the need for significant judgement in assessing the future levels of profitability in the UK over an extended period.</p> <p>The additional loss reported for 2020, along with the existence of tax losses brought forward and other deductible temporary differences in Rolls-Royce plc, combined with the impact of COVID 19 and climate change on future forecasts, presents a heightened risk that deferred tax assets previously recognised may not be recoverable. Further there is an inherent increased level of uncertainty in the future level of forecast profits.</p>	<p>We evaluated management’s methodology for assessing the recognition and recoverability of deferred tax assets, including the ability to offset certain deferred tax liabilities and deferred tax assets. Where recognition is supported by the availability of sufficient probable taxable profits in future periods against which the asset can be utilised in future periods, our evaluation of these future profits considered both the business model and the tax jurisdiction.</p> <p>We assessed the future profit forecasts and the underpinning assumptions including management’s risk weighting of particular profit streams in Rolls-Royce plc and tested that the assumptions and forecasts for periods beyond the normal five year forecasting horizon were reasonable. The right of offset of certain deferred tax liabilities and deferred tax assets was also assessed.</p> <p>Where applicable we assessed the consistency of the forecasts used to justify the recognition of deferred tax assets to those used elsewhere in the business, including for long-term contract accounting, impairment assessments, or for the Directors’ viability and going concern statements. We also assessed the risk adjustments applied by management to these profit forecasts to future periods that are significantly further in time than the group’s normal five year forecasting process and considered whether these appropriately reflect the potential impact of climate change on the group’s mix of results.</p> <p>We assessed the treatment of the losses that are realised or unrealised on the group’s hedge book and whether they were treated appropriately and how they are recovered using the same profit forecasts.</p> <p>We also assessed the adequacy of disclosures over this area, particularly the derecognition of a portion of the deferred tax asset and impact of changes in key estimates of the asset recognised and this has been disclosed in notes 1 and 5.</p> <p>We did not identify any material uncorrected exceptions from our audit work.</p>

Key audit matter

Translation of foreign-currency denominated transactions and balances*(relevant to the Consolidated Financial Statements)**Page 119 (note 1 to the Consolidated Financial Statements – Accounting policies – Foreign currency translation)*

Foreign exchange rate movements influence the reported Consolidated income statement, the Consolidated cash flow statement and Consolidated balance sheet. One of the group's primary accounting systems that is used by a number of its subsidiaries translates transactions and balances denominated in foreign currencies at a fixed budget rate for management information purposes.

Foreign currency denominated transactions and balances are then re-translated to actual average and closing spot rates through manual adjustments. Due to the manual nature of the process and significance of the recurring adjustments needed there is a risk that transactions and balances denominated in foreign currencies are incorrectly translated in the Consolidated Financial Statements.

Presentation and accuracy of underlying results and disclosure of other one-off items (including exceptional items)*(relevant to the Consolidated Financial Statements)**Page 114 (note 1 to the Consolidated Financial Statements – Accounting policies – Presentation of underlying results), page 126 (Note 2 to the Consolidated Financial Statements – Segmental analysis) and page 175 (note 29 to the Consolidated Financial Statements – Derivation of summary of funds flow statement)*

In addition to the performance measures prescribed by International Financial Reporting Standards, the group also presents its results on an "underlying" basis, as the Directors believe this better reflects the performance of the group during the year. The group also presents a free cash flow metric which the Directors believe reflects the cash generated from underlying trading; this differs from the cash flows presented in the Consolidated cash flow statement.

A key adjustment between the statutory results and the underlying results relates to the foreign exchange rates used to translate foreign currency transactions and balances. The underlying results reflect the achieved rate on foreign currency derivative contracts settled in the period and retranslates assets and liabilities at the foreign currency rates at which they are expected to be realised or settled in the future. As the group can influence which derivative contracts are settled in each reporting period it has the ability to influence the achieved rate and hence the underlying results. This risk is more limited for free cash flow as there are a small number of items that are excluded from free cash flows, however, there may be judgement to determine whether an item meets the definition for being excluded from free cash flow.

How our audit addressed the key audit matter

In addition to our testing in other areas of the various financial statement line items, we performed the following specific audit procedures over this area:

- Obtained an understanding of the process employed by management to correctly report the translation of foreign currency balances and transactions;
- Tested system reports identifying transactions and balances in source currency by agreeing these to general ledger balances;
- Tested on a sample basis the manual calculations of the adjustment needed to correctly report the translation of the foreign currency denominated transactions and balances;
- We sample tested the balances and transactions requiring adjustment by source currency to source data and assessed the completeness of these balances and transactions;
- We agreed the exchange rates used in management's translation adjustments to an independent source; and
- For each adjustment sampled we assessed whether the foreign currency denominated balance or transaction was translated at the appropriate exchange rate depending on its nature.

There are no material uncorrected exceptions from our audit work.

We have considered the judgements taken by management to determine what should be treated as a one-off or exceptional item and the translation of foreign currency amounts and obtained corroborative evidence for these.

We also considered whether there were items that were recorded within underlying profit that are exceptional in nature and should be reported as an exceptional item. No such material items were identified. As part of this assessment we challenged management's rationale for the designation of certain items as exceptional or one-off and assessed such items against the group's accounting policy, considering the nature and value of those items.

Within underlying results, foreign currency transactions are presented at rates achieved on derivative contracts hedging the net operating cash flows of the group. In the current year the group experienced a net US Dollar outflow rather than inflow as had been anticipated prior to the COVID-19 pandemic. The impact on trading also resulted in a reduction in the levels of future net US Dollar inflows compared to the forecast position prior to the start of the pandemic resulting in an overhedge position in 2020 as well as a forecast overhedge position in subsequent years to 2026. As a result the achieved rate in 2020 was similar to the average spot rate for the year. To address the overhedge position the group entered into a number of offsetting derivative contracts for a notional value equal to the deficit between its pre-pandemic expectation of net US Dollar cash inflows and its current forecasts. Some of these contracts were used in 2020 to purchase US Dollars to close out derivative positions that could not be met from cash generation in 2020 and the remainder are being used to offset similar forecast positions in the short and medium term.

Key audit matter

Presentation of underlying results and disclosure of other one-off items (including exceptional items)
continued

During the year, the group recognised a finance charge of £1,689m to underlying profit before tax arising from the impact of closing out derivatives that were to hedge \$11.8bn of actual and forecast net US Dollar inflows which are no longer expected. This was transacted primarily by entering into offsetting forward foreign currency derivatives. In addition, the group has excluded £1,293m of impairment charges, £584m of exceptional credits and pension past service credits of £308m in arriving at underlying profit before tax.

The underlying results differ significantly from the reported statutory results and are used extensively to explain performance to the shareholders. Alternative performance measures can provide investors with a better understanding of the group's performance if consistently calculated, properly used and presented. However, when improperly used and presented, these non-GAAP measures can mislead investors and may mask the real financial performance and position.

How our audit addressed the key audit matter

The net overhedge position in 2020 was addressed by entering into and closing out offsetting derivative contracts. A charge was recognised within underlying financing to reflect cost associated with those closed out in 2020 and the expected future cash cost of settlement relating to the over hedged position. This cash cost was partially incurred in 2020, with the balance falling between 2021 and 2026. We have agreed key terms of the offsetting derivative contracts to confirmations or cash settlement, and have recalculated the over-hedged charge presented within underlying finance costs.

Within underlying results, monetary assets and liabilities are also retranslated at rates forecast to be achieved on derivative contracts when the associated cash flows occur. We have agreed these forecast rates to the profile of the derivatives that are expected to mature in the future and tested their application to the relevant monetary assets and liabilities.

We audited the reconciling items between the underlying loss before tax and free cash flow disclosed in note 29 including verifying that the items adjusted for are consistent with the prior period. We also considered whether free cash flow contains material one-off items which require further disclosure.

We also assessed the appropriateness and completeness of the disclosures of the impact of one-off or non-underlying items primarily in notes 1, 2, 4 and 29 to the Consolidated Financial Statements and found them to be appropriate. This included assessing the explanations management has provided on the reconciling items between underlying performance and statutory performance in note 2 and disclosure of the impact of a further deterioration of forecast US Dollar cash inflows to the overhedge position within note 4.

Overall we found that the classification judgements made by management were in line with their policy for underlying results and exceptional items, had been consistently applied and there are no material uncorrected misstatements resulting from our testing. Given the size of the net hedge book against future projected cash flows, future results are sensitive to further charges if net cash inflows fall below those projected, this sensitivity is disclosed in note 4.

Recoverability of accounts receivable and contract assets
(relevant to the Consolidated Financial Statements)

Page 147 (note 15 to the Consolidated Financial Statements – Trade receivables and other assets) and page 148 (note 16 to the Consolidated Financial Statements – Contract assets and liabilities)

At 31 December 2020, the group holds trade receivables and other financial assets of £4,576m (2019: £4,137m) and contract assets of £1,076m (2019: £1,496m). Management is required to assess the recoverability of these balances and recorded a provision against future expected credit losses. At 31 December 2020 this provision was £252m (2019: £138m). Given the impact of COVID-19 we assess there to be a heightened risk of the recoverability of the group's trade receivables and contract assets within the Civil Aerospace business.

Management estimates the expected credit loss provision by assessing the credit grade of its customers and determining the expected credit loss based on rates provided by rating agencies. The recognition of provisions for credit losses generally occurs earlier under IFRS 9 than the previous accounting standard and so there is a heightened risk that additional provisions should be recognised over these balances.

We obtained management's calculation of the expected credit loss provision. For a sample of customers we verified the credit rating issued by the rating agencies and recalculated the resulting expected credit loss provision required to compare against management's estimate.

We performed sensitivity analysis in order to quantify changes to the expected credit loss rate that would be required in order to result in a material change in the provision.

Where customer balances are subject to specific provisions, we considered the reasonableness of the provision after discussions with management to understand their rationale for the provision, reviewing customer correspondence, payment history and our knowledge of the financial condition of the customers. We also considered what balances were settled subsequent to the year end.

Overall we found management's estimate of the expected credit loss provision to be appropriate and found no material exceptions from our testing.

Key audit matter

Recoverability of intangible programme assets*(relevant to the Consolidated Financial Statements)*

Page 122 (note 1 to the Consolidated Financial Statements – Accounting policies – Impairment of non-current assets), page 139 (note 9 to the Consolidated Financial Statements – Intangible assets) and page 143 (note 12 to the Consolidated Financial Statements – Impairment of intangible assets, property, plant and equipment, right of use assets and investments)

At 31 December 2020, the group had £1,761m (2019: £2,093m) of capitalised development expenditure, predominantly related to Civil Aerospace engine programmes. In addition, the group has recognised customer relationship intangible assets of £925m (2019: £949m) most significantly in relation to ITP Aero. Intangible assets are tested for impairment if an indicator exists and the fall in forecast cash flows as a result of COVID-19 was identified by management as such an indicator.

The recoverable value of intangible assets is dependent on a number of significant judgements including the shape and speed of the expected recovery in engine flying hours, which drives a significant proportion of the programme's cash flows, the timing and amount of engine sales, the rate at which costs will grow and discount rates. Management has reflected the increased uncertainty from COVID-19 by probability weighting a base case and downside scenario in order to arrive at expected future cash flows.

Following the impairment reviews, management has recorded an impairment charge of £571m.

How our audit addressed the key audit matter

We obtained management's impairment model and tested its logic and mathematical accuracy. We also tested the reasonableness of key assumptions, including the cash inflows from original equipment and aftermarket sales, cost of sales and operating cash flows and the selection of discount rates. We also assessed the reasonableness of the two scenarios used by management and the associated probability given to each.

We agreed projections to management approved budgets and forecasts and assessed how these projections are compiled.

Deploying our valuations experts, we assessed the terminal growth rate and discount rate applied to the programmes with third party information, past performance, the group's cost of capital and relevant risk factors.

We performed our own risk assessment by considering historical performance and management's forecasting accuracy to highlight the programmes with either lower headroom or which are more sensitive to changes in key assumptions. We also performed our own independent sensitivity analysis to understand the impact of reasonably possible changes in management's assumptions on the available headroom. We challenged the significant assumptions, specifically relating to revenue and cash flow growth in light of the individual programme's past performance to assess whether the forecasts are achievable.

As a result of our work, we determined that the impairment charge recognised in 2020 for intangible assets was appropriate. We have assessed management's disclosures in light of the impairment testing we performed, and we consider the disclosures made to be reasonable. For those intangible assets where management has determined there is a risk of future impairments, we found that suitable disclosure has been given showing the impairment charge that would result from reasonably possible changes in the underlying key assumptions.

Ability of the group and company to continue as a going concern*(relevant to the Consolidated and Company Financial Statements)*

Page 52 (Going Concern Statement), page 114 (note 1 to the Consolidated Financial Statements – Accounting policies), page 179 (Note 1 to the Company Financial Statements – Accounting policies).

COVID-19 and the impact of lockdowns on global aviation has had a significant impact on the group's cash generation. While the Defence sector remains robust, and the Power Systems sector has been moderately impacted by the pandemic, the group's core Civil Aerospace business has experienced a significant deterioration in cash generation. The unprecedented decline in air travel, particularly long haul, which is the focus market for a large proportion of the Civil Aerospace business has meant engine flying hour receipts in 2020 and forecasts for 2021/22 have been severely impacted as has cash generated from OE sales to Boeing and Airbus that have been impacted by airline order deferrals, cancellations and reduced production levels. Overall the group experienced a £4.2bn free cash outflow in 2020, which after excluding the impact of largely discontinuing its use of invoice discounting was a £3.1bn free cash outflow.

At the half year management disclosed two material uncertainties, being the timing of recovery in the commercial aviation market to pre-crisis levels and the availability of sufficient funding. Since the half year management has improved available liquidity by £3.1bn with a £2bn rights issue, £2bn of new bonds, a £1bn new term loan, offset by the expiry of a £1.9bn revolving credit facility that was mandatorily cancelled with the rights issue. As a result overall liquidity at 31 December 2020 increased to £9bn.

Our procedures and conclusions in respect of going concern are set out below in the 'Conclusions relating to going concern' section on page 201.

Key audit matter

How our audit addressed the key audit matter

Ability of the group to continue as a going concern
continued

There is on-going and significant uncertainty over the shape and speed of potential recovery and the impact of new variants of the COVID-19 virus. The group's free cash flow forecasts for 2021 and 2022 have been significantly downgraded as a result by analysts. Given this uncertainty management has modelled a base and downside liquidity headroom position for its going concern assessment. The group's debt facilities do not contain financial covenants. The Directors have concluded that there is sufficient liquidity available for at least the 18 month period of its going concern assessment to September 2022.

As the going concern assessment is dependent on management's future cash flow forecasts there is significant judgement involved in determining these and concluding that there is not a material uncertainty.

Recoverability of the company's investments in subsidiary undertakings

(relevant to the Company Financial Statements)

Page 180 (note 2 to the Company Financial Statements – Investments – Subsidiary Undertakings)

Investments in subsidiaries of £14,688m (2019: £12,801m) are accounted for at cost less provision for impairment in the Company balance sheet at 31 December 2020. The increase in the year principally relates to a capital injection to the company's subsidiary, Rolls-Royce Group Limited.

Investments are tested for impairment if impairment indicators exist. If such indicators exist, the recoverable amounts of the investments in subsidiaries are estimated in order to determine the extent of the impairment loss, if any. Any such impairment loss is recognised in the income statement.

Management has identified the impact of COVID-19 on future cash flows of the group as an indicator of potential impairment. In addition, the carrying value significantly exceeded the market capitalisation of the group at 31 December 2020. These necessitated an impairment assessment to be performed, for which management engaged a third party expert.

Judgement is required in this area, particularly in assessing: (1) whether an event has occurred that may indicate that the related asset values may not be recoverable; (2) whether the carrying value of an asset can be supported by the recoverable value, being the higher of fair value less cost of disposal or the net present value of future cash flows which are estimated based on the continued use of the asset in the business; and (3) key assumptions to be applied in preparing cash flow projections including whether these cash flow projections are discounted using an appropriate rate. Changing the assumptions selected by management to determine the level of any impairment, including the discount rates or the growth rate assumptions in the cash flow projections, could materially affect the recoverable value determined by the impairment test and as a result affect the company's financial condition and results.

We evaluated management's determination of whether any indicators of impairment existed by comparing the carrying value of investments in subsidiary undertakings to the market capitalisation of the group at 31 December 2020 and post year-end and by comparing the performance of the group in the year to previous budgets and agreed that an impairment assessment is necessary.

The recoverable value of the group was determined from the discounted future cash flows of the group. We have tested the reasonableness of the key assumptions used, including revenue, profit and cash flow growth rates, terminal growth rates and the discount rate that management has applied. We tested that the underlying assumptions were consistent with other forecasts such as those used to assess the recoverability of the deferred tax asset. We also assessed whether management's probability weighted cash flow forecasts appropriately reflects the estimation uncertainty over the group's forecast cash flows especially within Civil Aerospace.

Deploying our valuations experts, we assessed the methodology applied by management's expert as well as certain key assumptions such as the discount rate. We also considered other estimates of the group's valuation such as third party analyst reports and considered the potential reasons why the market capitalisation of the group was lower than the carrying value and valuation produced by management's expert.

We performed our own independent sensitivity analysis to understand if reasonable possible changes in management's assumptions would result in an impairment.

As a result of our work, we did not identify any material impairment and consider the carrying value of the investments in subsidiary undertakings to be supportable in the context of the Company Financial Statements taken as a whole. We have assessed the disclosures provided, including the sensitivity disclosures and consider them to be appropriate given the estimation uncertainty inherent in the analysis.

Key audit matter

Impact of the COVID-19 pandemic

(relevant to the Consolidated and Company Financial Statements)

Page 52 (Going Concern Statement), page 114 (note 1 to the Consolidated Financial Statements – Accounting policies), page 179 (Note 1 to the Company Financial Statements – Accounting policies).

The COVID-19 pandemic has had a significant impact on the trading performance and cash generation of the group during the year which has continued into 2021. The pandemic has brought significant estimation uncertainty over future performance in the Civil Aerospace business in particular, given the shape and speed of recovery is uncertain particularly with new variants of the virus. Further this may impact consumer behaviour in the short and longer term.

Management has considered the impact of COVID-19 on the Consolidated and Company Financial Statements particularly in connection with long term contract accounting, deferred tax asset recognition and the recoverability of tangible and intangible fixed assets, the treatment of the group's derivative financial instruments, the company's investment in subsidiary undertakings and the Directors' going concern and viability assessments.

There is a risk that the assessment of the financial impact made by management may be inappropriate. Accordingly we have focused on areas where the financial impact is likely to manifest in the financial statements. Many of these are risks that are the subject of separate key audit matters set out above. In addition we have identified the following:

- The group announced a fundamental restructuring programme during the year. This resulted in a provision of £373m, representing management's best estimate of the related severance costs. In addition, the group has decided to exit certain sites and has therefore written down the related assets at those sites to their fair value less cost of disposal. This resulted in an impairment charge of £288m;
- The group received £47m from the UK Government as part of the Coronavirus Job Retention Scheme (CJRS) and issued £300m of commercial paper under the Covid Corporate Financing Facility (CCFF). In addition it obtained a £2bn term loan that is 80% guaranteed by UK Export Finance; and
- Management's way of working, including the operation of controls, has been impacted by COVID-19 as a result of a large number of staff working remotely. There is inevitably an increase in risk due to the remote accessing of IT systems and potentially heightened cyber risk.

How our audit addressed the key audit matter

COVID-19 has impacted a number of areas of the financial statements that are described in the key audit matters above. We have held regular meetings with management during the year to understand the impacts of the pandemic on the business and how it has impacted the significant estimates and judgements used in the preparation of the Consolidated and Company Financial Statements.

To test group's restructuring provision, we assessed whether a legal or constructive obligation was present to carry out the restructuring by reference to the communications that the group has made externally and internally and the actions it had taken by 31 December 2020. We validated the assumptions used to quantify the expected costs of restructuring including by comparing those costs against the experience of past restructuring exercises and leavers in the year.

In respect to the CJRS, we tested a sample of employees for which a claim has been submitted and recalculated the claim amount based on payroll data and the rules of the scheme. We also verified that the other conditions of the scheme, such as the requirement to inform the impacted employees in writing, were met.

We assessed the accounting treatment of the £300m financing under the CCFF and the £2bn UKEF loan to consider whether they were sufficiently close in pricing and terms to equivalent debt that may be raised by the group without any Government involvement. We considered the timing of the issues, the terms of the UKEF loan and compared the rates payable on this debt to indicative quotes received from other financing options and found the resultant accounting treatment to be appropriate.

Our audit places only limited reliance on the group's IT and control environment. However, in response to any incremental risk from remote working, we understood key changes to the group's IT controls and processes as part of our assessment of audit risks to consider where additional testing might be required. We also met with senior management responsible for cyber security and considered whether there were developments in the year that warranted further procedures to be performed.

We have assessed the adequacy of the disclosures in the Consolidated Financial statements explaining the impact of COVID-19 and the disclosure management has given to explain and quantify key judgements and sources of estimation uncertainty and found these to be appropriate.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the group and the company, the accounting processes and controls, and the industry in which they operate.

Our scoping is based on the group's consolidation structure. We define a component as a single reporting unit which feeds into the group consolidation. Of the group's 468 reporting components, 32 individual components (including three joint ventures) were subject to full scope audits for group purposes, which following an element of consolidation, equates to 16 group reporting opinions; and eight components performed targeted specified procedures.

In order to achieve audit coverage over the financial statements, under our audit methodology, we test both the design and operation of relevant business process controls and perform substantive testing over each financial statement line item.

The group operates Finance Service Centres (FSCs) to bulk process financial transactions in Derby (UK), Indianapolis (US) and Bangalore (India). Based on our assessment with management it is not possible to fully test revenue and profit centrally as certain key processes, such as long-term contracting, remain within the business due to their nature and are not handled by the FSCs.

INDEPENDENT AUDITORS' REPORT

Our audit covered 93% of revenue, 89% of loss before tax and 90% of total assets. All entities that contribute in excess of 3% of the group's revenue were included in full scope.

Further specific audit procedures over central functions, the group consolidation and areas of significant judgement (including corporate costs, taxation, certain goodwill balances, intangible assets, treasury and post-retirement benefits) were directly led by the group audit team.

Where work was performed by component auditors, we determined the level of involvement we needed to have in the audit work at those reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Consolidated Financial Statements.

We issued formal written instructions to all component auditors setting out the audit work to be performed by each of them and maintained regular communication with the component auditors throughout the audit cycle. These interactions included attending certain component clearance meetings and holding regular conference calls, as well as reviewing and assessing any matters reported. The group engagement team also reviewed selected audit working papers for certain component teams.

In addition, senior members of the group engagement team have virtually visited component teams across all group segments in the United Kingdom, United States of America, Germany, Spain and Saudi Arabia. These visits included meetings with the component auditor and attendance at segment clearance meetings.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows::

	Financial statements – group	Financial statements – company
Overall materiality	£70m (2019: £75m).	£147m (2019: £126m).
How we determined it	0.5% of three year average underlying revenues.	1% of total assets
Rationale for benchmark applied	We have consistently used underlying revenue to determine materiality as opposed to a profit based benchmark. This is because there is considerable volatility in profit/loss before tax as a result of revenue recognition under IFRS 15 and from the fair value movement in the group's derivatives. Underlying revenue continues to be a key performance metric for the group and is much less volatile than the profit metric. However, for 2020 COVID-19 introduced additional volatility that impacted benchmarks. To mitigate this we have used a three year average underlying revenue measure to calculate materiality.	We determined our materiality based on total assets, which is more applicable than a performance-related measure as the company is an investment holding company for the group. Where there were balances and transactions within the Company Financial Statements that were within the scope of the audit of the Consolidated Financial Statements, our procedures were undertaken using the lower materiality level applying to the group audit. The higher company materiality level was used for the purposes of testing balances not relevant to the group audit, such as investments in subsidiary undertakings and inter-company balances.

For each component in the scope of our group audit, we allocated a materiality that is less than our overall group materiality. The range of materiality allocated across components was between £5m and £63m. Certain components were audited to a local statutory audit materiality that was also less than our overall group materiality.

We use performance materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall materiality. Specifically, we use performance materiality in determining the scope of our audit and the nature and extent of our testing of account balances, classes of transactions and disclosures, for example in determining sample sizes. Our performance materiality was 75% of overall materiality, amounting to £53m for the Consolidated Financial Statements and £110m for the Company Financial Statements.

In determining the performance materiality, we considered a number of factors – the history of misstatements, risk assessment and aggregation risk and the effectiveness of controls – and concluded that an amount at the upper end of our normal range was appropriate.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £3m (group audit) (2019: £3m) and £7m (company audit) (2019: £6m) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

Our evaluation of the directors' assessment of the group's and the company's ability to continue to adopt the going concern basis of accounting included:

- Testing the model used for management's going concern assessment which is primarily a liquidity assessment given there are no significant financial covenants in its committed debt facilities. Management's assessment covered the 18 months to September 2022. We focussed on this period and also considered the subsequent three months to the end of 2022 given the group's £1bn term loan expires in October 2022.
- Management's base case forecasts are based on its normal budget and forecasting process for each of its businesses for the next five years. We understood and assessed this process by business including the assumptions used for 2021 and 2022 and assessed whether there was adequate support for these assumptions. We also considered the reasonableness of the monthly phasing of cash flows. A similar assessment was performed of the downside cash flows, including understanding of the scenarios modelled by management, how they were quantified and the resultant monthly phasing of the downside cash flow forecasts.
- Comparison of the going concern base case forecasts to Board approved forecasts and where applicable, we compared these forecasts for consistency to those used elsewhere in the business, including for long-term contract accounting and impairment assessments.
- We have read and understood the key terms of all committed debt facilities to understand any terms, covenants or undertakings that may impact the availability of the facility.
- Using our knowledge from the audit and assessment of previous forecasting accuracy we calculated our own sensitivities to apply to management's cash flow forecasts. We overlaid these on management's forecasts to arrive at our own view of management's downside forecasts. This included considering the three month period after September 2022 to assess the impact on liquidity headroom of the £1bn term loan expiring in the downside case together with our sensitivities.
- We considered the potential mitigating actions that management may have available to it to reduce costs, manage cash flows or raise additional financing and assessed whether these were within the control of management and possible in the period of the assessment.
- We assessed the adequacy of disclosures in the Going Concern statement on pages 52 to 54 and statements in note 1 of the Consolidated and Company Financial Statements and found these appropriately reflect the key areas of uncertainty identified.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the group's and the company's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

In auditing the financial statements, we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

However, because not all future events or conditions can be predicted, this conclusion is not a guarantee as to the group's and the company's ability to continue as a going concern.

In relation to the company's reporting on how they have applied the UK Corporate Governance Code, we have nothing material to add or draw attention to in relation to the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting.

Our responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic report and Statement of the Directors' responsibilities in respect of the Financial Statements, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on our work undertaken in the course of the audit, the Companies Act 2006 requires us also to report certain opinions and matters as described below.

Strategic report and Statement of the Directors' responsibilities in respect of the Financial Statements

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic report and Statement of the Directors' responsibilities in respect of the Financial Statements for the year ended 31 December 2020 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the group and company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic report and Statement of the Directors' responsibilities in respect of the Financial Statements.

Directors' Remuneration

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

Corporate governance statement

The Listing Rules require us to review the directors' statements in relation to going concern, longer-term viability and that part of the corporate governance statement relating to the company's compliance with the provisions of the UK Corporate Governance Code specified for our review. Our additional responsibilities with respect to the corporate governance statement as other information are described in the Reporting on other information section of this report.

Based on the work undertaken as part of our audit, we have concluded that each of the following elements of the corporate governance statement is materially consistent with the financial statements and our knowledge obtained during the audit, and we have nothing material to add or draw attention to in relation to:

- The directors' confirmation that they have carried out a robust assessment of the emerging and principal risks;
- The disclosures in the Annual Report that describe those principal risks, what procedures are in place to identify emerging risks and an explanation of how these are being managed or mitigated;
- The directors' statement in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the group's and company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements;
- The directors' explanation as to their assessment of the group's and company's prospects, the period this assessment covers and why the period is appropriate; and
- The directors' statement as to whether they have a reasonable expectation that the group and company will be able to continue in operation and meet its liabilities as they fall due over the period of its assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Our review of the directors' statement regarding the longer-term viability of the group was substantially less in scope than an audit and only consisted of making inquiries and considering the directors' process supporting their statement; checking that the statement is in alignment with the relevant provisions of the UK Corporate Governance Code; and considering whether the statement is consistent with the financial statements and our knowledge and understanding of the group and company and their environment obtained in the course of the audit.

In addition, based on the work undertaken as part of our audit, we have concluded that each of the following elements of the corporate governance statement is materially consistent with the financial statements and our knowledge obtained during the audit:

- The directors' statement that they consider the Annual Report, taken as a whole, is fair, balanced and understandable, and provides the information necessary for the members to assess the group's and company's position, performance, business model and strategy;
- The section of the Annual Report that describes the review of effectiveness of risk management and internal control systems; and
- The section of the Annual Report describing the work of the Audit Committee.

We have nothing to report in respect of our responsibility to report when the directors' statement relating to the company's compliance with the Code does not properly disclose a departure from a relevant provision of the Code specified under the Listing Rules for review by the auditors.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of the Directors' responsibilities in respect of the Financial Statements, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for 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.

In preparing the financial statements, the directors are responsible for assessing the group's and the 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 the directors either intend to liquidate the group or the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

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 error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Our audit testing might include testing complete populations of certain transactions and balances, possibly using data auditing techniques. However, it typically involves selecting a limited number of items for testing, rather than testing complete populations. We will often seek to target particular items for testing based on their size or risk characteristics. In other cases, we will use audit sampling to enable us to draw a conclusion about the population from which the sample is selected.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting

Companies Act 2006 exception reporting

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

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

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the members on 3 May 2018 to audit the financial statements for the year ended 31 December 2018 and subsequent financial periods. The period of total uninterrupted engagement is three years, covering the years ended 31 December 2018 to 31 December 2020.

Ian Chambers (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors

London

11 March 2021

SUSTAINABILITY ASSURANCE STATEMENT

Independent Limited Assurance Statement

To the stakeholders of Rolls-Royce Holdings plc

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 2020 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 Rolls-Royce's 2020 Annual Report ('the Report') for the period 1st of January to the 31st of December 2020 (the 'Selected Information'):

- Total Energy consumption;
- Total Scope 1 & 2 greenhouse gases (GHG) emissions;
- Total waste;
- Total Reportable Injuries;
- Number of people reached through the Science, Technology, Engineering and Mathematics (STEM) education outreach programmes; and
- Employee engagement score - 'grand mean' and increase compared to 2019.

Reporting criteria

The Selected Information are reported according to the Rolls-Royce "Basis of Reporting", a copy of which is available from <http://rolls-royce.com/sustainability>.

Limitations and exclusions

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

- Activities outside the defined verification period;
- Financial data taken from the Report which are audited by an external financial auditor;
- The appropriateness of the reporting criteria; and
- Other information included in Rolls-Royce's Report;

This limited assurance engagement relies on a risk based selected sample of sustainability data and the associated limitations that this entails. The scope of a limited assurance engagement is substantially less than for reasonable assurance both in terms of the risk assessment procedures and in performing the procedures to address the identified risks. 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 to a limited level of assurance in accordance with the 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 December 15, 2015), and in accordance with International Standard on Assurance Engagements 3410 – 'Assurance Engagements on Greenhouse Gas Statements' ('ISAE 3410'), 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 remotely:

1. Conducted interviews with relevant personnel of Rolls-Royce;
2. Carried out nine virtual site audits, selected employing a risk-based approach, in the United Kingdom, United States, Norway, Mexico, and Singapore;
3. Reviewed the data collection and consolidation processes used to compile the Selected Information, including assessing assumptions made, the data scope and reporting boundaries;
4. Reviewed documentary evidence produced by Rolls-Royce;
5. Agreed a sample of the Selected Information to the corresponding source documentation;
6. Re-performed aggregation calculations of the Selected Information; and
7. Report our conclusions and recommendation in a formal Management Report to Rolls-Royce.

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 Quality Management System which complies with the requirements of ISO 9001:2015, 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) 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
03 March 2021

¹ Certificate of Registration can be provided on request

² International Federation of Inspection Agencies – Compliance Code – Third Edition

GREENHOUSE GAS EMISSIONS

In 2020, our total gross greenhouse gas (GHG) emissions were 423,000 tonnes of carbon dioxide equivalent (tCO₂e). This represents a decrease of 14% compared with 494,000 tCO₂e in 2019.

Aspect	tCO ₂ e	2016	2017	2018	2019	2020
Emissions from activities for which the company own or control including the combustion of fuel and operation of facilities. [Direct GHG Emissions (Scope 1)]	Global (excluding UK)	135,647	158,217	160,029	164,359	140,676
	UK	100,791	99,454	84,868	91,698	88,353
Emissions from the purchase of electricity, heat, steam and cooling purchased for our own use. [Indirect GHG Emissions (Scope 2) location-based]	Global (excluding UK)	163,999	154,484	152,787	150,997	126,654
	UK	144,334	122,635	100,808	86,803	67,333
Total gross GHG emissions	Global (excluding UK)	299,646	312,701	312,816	315,356	267,330
	UK	245,125	222,089	185,677	178,501	155,687
Energy consumption used to calculate above emissions- kWh	Global (excluding UK)	1,112,270,000	1,158,262,000	1,182,643,000	1,178,103,000	1,000,063,000
	UK	821,460,000	810,020,000	761,816,000	772,438,000	702,092,000
Intensity Ratio (total GHG emissions per £m revenue)	Total	40.0	38.6	33.3	30.1	35.7
Emissions from the purchase of electricity, heat, steam and cooling purchased for our own use. [Indirect GHG Emissions (Scope 2) market-based]	Global (excluding UK)	-	-	-	303	2,399
	UK	-	-	-	952	2,090
Outside of Scopes	Global (excluding UK)	-	-	-	0	0
	UK	-	-	-	20,743	46,252
Additional Supporting Information						
Electricity purchased from renewable sources – kWh	Global (including UK)	-	-	-	245,315,000	311,619,000
Energy generated on-site from renewable sources kWh	Global (including UK)		3,202,000	5,076,000	7,518,000	8,811,000

The above figures include 311,619,000 kWh of renewable energy purchases either backed by the Renewable Energy Guarantees of Origin (REGO) scheme in the UK or the Guarantees of Origin (GoO) from a relevant EU Member State. This energy is used by the majority of our facilities in the UK and Germany. The source in the UK includes a proportion of electricity that was generated by the combustion of biofuel. The associated emissions are included above under the location-based Scope 2 emissions (using grid average emission factors). They are also reported separately as market-based Scope 2 emissions (covering the emissions of nitrous oxide and methane) and Outside of Scopes (covering the emissions of carbon dioxide). This has resulted in a net reduction of 31,000 tonnes from our total GHG emissions. In addition, the above figures include 8,811,000 kWh of electricity and heat generated on-site from renewable energy sources, including solar panels and ground source heat pumps.

The figures for 2016 through to 2019 have been restated to remove emissions associated with the North American Civil Nuclear business sold on 3 February 2020 and Trigno Energy S.r.l. sold in April 2020. We include the reporting of fugitive emissions of hydrofluorocarbons (HFCs), associated with air conditioning equipment, into our GHG emissions figures. These include emissions from our facilities in the

US and Canada only. We do not anticipate that emissions from other facilities will have a significant impact on the above figures.

With the exceptions noted above, we have reported on the underlying energy use and emission sources required under the Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018. All these sources fall within the scope of our Consolidated Financial Statements.

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014 utilising the operational control approach, supplemented by the GHG Reporting Guidance for the Aerospace Industry (version 3) and emission factors from the UK Government's GHG Conversion Factors for Company Reporting 2020. We report our emissions of: carbon dioxide; methane; nitrous oxide; hydrofluorocarbons and perfluorocarbons on a carbon dioxide equivalent basis. We had no emissions of sulphur hexafluoride or nitrogen trioxide.

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

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:

		2020	2019	Change
USD per GBP	Year-end spot rate	1.36	1.32	+3%
	Average spot rate	1.28	1.28	-
EUR per GBP	Year-end spot rate	1.11	1.18	-6%
	Average spot rate	1.13	1.14	-1%

The Group's global corporate income tax contribution

The Group's total corporation tax payments in 2020 were £231m. Around 85% of this was paid in the US, Germany, UK and Singapore which reflects the fact that the majority of the Group's business is undertaken, and employees are based, in these countries. The balance was paid in around 40 other 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 loss before tax reported on page 106. The main reasons for this are:

- the consolidated income statement is prepared under IFRS, whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;
- 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
- specific tax rules including exemptions or incentives as determined by the tax laws in each country.

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. The underlying tax rate can be found on page 20. 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 77) – 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 and key sources of estimation uncertainty (in particular the recognition of deferred tax assets and provisions for uncertain tax positions);
- note 1 to the Consolidated Financial Statements (page 114) – Details of key areas of uncertainty and accounting policies for tax; and

- note 5 to the Consolidated Financial Statements (page 134) Details of the tax balances in the Consolidated Financial Statements together with a tax reconciliation. This explains the main drivers of the tax rate and the impact of our assessment on the recovery of UK deferred tax assets.

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 losses and advance corporation tax.

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

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. All of our major investments and projects are assessed using a range of financial metrics, including discounted cash flow and return on investment.

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 21. The Frc is chaired by the Chief Financial Officer or group controller. 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	2020	2019
Total equity	(4,875)	(3,354)
Cash flow hedges	94	96
Group capital	(4,781)	(3,258)
Net funds (excluding lease liabilities)	(1,533)	1,361

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 issued \$1,000m, €750m and £545m of bond notes, \$1,000m and £545m of which mature in 2027 and €750m in 2026. The Group issued £300m of commercial paper under the Covid Commercial Finance Facility made available by the Bank of England in response to COVID-19. The Group also entered into a new committed £2,000m loan maturing 2025 (supported by an 80% guarantee from UK Export Finance) and a new £1,000m bank loan maturing 2022. Also during 2020 the Group extended the maturity of the £2,500m committed revolving credit facility from 2024 to 2025. The £2,500m revolving credit facility, the £2,000m loan and £1,000m loan were undrawn at the period end. The Group also repaid a \$500m bond during the year. At the year end, the Group retained aggregate liquidity of £9.0bn, including cash and cash equivalents of £3.5bn and undrawn borrowing facilities of £5.5bn.

Circa £1.0bn of drawn borrowings mature in 2021 (£1.3bn including lease liabilities).

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 12.

Credit rating

£m	Rating	Outlook
Moody's Investors Service	Ba3-	Negative
Standard & Poor's	BB-	Negative
Fitch	BB-	Negative

The Group subscribes to Moody's, Standard & Poor's and Fitch for independent long-term credit ratings with the ratings in the table above being applicable at the date of this report.

Accounting

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

No new accounting standards had a material impact in 2020, or are expected to have a material impact in 2021.

Additional commentary on key performance indicators

Order backlog, also known as unrecognised revenue, is the amount of revenue on current contracts that is expected to be recognised in future periods. Civil Aerospace OE orders where the customer has retained the right to cancel (for deliveries in the next 7-12 months) are excluded. Further details are included in note 2 on page 130.

Underlying revenue is used as it reflects the impact of our foreign exchange (FX) hedging policy by valuing foreign currency revenue at the actual exchange rates achieved as a result of settling FX contracts in the year. This provides a clearer measure of our year-on-year performance. Further details and reconciliation to reported revenue are included in note 2 on page 131.

Self-funded R&D as a proportion of underlying revenue – We expect to spend approximately 5% of underlying revenue on R&D although this proportion will fluctuate depending on the stage of development of current programmes. We expect this proportion will reduce modestly over the medium term. Further details are included in note 3 on page 132.

Capital expenditure as a proportion of underlying revenue – All proposed investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money. We measure annual capital expenditure as the cash purchases of property, plant and equipment acquired during the period; over the medium-term we expect a proportion of around 4%. Further details are included in note 10 on page 140.

Underlying operating profit includes: (a) revenue and costs denominated in US dollars and euros on the basis of the exchange rates achieved based on our FX hedge book; (b) similar adjustments in respect of commodity derivatives; (c) consequential adjustments to reflect the impact of exchange rates on trading assets and liabilities, and long-term contracts, on a consistent basis; and (d) items of a one-off nature. Further details and reconciliation to reported operating profit are included in note 2 on page 131.

Free cash flow is the movement in net debt from cash flows excluding: transactions with ordinary shareholders; M&A activity; financial penalties paid; exceptional restructuring payments; and the capital element of lease payments. Further details and reconciliation to reported cash flow are included in note 29 on page 176.

Cash flow per share is calculated using free cash flow (as defined above) and the average number of shares in issue during the year, consistent with the EPS calculations in note 6 on page 137.

Cash return on invested capital (CROIC) is calculated as cash flow divided by invested capital. Cash flow is the free cash flow (as defined above), adjusted to remove R&D, PPE and software capital expenditure, certification costs, other intangibles, and working capital (excluding change in the net LTSA balance in Civil Aerospace). Invested capital is defined as the sum of 15 years net R&D investment, PPE and software at cost, certification costs, other intangibles (excluding M&A and goodwill), and working capital (excluding net LTSA balance in Civil Aerospace) and ten times current year lease payments.

DIRECTORS' REPORT

Index

Accounting policies	116 to 125	Employment of disabled people	43
Agreements for compensation for loss of office	91 and 95	Financial instruments and risk management	154 to 163
Authority to issue and purchase shares	209	Future developments	4 to 15, 18 to 33 and 34 to 45
Board of Directors	64 to 66 and 208	Greenhouse gas emissions	205
Change of control	210	Major shareholdings	209
Changes to the Articles of Association	210	Political donations	210
Corporate governance statement	60	Post-balance sheet events	125
Directors' conflicts of interest	75	Purchase of own shares	209
Directors' indemnities	208	Related party transactions	172
Directors' service contracts and letters of appointment	91 and 99 to 100	Research and development	2, 6 to 8, 13, 18 to 35 and 102
Directors' share interests	95 to 96 and 100	Share capital and rights	208 to 209
Disclosure of information to auditors	103	Stakeholder engagement by the Board	72 to 73
Employee involvement	43 and 72 to 73	Subsidiaries, joint ventures and associates	183 to 189
		Task force on climate-related financial disclosures	38

Board of Directors

The Directors of the Company who were in office during the year and up to the date of signing the financial statements were Sir Ian Davis, Warren East, Stephen Daintith, Lewis Booth, Sir Frank Chapman, George Culmer, Irene Dorner, Beverly Goulet, Lee Hsien Yang, Nick Luff, Sir Kevin Smith, Jasmin Staiblin and Dame Angela Strank.

Directors' indemnities

The Directors have the benefit of an indemnity provision contained in the Articles. In addition, the Directors have been granted a qualifying third-party indemnity provision which was in force throughout the financial year and remains in force. Also, throughout the year, the Company purchased and maintained Directors' and Officers' liability insurance in respect of the Company and for its Directors and Officers.

Share price

During the year, the share price reduced by 53% from 234p* to 111p, compared to a 27% decrease in the FTSE aerospace and defence sector and a 14% decrease in the FTSE 100. The Company's share price ranged from 35p in October 2020 to 242p* in February 2020.

* Share price adjusted to reflect the rights issue.

Share capital

On 31 December 2020, the Company's issued share capital comprised:

8,367,596,989	Ordinary shares	20p each
27,540,015,227	C Shares	0.1p each
1	Special Share	£1

The ordinary shares are listed on the London Stock Exchange.

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. Further information on payments to shareholders is on page 211.

Share class rights

The full share class rights are set out in the Company's Articles, which are available at 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 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 provisions of the 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 their successor or nominee.

Shareholder agreements and consent requirements

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 2020 AGM, 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, an ordinary resolution was passed authorising the Directors to allot new ordinary shares up to a nominal value of £128,733,021 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 2021 AGM or 30 June 2021, whichever is earlier, and the Directors propose to renew each of them at the 2021 AGM. The Board believes that these authorities will allow the Company to retain flexibility to respond to circumstances and opportunities as they arise.

Rights issue

A rights issue was approved by shareholders at a general meeting on 27 October 2020, resulting in the issue of a total of 6,436,651,043 new ordinary shares. The majority of these shares were subscribed for by existing shareholders before the rights issue closed at 11:00am on 11 November 2020 and the remaining shares were issued in the rump placing.

No. of ordinary shares	Price per share (p)	Date of issue
6,061,504,884	32	12 November 2020
375,096,792	90	13 November 2020

Authority to purchase own shares

At the 2020 AGM, the Company was authorised by shareholders to purchase up to 193,099,531 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 2021 AGM or 30 June 2021, whichever is the earlier. A resolution to renew the authority will be proposed at the 2021 meeting.

The Company did not purchase any of its own ordinary shares under this authority during 2020.

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.

Major shareholdings

At 31 December 2020, the following shareholders had notified an interest in the issued ordinary share capital of the Company in accordance with section 5.1.2 of the Disclosure and Transparency Rules:

Shareholder	Date of change in interest	% of issued ordinary share capital*
Causeway Capital Management LLC	21 December 2020	6.98
Harris Associates L.P.	16 November 2020	4.99
Blackrock, Inc.	12 November 2020	5.99
The Capital Group Companies, Inc.	10 November 2020	8.69

* Percentages are shown as a percentage of the Company's issued share capital at the date of change in interest.

As at 11 March 2021, the following changes had been notified:

- Causeway Capital Management LLC notified the Company that on 25 January 2021 their holding had increased to 7.02% of issued ordinary share capital.

Changes to the Articles of Association

The Articles may be altered or added to or new articles may be adopted by a special resolution of the shareholders of the Company, subject to the provisions of the Act.

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 2020, these facilities were 26% drawn (2019: less than 2%).

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:

- Incentive Plan – deferred share awards will normally vest immediately, and may be time pro-rated. The new controlling company might offer an award in exchange instead (normally on substantially equivalent terms to the existing award).
- 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.

Political donations

The Company's policy is that it does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. However, the Act defines political donations very broadly and so it is possible that normal business activities, such as sponsorship, subscriptions, payment of expenses, paid leave for employees fulfilling certain public duties and support for bodies representing the business community in policy review or reform,

which might not be thought of as political expenditure in the usual sense, could be captured. Activities of this nature would not be thought of as political donations in the ordinary sense of those words. The resolution to be proposed at the 2021 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\$68,100 (2019: US\$81,866). 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 2020 AGM.

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 employment of disabled people;
- the future development, performance and position of the Group; and
- research and development activities.

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.

By order of the Board
Pamela Coles
 Company Secretary
 11 March 2021

SHAREHOLDER INFORMATION

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). This is 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.

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.

If you hold your shares in a share dealing account (sometimes referred to as a nominee account) then you must contact your account provider with any questions about your shareholding.

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 proceeds in the C Share Reinvestment Plan (CRIP) 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.

The Board decided in 2020 that, given the uncertain macro outlook, they would not recommend a final shareholder payment for 2019 or make an interim shareholder payment for 2020. In addition, under the terms of certain of its recent loan facilities, the Company is restricted from declaring, making or paying distributions to shareholders on or prior to 31 December 2022 and from declaring, making or paying distributions to shareholders from 1 January 2023 unless certain conditions are satisfied. The restrictions on distributions do not prevent shareholders from redeeming C Shares issued in January 2020 or prior to that.

Shareholders wishing to redeem their existing C Shares, or participate in the CRIP must lodge instructions with the Registrar to arrive no later than 5.00pm on 1 June 2021 (CREST holders must submit their election in CREST by 2.55pm). The payment of C Share redemption monies will be made on 5 July 2021 and the CRIP purchase will begin as soon as practicable after 5 July 2021.

Share dealing

The Registrar offers shareholders an internet dealing service at 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 £50. 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 depository, JP Morgan, by calling +1 (800) 990 1135 (toll free within the US) or +1 (651) 453 2128 (outside the US) or via www.adr.com/contact/jpmorgan.

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 at 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 www.actionfraud.police.uk.

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

SHAREHOLDER INFORMATION

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.

Communication preferences

You can sign up to receive the latest news updates to your phone or email by visiting www.rolls-royce.com and registering for our alert service. If you do not wish to receive a hard copy Annual Report in future, please email webqueries@computershare.co.uk.

Analysis of ordinary shareholders at 31 December 2020

Type of holder	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	168,008	97.98	214,427,740	2.56
Institutional and other investors	3,465	2.02	8,153,169,249	97.44
Total	171,473	100.00	8,367,596,989	100.00
Size of holding (number of ordinary shares)				
1 – 150	50,450	29.42	4,421,407	0.05
151 – 500	60,593	35.34	16,254,960	0.19
501 – 10,000	55,811	32.55	107,203,767	1.28
10,001 – 100,000	3,780	2.20	90,504,771	1.08
100,001 – 1,000,000	504	0.29	181,441,403	2.17
1,000,001 and over	335	0.20	7,967,770,681	95.22
Total	171,473	100.00	8,367,596,989	100.00

GLOSSARY

ABC	anti-bribery and corruption	HSE	health, safety and environment
ACARE	Advisory Council for Aviation Research and Innovation in Europe	IASB	International Accounting Standards Board
AGM	annual general meeting	IFRS	International financial reporting standards
ALPS	Advanced Low Pressure System	KPIs	key performance indicators
AMRCs	Advanced Manufacturing Research Centres	ktCO₂e	kilotonnes carbon dioxide equivalent
AOG	aircraft on ground	kW	kilowatts
APM	alternative performance measure	LGBT+	lesbian, gay, bisexual and transgender
Articles	Articles of Association of Rolls-Royce Holdings plc	LIBOR	London inter-bank offered rate
bps	basis points	LRIP	low rate initial production
Brexit	UK exit from the European Union	LTIP	long-term incentive plan
C Shares	non-cumulative redeemable preference shares	LTPR	long-term planning exchange rate
C&A	commercial and administrative	L TSA	long-term service agreement
CARs	contractual aftermarket rights	M&A	mergers & acquisitions
CEO	chief executive officer	MoU	memorandum of understanding
CFO	chief financial officer	MRO	maintenance repair and overhaul
CGT	capital gains tax	MW	megawatts
Our Code	Global Code of Conduct	NCI	non-controlling interest
the Code	UK Corporate Governance Code 2018	NED	Non-Executive Director
Company	Rolls-Royce Holdings plc	NOx	nitrogen oxide
CPS	cash flow per share	OCI	other comprehensive income
CRIP	C Share reinvestment plan	OE	original equipment
CROIC	cash return on invested capital	OECD	Organisation for Economic Co-operation and Development
D&I	diversity & inclusion	OEM	original equipment manufacturer
DJSI	Dow Jones Sustainability Index	P&L	profit and loss
DoJ	US Department of Justice	PBT	profit before tax
DPAs	deferred prosecution agreements	PPE	property, plant and equipment
DTR	the FCA's Disclosure Guidance and Transparency Rules	PSMS	product safety management system
EASA	European Aviation Safety Agency	PSP	performance share plan
EFH	engine flying hours	R&D	research and development
EIS	entry into service	R&T	research and technology
ELG	Enterprise Leadership Group	REACH	registration, evaluation, authorisation and restriction of chemicals
EPS	earnings per share	Registrar	Computershare Investor Services PLC
ERG	employee resource group	RMS	risk management system
ESG	environment, social and governance	RRMS	Rolls-Royce management system
EU	European Union	RRSAs	risk and revenue sharing arrangements
EUR	euro	SAF	sustainable aviation fuel
EVTOL	electric vertical take-off and landing	SID	Senior Independent Director
FCA	Financial Conduct Authority	SFO	UK Serious Fraud Office
FCF	free cash flow	SMR	small modular reactors
FRC	Financial Reporting Council	STEM	science, technology, engineering and mathematics
FTE	full time equivalent	TCFD	Taskforce on Climate-related Financial Disclosures
FX	foreign exchange	TRI	total reportable injuries
GBP	Great British pound or pound sterling	TSR	total shareholder return
GHG	greenhouse gas	USAF	United States Air Force
Group	Rolls-Royce Holdings plc and its subsidiaries	USD/US\$	United States dollar
HPT	high pressure turbine	UTCs	University Technology Centres